Market Overview

Global investors, baffled but enriched by the extraordinary events of the last eighteen months, might have to learn to pay more attention to politics than has been necessary the last few decades.

For some time, the USA has been the hegemon, the dominant power—arguably since World War II, and definitely since the fall of the Soviet Union. But as China rises, declining US influence is revealing not another duopoly, but a new multipolar line-up. Rishi Sunak linked news of the failure of EU equivalence talks—which would have enabled the UK's finance sector to operate freely in the EU, post-Brexit—to ambitions for trade with China; the EU, in turn, agreed to an investment deal with China (albeit currently on hold) just before Biden assumed office, annoying the incoming president with its timing. With 'allies' like these, it will be difficult for Biden to build an aggressively anti-China consensus. In a bipolar trade war, barriers and tariffs push up prices and reduce trade, but in a multipolar world, third parties nip in and replace the missing trade, though not to previous free trade levels. The other downside is that, unlike regimes in which hegemons enforce stability, multipolarity allows smaller belligerents to create conflict and veto holders to prevent consensus. It is much easier to read geopolitics when the world is simpler.

Meanwhile, we have become accustomed to see central banking as a rarefied world, run by monk-like academics, untainted by politics. This too is likely to change. The idea of a central bank was political in origin. The Bank of England was 'emphatically the servant of the State…cradled in a Ways and Means Act dealing with tunnage duties'[1] and nicknamed the 'Tunnage Bank'. Napoleon established the Bank of France to 'compel it to meet his wishes'[2], and early central banks were regularly exploited for fiscal gain.[3] The ECB is nakedly political, stripping power from national governments. But in 1951, the US Federal Reserve broke out from tutelage to the Treasury after the Korean War, on the grounds

it risked becoming 'an inflation engine'. Bank of England technocrats took on more responsibility for interest rate policy in the 1970s, after years of disastrous inflation. Since the 2008 GFC the keys everywhere have been heading back to their real owners, Trump's 2019 tweets demanding lower rates and more QE to send the US economy 'up like a rocket', a colourful example.

Such a shift reflects deeper change, as Western electorates, battered by China's 2000 WTO admission, move leftward. A recent Institute for Economic Affairs survey[4] found 67% of 17- to 30-year-olds in the UK prefer socialism to capitalism. Politicians have obliged with escalating deficits. In the US, 'QE' is morphing into 'fiscal QE', the difference being that fiscal QE is used for purposes other than fighting recessions. In one Green New Deal proposal in February 2019, Democrats envisaged fiscal QE helping finance a decade-long spending program costing over $6 trillion (34% of GDP) a year! COVID pushed things well past the Rubicon, as Western governments distributed funds directly to individuals' pockets via banking systems they now controlled. As a result, money supply has been soaring.

The question raging now, as peak fiscal and monetary interventions collide with lockdown vandalised supply chains, is whether inflation is simply a short-term impulse or will be returning as a new multi-year regime. The issue divides on ideological as much as theoretical lines and the evidence is still ambiguous, with commodity prices ricocheting, some mimicking meme stocks and cryptocurrencies as they crash from peaks, while labour shortages push up wages. At the same time, the scale of 'support' for the recovery is extraordinary with potentially over $6 trillion fiscal stimulus and the Fed buying $120bn bonds a month. As a result, the banks are gorged on cash, swimming in reserves equivalent to some 17% of the USA's $22 trillion GDP. For comparison, bank reserves were only $46bn or 0.3% of GDP the day of Lehman's collapse in 2008. Other developed world banks are doing the same. Will the first pulse of goods-driven inflation peaking at around 8% be followed by persistent inflation at over 4%, or will it sink back to 1%? Left to its own devices, human business activity is deflationary[5]: we continually make 'stuff' better and cheaper. But when governments seek to pump up economies by printing money, the price of 'stuff' goes up. The scale of recent money creation lends weight to the upper end of these inflation expectations.

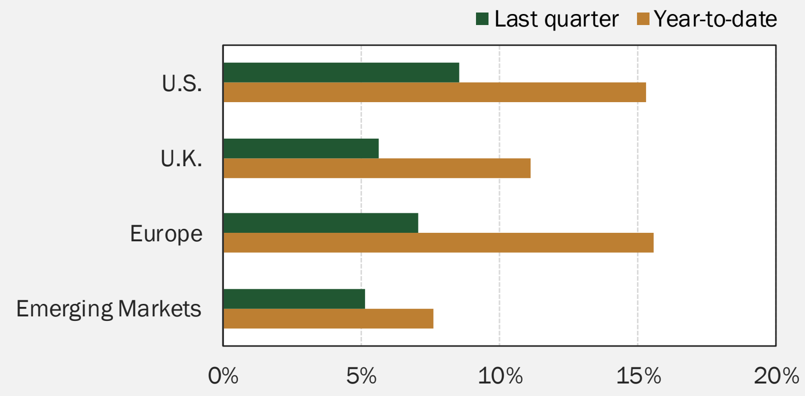
Which brings us to asset valuations. What should you hold to preserve and build value in times of high or highish inflation? Definitely not cash or low risk fixed income, which yield less than nothing and lose value. Given the determination to keep interest rates low, equities, commodities and index-linked bonds look interesting. Less exposed to inflation risk are areas like litigation finance and reinsurance. Of course, there are plenty of signs that equities are overvalued, but these are strange times. COVID has given governments a taste of running projects to save the world, and in a sea of liquidity looking for returns, there are some gigantic opportunities—from onshoring supply chains to fighting global warming—waiting to oblige.

Asset Classes

Equities

Figure 1 | Equity Market Performance

Returns as of 30 June 2021



Source: S&P 500 (USD), FTSE All-Share (GBP), EURO STOXX 50 (EUR), and MSCI EM (USD) via Bloomberg.

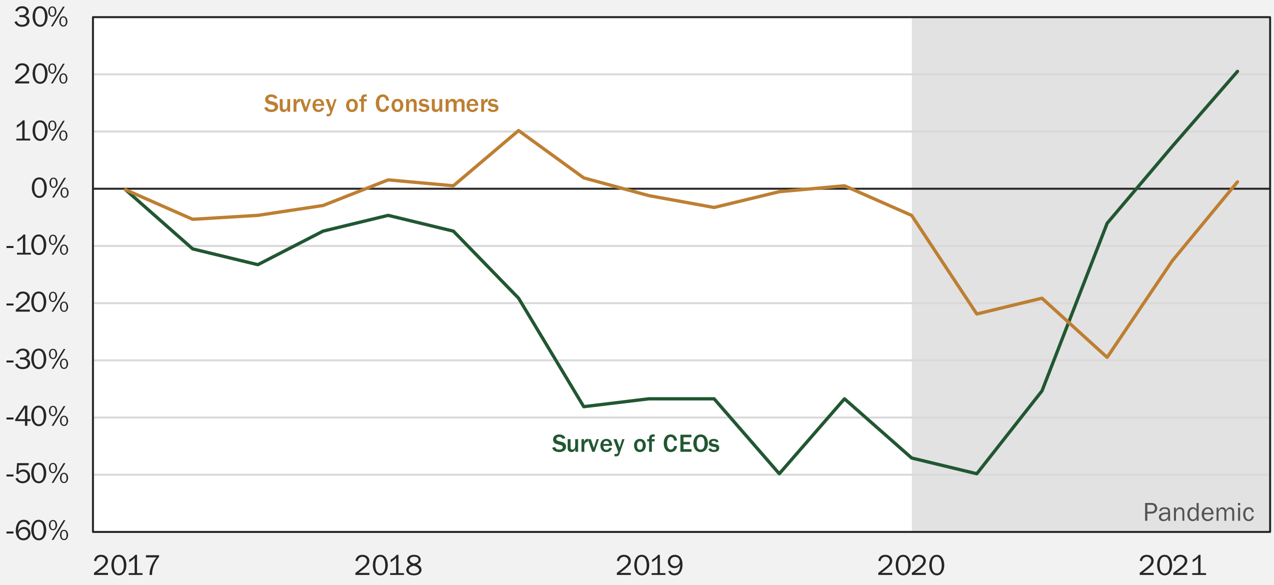
Stocks continued to rally in the second quarter of 2021, as policy-makers' one-two punch—stimulus to minimize COVID's economic damage in the short run, vaccines to enable reopening in the longer term—brought more positive macro data. Despite a slow and disorganized start, vaccinations and lifting of COVID restrictions put the US near the head of the pack in both its economic recovery and stock market performance in Q2, with US equities gaining 8.5% for the quarter, up over 15% on the year (see Figure 1). European stocks rallied 7.0% in Q2 on robust corporate earnings, culminating in a eurozone June PMI reading unmatched in the last 15 years. UK equities returned 5.6% for the quarter, despite the delta variant and a late surge in case counts casting a shadow over the country's planned "Freedom Day" and roiling stocks associated with reopening. EM stocks added 5.1% in Q2, as global growth resumed, with rallying commodity prices serving as an additional tailwind.

As stocks around the world reach new highs, it is useful to push past prices and consider the strength of economic conditions from different perspectives and whether they might justify rising valuations. Last quarter, we investigated equity analyst sentiment and saw a steady upward march in earnings forecasts as analysts positively revised gloomy predictions in response to an accumulation of good news about the global economy. It turns out the view from the C-suite has also been improving over the last year, as revealed by survey data from The Conference Board (see Figure 2). Beginning in 2018, evidence of slowing growth and increased geopolitical risk put a meaningful damper on the mood of CEOs at top U.S. companies, such that when the pandemic hit, corporate sentiment had already fallen by half. Generous stimulus and a successful rollout of vaccines sparked a resurgence in executives' optimism, boosting confidence to its highest level in June since the survey began in 1976. By contrast, consumers—who had long seen things more positively than company insiders—suffered a greater jolt when COVID hit in early 2020, and only returned to pre-pandemic confidence at the close of Q2, this year.

Figure 2 | Consumers Lagged CEOs in Return to Pre-Pandemic Peace of Mind

For years prior to the COVID crisis, sentiment on the part of corporate insiders and U.S. consumers had been diverging, with firms bracing for a slowdown in global growth and wary of looming geopolitical threats, even as strong labour markets kept household confidence high. CEOs and consumers registered serious concern about the economy in the face of lockdowns and layoffs at the start of last year, although corporate confidence rebounded sharply in the second half of 2020 on the strength of massive stimulus and the success of vaccines, ending Q2 at the highest level recorded since 1976, when The Conference Board began surveying U.S. executives. Meanwhile, consumers were just about as optimistic at the close of Q2 as they were when the pandemic hit.

Cumulative percentage change in confidence of those surveyed, Jan. 2017—Jun. 2021

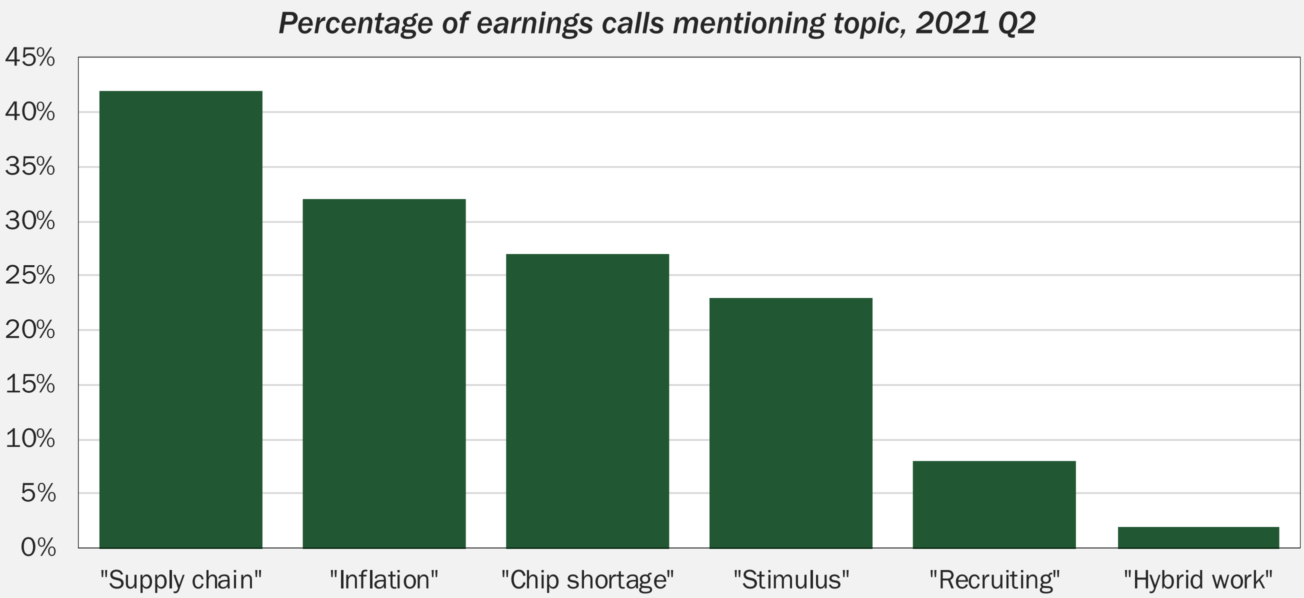


Source: Consumer Confidence Index and CEO Confidence Index from The Conference Board.

Perhaps the greatest proof of an economic resurgence is data on inflation, which mounted throughout the second quarter, prompting worries in June, when U.S. "headline" CPI clocked in at 5.4%, a level exceeded only once in the last three decades, as a 2008 oil price spike saw crude approach $150 per barrel. Even "core" CPI, which excludes volatile food and energy prices hit a 30-year high of 4.5% in June. Once again, managers were one step ahead of economists in recognizing rising prices, with data from IoT Analytics' analysis of roughly 2,500 transcripts from earnings conference calls conducted during Q2 showing "supply chain" issues and "inflation" among the topics most widely discussed, mentioned on 42% and 32% of calls, respectively (see Figure 3). On the other hand, those with a more optimistic view on inflation have pointed to "trimmed" CPI, which drops outlier goods with the most extreme price changes. That measure came in at a mere 2.9% for June, indicating at least part of the move in prices is transitory and pandemic-induced (e.g., an 88% YoY rise in the cost of a car rental).

Figure 3 | Transcripts Suggest Supply Chains, Inflation on Managers' Minds in Q2

Surveys have long been an indispensable tool for synthesizing insiders' perspectives on business conditions, although the field of big data now promises to aggregate and analyse an array of information that provides even higher-resolution views into the state of the economy and the mindset of managers. Based on IoT Analytics' breakdown of roughly 2,500 earnings conference call transcripts for U.S. companies from Q2, it's clear supply chain issues—including shipping disruptions and a massive shortage in semiconductors—along with concern over inflation have taken centre stage in conversations with shareholders. Anxiety over a return to the office was also showing, with references to "hybrid work" more than doubling since last quarter.



Source: IoT Analytics.

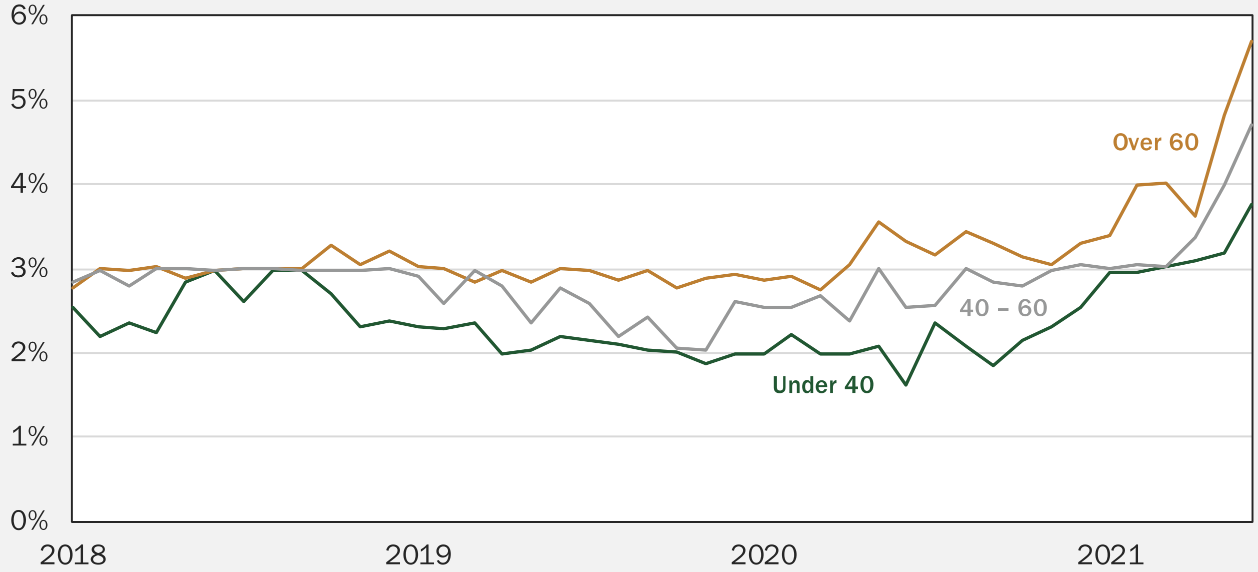
An answer to the question of how much of inflation will be with us in the long term might just come down to one's personal experience with rising prices. Financial economists Ulrike Malmendier and Stefan Nagel, writing in 2016, observed that the way individuals form expectations of inflation seems to depend substantially on whether one has lived through periods of high inflation, like the 1970s. Indeed, according to data from the Federal Reserve Bank of New York, which surveys U.S. consumers on their beliefs about one-year-ahead inflation, individuals in the "Over 60" cohort predict prices to rise by 5.7% over the next twelve months, versus an expectation for 3.8% inflation on the part of "Under 40" respondents (see Figure 4). In a more recent paper, Malmendier, Nagel, and co-author Zhen Yan, show that the same history-dependence affects the views and decisions of central bankers at the Fed—an interesting finding, Bloomberg's Tracy Alloway notes, as current FOMC members average 66 years.

Bank of America provides one additional data point, polling a presumably younger crowd of 224 money managers with combined assets of more than $660 billion, and reporting that 72% of managers expect high inflation prints are mostly transitory. Those equity managers, regardless of their views on the likelihood of inflation, might be in a good position to profit from it when it does arise. Recent research by GMO's Focused Equity Team, conducted using data on U.S. stocks beginning in the 1920s, found that during the worst periods of inflation over the last century, equity strategies with a preference for high-quality value stocks—two pillars of Henderson Rowe's systematic approach to stock selection—provided positive real returns even as the market delivered negative inflation-adjusted performance.

Figure 4 | Expectation of Inflation? That Might Depend on Your Experience

June's "headline" CPI reading for the U.S. clocked in at an eye-popping 5.4%—only the second time it has surpassed 5% in three decades—settling any debate as to whether prices are rising. That said, observers might still differ on how much of the rise in prices is transitory. Interestingly, one's position on that question turns out to depend on one's own history with inflation. In a 2016 paper, financial economists Ulrike Malmendier and Stefan Nagel proposed a model for how individuals form expectations of inflation, and found that much of our beliefs about inflation come from personal lifetime experiences. Data from Federal Reserve Bank of New York surveys support this view, with respondents over the age of 60 anticipating nearly 2% higher inflation over the next year than those in the "Under 40" cohort.

Median one-year-ahead consumer expected inflation rate, by age group, Jan. 2018—Jun. 2021



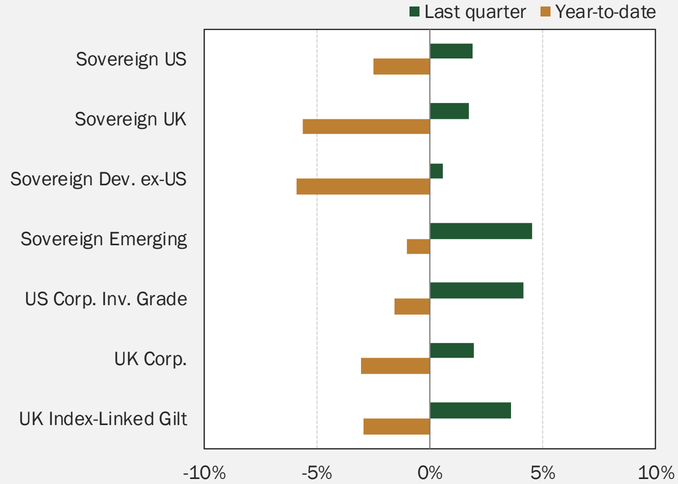
Source: Federal Reserve Bank of New York.

Fixed Income

After a horrific first quarter, bonds rebounded over the last three months, but still remained underwater for the year (see Figure 5). Particularly hot were EM sovereign and investment-grade corporate bonds, offering higher yield, and index-linked bonds designed to hedge against inflation. Speaking of inflation, all eyes were on the US Fed in Q2, with the open market policy committee indicating during their April meeting that, despite high CPI numbers, they viewed price increases as transitory and wouldn't soon intervene—only to come back in June and signal a sooner-than-expected rise in rates (the median FOMC member called for two hikes by the end of 2023).

Figure 5 | Fixed Income Market Performance

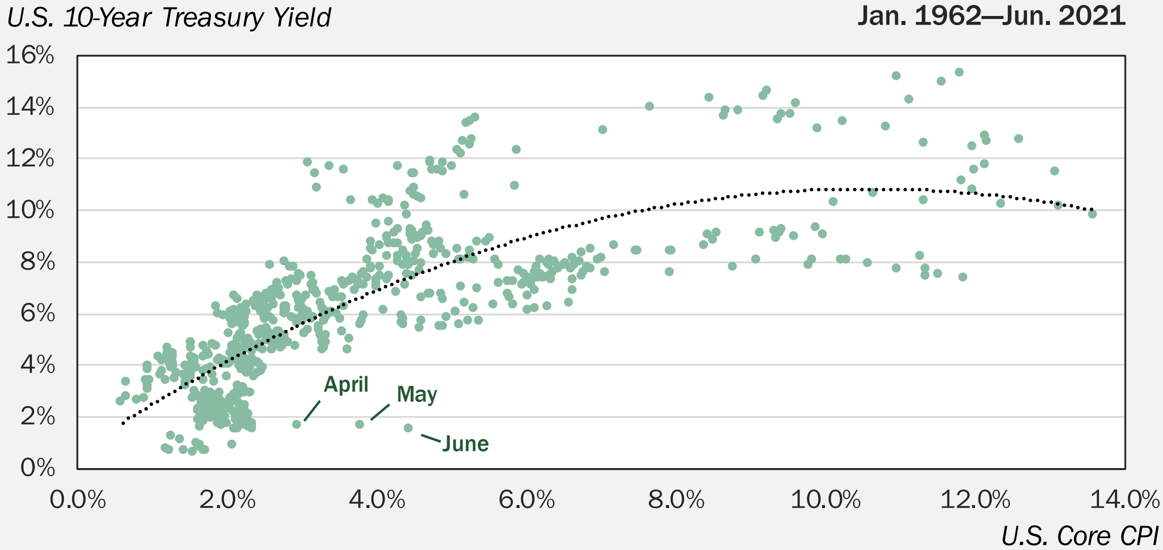
Returns as of 30 June 2021



Source: Bloomberg, expressed in USD except for UK Gilts and UK Corporate in GBP.

Figure 6 | Treasury Investors Seem to Agree With the Fed on Transitory Inflation

The relationship between inflation and yields is simple enough: When investors expect to receive cash that is worth less in the future, they demand higher returns to compensate. A chart from TS Lombard plotting Treasury yields and CPI over 60 years clearly shows such a pattern in the data—with the exception of observations over the last quarter, which fall in the top third on inflation and in the bottom two percent of the sample on yield. In part, low yields reflect strong demand from institutional investors for a low-risk source of return, although bond investors are obviously pricing a short-lived inflationary spike, and will pay a heavy price if that trust is misplaced.



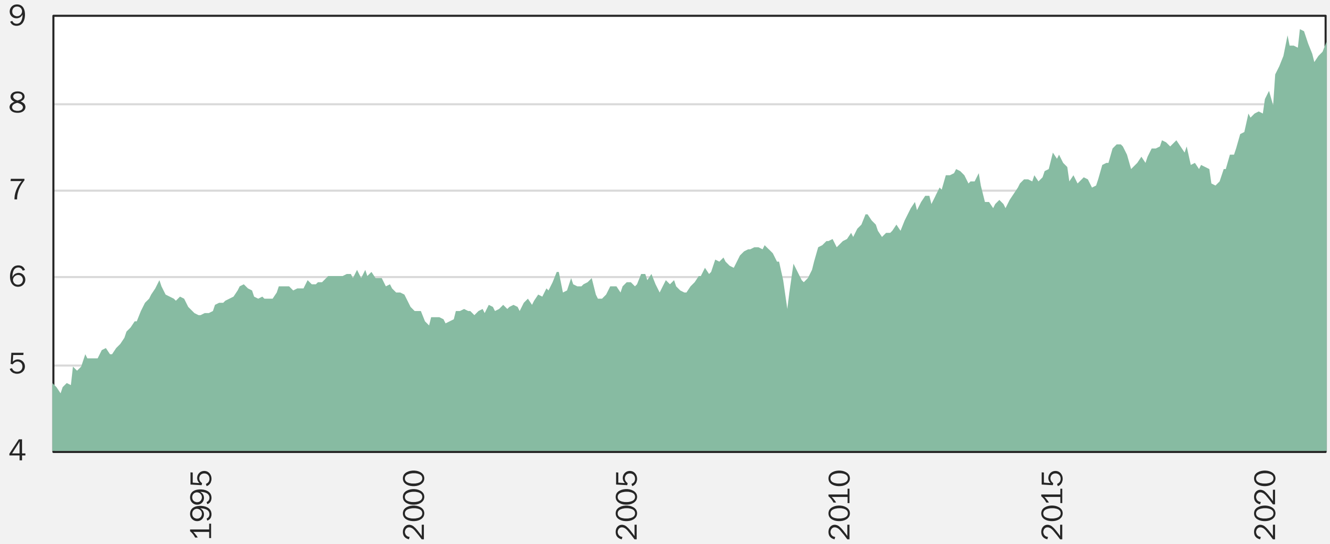
Even so, with other developed markets' sovereign debt offering minimal (and often negative) rates, institutional investors looking for even modest returns without taking on credit risk have piled into US government bonds, keeping downward pressure on yields. In part, such strong demand could explain why the last few months seem to upend a basic intuition that higher inflation—which erodes bond investors' returns—should correspond to greater yield. Over most of the past 60 years, that relationship holds, with last quarter's three observations landing as obvious outliers at the bottom left of the graph: above-average CPI, coupled with meager yield (see Figure 6). By the looks of the chart, a good number of bond investors must be happy with the Fed's contention that recent inflation is but a blip.

That said, apparently not everyone is on board with "transitory" inflation, as indicated by short interest in the iShares 20+ Year Treasury Bond ETF (TLT) reaching one-quarter of the $16 billion fund's shares outstanding in Q2. For those expecting inflation to persist and push yields higher, betting against TLT makes good sense, given the fund's "duration"—it's sensitivity to changes in interest rates. Longer-dated bonds naturally have higher duration because the bulk of their payments comes far in the future, compounding the negative effect of a rise in rates today. But it's not just TLT's long-term T-bonds set to suffer if short-lived inflation turns out to be wishful thinking. Given low rates and strong demand for fixed income securities, firms and governments around the world have been rushing to lock in a low cost of debt over long horizons, resulting in record-breaking duration for corporate bonds in 2021 (see Figure 7), and increased risk to bond investors if CPI in Q2 can't be so easily written off.

Figure 7 | Record Bond Duration Leaves Investors Especially Exposed to Inflation

A bond's "duration" measures its sensitivity to changes in interest rates. Since payments collected far in the future are worth significantly less if rates rise today, long-dated debt has higher duration. Robust demand by fixed income investors and very low rates have led corporate and government issuers to lock in a low cost of debt over long horizons. Indeed, 2021 has seen a number of "ultra-long" issues, including Mexico and Indonesia, who sold debt maturing in 50 years, and the German state of North Rhine-Westphalia, which sold €2 billion in 100-year bonds. Such issuance has pushed average bond duration to record levels, leaving fixed income investors much more exposed to surging inflation.

Average duration, U.S. corporate bonds, Jul. 1991—Jun. 2021



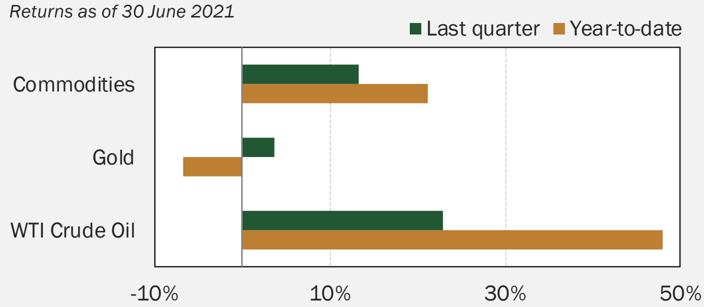
Source: Bloomberg, modified adjusted duration of Bloomberg Barclays US Aggregate Corporate Bond Index.

Commodities

Despite headwinds late in the second quarter, commodities surged upward through the end of June, as vaccine rollouts progressed, and a global economic recovery continued. Bloomberg's broad commodity index added 13.3% in Q2, bringing its gains to 21.1% in the first half of 2021 (see Figure 8). Because the opportunity cost associated with holding precious metals rises as rates increase, the Fed's hawkish tone near the end of the quarter put downward pressure on gold, which ended June with modest gains. Crude climbed by nearly 23% in Q2, extending its first-quarter gains on a combination of increased demand as economies reopened and more effective coordination among OPEC+ members to keep prices in check through controls on supply. Oil's freefall at the pandemic's outset and its subsequent rebound are, in fact, the most rapid the commodity has experienced in at least three decades (see Figure 9), underscoring how strange conditions have been for energy markets since early 2020.

Figure 8 | Commodities Performance

Returns as of 30 June 2021

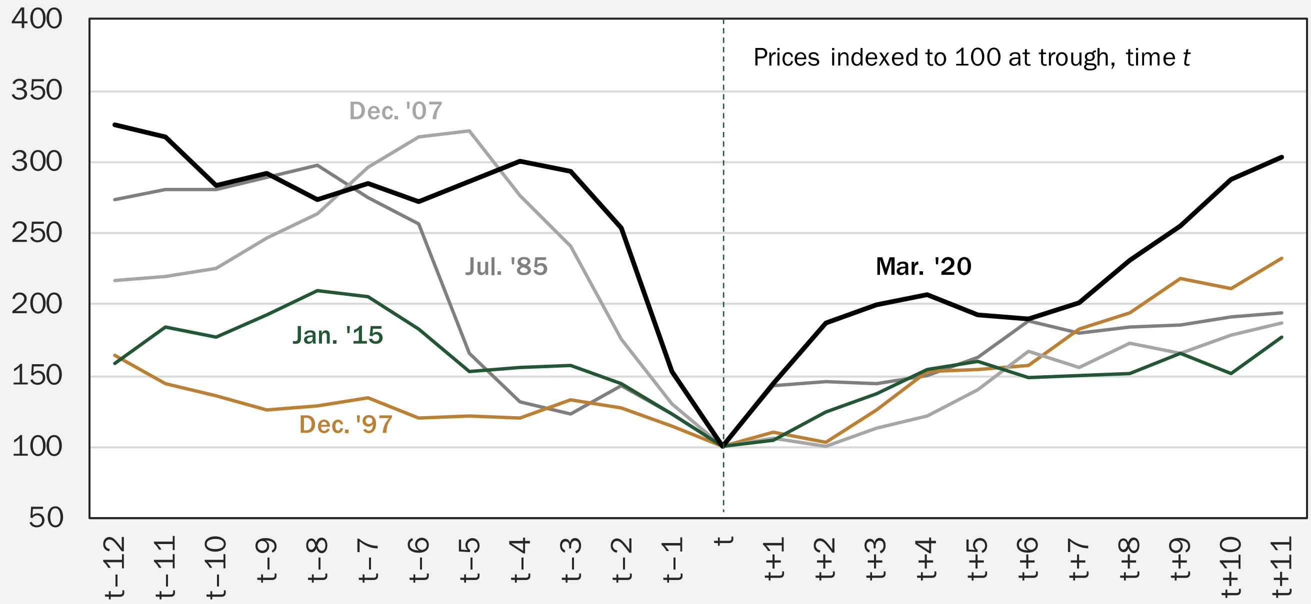


Source: Bloomberg Commodity Index (USD), WTI Crude (USD), Gold Spot (USD) via Bloomberg.

Figure 9 | Record Bounce Back for Crude After Plummeting Amid Pandemic

At the onset of the pandemic, oil was hit with decreased demand as the global economy shut down, along with a shock to supply from squabbling among OPEC+ members over production cuts. The result was a staggering price decline in the first quarter of 2020, sharpest among the last five great collapses in crude, going back to 1985. The rebound turned out to be record-breaking, as well, with prices rocketing back over 300% in the next 11 months. That recovery continued in the first half of 2021, as effective vaccines allowed economies to reopen, boosting demand, and coordination among members of OPEC+ restricted supply in support of higher prices.

Price path of oil in 12 months before and after the last five great collapses in energy



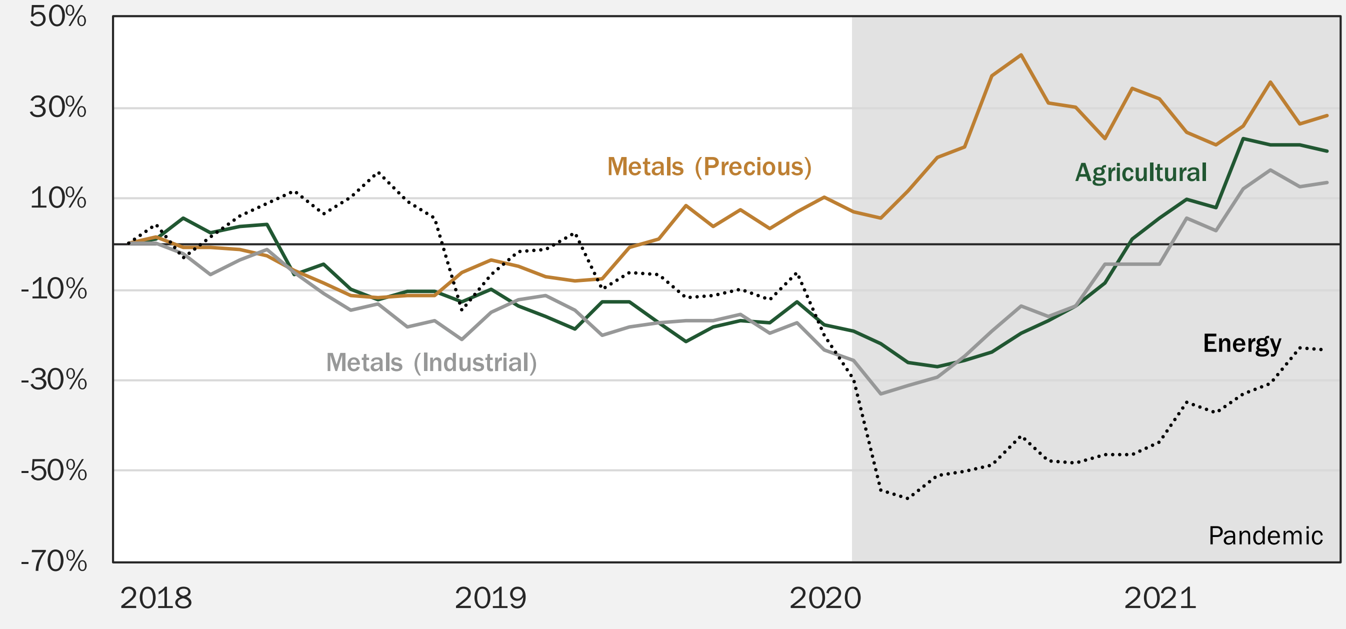
Source: World Bank.

Looking over a slightly longer period, it's clear COVID-19 wreaked havoc on commodities across the board at the start of last year—even briefly driving investors out of gold in search of a safer haven (see Figure 10). Nevertheless, in a few months' time, conditions started to improve, and prices were on the road to recovery, with all major commodity groups having surpassed pre-pandemic levels at the end of June. The latter half of Q2 actually saw a bit of a pullback in a number of commodities, as fears the delta variant might deliver a blow to global growth, USD strength on talk of the Fed tapering, and intervention by Chinese authorities to fight input cost inflation weighed on the year-long rally.

Figure 10 | Industrial Metal and Agricultural Commodities Shine

It wasn't just energy prices reeling from the effect of COVID-19 on global demand. Agricultural commodities and industrial metals also saw steep drops to start 2020. Even gold suffered losses in March of last year, as pandemic uncertainty drove investors to cash—the ultimate safe haven—although precious metals quickly posted big gains as the initial panic faded. By the middle of 2021, all major commodity groups had recovered to pre-pandemic levels on the back of a return to global growth and price pressure from supply disruptions, including rising shipping costs and a container shortage. The threat of COVID variants, US dollar strength in the event of Fed action, and China's release of strategic metal reserves to combat input cost inflation represent risks to the rally, contributing to a pullback in the latter half of Q2.

Cumulative percentage return in various commodity sub-indices, Jan. 2018—Jun. 2021



Source: Bloomberg Commodity Sub-Indices: Agriculture, Energy, Industrial Metals, Precious Metals.

Looking Ahead

The current burst of inflation in the US is not necessarily a bad thing. Prices are rising as the economy picks up, thanks to vaccination, macroeconomic support, and the contribution of effective remote working. Bottlenecks in supply chains are only to be expected. Wait times are rising, as are wages. A certain degree of inflation can stimulate demand and, so far, is consistent with a managed recovery. It is really only at higher inflation levels that equities risk losing ground. At high rates, inflation tends to hit income and cost lines differently. Cost inflation can race ahead of price increases, so what is known as the 'inflation flow-through' may not occur. In the 1970s and '80s real rates were high, making it impossible to build capital reserves. Low interest rates, if maintained, should help. The first priority has to be getting the economy back on its feet again, and a 4% to 5% level of inflation the next few years—if it comes to pass—would be a small price to pay, a welcome change from the deflation of the last ten years, and in a fairly safe zone for equities.

Key Economic Releases and Events for Q3 2021

UNITED KINGDOM

Bank of England Official Bank Rate Release: 5th August, 23rd September

PMI Figures: 23rd July, 4th August, 3rdSeptember

EUROZONE

YoY GDP: 30th July, 17th August, 7th September

PMI Eurozone: 23rd July, 4th August, 3rd September

Unemployment Report: 27th July, 24th August, 21st September

ECB Monetary Policy Meeting: 27th July, 24th August, 21st September

UNITED STATES

FOMC Rate Decision: 28th July, 22nd September

GDP Figures: 29th July, 26th August, 30th September

PMI Figures: 23rd July, 4th August, 23rd August, 3rd September & 23rd September

Closing Comments

US equities and fixed income have closed Q2 at all-time highs. Historically, this implies poor medium- and long-term returns, but on a one- to two-year view it does not tell us much. High prices can keep going higher—it is very hard to call a top. US equities have been 'expensive' for the last thirty years, after all. Rising inflation and negative real interest rates make it difficult to justify investing anywhere else and the forces squeezing equity markets ever upward do not look as if they'll go away any time soon. In such an environment, managers and models geared to find high-quality companies trading at bargain prices might ultimately serve as the most effective hedge. In any case, one thing is certain: cash will lose value in line with whichever kind of inflation you choose to apply. Having done particularly badly against property and equities over the last year, its rate of decline against high street goods is likely to pick up as CPI rises this year.

Endnotes

[1] H. S. Foxwell. 1911. Introduction in 'History of the Bank of England and its Financial Services to the State' by E. von Philippovich. Washington: Government Printing Services.

[2] A. Liesse. 1909. 'Evolution of Credit and Banks in France.' Washington: Government Printing Office.

[3] W. Roberds and F. Velde. 2014. 'Early Public Banks.' Working Paper no 2014 – 03. Federal Reserve Bank of Chicago.

[4] K. Niemitz. 2021. 'Left Turn Ahead.' IEA.

[5] M. Mobius. 2021. 'The Inflation Myth and the Wonderful World of Deflation.' Wiley.

Important Information

This publication does not constitute a financial promotion as defined by Section 21 of the Financial Services and Markets Act 2000 (FSMA).

This document is intended for the use and distribution to all client types. It is not intended for distribution to, or use by, any person or entity in any jurisdiction where such distribution would be unlawful and participation in the portfolio referred to herein shall not be offered or sold to any person where such sale would be unlawful. Any onward distribution of this factsheet is strictly prohibited.

The value of investments and the income from them can go up as well as down and you may realise less than the sum invested. Some investments may be subject to sudden and large falls in value and you may realise a large loss equal to the amount invested. Past performance is not an indicator of future performance. If you invest in currencies other than Sterling, the exchange rates may also have an adverse effect on the value of your investment independent of the performance of the company. International businesses can have complex currency exposure.

Nothing in this document constitutes investment, tax, legal or other advice by Henderson Rowe Limited. You should understand the risks associated with the investment strategy before making an investment decision to invest.

Investors should be aware of the risks associated with data sources and quantitative processes used in our investment management process. Errors may exist in data acquired from third-party vendors, the construction of model portfolios, and in coding related to the index and portfolio construction process. Information contained in this fact sheet is based on analysis of data and information obtained from third parties. Henderson Rowe Limited has not independently verified the third-party information. The firm, its directors, employees, or any of its associates, may either have, or have had, a position, holding or material interest in the investments concerned or a related investment.

Henderson Rowe is a registered trading name of Henderson Rowe Limited, which is authorised and regulated by the Financial Conduct Authority under Firm Reference Number 401809. It is a company registered in England and Wales under company number 04379340.

CONTACT

Kimmy Beattie
Head of Compliance & MLRO
kimmy.beattie@hendersonrowe.com
+44 20 7907 2200

Artur Baluszynski
Head of Research
artur@hendersonrowe.com
+44 20 7907 2200