GEMINI

FINANCIAL PLANNING

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SQUARE MILE

INVESTMENT SERVICES

Macro Highlights

Expectations of global economic growth in 2021 continue to be revised higher and even now may prove to be conservative. The release of pent-up demand as vaccines are rolled out and economies re-open, whilst the monetary and fiscal taps still remain fully open, is a heady mix. Since winning the election last November, President Biden has announced the pandemic-relief American Rescue Plan, the infrastructure-related American Jobs Plan and the welfare-focused American Families Plan, totalling US$6trn in additional spending. At the same time, the US Federal Reserve continues to pump US$120bn into the economy each month through quantitative easing. The widely respected US Conference Board is forecasting that the US economy will have grown by 9% on an annualised basis in the second quarter of 2021 and both the Federal Reserve and the OECD have increased their projections for the whole of the year to 7%. Similarly, in May the Bank of England raised its forecast of economic growth in the UK in 2021 to 7.25% (from 5% just three months earlier). In the eurozone, where vaccination rates have lagged significantly behind those in the UK and US causing restrictions to remain in place for longer, growth of 4.3% is now expected in 2021. Despite this and as in the US, neither the Bank of England nor the European Central Bank seem keen to begin the pullback from quantitative easing.

FALLING BOND YIELDS

DEFY RISING INFLATION

The main focus of attention over the last few months, however, has not been excitement about the rebound in economic growth. Instead, it has been worries about the threat of inflation, dormant for so long, as persistently lacklustre economic growth since the financial crisis, globalisation and technological advances have combined to subdue prices, but never extinct. In the US, the annual inflation rate (CPI) has soared from 1.7% in February to 5.0% in May, its highest level since August 2008. In the UK, the inflation rate has tripled from just 0.7% in March to 2.1% in May and the Bank of England expects it to rise above 3% in the months ahead. Even in the eurozone where prices were falling as recently as in December, inflation is now running at 2%. Finally, in China, for long a byword for the cheap manufacturing that has helped keep global inflation at bay, factory gate prices rose by 9% in the year to May. Interestingly, China is now seeing the same demographic trends as much of the developed world with an ageing population, declining birth rate (despite the abolition of first its one child policy and then its two child limit) and a shrinking workforce.

Commodity prices are soaring with the price of oil up by 45% in the first half of 2021. The prices of iron ore and copper are up by 39% and 20% respectively. Supply bottlenecks, which exert upward pressure on prices, are commonplace, spanning semiconductors for use in computer chips to lumber to labour. The trillions of dollars and pounds being earmarked for infrastructure and environmental projects as well as to address social inequality may also be inflationary in nature. The years since the financial crisis have been extremely kind to those with assets such as property, and savings, including pension funds, as values have been inflated as a result of extremely loose monetary policy. Amidst signs of mounting populism as the young and less well-off become increasingly disaffected, it is possible that governments will seek to engineer some rebalancing and wealth redistribution in the years ahead.

Central bankers, however, remain steadfast in their assertion that the inflationary spike we are seeing is transitory and not the beginning of something more structural. If wrong, they could find themselves dangerously behind the curve and needing to raise interest rates quite significantly and rapidly in order to reconfine the inflation genie back in its bottle. To be clear, at this time there is insufficient evidence to determine if the upward trend in inflation is transitory or not, but it is something we are watching especially closely as it could have very important implications for investment portfolios.

Bonds

Inflation is bad news for investors in bonds because it erodes the real value of interest payments and capital return, both of which are fixed. You might have thought, therefore, that the sharp increases in inflation seen in the second quarter would have caused bond prices to fall (and yields therefore to rise). However, 10-year gilt yields fell from 0.85% to 0.72% in the period, so gilts provided a positive return. Despite a much bigger jump in inflation it was the same in the US where 10-year US Treasury bond yields declined from 1.75% to 1.47%.

Of course, it should be remembered that yields soared in the first three months of the year, from 0.20% to 0.85% and from 0.91% to 1.75% for gilts and US Treasury bonds respectively, so government bonds have still been a very poor investment year-to-date. Indices representing the return of the broad gilt market are down by about 6% in the first half of 2021. The slight recovery in the second quarter of the year therefore suggests that the sell-off earlier in the year was overdone or that, for now at least, investors believe the assurances being proffered by central banks that the current bout of inflation will indeed be transitory. It remains to be seen, however, how long investors in government bonds will tolerate real yields (i.e. yields minus inflation) which are so negative.

Against a backdrop of economic optimism and ebullient stock markets, it is no surprise that corporate bonds again provided better returns than government bonds in the second quarter. Credit spreads (the excess yield that investors demand for accepting the additional risk of lending to companies as opposed to governments) continued to compress. In the US, credit spreads on high yield or so-called 'junk' bonds (because of their perceived inferior creditworthiness) have fallen to their lowest levels since before the financial crisis. In a financial world in which investors remain starved of income-generating investments, we certainly understand the optical attraction of a high yield bond which yields 3% more than a government bond. However, we continue to question if an overall yield of less than 5% in absolute terms represents sufficient compensation for the risk of default.

Equities

It was another barnstorming quarter for stock markets. The UK stock market (including dividends) reprised its performance of the first quarter with another gain of more than 5%, taking its year-to-date advance to just over 11%. However, the performance of UK stocks was eclipsed yet again by their counterparts in the US, the main benchmark rising by over 8% to take its year-to-date return to more than 15% including dividends. The only notable stock market laggard in the second quarter was Japan, which was broadly unchanged. Japan's vaccine rollout has been much slower than many other developed countries, with only just over 10% of its population fully vaccinated. This compares with figures of approximately 50% in both the UK and the US. As a result, restrictions have lingered for longer, causing the Japanese economy to contract by almost 4% in the first three months of the year.

The last few years have witnessed an extraordinary divergence between the performance of usually high-priced and often technology-related 'growth' stocks and cheaper, more economically sensitive 'value' stocks in sectors such as commodities and financials. The former have trounced the latter. In the first three months of 2021, value stocks at last had their day, outperforming growth stocks by almost 10% as economic growth surged. The recovery accelerated in the second quarter so it would be rational to expect value stocks to continue to have done better than growth stocks. In fact, the opposite happened with growth stocks outperforming value stocks by about 6%. The explanation lies in the bond markets. Growth stocks are valued according to their predicted profits and cash flows in the sometimes-distant future, which are then discounted at the prevailing interest rate (the discount rate) in order to arrive at what is called a 'net present value' or, effectively, share price. As noted above, bond yields, and hence the discount rate, unexpectedly declined in the second quarter, making the future cash flows and valuations of growth stocks more attractive to investors. Actively managing the tilt between growth and value in a portfolio might seem like a perfectly valid investment strategy but the experience of just the last two quarters shows just how easy it is to be wrongfooted. We therefore prefer to maintain a balance in the portfolios we manage.

ANOTHER BARNSTORMING QUARTER FOR STOCK MARKETS

Stock markets are revelling in a Goldilocks set of circumstances. Economic growth is buoyant and corporate profits will benefit accordingly. Inflation is going up but is not out of control (according to central banks). In any case, stock markets have historically taken modest, say low to mid-single digit, inflation in their stride as it allows companies to increase their revenues. Similarly, bond yields have risen but not by too much. So why are we not overweight in equity exposure in our portfolios? First, there is the risk that central banks are wrong about inflation and that interest rates have to rise considerably. Second, share valuations are expensive even allowing for the anticipated bounce in corporate profits and there is therefore little or no margin of safety if, for example, profit margins begin to be squeezed by higher labour or other costs. We will remain disciplined.

One other area of concern is the degree of speculation evident in stock markets. The prominence of social media sites such as Reddit's r/wallstreetbets and the advent of commission-free trading through platforms like Robinhood has lured a generation of new retail investors into stock markets, many of whom have no understanding of the risks they are taking. This has led to extraordinary volatility in the share prices of so-called 'meme' stocks such as video games retailer Gamestop, cinema chain AMC Entertainment and Blackberry, which along with Nokia once dominated the mobile phone market. Another symptom of the exceptionally loose monetary policies being pursued by central banks is the explosion of margin debt, which represents investments funded by borrowed money. According to regulator FINRA, margin debt in the US now totals US$847bn, up by more than 60% over the last twelve months and is substantially higher than before the financial crisis. Finally, there has been the recent investor mania for Special Purpose Acquisition Companies ("SPACs"). SPACs have enabled a string of private companies to become publicly listed, some on the basis of heroic assumptions about future prospects which may border on fraud and which would never be allowed in a traditional stock market listing. Nikola, an electric truck maker, was valued at US$12bn when it listed on the US stock market via a SPAC in March 2020. Some months later it was exposed that the movement of a prototype vehicle in a promotional video was not self-powered but was because it was rolling downhill!

Currencies

According to the statistics, it was an uneventful three months in currency markets, with the pound appreciating by 0.1% against the US dollar and falling by 0.9% against the euro. However, the quarter saw considerable volatility centred around the dollar. At the end of May, the pound was up by more than 3% against the dollar. However, the unexpected announcement after the meeting of the Federal Reserve's Open Market Committee in mid-June that the majority of its members now thought that US interest rates would begin to rise in 2023 spurred a sharp rally in the dollar. The committee had previously indicated that interest rates were unlikely to go up until 2024.

Year-to-date the pound remains the strongest currency, up by a little over 1% against the dollar, by 4% against the euro and by nearly 9% against the Japanese yen. The strength of the pound in the first quarter and therefore year-to-date reflects expectations of an earlier and stronger economic recovery following the world-beating rollout of coronavirus vaccines and also the removal of uncertainty about the UK's trading relationship with the EU following Brexit.

Alternative Investments

The price of gold rose by 4% in dollar terms in the second quarter of 2021, having fallen by 11% in the first three months of the year. One of the main drivers of the price of gold is the trend in real interest rates (interest rates less inflation). Thus, as bond yields rose in the first quarter but signs of inflation were yet to emerge, the price of gold fell as real interest rates increased. Of course, year-on-year inflation rates increased sharply in the second quarter and bond yields were surprisingly lower so a much bigger increase in the price of gold might have been expected. Part of this might be explained by the strength of dollar in June, but it might also imply that investors in gold agree with central bankers that the rise in inflation will be transitory or that it is the decline in bond yields that is transitory.

Having doubled in the first three months of 2021, the price of bitcoin tumbled by almost 40% in the second quarter as regulators engaged in a further clampdown in the war against its use to launder money and concerns intensified about the environmental impact of bitcoin mining which requires vast amounts of electricity. We continue to regard bitcoin and other cryptocurrencies as highly speculative investments which are wholly unsuitable for use in the portfolios we manage.

Our decision to exit from investments in property funds a few years ago has been proved a very good one, not only because the opportunity costs of investing in the sector have been very substantial but also because we have avoided the anguish of being stuck in investments which we might have been unable to sell for more than a year. Most property funds have now lifted their suspensions of redemptions which were imposed on investors in the first quarter of last year but the outlook for the sector remains highly uncertain. Big question marks remain about the values of many office and retail properties. In addition, the FCA has delayed its verdict on how to resolve the gaping mismatch in liquidity between daily-dealing property funds and

Important information

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