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B Capital Commentary and Outlook Update 3Q2021

If the first quarter of the year was all about the reflation trade as investors ran from fixed income into commodities and equity sectors likely to benefit from higher inflation and higher interest rates. Energy and banking sectors performed well while the 'stay at home' pandemic favourites lagged behind. The US 10-year bond saw its benchmark yield rising as the Fed released a slightly hawkish message about the end of the extended period of ultra-low interest rates. In the second quarter, however, much of the reflationary fervour waned as fears that the easing of global restrictions might not come so easy. Although the vaccination programme has been widely accelerated, there has also been an uptick in infection rates all over the world in an uneven and unpredictable way, combined with new variants that could mean little or could mean a lot depending on which news stream you read.

Fig 1 - Global Benchmark Index Performance 1H2021
***source: Bloomberg**

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This has caused the 10-year yield to drop again and has given a boost to tech stocks which have caught up after a slow start to the year. All in all, with a likely resurgence of infections in the Autumn, we think that within the equity allocations maintaining a balance between blue-chip stocks and tech titans is still prudent and in any event, the higher growth rates of the latter will likely improve overall returns. Looking out longer-term, the outlook is for a post-COVID recovery and a return to the 'new normal' for work, travel and socialising, whatever that may look like. In general, the way we do these things has changed but it certainly has not stopped and our desire to be social both in the workplace and elsewhere will mean that life does in fact go on. No more of the doom and gloom of 2020, rather a return to different ways of doing everything that we were doing before.

Where Are The Risks?

So, what are the risks at this stage in the cycle? Strangely it probably is not COVID at the top of the list. It is clearly on the radar as we follow news about the efficacy of vaccines and variants of the virus. But for financial markets the risks may now be more tending towards volatility caused by a combination of central bank changes to interest rate policy and the related currency movements which can follow. We have seen the taper tantrum before and it reminds us of the vulnerability of markets when investors wake up to the likely end of more than a decade of easy monetary policy. It could happen again, and the hawkish message from the Fed in Q2 was rapidly watered down to keep a lid on rising concerns over inflation data.

Inflation has picked up and faster than expected. In our last report we flagged that inflation in the US would rise above 4-5% in the summer and so it’s no surprise that this is the case. Global investors on the other hand seem a bit surprised and, according to surveys, there is a fear of persistent inflation at the top of the worry list. The FOMC states that this higher inflation is transient and we would agree; the bounce back has come quick and it should settle into a period that transitions from recovery to expansion. Much of the inflation data has come from sectors that had been very depressed, such as second-hand auto sales and energy. Once the driving season passes and economies around the world get back to the new normal we expect inflation to flatten. That is not say it goes away, but instead the rate reverts towards the trend line.

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Two risks to think about in this transition phase are the US Dollar and the growth rate in China. The global currency is showing some signs of bottoming out. Mid-2020 we predicted that the dollar would weaken further - as part of a political and central bank policy to boost exports while inflation was absent - and then reach a low in the middle of this year. That change may now be happening.

Fig 2 - DXY (US Dollar Spot Index), 5 Year Graph
***source: Bloomberg**

The DXY Index is a representation of the US Dollar against a basket of currencies and when looking at the five year graph there looks like a bottom is being found. This needs further observation and consideration regarding exposures to commodities and precious metals, as well as potential effects on export sectors in equities. It is always hard to predict currencies with any certainty, but we suggest that the likely outcome is a moderate appreciation of the dollar of 5-7% from here.

China may not be growing as evenly and as fast as expected towards the end of last year. The verdict is not back yet but we are looking at the leading data and have put it on the watchlist as a potential brake on the expansion phase continuing as we saw it 3-6 months ago.

What To Expect Next?

The strategy is to keep the faith with global equities as a combination of superior dividend yields and continued economic expansion supports the asset class into the second half of the year. Fixed income needs to be kept short duration, just as we have maintained for some time, and we favour corporate issuers on the line between IG and HY rather than sovereign debt that offers little reason to hold when thinking about inflation.

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We have kept gold and silver in the asset allocation for now, as a prolonged inflationary read could spook investors into a rush for potential inflation protection. This is not the base case but is in place as a small inflation hedge along with equity exposure.

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