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INDEPENDENT FINANCIAL PLANNING
& INVESTMENT MANAGEMENT

Asset Class Commentary August 2021

After lots of recent positivity, investors are now concerned with the rising number of Delta variant cases.

There is much uncertainty as to how events will eventually play out, and because of this investors are overreacting to news flows. Volatility is high and large swings in prices are commonplace. Markets seem to have lost their sense of direction to a large degree, with many earnings upgrades now being effectively ignored.

American equities have very high valuations, but the S&P 500 and NASDAQ are still climbing higher. The increased progress of the $1 trillion infrastructure bill is lending a helping hand.
In the UK, restrictions on travel are lifting and while this is benefiting travel and tourism stocks, there is a real risk rising Covid infections and the potential for new lockdowns and stricter measures in the Autumn.

The threat of rising inflation has taken a back seat to the threat of Covid – at least for now – which has resulted in lower bond yields as investors brace for potential stalls in economic growth.

Asian equities have been hit hard with surging covid cases. The Chinese economy is growing at a slower rate and regulatory crackdowns are making the region less attractive.
All in all, the high volatility and unpredictability is a reminder to keep diversified portfolios, and a signal that although fixed income returns have been poor, they still offer a measure of protection.

Areas of focus

- Asian equities are presently unattractive as many countries struggle to contain Covid.
- China is a concern due to regulatory crackdowns and slowing growth.
- Despite this, commodity prices have risen as productivity picks up.
- UK equities are still looking undervalued. The higher weight of financials provides good protection from rising interest rates.
- US real bond yields have fallen. Inflation protected securities have continued to see positive inflows.
- Emerging Markets short-term stagnation could possibly damage long-term growth.

UK
Relatively little has changed for the long-term outlook of UK equities. The UK economy grew by 4.8% in the second quarter, recovering much of the lost ground in the last 2 years. This was below

the Bank of England's 5% expectation however, in part due to the spread of the Delta variant of Covid and the resulting "pingdemic".

As long as the virus is kept under control, the economy is expected to return to pre-Covid levels by the end of 2021. Much of this expected growth is due to the reopening of restaurants and bars, and the relaxation of travel and quarantine rules for fully vaccinated travellers. While this is positive for business and economic growth, there is a risk of a surge in infections.

The BoE has forecast inflation to hit 4% this year and has hinted that interest rates may rise moderately in the next two years. This was mostly ignored by markets.

Housebuilder stocks have seen their earnings skyrocket as the demand for new houses has increased drastically. The increase in input costs has been more than offset by rising house price inflation.

US

A high proportion of S&P 500 stocks have beaten analysts' earnings expectations so far this year.

However, this was met with a muted response from investors as prices moved only marginally higher. Stocks that missed their targets were punished with a bigger drop in price.

There have long been concerns that the valuations of US companies are very high. Some investors believe that US equity growth has run out of momentum and other markets are more attractively priced.

We see this when we look at 10-year cyclically adjusted Price/Earnings ratios. For the US it currently stands at 31.6, compared with 15.6 for Europe and 11.8 for the UK. A lower number indicates a market which is at a lower value to future earnings, and therefore more attractive to buy.

The increase in companies' earnings should help pull US stock P/E ratios lower, as long as prices do not jump.

The $1 trillion US infrastructure bill has made progress and has passed through the Senate, but still faces the hurdle of passing through the House of Representatives. This was met with a positive reaction as markets around the world pushed higher.

If passed, this infrastructure initiative will be a positive for many stocks, not just those that will directly benefit such as clean energy. Many other stocks will indirectly benefit, for example from improved internet access or transportation.

In September some analysts believe that the Fed will taper back its bond buying program, while others think this will happen in November. This will only be the case if there are strong job reports.

Key inflationary drivers may already have peaked, but the Fed is still expected to keep its main interest rate unchanged until 2023.

Europe

Inflation in Europe has risen above the ECBs target of 2%, reaching 2.2% in July which is above analysts' expectations. By the year's end, inflation in the Euro countries is expected to peak at 2.5%, but the ECB has said one-off factors would not prompt a tighter monetary policy as they expect these to decline next year e.g., higher oil prices.

Earnings season was also very positive in Europe as well, yet received with much of the same muted reactions from investors as in the US, suggesting most of the recovery in company profits was priced in long ago.

Inflows into the sector are starting to pick up on a broadening restart and a pick-up in vaccination numbers. The values of European stocks are also looking attractive relative to both past valuations and other regions.

China

In the short-term Chinese equity returns are suffering as growth in the country slows and at the same time monetary policy is tightened. There has been heavy recent selling of Chinese tech firms because of regulatory crackdowns in the country. The Nasdaq Golden Dragon China Index which tracks Chinese tech stocks fell 22% last month.

There is a lot of concern over these government crackdowns on industry sectors, mostly aimed at what the Chinese government considers "anti-competitive" practices. Investors are wondering which sectors will be targeted next, how intense the regulatory reaction will be and how long it will last.

The Delta variant has also restricted growth as it spreads throughout the region. Growth was already starting to slow, but this is worsening the situation further.

If China goes into complete lockdown to contain and control the outbreak then there will be a significant knock-on effect for other major economies, and this is likely to stunt global growth. Emerging market funds are also expected to suffer as China makes up a significant proportion of their weighting.

A major port in China has recently closed which will further compound shipping and supply issues ahead of a busy winter spending season.

Japan

Japan has been very slow in rolling out its vaccine program. This has led to outbreaks in the virus in many regions and the Olympics has only made the situation worse.

This is one of the key reasons why Japanese equities have performed poorly, with negative performance in the Nikkei 225 of around -5% in the last month. An economic revival is not looking likely anytime soon. Around half of the population is expected to be vaccinated come September – only when a high percentage of the population is vaccinated can a full economic reopening happen.

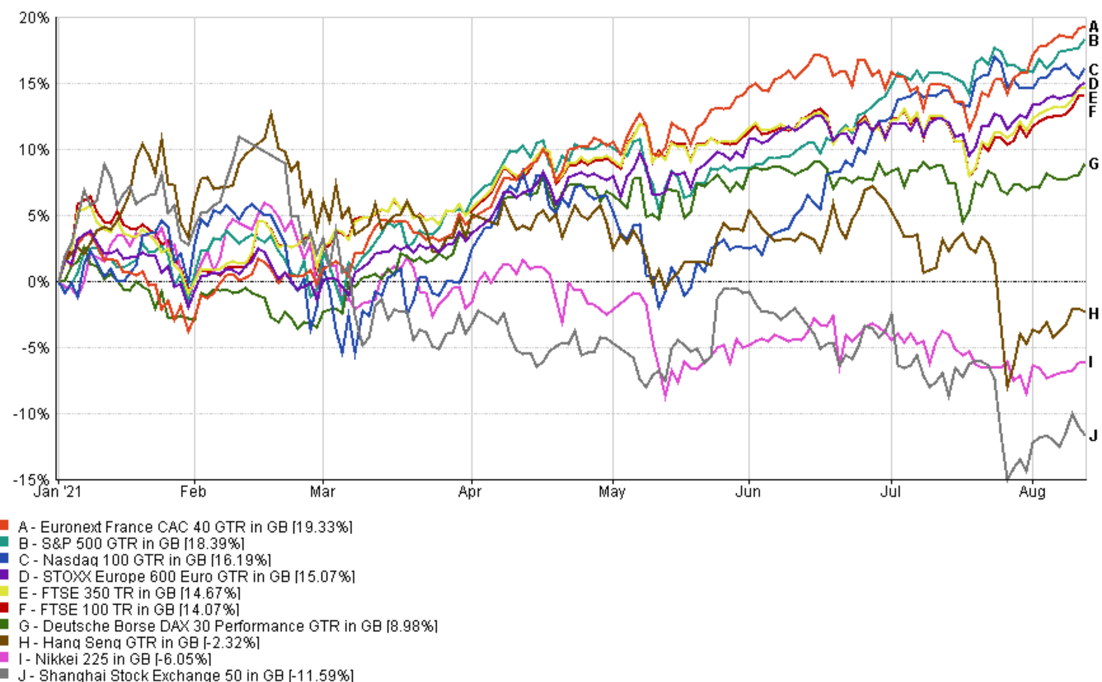
Emerging Markets

Emerging markets have stagnated as they contend with outbreaks of Covid. This could potentially become a much longer-term issue, damaging economic growth and making the regions less attractive for investment.

Vaccine roll-outs have been picking up, but remain a long way behind those of developed nations. Even if they do continue on the right track, limited policy space in emerging markets may weigh on growth potential.

In Russia, Brazil and Mexico, rising sustained inflation has caused the central banks to tighten their monetary policy already.

Local currency emerging market debt is also predicted to underperform in the short-term.



31/12/2020 - 12/08/2021 Data from FE fundinfo2021

Graph showing YTD performance of major stock market indices

Fixed Income
Bond yields around the world have been falling. US yields are currently low relative to previous levels.

As of 16th August the US Treasury 10 -year yield is 1.242%, down from this year's high point in April of 1.778%.

Many investors believe this is too low given the powerful economic restart in the US. This view would support an underweight stance on government bonds. Yields are likely to rise again in the near future and this will reduce the returns from government bonds.

However, Chinese government bonds are still looking more attractive due to more stable interest rates.

If yields do rise back to their previous highs in March, or as some analysts believe, even higher, this again will damage equity valuations, particularly growth stocks. This is something to look out for in the US as there are a high proportion of growth stocks which are already deemed to be over-valued. Investment grade bonds are underweight in many portfolios. This is because spreads have most likely been compressed as far as they will go. High-yield bonds are also considered to be appropriately valued but are expected to perform better then investment grade bonds.

Commodities
Oil prices fell sharply last year to below $40 a barrel as the pandemic began but have since rebounded strongly to just under $70 a barrel. OPEC is being pressured by the US to increase production to control prices. Oil price inflation is becoming a concern as consumers are spending more at the pump.

Gold is currently under pressure as investors are uncertain over when the Fed plans to reduce its bond buying program. As gold is a good hedge against inflation, any reduction in monetary support will dull its appeal – rate rises increase the opportunity cost of holding this non-yielding precious metal.

There is an expectation for gold to trend lower over the coming year as yields increase. In March 2020 the price of gold was $1474.25 per ounce; it has since risen to $1756.61 per ounce (as of 13/08/2021).

Robert Dougherty, July 2021.

This article is not a recommendation to invest and should not be construed as advice. The value of an investment can go down as well as up, and you may get less back than you invested.