FPWM
TAILORED FINANCIAL SOLUTIONS

QUARTER 3 2021

Investment Strategy Committee Tactical Asset Allocation Views & Commentary

Tactical positions relate to the strategic allocations for our five risk rated portfolio benchmarks which power our investment process. They are expressed as in the key below.

- - Strong Underweight	- Underweight	N Neutral	+ Overweight	+ + Strong Overweight

Please contact us if you require further information.

ASSET CLASS	TACTICAL POSITION	COMMENTARY
Global Government Bond	N	No change here and we continue to favour US TIPS as well as USD exposure as an ultimate hedge. Our managers tend to avoid European issues which are in negative rate territory, seeking value elsewhere. While low yields reduce their value to balance portfolios we value diversification
Investment Grade Bond	N	Significant Central bank and government support has benefitted this market along with improving fundamentals. Spreads over government bonds are at long term lows, leaving little margin for error, but this is balanced by the scarcity of income producing assets. Credit quality is key here.
High Yield Bond	N	No change with an improvement in corporate earnings reducing leverage. We expect this dynamic to continue although very tight credit spreads mean valuations leave little room for error. European HY fundamentals appear stronger given lower leverage and better interest coverage.
Emerging Market Bonds	N	The risk of US tapering remains a headwind to the performance of EM local bonds. The Latin America region has improved given the stronger growth outlook helped by the roll-out of vaccinations and the spill over effects from US fiscal stimulus. Prefer higher quality EM corporate credit now
UK Equity	+	Despite recent concerns, there is still scope for the performance of UK equities to catch up to peers. Accommodative monetary policy and the success of the UK vaccination programme are real positives. We stay with the value tilt alongside our quality growth exposures for long term.
Developed Market Equity	+	US stocks still better placed to recover and tilt towards value strategies and lower down the capitalisation scale for better value. Asia expected to be the surprise package for 2021. Europe may catch up as vaccination programmes accelerate, despite fiscal muddle in the EU being a handicap
Emerging Market Equity	N	EM continues to offer attractive valuations compared to other stock markets. A softer US dollar could be a tailwind for EM equities. We favour emerging Asian (particularly South Korea and Taiwan) manufacturers given strong global demand while semiconductor inventories are low.
Commodities	N	We maintain our view on commodities and expect moderate gains as global economic activity normalises. This should support energy prices and increase demand for metals. Inflation concerns and low interest rates are generally supportive of gold prices, which are seen as an inflation hedge
UK Commercial Property	N	Industrial likely to be the best sector this year, and portfolio balance is key with retail and offices likely to be under pressure in the short term. The recent stabilisation and reflationary trend points to recovery, as rental values bottom out and international investors return and drive down yields.
Absolute Return	+ +	The current market dynamics continue to place focus on this basket to provide diversification, reduce portfolio volatility and provide downside protection. We stay with a combination of market neutral and macro strategies to help diversify risk exposure, despite challenging sector dynamics
Cash	N	No significant change to cash weighting as the recent market uncertainties and the future outlook for inflation, interest rate rises and market valuations cause volatility, interrupting the market's one way journey. Cash gives some optionality in the event of further market volatility

LOOKING BACK…

Global equities advanced in Q2 (**FTSE World +6.78%**), supported by the accelerating roll-out of Covid-19 vaccines in most developed economies, especially Europe, which is now catching up with the UK and the US. Emerging economies continued to lag on the vaccination front, but cases remain very low in China and seem to have peaked in India. Growth stocks outperformed Value in a reversal of the recent trend as the quarter ended. Government bond yields were mixed as US 10-year yields fell while yields rose in Europe. Corporate bonds outperformed government bonds and Commodities were the strongest asset class, with energy the leading index component.

The second quarter was strong for US equities, the **S&P 500 +8.17%** reaching a new all-time high in late June. The Federal Reserve (Fed) made no move on rates but indicated that interest rate rises could come in 2023, surprising the market and then leading the Fed to stress it would not tighten monetary policy too quickly. Q1 GDP grew at 6.4% slightly lower than the expected 6.7%. Industrial activity rose strongly with the US composite purchasing managers' index (PMI) moving to 63.9 in June, signalling strong expansion. Inflation was a big story with May's core consumer price index (CPI) inflation rising from 3% to 3.8% - the largest increase since June 1992 – reflecting the reflationary theme. President Biden's $1 trillion infrastructure package fell short of the $2.3 trillion announced in March and failed to address the social safety-net spending proposed in April. Tech giants like Apple, Alphabet and Microsoft made strong gains as IT, energy, communication services and real estate were amongst the strongest areas of the market.

Eurozone shares gained in the quarter, **(FTSE Europe ex UK +5.74%)** reflecting strong corporate earnings and significant improvements in the pace of vaccine roll-out. Many countries saw Covid-19 infections fall allowing loosening of restrictions on social and economic activity. We saw a reversal in the market rotation between growth and value and a mixed group of sectors led gains. Top performing sectors included defensive areas such as consumer staples and real estate, which had lagged in Q1. Information technology was one of the top gainers with utilities and energy laggards. Quarterly earnings were strong, with the exception of the healthcare sector. Economic data showed a strong rebound with the eurozone composite PMI rising to 59.2 in June, its highest level since 2006. Eurozone inflation was estimated at 1.9% in June, down from 2.0% in May. The European Commission signed off on the first of the national recovery plans which will receive funding from the €800 billion Next Generation EU fund. Spain and Portugal were the first countries to have their spending plans approved.

UK equities performed well overall in Q2 **(FTSE All-Share +4.79%)**, although with mixed returns within the broad index. Markets were largely driven by Value stocks during April and May, continuing the trend that started in November post the vaccines announcements. Improving sentiment to global asset allocators being "overweight" UK for the first time since 2014. Small and mid-cap equities outperformed especially those set to benefit from economic recovery domestically and internationally. The UK GDP forecasts were upgraded while the Bank England said it was to slow the pace of quantitative easing. June was a difficult month as Covid-19 infections rose and inflation expectations fell. Defensive large cap equities were in favour in June aided by a weaker sterling vs USD. Healthcare, consumer staples and energy performed well in June, while generally Value or economically sensitive sectors struggled. Falling market interest rates hit financials, which had done well in Q1 as they tend to benefit as rates rise, in this case due to inflationary concerns. Domestically focused areas which had performed very well fell back quite sharply in June, partly due to concerns about the delta variant of Covid-19 on re-opening plans and also the UK government's decision to delay "Freedom Day" when rules were due to be relaxed.

Japanese shares underperformed **(TOPIX -0.53%).** While Japan's infection rate was below most other countries, the government delayed lifting the state of emergency which together with initial slow progress in the vaccine roll-out, damaged the credibility of the Suga administration. Re-imposing the state of emergency in the near term would be politically very difficult ahead of the Olympic games starting on 23 July. The end of May saw an acceleration in vaccinations and Japan can now administer one million vaccinations per day. The May corporate results season saw the majority of companies reporting in line with, or slightly ahead of, consensus expectations, continuing the positive trend seen over the past two quarters. Economic data has been mixed, with Industrial production data weaker than expected, reflecting slowed car production due to the global shortage of semiconductors which has impacted the whole auto supply chain. Despite the rise in global inflation expectations, Japan's data continues to show mild deflation due to short term effects.

Asian markets were positive **(FTSE Asia Pacific ex Japan +3.61%)** as investors expected a return to economic normality. Towards the end of the quarter the resurgence of Covid-19 infections, the delta variant and further lockdowns took the gloss off investor optimism at the same time as US dollar strength also weighed on returns. In addition, the move to a more hawkish tone by the Fed and growing concerns over inflation further weakened investor sentiment. The Philippines was the leading market in the quarter, with Taiwan and India following behind. China and Hong Kong showed modest gains during the quarter. Pakistan, Indonesia and Thailand ended the quarter in negative territory mostly due to regional virus concerns. Healthcare and industrials performed best, while real estate and communication services were weak.

Emerging market equities registered a strong return **(FTSE Emerging +3.30%)** despite a May sell-off as US inflation concerns led investors to question the timing of global monetary policy tightening. Brazil led country returns as Central bank actions to tighten policy in the face of rising inflation, an acceleration in vaccine roll-out, an easing in fiscal concerns and renewed reform progress all boosted sentiment. Currency strength provided a following wind for returns. Poland, Hungary and the Czech Republic did well as economic prospects improved. Higher oil prices aided Russia and Saudi Arabia. Chile and Peru were among the weakest markets in the index, undermined by political uncertainty. China lagged due to regulatory concerns which broadened beyond the technology sector, while South Korea also underperformed.

Government bond markets saw a reversal of the trend seen in Q1 **(FTSE WorldBIG Domestic Sovereign +0.69%).** US Treasury yields fell, with the 10-year falling from 1.74% to 1.47% getting back some of the Q1 losses. The Federal Reserve (Fed) policy meeting in June saw a shift in tone to a more hawkish stance as their "dot plot" projections suggested that interest rates will likely rise earlier than expected giving some insight into their tolerance to an inflation overshoot, thereby undermining the market's belief of infinite policy support. Short term yields rose following the meeting while longer term 10-year yield fell, showing how the market views the direction of US interest rates – increasing faster than previously thought, but flattening for the longer term. European government bonds underperformed, amid growing optimism about the EU recovery and their accelerating vaccination programme. The German 10-year yield rose from -0.29% to -0.20%, France's from just below zero to 0.13%. The Italian 10-year yield rose from 0.67% to 0.82%. The UK 10-year yield fell from 0.85% to 0.72%, retracing some of the sharp rise in the previous quarter.

Corporate bonds performed well, outpacing government bonds. Both global investment grade (**Barclays Global Corporate +2.66%)** and high yield **(Barclays Global High Yield USD +3.06%)** showed strong returns as US investment grade rebounded well following the Q1 declines, helped by falling yields. High yield benefited from the economic recovery and positive fundamentals, including low expected default rates. Emerging market bonds had a strong quarter **(JPM GBI-EM Global Composite +3.63%)**, led by high yield, while EM currencies performed well despite a pullback in June, helping local currency bond issues.

Commodities were the strongest asset class in the second quarter **(Bloomberg Commodity +10.28%)** driven by strong growth in energy prices as the success of the Covid-19 vaccination programs spurred investor optimism for a global economic recovery in 2021. Energy was the best-performing index component, driven by strong performances from crude oil and natural gas as global economic activity ramped up. Brent crude and gasoil also achieved strong gains on the back of higher demand. Industrial metals also did well, with sharply higher prices for aluminium, lead and nickel. Agriculture was positive with sugar and coffee prices sharply higher, and wheat and corn prices rose. Precious metals achieved modest gains, with both gold and silver moving higher.

UK Commercial Property provided pleasing positive returns **(FE UK Property Proxy +2.86**%) as the economic rebound led investors to feel that the market may have bottomed, and large Property funds worked through their liquidity issues.

In the currency markets, recent Sterling strength waned with no significant moves over the quarter **USD -0.01%, EUR+0.84 %, JPY -0.43%** and **RMB +1.47%.**

Please Note: All quoted returns are on a price basis in local currency terms.

LOOKING FORWARD…

*"As we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know" - **Donald Rumsfeld***

Q2 2021 also saw the death of ex Secretary of Defence Donald Rumsfeld, whose famous speech paraphrased above, can always serve as an aphorism for the world of investment. So, in this edition of our quarterly views, we will look at what we know, what we think we know and what we are yet to know…….

One thing we do know is that looked at in isolation, US equities are expensive. Whether measured by the real value of share prices, market capitalisation, Shiller PE, Price to Book ratio, or as a percentage of US household assets, they sit at historic highs. However, in the minds of a vast majority of investors, low yields seem to justify the price extremes. With bond yields at historic lows many traditional valuation metrics add up due to the low yields and their effect on the valuation basis. But if bonds weaken, what does that do to equity valuations? Bond yields drive the discount rate used to value companies over the long term and also for debt-financed share buybacks which have been market drivers in recent years, and any increase in yields puts pressure on both of these. It also reduces the ability of the leveraged fund community to borrow. Consequently, it would be easy to say that it is all about bonds now, and if that is true, then rising inflation is a real threat to markets. But we should also remember that bonds are not just about inflation - in the QE era there are other factors in play.

We also know that the US authorities have responded to the various crises of the last fifty years by adding money to the financial system, so recent actions on the same theme should be no surprise. However, 2020/21 set new records with the increase in the broad money supply (M3) being even greater than the response post the Great Financial Crisis (GFC). The growth in the amount of money in the financial system has been immense, and the huge pressure on the Federal Reserve to support markets has led to a total response of almost 20% of US GDP. To make that even worse, a large part of that stimulus was used in March 2020 to rescue some large investment funds, again sending the message that the Fed has removed moral hazard from the markets. What is unknown is how long this may continue….

The US Treasury enacted a heavily monetized stimulus package that added a further 5% to the broad money supply from the Treasury General Account. However, what is not widely known is that an unintended consequence of the stimulus has been a tidal wave of short-term deposits hitting the US banking system. This has in turn led to banks facing Capital Adequacy and Liquidity Ratio problems making them less willing to lend. The result of this is a partial credit crunch in the corporate sector and consequent low inventory ratios, as companies have insufficient working capital to re-stock, and low stocks allied with high demand means pricing power.

It is known that the pandemic has reduced potential supply, thereby limiting the ability of companies to meet surging demand – or rebuild inventories. We believe that companies will seek to maximize profits by exploiting any pricing power. Rising nominal demand but constrained supply = extraordinary profits and inflation. We are "super bullish" on company profits in the short-term expecting a great earnings season.

Rising inflation is a known, which is acknowledged widely across the market, however what makes it a known unknown, is the actual rate of inflation and how sticky or otherwise it will be.

Our economist Andrew Hunt runs a Demand Pressure Index with a thirty-year-track-record that suggests that the economy is already overheating, and the index sits higher than at any point since 1970. Andrew is fairly confident that this analysis can cope with supply-side shocks, providing relevant info for our analysis (the previous supply shock occurred back in 1973). In 2009 and 2010 post the GFC, while central banks flooded financial markets with liquidity, US inflation was held in check by falling import prices from Asia and elsewhere. Today, Asia is inflating rapidly with export prices at the highest point for over 10 years. We believe that the World Trade Price Environment is profoundly inflationary, as we see signs of inflation returning to the (usually deflationary) Euro Zone and China also has rising inflation courtesy of a massive credit boom.

Earlier this year, the Fed argued that the Phillips Curve was redundant, that growth could come without inflation, and therefore it could run the economy hotter and look through any near-term rise in inflation. But, when growth is synchronized across the economy, the Phillips Curve returns. The Post Covid-19 Recovery will likely be highly synchronized, and recent comment from the Fed suggests that they may not be quite so confident in the death of the Phillips Curve. Nevertheless, they are anchored to their intention to look through what they see as a transitory inflation spike, but we don't know how they might react if their assumptions are wrong.

The US labour market data seems to be suffering some COVID related measurement issues, but anecdotal evidence suggests that there seem to be labour shortages as often as job shortages. If this is the case, then employees may have pricing power in the job market. As a consequence of the information we see, we wonder if inflation expectations really are anchored as the Fed claims, and therefore we are very much less certain about how transitory the inflation spike will prove to be. Looking at inflation data for high frequency purchases (a good indicator of short-term trends) US inflation is running at around 6%, which is far higher than the 3% the market and the Fed thinks is the case. We believe that Inflation is here, is higher than the market believes, and will be sustained for longer unless something happens to contain it in the meantime.

We know that in the "normal" world and typical economic environment, inflation would cause an increase in bond yields, potentially affect the valuation metrics for equities, weakening the argument for equity prices. But this is not a normal environment and there is a profound shortage of US T bonds. The lack of issuance & the Fed's Quantitative Easing (buying up T Bonds) has reduced the outstanding stock of T Bonds and there are also a number of other issues exacerbating this effect. There is a positive carry on a hedged basis for Japanese life companies making T bonds a lucrative trade. The US banking system is also having to buy bonds as the tidal wave of short-term deposits that hit the US banking system has created Capital Adequacy Ratio and Liquidity Ratio problems. In fact, we know that if we take account for the recently historic levels of Reverse Repo Operations (needed to keep interest rates low) there has been such a shortage in financial markets that the Fed has recently shifted to being a net seller of Bonds. This suggests that the Fed is moving into new territory in an attempt to keep yields low.

What is an unknown is what comes next as they try to avoid running out of ammunition? There are rumours that the Fed is considering lifting the limits on Wells Fargo's asset growth imposed post their GFC issues, thereby creating more demand for bonds. This really would be micro-managing the debt markets, but the Fed probably believes that the value of the stock of collateral must be preserved to maintain the complicated dynamics in the US T Bond market and keep yields low.

So, what might this all mean? Inflation has a greater effect on those with lower incomes, so if it is greater than currently thought, Chairman Powell will have to change tack one day if he is to protect the man in the street. But the MMT experiment is consensus across major economies and the "Five Eyes Group" (US, Australia, Canada, NZ and UK) is exerting pressure to continue the policy experiment. One day inflation will force yields higher, but the bond bears may need to exercise patience as in the short term, just like in the late 80's, the micro factors may just outweigh the macro factors and yields may stay artificially low for some time yet, despite rising inflation pressures.

We know that the TGA is finite, so the short-term effect of running it down to provide stimulus will wane and therefore absent other action, monetary tightening will happen. Private credit growth is zero, so help from that angle is unlikely and savings rates are still high. Unless the Fed does more QE in the second half of 2021 than it did in the first, money growth will more than halve and money balances will fall relative to incomes, which is not usually good news for asset prices. However, given the rate of growth currently being experienced, perhaps the Fed merely has to stand still? Could the Fed do nothing and see the heat come out of the overheating economy, miraculously solving their own problem? That is certainly an unknown.

We know that Inflation is likely to create market jitters for the rest of the year, but it will take a lot to shift the central banks away from their current preference for tightening too late, rather than too early. Talk of tapering by the Federal Reserve will no doubt become louder over the summer, but when a reduction in asset purchases might become reality is very difficult to predict. This new, more patient approach from the central banks is risky. A willingness to let the economy run hot provides an environment for a strong near-term rebound. But when the time for rate hikes arrives, will central banks (especially the Fed) have to tighten policy more quickly than the market currently expects? That would be a difficult period for stock markets that often overreact to "surprises". (Hence the Double Take Brothers analogy in last quarters commentary….)

If we look deeper into equity markets, we see a continuation of the Growth versus Value debate as we head into the next quarter. Until the uncertainty caused by the revised interest-rate guidance from the Fed in Q2, value stocks were very much in favour, but a combination of the decline in long-term bond yields and the market's lower inflation expectations after the latest FOMC saw growth stocks outperform. The current argument about growth and value may be clearer once the inflation question is answered. If the surge in inflation is transitory and just a reflection of supply-side bottlenecks caused by the pandemic, then we could well see quality growth stocks perform relatively strongly as they did until the summer of last year. However, should there be a structural shift higher in inflation along with consequential higher wage growth, then we may well see Value take the lead again. We feel that given the uncertainties around inflation and monetary policy; it is best to have a combination of both equity styles. Nevertheless, we maintain a slight preference for quality growth, reflecting our style bias and belief in our managers ability to buy good companies that exhibit strong growth characteristics over the long term and through the economic cycle. Simply, we feel that great companies are great long-term investments whatever the weather.

Looking at the general equity market outlook, we see many unknowns and expect more modest returns in the second half of this year. However, given our bullish view on company profits and that we have yet to see the peak in economic activity and corporate earnings momentum, we feel it is a little too early to become more defensively positioned. That said we do favour inflation protection through Index Linkers and in some portfolios, gold, and commodity exposure. Our Macro Absolute Return managers also balance our equity positions, and we expect them to help us manage downside volatility in the event that inflation, tapering, or rising yields derail markets in the shorter term.

A key part of our global view at present is that the disruptions to the Global Supply System from the pandemic have been both severe and long-lasting. In addition, we fear that there may be further disruptions ahead as a result of the new variants of the virus and the questionable effectiveness of some of the vaccines. However, even without further disruptions and life returns to normal sooner rather than later, we suspect that the backlogs of orders within the global system, component shortages, and low levels of inventory will take several quarters to resolve. This bodes ill for inflation rates over the medium term. Then we must wait to see what central banks do in reaction to this - the greatest unknown.