FPWM
TAILORED FINANCIAL SOLUTIONS

QUARTER 2 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 USD exposure as an ultimate hedge. W continue to look for diversification away from European issues which are in negative rate territory. After sharp yield increases regular bonds are giving more value and balance to portfolios
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	In the US, corporate leverage has fallen but interest coverage for HY is at record lows. European HY has lower leverage and better interest coverage. We expect continued support from the Fed BoE & ECB through at least H1 2021. We stay neutral given tight valuations and weak fundamentals.
Emerging Market Bonds	N	We stay neutral despite signs of reducing liquidity. We favour higher quality EM corporate credit. Local currency sector provides attractive valuation opportunities and, also very select parts of high yield EM sovereign provide real long-term possibilities. USD issues appear to be fully valued
UK Equity	+	Post Brexit, there is 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 but also maintain our underlying quality growth exposures for long term
Developed Market Equity	+	We favour US stocks as they are better placed to recover and tilt towards value strategies and lower down the capitalisation scale for better value. Asia may be the surprise package for 2021 along with Japan, which is well placed to benefit from global trade normalisation. Europe likely to lag
Emerging Market Equity	N	Emerging equities benefit from strong China recovery and offer attractive valuations. The weaker US dollar has supported emerging markets, which are vulnerable to any tightening in monetary conditions or restriction in credit availability. Trade war risks have risen with a Biden Presidency
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. Optimism has reversed the Gold price trend in the short term, but low interest rates are supportive of Gold prices
UK Commercial Property	N	Industrial likely to be the best sector this year, while shopping centre and leisure capital values are likely to fall. Offices are also under pressure in the short term, but recent stabilisation 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 market rise since Q4 with the vaccine news was very rapid. Currently, the market is focussing solely on the reflationary story above all else. Cash gives some optionality in the event of further market volatility, balancing the lack of yield on this basket

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Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements.

LOOKING BACK…

The first quarter of 2021 saw rising bond yields and a continuation of the equity market rally. Investment markets were driven by the Democrat victory in Georgia which cleared the way for a massive further US fiscal stimulus and the success of the vaccine rollout in the US and UK. More economically sensitive value strategies fared well, as did smaller companies. The 10-year US Treasury yield now stands at 1.75%, vs. 0.5% at the low in August and 0.9% at the start of the year. Corporate bonds underperformed government bonds. Commodities gained in line with sentiment, with the energy component boosted by stronger demand.

US equities gained **(S&P 500 +5.77%)**, despite an uncertain start in January due to some highly targeted trading activity surrounding US retailer GameStop, as activist retail investors clubbed together via Reddit to try to beat short selling Hedge Funds, rattling markets. Optimism then recovered strongly due to significant government stimulus. New President Joe Biden confirmed a fiscal stimulus package of $1.9 trillion, and then followed up with an additional promise of $2 trillion in infrastructure spending. Energy, financials and industrials made strong gains, while 2020's winners in Technology and consumer staples lagged the market.

UK equities rose again **(FTSE All-Share +4.29%)** with economically sensitive areas of the market continuing the recovery seen since November, with a very strong performance from materials, energy and financials. Banks performed particularly well as results surprised on the upside, a sharp increase in bond yields promised better margins and the global economic outlook improved. The UK led the world in the vaccine roll-out and domestically focused areas of the market outperformed as the forward-looking data for the UK economy improved in anticipation of the easing lockdown measures after the quarter end. The Purchasing Managers Index (PMI) for the UK (a measure of economic activity) rose in March to 58.9 - the fastest rate of expansion for seven months.

European equities fared well **(FTSE Europe ex UK +7.66%)** as the expectation of global economic recovery supported sectors that fared poorly in 2020, such as energy and financials. Consumer discretionary stocks also performed well, with car maker Volkswagen announcing ambitious electric vehicle targets. Underperformers were defensive areas that are less tied into the economic recovery, such as utilities and real estate. The Eurozone composite PMI for March reached a record high of 62.5, suggesting strong growth. However, as the quarter drew to a close, rising Covid infection rates in some key countries, and new lockdown curbs led to concerns regarding the Eurozone economy and particularly the prospects for services, such as tourism.

Japanese equities continued their rally leading developed markets returns **(TOPIX +8.27%)** over the quarter. Confidence in the corporate profit recovery improved after a strong set of quarterly results helped by the consistent weakness of the yen against the US dollar. As elsewhere, the market was led by cyclical sectors and value style stocks, partly in response to early indications of changes in global interest rates and inflation expectations. It seems increasingly likely that the Tokyo Olympics will take place, although it has been confirmed that it will happen without any international spectators.

The FTSE Asia Pacific ex Japan Index was positive **(+4.03%)** as Asian investors bet on a return to economic normality. Despite this, sentiment weakened towards the end of the quarter due to problems with vaccination rollouts in some countries which led to them reintroducing lockdown restrictions. The best performing markets in the index were Taiwan, where strong gains from IT companies drove the market, and Singapore, where the banks led returns. Conversely, a sharp rise in new cases of coronavirus resulted in tighter restrictions in the Philippines, weighing on the outlook for the services-oriented economy. In China, expectations for policy normalisation, regulatory uncertainty for certain industries, and ongoing geopolitical concerns somewhat dampened sentiment over the quarter.

Emerging market equities had a positive quarter **(FTSE Emerging +3.75%)** despite weakness later in the quarter as EM vaccine programmes lagged those in many developed countries, and their equity markets followed suit. Increases in new cases of Covid-19 led to renewed activity restrictions in some countries. At the same time, the increase in US Treasury bond yields affected higher growth areas of the equity markets and accompanying US dollar strength was also a headwind for EM economies that need USD to fund their growth. Chile was the best-performing country in the EM universe due to a strong copper price, and a good start to its vaccination programme. Turkey was the weakest index constituent, as the unexpected departure of the head of the central bank led to a sharp fall, while Brazil and China also finished in negative territory.

A combination of the swift rollout of Covid-19 vaccinations - particularly in the US and UK - and expectations of a large US economic stimulus led to a significant rise in Bond yields **(FTSE WorldBIG Domestic Sovereign -6.55%)**. Q1 2021 was the second worst quarter since 1980 for US Treasuries, with the 10-year US Treasury yield moving from 0.91% to 1.74%. As the 2-year yield rose modestly, the yield curve steepened quite significantly, indicating the markets rising growth expectations. Other bond markets also saw large moves, with the UK 10-year yield increasing by 0.65% to 0.88%. In Europe, where the vaccination programme is slower than the US and UK, the German 10-year yield increased from -0.57% to -0.33%, Italy's 10-year yield rose from 0.52% to 0.63% reflecting political uncertainty and Spanish 10-year yields rose from 0.06% to 0.34%.

Corporate bonds marginally underperformed government bonds, firmly in negative territory. Investment grade struggled **(Barclays Global Aggregate Corporates -4.25%)** and the US dollar market in particular as yields rose. High yield fared better **(Barclays Global High Yield USD -0.95%)** but were still below water amid healthy risk appetite and rising growth expectations. Emerging Market bond brought up the rear as US yields rose **(JPM GBI-EM Global Composite -5.08%)** creating a headwind they struggled with.

Commodities rallied strongly **(Bloomberg Commodity +6.92%)** as the global vaccine roll-out fed investor optimism for economic recovery and demand for commodities, despite a stronger US dollar. Energy was the best-performer, driven by good returns from unleaded gasoline and Brent crude due to higher demand and continuing controls on supply. Industrial metals also rose strongly, led by good gains for aluminium and copper. The agricultural sector also provided positive returns with robust gains for corn and soybeans. The precious metals component of the index was weak, with sharp declines in both silver and gold.

UK Commercial Property returns were solid after a difficult period **(FE UK Property Proxy +1.74**%) and the hopes for normalisation of the economy buoyed prices.

Sterling was strong against all other major currencies reducing the returns from foreign unhedged assets with **USD -1.08%, EUR -4.93%, JPY -7.62%** and **RMB -1.42%.**

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

LOOKING FORWARD…

"Optimism is highly valued, socially and in the market; people and firms reward the providers of dangerously misleading information more than they reward truth tellers. One of the lessons of the financial crisis that led to the Great Recession is that there are periods in which competition, among experts and among organizations, creates powerful forces that favour a collective blindness to risk and uncertainty." — ***Daniel Kahneman***

It would be tempting to conclude that with vaccination programmes increasing, massive government and central bank stimulus, easy monetary conditions and consumers in their starting blocks ready to spend, spend, spend, everything in the garden is rosy and equity markets will continue onwards and upwards. Commentary done, excellent. But where would the fun be in that?

On the surface it is a simple story. The US economy is recovering and should gain momentum as the stimulus measures have full effect and as mobility recovers. China's economy finished 2020 growing rapidly and there are hopes that this will continue. Europe should manage a belated recovery once the 'third wave' dissipates and the vaccine roll-out accelerates. Superficially, the world looks set for a 'strong' 2021-22. So surely, we should just sell bonds, buy the USD and cyclicals?

At the risk of misjudging the commentary's distribution list demographic, it is at times like this in market cycles, that I am reminded of comedian Harry Enfield's recurring characters – The Double-Take Brothers. These two gormless characters had an irritating propensity for double takes whenever the unexpected occurred, which was always something obvious to everyone else. When equity markets are at a point of maximum bullishness they can be seen to act in a similar way, bowling on regardless of background risks until suddenly they become aware of these risks and then often overreact creating greater volatility as a result.

If we look at the performance of the US stock market it shows ongoing optimism among investors. New all-time highs have been reached in the S&P 500, Dow Jones Industrials, Nasdaq 100 and Dow Jones Transportations indices. Various sentiment and market indicators point to a very high degree of bullishness and possibly excessive bullish complacency reminiscent of the conditions seen in the run-up to the melt-up tops in early 2018 and early 2020. For example, the trade-futures.com Daily Sentiment Index recently saw 90% of those surveyed as S&P 500 bulls and the proportion of equities in total US household assets has now surpassed the 'dotcom bubble' peak and risen to record-highs. We are always wary when there is very high bullish consensus as it is often a warning signal that could indicate that the US stock market has gone too far and that in the near-term is vulnerable to a pullback or even a larger correction. The market sometimes acts just like the Double Take Brothers……….

Of all the major economies, the US and the UK are far ahead of the rest with their vaccination programmes. We will see whether Europe will catch up quickly, despite the setbacks surrounding the AstraZeneca and Johnson & Johnson vaccines. Europe and the UK relied heavily on AstraZeneca in their strategy, while Anthony Fauci of the CDC has said that the US is doing so well with other vaccines it may not even need AstraZeneca. Vaccine nationalism could play big role in politics and markets if supply threatens to be jeopardised, worsening the climate in international relations. China and Russia hoped to make geopolitical progress by drawing other countries into their camp with large-scale exports of vaccines. But there are growing doubts about the effectiveness of Chinese vaccines, and the leading Russian vaccine uses the same technology as AstraZeneca and Johnson & Johnson and is likely to suffer similar blood clot stories. It therefore seems doubtful that Chinese and Russian vaccination diplomacy will be as successful as many initially believed. The divergence in progress between the US and 'the rest' is likely to continue with Europe and Asia suffering in comparison with North America. This may mean that the performance of European shares could disappoint, unless poorer prospects in terms of COVID and the economy result in a more dovish ECB, creating even more surplus money to flow to the European stock markets. Conversely, a weaker euro could boost stocks that depend on exports outside Europe.

We feel the most likely scenario is that the US stays ahead in terms of economic recovery, with Europe lagging several quarters behind. Many emerging markets will also lag further behind, as they have generally bet heavily on AstraZeneca and Johnson & Johnson, and there is increasing scepticism in many emerging market countries with regard to vaccines, and concerns that the West is keeping the best vaccines to itself, dumping second-rate vaccines on the rest.

Once it has largely completed its own vaccination programme by early summer the US could conceivably act as the world's lifesaver by exporting or giving away vast amounts of vaccines. While in the short term, this is unlikely to provide a great deal of additional stimulus for the US economy they would benefit if the global economy returned to full speed sooner with help from the US. This success in vaccination diplomacy would help in the battle with China for world leadership in the decades to come.

Which leads us to the new Cold War. In this time of COVID it is easy to forget the geopolitical conflict which is likely to shape at least the first half of this century: that between the superpower America that has dominated the last 70+ years and challenger China. This is a recurring theme for us, and it seems that that the barricades have been raised even higher in recent weeks. China is increasingly challenging Taiwan with military flight movements close to the island, which maintains close ties with Washington. In recent years, Hong Kong has increasingly come under Beijing's control, and now China has set its sights on Taiwan. These tensions will increase rather than decrease in the coming years, and according to military experts, China already has the maritime upper hand over the US in the region, meaning that Beijing is likely to win a short war. If the US were to subsequently deploy all its military might plus alliances, China would probably lose, but it remains to be seen whether a US that still remembers Vietnam, would be willing to do so to assist a remote island. However, this is an island that is essential in terms of guaranteeing open sea routes and the production of computer chips. There are numerous points of contention between Beijing and Washington, the battle for economic and technological leadership, competition for the favour of African and Latin American countries, cyber espionage and the human rights situation in Xinjiang. US President Biden has already demonstrated that he does not treat China with kid gloves, and Beijing is very unlikely to do much to change its assertive approach.

For both sides, any escalation in Cold War tensions will have an economic cost but there is an assumption that for China these could easily be mitigated through domestic policy actions, such as an easier fiscal stance or a further easing of monetary policy. However, providing any form of monetary or fiscal stimulus to the domestic economy means raising the amount of money in the economy, and by association further increasing the level of excess money balances within the economy. Over the last 5 years, China has witnessed a sharp build-up in excess money balances, which our economist believes may now be the equivalent of 17% of the broad money supply, or an astounding 20% of nominal GDP. Clearly, if the

population decided to spend these excess money balances, the impact on nominal growth and therefore domestic inflation would be extreme. We suspect that Beijing would not wish to see the return of higher inflation in the country – and neither would the West.

One of the risks to markets is that the return of inflation could force a change the Fed's stance and it is worth considering whether despite the recent dialogue, will the Powell Fed preside over tighter monetary conditions?

The US policy response to the Great Financial Crisis (GFC) in 2008 was a heavily monetised fiscal transfer from the public sector to the private sector and mostly banks and financial companies. The money was then used to repay debt, rebuild bank's balance sheets, invested to inflate asset prices, or it was exported. Hence, there was never a 'glut' of dollars (or EUR) following the Post GFC policy responses as the transmission mechanism into the real economy did not function. The rich got richer, and the rest largely trod water.

In 2020's response to the COVID crisis, the private sector hoarded the transfers that they received – and even augmented them via a new leg to the domestic credit boom. There is now a glut of dollars. Further, the US Treasury has announced a heavily monetized stimulus package that may have added a further 6% to the broad money supply via a reduction in the Treasury General Account (TGA) – the US Governments "current account". In 2009 and 2010, US inflation was also held in check by falling import prices from Asia and elsewhere. There was domestic inflation during much of the early 2010s, but it was obscured by stable or at times falling goods prices, which meant the composite inflation indices looked benign. The effect of the Pandemic has been to reduce potential supply as well as current demand as production was affected and people stayed at home unable to spend as normal. As the population becomes mobile again in the second half of the year, we expect a strong rise in profits but the creation of a 4-5% of GDP positive output gap – meaning demand outstrips supply which is an environment for price inflation.

The Fed meanwhile argues that the Phillips Curve is dead - that economic growth is not inflationary - so it can run the economy hotter and look through any near term rise in inflation. But we think that when growth is synchronized across the economy, the Phillips Curve returns, and the Post Covid-19 recovery is very likely to be highly synchronized. In the very near term, the objective inflation data may be well-behaved, even if the subjective data looks awful and the US is looking at the highest inflationary pressure for a decade. The Fed is keen to maintain its credibility after creating so much money, so Q2 may still see no changes to the policy narrative. But there are other ways in which the financial conditions can tighten.

As a result of the regulatory reaction to the GFC, the financial system has become heavily regulated and ever more dependent on collateral in its day-to-day operations. As a result, credit growth is now subject to many more possible constraints, which for the purpose of this commentary are worth considering. At the time of writing post the injection from the TGA, there is sufficient money in the economy, but it seems like the TGA drawdown is pausing. Bank Leverage Ratios are healthy and, on the surface, not a problem, but in reality, the banks' internal rules are now more constraining than the official regulations as the largest US banks are wary of becoming like the large utility-like Japanese banks. There are effectively 5 major US banks that serve as the transmission mechanism for the US system, and they seem wary of increasing their assets as this puts pressure on their capital to asset ratios. As they grow their profit margins decrease and as they seem motivated to do stock buybacks to inflate their share prices (senior management hold massive share options), this is a potential problem, which will get worse as the TGA declines and the banks' deposit bases inflate. It is starting to become clear that the trillion-dollar question, is whether borrowers have sufficient collateral to pacify the banks' risk & compliance departments - something that is dependent on the trajectory of bond prices. As so much of the high-grade government bond stock has been bought by governments to fuel liquidity, there is a limited pool of assets which are acceptable as collateral for intra-bank lending. During 2020 the volume of bonds available decreased by $350 billion but prices increased by circa 15%, meaning there was a 10-12% increase in the collateral base so everything in the garden was rosy. However, this year it has reversed and $50 billion of T bonds have been absorbed by the public sector while rising yields mean prices are lower, creating a decline in the Collateral Base which is key to intra-system credit This has led to some recent "blow ups" in leverage land, the largest of which was Archegos Capital - are there more to come?

Last month the TGA influx succeeded in raising liquidity in the markets and even the broader money supply as measured by M2. But, as previously mentioned it looks like the TGA drawdown is pausing, which may mean that despite Chairman Powell's wishes the amount of money in the economy may weaken in the near term and we may already be seeing the global liquidity tide ebb away. This is usually a poor environment for the Emerging Markets - when the US sneezes, the rest of the world gets a cold.

However, as the US economy is set for rapid nominal growth, has very liquid corporates and low household debt ratios, it may be well placed to weather any tightening in monetary conditions as credit availability is less of an issue. It seems that value stocks and small and mid-cap stocks may be a productive hunting ground for stock-pickers. We will avoid countries with high debt ratios and weak balance of payments, as a tightening phase is not the time to have a weak balance of payments.

If global credit conditions harden and credit becomes more difficult to access, will this accelerate the change in the Asian economic model from maximizing employment & output to increasing profits & cash flow? This is a theme that we have touched on in previous commentaries and was seen in Japan following the bursting of their bubble and were it repeated in Asian economies, it would be bullish for Asia over the long term but bad news for Western consumers as it would import inflation to the West. This is one reason why we are concerned that western inflation may surprise on the upside. The absence of goods price inflation post the GFC was a reason that QE was not inflationary, but if Asia changes its approach, stable or falling goods prices will not then balance service inflation in the west.

The UK Pandemic Response has preserved the economy's supply potential rather than supporting demand, so in contrast to the situation in the US, the UK has a significant negative output gap with supply exceeding demand. On the positive side, this means that the UK can accommodate a Post Covid-19 bounce without inflation. If GBP stays stable or even strengthens, the UK could look forward to years of low inflation growth ahead. However, to drive that we would have needed a big reforming budget that supported long term policy credibility, which at this point is not in place. It is clear that the UK has an immense opportunity for non-inflationary growth but without government action it will once again snatch defeat from the arms of victory.

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