Investment Review

Q1 2021

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Contents

1. Summary

The first quarter of 2021 has been mixed for investors, as global stock markets put in a strong performance but government and corporate bonds lost value as a result of rising market yields.

• Europe, UK and US stock markets continue to make progress each rising over 5% (in pounds).

• Government bond values fall 7% as market yields rise toward 0.8% pa.

• Investor confidence grows as vaccine roll outs continue and pent up consumer and business demand set to be unleashed.

• Growing inflation concerns mount as commodity prices soar.

Investors will recall that the trough of the market in 2020 occurred towards the end of March. On a 12-month view that data has now fallen out of the performance tables, uncovering the extent of the recovery that took place from 1st April 2020 to 31st March 2021 - the US S&P500 for example returned 46%!

With hindsight what a fantastic time to invest but from a behavioural standpoint it would have been an extremely difficult decision given the uncertainty present with the onset of the pandemic and the world economy closing down.

In order to target acceptable risk adjusted returns going forward, investors are having to consider increasing allocations to growth assets (shares) within a traditionally diversified portfolio given the low returns on offer from fixed interest and fund flow data seems to demonstrate that investors are voting with their feet.

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- This investment review contains information and opinion and does not constitute advice.
- The information is provided in good faith and is believed to be accurate, but as some data is provided by third parties this can not be guaranteed.
- Past returns should not be seen as predictors of future returns.

2. Market Performance (Year to Date)

Asset Class	Index	Q1 2021	1/4/20 - 31/3/21
European Shares	Euro STOXX 50	5.3%	44.5%
UK Shares	FTSE All Share	5.2%	31.6%
North America Shares	S&P 500	5.1%	46.6%
World Shares	FTSE World ex UK	4.0%	46.7%
Asia Pacific Shares	MSCI AC Asia Pacific ex Japan	1.8%	45.0%
UK Commercial Property	FE UK Property Proxy	1.7%	1.2%
Emerging Market Shares	MSCI Emerging Markets	1.3%	46.3%
Japanese Shares	TSE TOPIX	1.0%	28.4%
Corporate Bonds	Bloomberg Barclays Sterling Aggregate Corporate	-4.7%	8.8%
UK Gilts	Bloomberg Barclays Sterling Gilts	-7.4%	-6.5%
Gold	S&P GSCI Gold Spot	-10.6%	-5.7%

Fixed Interest

Fixed interest investors have become used to seeing the value of their government (gilt) and corporate bond holdings increase, providing a tailwind to portfolios. This has largely been due to the reduction of interest rates increasing the value of the income stream from existing investments. This quarter has however been challenging, with rising rate expectations causing a loss of capital value, with gilts -7.4% and corporate bonds -4.6%. There are reasons to believe that further loss of value may be limited (see below).

UK Shares

UK stock markets started 2021 on the front foot with the FTSE All Share rising +5.1%. This follows on from improved performance towards the end of last year with a growing feeling that the UK economy is ahead of the pack thanks to the vaccine roll out. Those sectors that held back the index last year are recovering strongly with metals & mining +24%, banks +16% and oil & gas +11% over the quarter, all of which are sensitive to higher global economic activity. The UK market remains relatively attractive from a valuation perspective.

Global Shares

European shares led the global sector +5.3%, narrowly beating North America +5% in pounds. Performance in euros was even stronger +10% but currency movements saw the pound rally 4% v the euro. The European Central Bank (ECB) has pledged continued support to ensure that market interest rates remain low, as the risks to sluggish growth are high due to structural issues within the bloc and poor vaccine distribution meaning a third wave of COVID is imminent.

North America remains strong as new President Biden announced an enormous $1.9trn stimulus plan which The Economist notes will bring spending to $3trn or 14% of pre-crisis GDP since he took office[1]. Following this is an additional $2trn infrastructure spending plan, from which the impact on business activity will be vast.

[1] The Economist March 13th 2021 'Biden's big gamble'.

Property

An extension to the stamp duty holiday and a new mortgage guarantee scheme has continued to buoy residential housing market activity. According to the Halifax, average house prices are now +6.5% higher than in March 2020 at £254,606, with a continued shortage of properties as ever a major support[2]. The jury remains out on commercial property for now until economic activity picks up.

Alternative

The relative performance of precious metals to industrial commodities has been interesting indicating that we are poised for strong economic expansion. Gold has lost -10.6% this quarter as bond yields rise and investors become more confident in the prospect for other assets. Meanwhile, the price of copper has risen +11% and Brent oil is up by +24% to $63 a barrel this quarter given the improving demand outlook (having traded below $20 in April 2020 when nobody wanted, or in fact could take, immediate delivery of oil due to storage issues!).

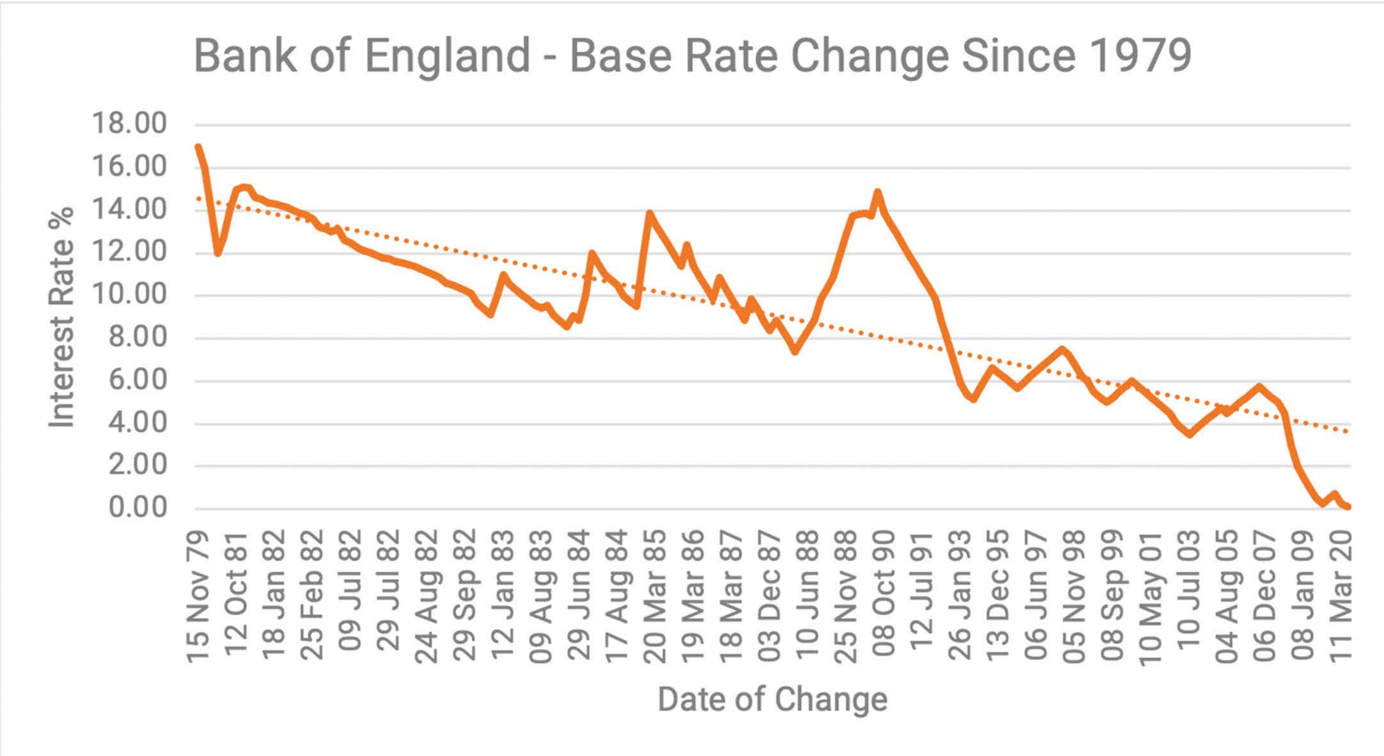
[2] https://www.halifax.co.uk/assets/pdf/march-2021-house-price-index.pdf

3. Fixed Interest in a Rising Rate Environment

As is often the case, the turn of the year can signal a change in trend for asset classes as market participants review portfolio positioning. Furthermore, the year end offered the finale to the market moving events of the US election and UK withdrawal from the EU, which led to increased investor confidence.

What we have seen, as noted above, is that fixed interest investments have fallen in value over the quarter with corresponding income yields rising. The yield on the 10-year UK gilt hit a low of 0.06% pa back in August 2020 so effectively you would have earned next to nothing lending the government money over the next 10 years. At the time of writing the yield has risen to 0.8% pa, which although still low is a significant rise.

This rise does not reflect any official movement in interest rates (the Bank of England rate is still 0.1%) rather an expectation from the market of where rates will be in the future. It is sign of confidence that economic growth lies ahead as we return to higher levels of activity and with better times comes a renewed consideration of inflation, for which investors will require higher returns to compensate.



The peculiarity of the current market backdrop of low interest rates with rising inflation expectations leads to a position where 'real' yields (returns after inflation) have the potential to be negative. For the private investor this is not an attractive position, so care needs to be taken as to which bond investments to hold.

3. Fixed Interest in a Rising Rate Environment cont.

For heavily indebted governments however the prospect of rising inflation with continued low interest rates is attractive as the size of the economy increases relative to the outstanding debt, making the debt issue less acute, whilst the cost of servicing remains low. Central banks across the world have indicated new policies that permit a more flexible approach to inflation, whilst also continuing to act to hold down market interest rates, so it is clear that this is the desired path. CPI inflation is currently running at 0.7% pa[3] but it is likely to trend higher in the near term as commodity input prices have soared.

Despite the wobble this year, we are not suggesting it is a given that fixed interest values are going to continue to fall, as interest rates will be held lower for longer by design. We adopt an active approach to our fixed interest allocation and our fund managers have levers they can pull to navigate a rising rate environment. Through the buying and selling of individual investments they can adjust the portfolio duration (the length of time before capital repayment) and look to specific sectors and companies with each action having the result of altering the sensitivity of bond values to the environment. In addition, as shorter-term bonds mature, the capital received is rolled over into new investments at potentially higher yields. Though a more challenging time right now, we believe bonds still have a role to play in portfolio construction.

[3] www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/february2021

4. Return of the Value Investor

A further trend that has emerged, albeit over a short time frame, is the return of investor interest in so called 'value' companies. In our Q3 2020 newsletter we highlighted the focus on 'growth' companies and the significant relative outperformance that has taken place over the past few years, leaving the gap between the two investor styles at the widest since the dot com bubble in 2000.

Market factors like these can establish themselves for a reasonable period of time but are not permanent and since November, following the vaccine announcements, the market shifted towards value, quietly at first, but with far more coverage recently. The value factor tends to cover economically sensitive sectors such as banks and energy, which are expected to perform well when economic activity is expanding. This idea of a reflation trade has taken hold and been dubbed the 'great rotation' with the MSCI World Value index outperforming MSCI World Growth by 14% in the six months to the quarter end as shown below:

5. Looking Forward

It is probable that stock markets, allowing for the unforeseen, will continue to make progress this year. North America, in particular, has a huge amount of demand set to be unleashed, which should support company earnings and therefore market valuations, which are deemed to be relatively high.

Equity funds saw record net investor inflows of £2.96bn in March, surpassing the April 2020 post-crisis bounce[4], which represents high conviction from investors that this is the asset class of choice given the current economic backdrop. That said, bonds do have a stabilising effect and we do not expect global central banks to allow market interest rates to climb too high, so loss of capital value should be limited.

[4] www.calastone.com - March Fund Flow Index

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- Understand and manage risk
- Get the "investment recipe" right
- Avoid market timing
- Fear inflation
- Manage tax and costs
- Process is paramount

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