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INVESTMENT OUTLOOK

Equities made further gains in the first quarter with the UK performing well but government bond markets sold off sharply. Rising inflation concern explained the rise in bond yields while the continuing success of the vaccination rollout, especially in the US and UK, boosted equity sentiment as evidence mounts of a significant economic recovery this year. Fiscal policy continues to be supportive with President Biden proposing not one but three expansionary bills to Congress.

Equity markets are now also beginning to notice the rising inflation numbers and have paused their rally as they begin to anticipate the response of the central banks to a higher inflation environment. While the rally continued into April, May has seen headwinds and it may be that we are about to enter the consolidation phase I argued last quarter was overdue. Certainly, technology stocks have corrected markedly with the running taken up by more cyclical value stocks.

The bigger picture though is, barring setbacks through new Covid variants, that confidence is returning to consumers and business and a sharp recovery in economic activity started in March This has sufficient traction that the BoE has raised its forecast to 7.25% GNP growth this year. While markets may have discounted this to a large extent, they should hold on to current levels or better during the year even if central banks take the first steps to tighten monetary policy.

ECONOMY

The $1.9mn US fiscal support package is probably more than the economy needs when the recovery is under way, but Biden has also proposed two additional five-year programmes of infrastructure spending and of social welfare spending which may struggle in Congress. The Federal Reserve has said it will tolerate inflation rising temporarily over its 2% target, but the latest inflation number jumped up to a disturbing 4%., partly driven by higher energy prices. With rising consumer demand and the prospect of some supply shortages, much will depend on how much slack there is in the labour market as to whether wages will respond to higher prices and lock in higher inflation levels. With China factory gate prices rising, it is easy to see why the US bond market has sold off.

This debate is at a less advanced stage in the UK though the latest inflation number popped up to 1.5%, ahead of expectations. With activity rising in March, Q1 GNP fell only 1.5%, a far better response than a year ago when the economy fell over 15% during the first lockdown. Manufacturing and construction are leading the way with services still struggling though as retail reopens that should improve. Growth is expected between 3-4% for the current quarter. Supply shortages and signs of incipient wage inflation are now putting pressure on consumer prices. Inflation should reach 2.5% before the end of the year but that is unlikely to lead to monetary tightening this year. Instead, the BoE may not complete the full amount of QE it promised. Looking into next year, it is more likely to start reversing QE by selling gilts than to increase interest rates. The March budget continued the support measures, but these will begin to taper off and the overall budget deficit will be lower than last year. The BoE's more optimistic forecast now puts the UK recovery ahead of other countries, but we start from a lower base of course. Brexit had clearly a dampening effect in Q1 through exports, but the impact has been eclipsed by Covid effects.

Elsewhere, the EU economies are expected to grow some 4% this year and next, helped by an EU long term fiscal support package over five years, equivalent to 5% GNP, modest compared to the US 9% stimulus! More limited vaccination success and intermittent lockdowns have impacted the recovery. In contrast, China is expected to grow 6% last year after last year's flat performance, still better than developed countries.

Finally, a word on currencies. In the last report, I commented on the weakness of the dollar which had helped sterling to recover to 1.40. The dollar is now recovering on the back of economic recovery and associated concerns over monetary tightening which would be dollar supportive. Sterling has held up pretty well, but the yen and euro have weakened.

MARKETS

Global equity markets in sterling terms rose 4% in Q1 and were 40% up on the depressed levels of a year ago, indicating the strength of the rally. The UK equivalent figures are 5% and 26% respectively so the UK is still well behind despite some recent catch up. The US and emerging markets have led the way while Europe and Japan have also lagged. In the UK, small and mid- cap stocks have strongly outperformed over both time periods. In terms of sector composition, Q1 saw technology stocks fall off sharply while resource stocks led the way, like energy and commodities. Banks have also staged a recovery on the back of rising interest rates. In style terms, this has meant that the dominance of growth stocks both before and during the pandemic is now being challenged by the revival in more cyclical value stocks as the business cycle begins to turn upwards.

While the year-end momentum carried on through the first quarter and indeed April, markets are now consolidating. Both the US and UK were up around 10% to mid-May so a pause is understandable and the FTSE 100 index is clinging on to the 7000level. Many new issues confirm the recovery in investor confidence though some have proved overpriced at issue. Markets were driven by fiscal support and vaccine success but are now considering the inflation news and possible policy response. There is an age-old debate as to whether inflation is good for equities, but the evidence is very mixed. Modest increases which allow companies to pass on cost increases and raise margins is supportive. A wage price spiral which leads to policy tightening is not however as both bonds and equities sell off after a lag. Given that

central banks appear to be looking through the current inflation numbers, markets should hold on to recent gains though they may become more volatile after such a long uptrend.

Bond markets are a different matter. There has been a very sharp rise in yields with 20-year gilt yields rising from 0.7% to 1.4% during Q1, a level they are maintaining. Implied inflation has risen from 3.3% to 3.6% so real yields have risen by 0.3% in consequence. Long dated gilts and index linked stocks have fallen 12% and 8% respectively during the quarter. Corporate bonds have also fallen in Q1, but credit spreads have remained unchanged suggesting markets are relaxed about bankruptcy risk as a consequence of the pandemic.

Property values have appeared to stabilise with prices rising some 1% in Q1, the second quarter running. Industrial property remains very popular and there are signs that the office market is beginning to bottom out. With a resumption of shopping, hopefully the same will be true soon of retail and areas like hospitality though the number of retail bankruptcies casts a shadow over the sector. It will not be until later in the year that we have proper visibility about the strength of any recovery in the overall property market.

INVESTMENT STRATEGY

The portfolio should now be broadly aligned with the agreed investment strategy following the major restructuring of the global equity portfolio in the first quarter. Any further changes would be relatively marginal, such as trimming the corporate bond portfolio or property. The strong market rally should have helped the funding ratio recover from its setback of a year ago. Similarly, the LDI portfolio has recovered all the losses of 2019 and Q1 2020 when the RPI wedge issue became a threat to the inflation hedging strategy. Not only has the market not adjusted for the full removal of the wedge but the recent rise in inflation concern has increased the value of the hedges. Hedging remains at around 30% of inflation risk and leverage has dropped markedly allowing for some increase in the hedge to be possible without more collateral.

FOR FURTHER INFORMATION

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