

Investment update



With the global economy set for its fastest recovery in 80 years, we're maintaining our positive position in equity to benefit from the improving backdrop.

Investment outlook

While the economic outlook is improving, the shape of the recovery will depend on the Delta variant and how this affects the emergence from lockdowns. If cases continue to surge, the brightening economic outlook risks being undermined by rising infection levels and the reintroduction of social restrictions.

Commodity prices have risen significantly this year, driven by accelerating economic activity as lockdowns ease, so it is little surprise inflation rose in the second quarter, particularly given the comparison to the economic freeze of 2020. We are also seeing a number of supply bottlenecks caused primarily by Covid-related disruption, but not helped by events such as the Suez Canal blockage. This is causing a shortage of goods, which is adding to inflationary pressures.

The Federal Reserve (Fed) has raised its forecast for inflation to 3.4% by the end of this year, up from 2.4% in its previous projection in March. While Fed officials had predicted that current rates would be maintained until 2024, the consensus has now shifted, with two rate increases expected in 2023. The move acted as a catalyst for a reversal in those asset prices that have been rising on the expectations of higher inflationary levels, such as some commodities and more cyclically exposed sectors of the equity market. The consensus among economists and central banks remains that these inflationary pressures will probably prove to be transitory.

Technology was the strongest sector globally in June, followed by energy and healthcare. The worst performers in June were financials and materials. While the tech sector lagged during the first half of the year, tech stocks have surged higher with the change in the growth and interest rate outlook.

As a result, the Nasdaq recorded growth of 5.5% in local currency terms in June, boosted by a rally in the giga-cap companies including Apple, Alphabet and Microsoft. This compares to the FTSE All Share Index, which recorded a rise of 0.2%. The copper price fell by 7.9% as economic growth expectations declined. Meanwhile, the oil price rose by 8.4% in the month as OPEC failed to reach an agreement that would increase supply.

The speed of US monetary policy tightening relies to an extent on how fast the economy returns to full employment. While hiring is picking up in the US as the lockdown eases, the lingering effects of the pandemic are keeping many potential workers out of the labour market. Although another 850,000 jobs were created in the US, the largest monthly increase since last August, employment is still well below the pre-pandemic level.

China's economic growth is beginning to lose steam after reducing its pandemic stimulus measures since returning to full employment. Alongside this has been a tightening of its monetary and regulatory policy, which has seen the Chinese market lag. Leading tech names have also fallen in value following a regulatory backlash, most recently against Didi Chuxing, the leading ride-hailing company and app.

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Our positioning

Our investment strategy and outlook remain unchanged from June. Strong performance in July meant our equity weighting rose slightly, but we are content to maintain our positions for the time being, reflecting the ongoing strength in corporate and consumer confidence and the view that the economic recovery looks well embedded over the next 12 months. This should support both a recovery in earnings and ongoing momentum in equity prices, although we think increases over the next six months will be more modest than in the first half of 2021.

Periods of sharply rising inflation tend to be bad for all asset classes in the short term. However, equities can continue to make progress if inflation settles at a higher level than it was pre-pandemic as many companies have the ability to price on pass on increased costs to consumers in higher prices.

For any long-term investor, bonds look to offer few attractions from a return-seeking basis, particularly after adjusting for inflation. Government bonds in the US and UK still offer some protective characteristics and a positive nominal return, providing some insulation against external shocks and unforeseen risks.

We see few benefits of investing in investment grade credit, which offers little yield pick-up to justify the additional risk over government bonds. The yield on US high yield bonds has now fallen below 5% and is negative after adjusting for inflation. Although this situation may persist given the benign environment, it looks an unattractive prospect given the current and past risks involved with this asset class.

The economic recovery will likely peak this summer and then begin to slow in the second half of the year but should remain in positive territory. This transitional period is likely to be characterised by some mixed signals and volatile data, which could prove challenging for assets. However, the biggest risk remains the further spread of the Delta and other variants of Covid, which could force further economic and social restrictions.

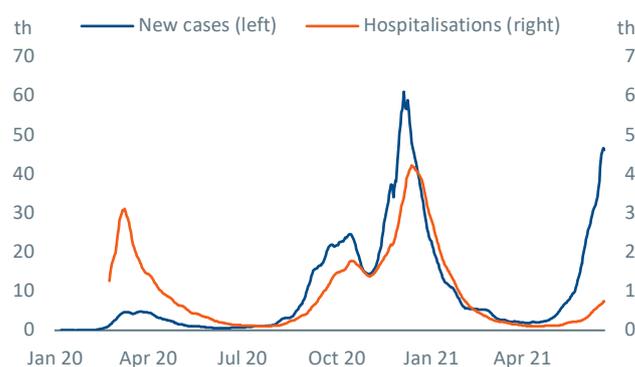
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Figure 1: The summer wave



Source: ourworldindata.org

Although new infections of Covid-19 are rising rapidly in the UK, the number of people being admitted to hospital is holding steady (thousands, 7-day moving averages).