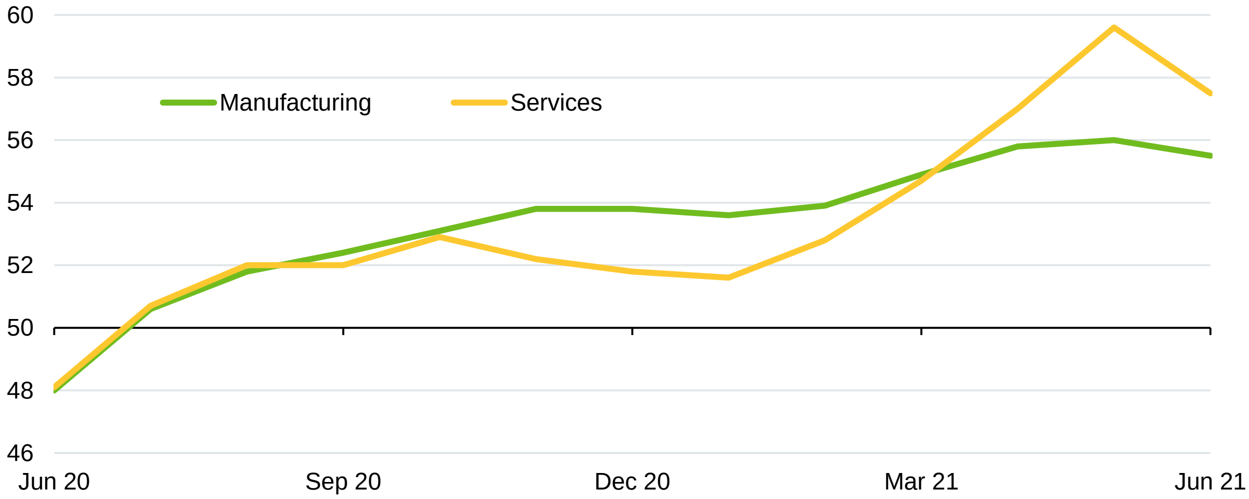
Capital Markets Update

Summer 2021

As vaccination campaigns continue at pace, and economies reopen, growth and inflation have surprised to the upside. Equities have risen and credit spreads have fallen, in line with the improving fundamental backdrop. However, sovereign bond yields have fallen, as bond investors perhaps sense an easing of recent momentum.

Economic data have outperformed expectations, and business surveys, which remain near multi-year highs, indicate the recovery has spread from manufacturing to services (Chart 1). The future output indices are still rising, European growth is yet to reach its peak and the consumer services PMI is also still rising. Global COVID-19 cases are rising once more but remain well below the level recorded during the most recent peak in April this year. Vaccination programmes continue at pace in the major advanced economies, which should benefit from the easing of lockdown restrictions in the coming months. Global growth forecasts have been revised upwards and are for output to expand by 5.9% in 2021 and 4.4% in 2022. Recent upgrades see output in many advanced economies reaching pre-pandemic levels by the end of 2021, much faster than previously thought. Indeed, forecasts of the level of US output at the end of next year are now higher than they were before the pandemic.

Chart 1: Global Purchasing Managers' Indices

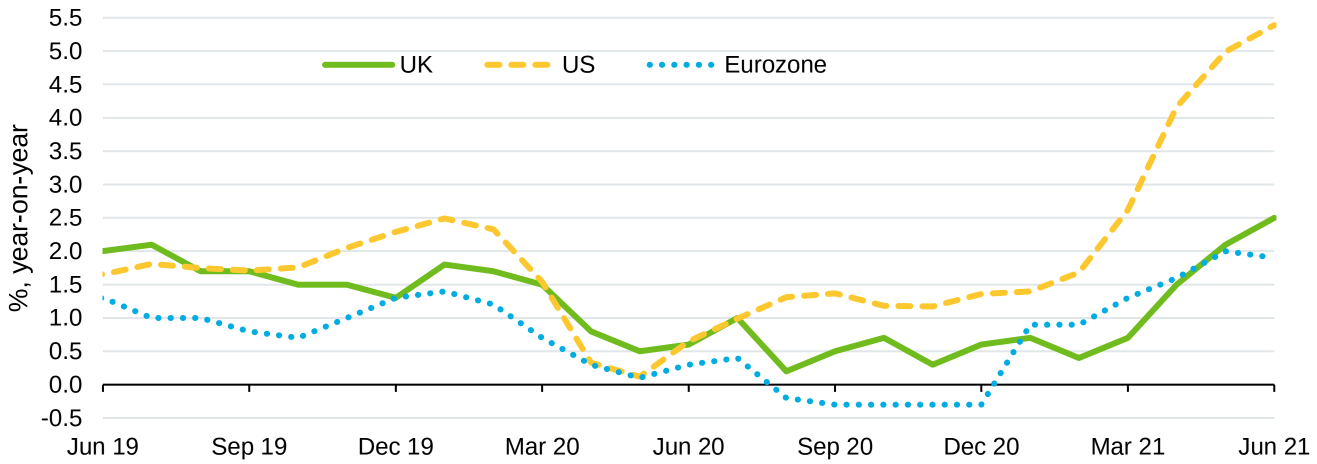


However, the quarterly pace of global growth is likely nearing its peak and the recent fall in bond yields reveals growing pessimism within markets.   Though the absolute level of surveys remains high, the drop in manufacturing and services PMIs in June perhaps suggests an easing of momentum. The pandemic has not gone away either: while vaccines are shown to be effective against the delta variant in preventing serious disease, efficacy against new strains and the spread of variants in countries with lower vaccination rates poses a downside risk to global demand.

Even if the near-term outlook remains bright, risk markets have taken a lot of good news on board and, in common with bond investors, we believe risks are tilted to the downside.

Surprisingly good growth has been accompanied by surprisingly high inflation in recent months. US inflation rose to 5.4% year-on-year in June (Chart 2), the highest since January 1991. Business surveys highlight the current extent of shortfalls of supply relative to demand and average selling prices for goods and services both rising at unprecedented rates. Most forecasters expect inflationary pressures to prove temporary. On balance, we would agree, but while a shift to a much higher inflation environment is perhaps unlikely, it is plausible we see some persistence in inflationary pressures. We discuss near-term inflation risks and potential medium term impacts in our recent Investment Perspectives article: Inflation – momentary or momentous?.

Chart 2: Headline CPI inflation

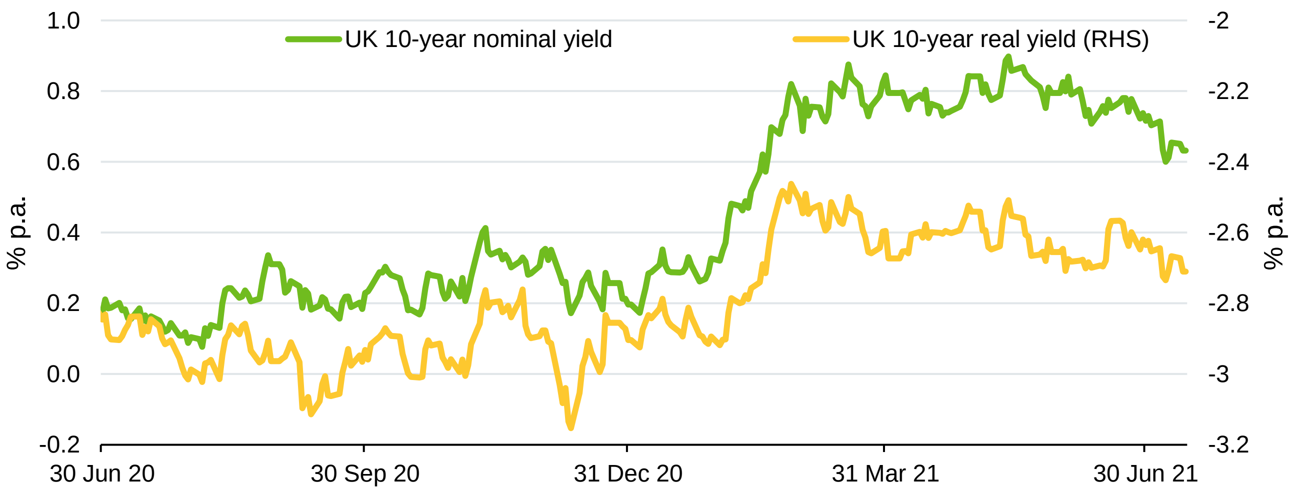


Government bonds

The Fed surprised markets by suggesting rates may rise in 2023 even as they re-iterated current inflationary pressures are likely transitory. Nevertheless, Treasury yields declined in Q2, perhaps reflecting perceptions the quarterly pace of US growth has already passed its peak. UK yields also drifted lower despite further upwards revisions to growth and inflation forecasts.

An easing of current growth and inflation momentum makes a sharp and disorderly rise in yields less likely, but our assumption of robust growth and a healthy level of inflation may still lead to a quicker tightening of monetary policy and place upwards pressure on yields. In those circumstances, a rise in real yields rather than an increase in implied inflation may be more likely.

Chart 3: UK 10-year yields

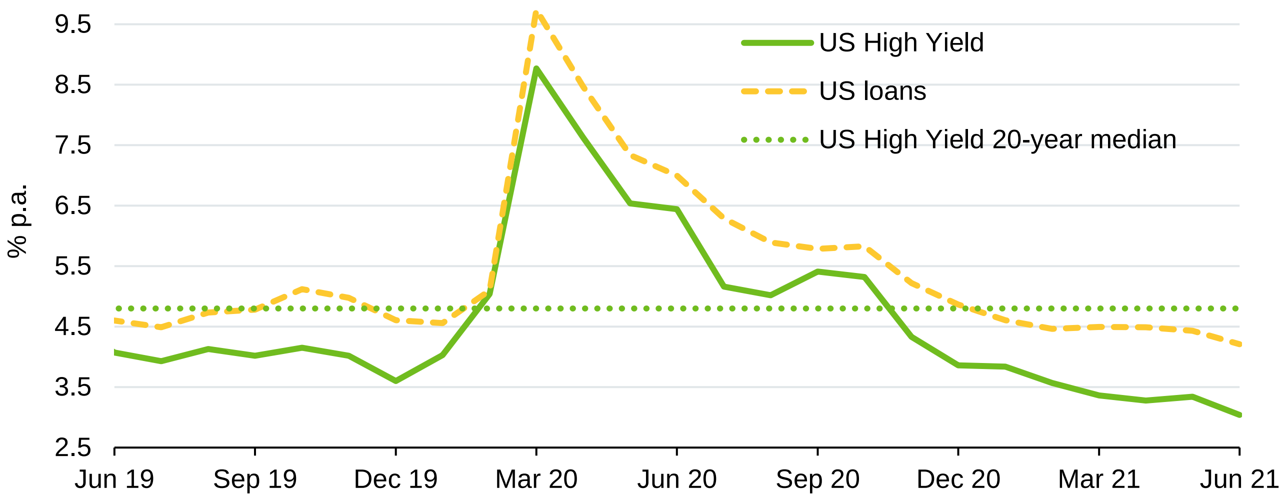


Real yields still look very low relative to nominal yields (Chart 3), even though the UK index-linked bond market benefits from substantial ongoing demand from price-insensitive UK institutional buyers. Implied inflation looks expensive at terms up to 10 years, with UK RPI inflation unlikely to average 3.6% p.a. over the next 10 years, and at the longer end of the curve, given the RPI premium over CPI is expected to fall close to zero after 2030.

Credit

As corporate earnings rebound, leverage levels are falling, and interest coverage is rising. Realised defaults are already falling and forecast defaults are expected to fall below median levels by the end of the year. Despite near-term fundamental support and tailwinds from ongoing investor demand for yield, we maintain a degree of caution in light of very low spreads, which have ground tighter and are at levels which indicate modest forward-looking returns.

Chart 4: Speculative-grade credit spreads



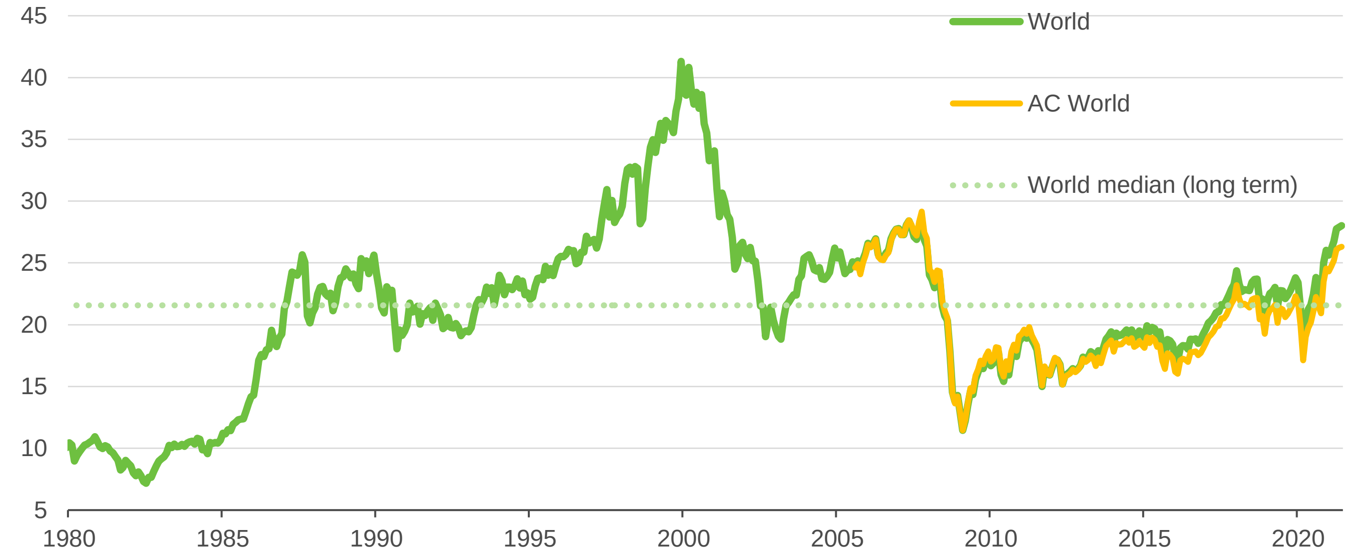
Given potential upwards pressure on yields over the near to medium term, which may see them rise more than current market pricing suggests, we prefer floating-rate assets. This is reinforced by relative value: asset-backed securities continue to offer a reasonable spread pick-up over similarly rated investment-grade corporate bonds, as do loans and private credit over fixed interest speculative-grade bond markets (Chart 4).

Equities

Global equities have risen 7.1% since the end of March on the back of the improving economic outlook. Year-on-year earnings per share (EPS) growth for US companies was 64% in Q1, the strongest since 2010, and 4-week earnings momentum, as indicated by the number of forecast upgrades versus downgrades, remains positive. To some extent, the increase in analysts' 2021 estimates is an acceleration of an earnings recovery previously expected over a longer period, but the forecast level of end-2022 earnings has also risen over the last 3 months and is now expected to be close to 28% above end-2019 levels.

However, recent fundamental improvements have to be seen in the context of valuations that are already very stretched. Our preference is to look at valuation metrics that are little affected by short-term cyclical variations in earnings. Chart 5 shows a price-earnings ratio based on the average level of inflation-adjusted earnings over the previous 10 years, as a guide to the underlying trend. Valuations, on this measure, have rarely been higher over the past 40 years or so. Even allowing for persistent low real yields, future returns are likely to be modest in absolute terms. This, and the hint that growth, and consequently earnings, momentum may have peaked, prevents us from holding a more positive view.

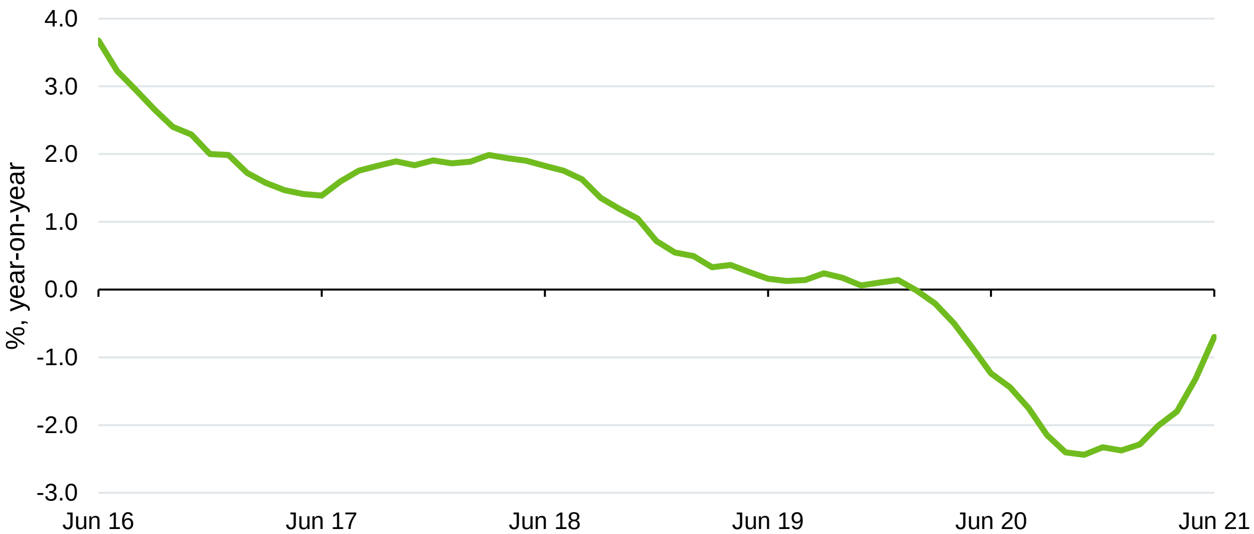
Chart 5: MSCI World and AC World cyclically adjusted price-to-earnings ratio



Property

Rolling 12-month metrics for the UK Monthly Property index have improved significantly as March 2020 values fall out of the comparison. Capital values, in aggregate, have risen over the past 12 months (Chart 6), largely due to the strength of industrials. However, while the pace of declines has slowed, retail capital values are still lower than they were a year ago and the pace of declines has increased in the office sector in recent months.

Chart 6: UK commercial property nominal rental growth



There have been some signs of improvement in property fundamentals. Nominal rents are rising on a monthly basis, (although the recent rise in inflation means that real rental growth is falling). The Royal Institute of Chartered Surveyors UK Commercial Market Survey points to healthier signs with occupational demand and rent expectations continuing to improve. Rent collection should improve with economic recovery (although vacancy rates have risen).

While these signs might point to more sustained improvements, uncertainty over post-pandemic conditions remains high, both in the short term, as government support is withdrawn, and long-term, as work and retail patterns evolve. Initial and reversionary yields remain low versus longer-term averages and suggest modest absolute returns, even allowing for low government bond yields. As a result, we remain cautious.

Conclusion

The economic backdrop remains strong but the quarterly pace of global growth is likely to ease beyond Q2. Meanwhile, the spread of virus variants in countries with lower vaccination rates and the potential for vaccine resistant strains poses a risk to global demand. Though the most acute current inflationary forces will likely prove transitory we expect some modest upwards pressure may persist.

That is an outlook more fundamentally supportive of equities than bonds and credit. While valuations are elevated, suggesting future returns from equities are likely to be modest, that is no less true of other markets, while equities offer some upside exposure. In both investment and speculative-grade credit markets, we have a fundamental preference for floating versus fixed-rate assets: in addition, investment-grade asset-backed securities continue to offer a reasonable spread pick-up versus similarly rated corporate credit, as do loans and private credit versus fixed-rate speculative-grade bonds. There are tentative signs of improvement in UK commerical property market fundamentals, but still elevated levels of both short-and long-term uncertainty keeps us cautious for now.

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