Quarterly review

for the three months to 30 June 2021

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Chief investment officer

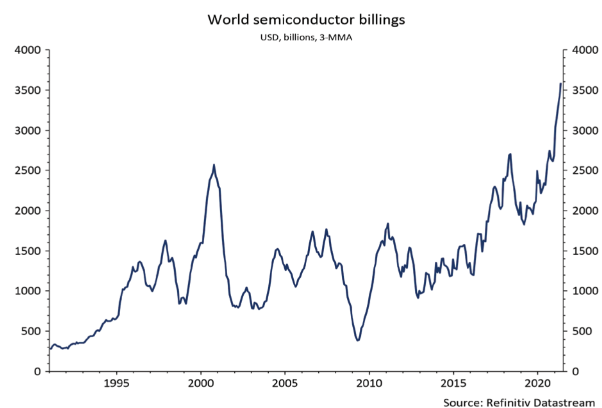
Global equities rose 7.39% in sterling over the second quarter of 2021 as the world economy recovered as a result of Covid-19 vaccination programmes, ultra-loose monetary policy and unprecedented fiscal stimulus. Global bonds rose 1.18% in sterling despite stronger-than-expected inflation data and signs that the "lift-off" for Federal Reserve policy tightening might occur earlier than initially flagged.

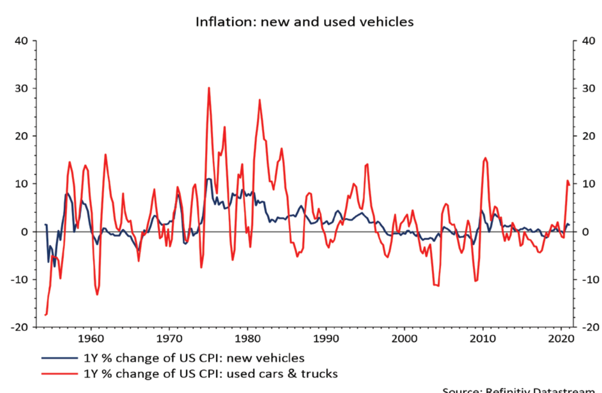
In June, Jerome Powell, the Fed chairman, struck a hawkish note when he raised the possibility that higher inflation might not be purely "transitory", the result of temporary supply-side bottlenecks, but could prove "more persistent". US headline inflation rose to 5.4% in June, up from 5% in May. The personal consumption expenditure price index, the Fed's chosen inflation measure, was up 3.9% year-on-year in May. Fed policymakers predicted 3.4% inflation for 2021, falling to 2.1% in 2022. Fed forecasts for interest rate tightening were brought forward. In July, the Fed funds target rate was expected to increase twice in 2023, against prior expectations that interest rates would remain pegged near zero until 2024. Stronger-than-anticipated inflation data may test the Fed's resolve to hold interest rates until maximum employment is achieved but investors have not as yet taken flight at the news because it may take some time for the jobs market to recover. In May, unemployment remained elevated and above pre-pandemic levels at 5.8% while workforce participation was lower as health concerns and unemployment insurance payments deterred potential job seekers.

The Bank of England's monetary policy committee remained dovish overall, concerned the recovery might be undermined by "premature tightening". The BoE forecast UK gross domestic product would regain its pre-pandemic level during 2021 and show a 7.25% rise for the year. UK inflation rose to 2.5% in June while unemployment for the three months to April was above the pre-pandemic level at 4.7%, with a lower level of workforce participation following the success of the furlough scheme. UK equities lagged, gaining 5.84% over the quarter, while smaller stocks rose only 5.47% as rising cases of the Covid-19 Delta variant delayed the full re-opening of the economy.

Equities in Europe excluding the UK outperformed, however, rising 8.12% in sterling as vaccination programmes gained traction after a slow start, paving the way for earnings upgrades. In June, the European Central Bank (ECB) said bond purchases under its €1.85 trillion Pandemic Emergency Purchase Programme would be maintained, the scale of the programme having been increased in June and December 2020. Fiscal stimulus may increase in the second half of 2021 as the €672.5 billion Recovery and Resilience Facility gives loans and grants to member states. In July, the ECB changed monetary policy significantly, adopting a 2% average inflation rate, removing its previous objective to keep inflation "below, but close to 2% over the medium term". The change brings the ECB in line with Fed, implying that inflation may be allowed to exceed 2% for some time before monetary policy is tightened.

Commentators are divided on inflation prospects. Producer prices have risen following increases in oil and other industrial commodity prices and shortages of some key components. Semiconductor shortages have, for example, slowed car production, increasing the demand for used cars. US used car prices rose 10.5% in June following April's 10% gain and May's 7.3% rise. The rising value of the semiconductor market and price increases for US new and used cars are shown in the charts below.





BROMPTON
ASSET MANAGEMENT

Quarterly review (continued)

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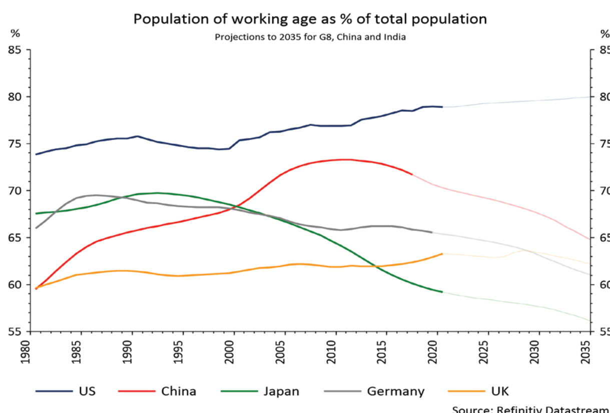
Price pressures may ease as supply catches up with demand and reduced lockdown restrictions lead to higher demand for consumer services at the expense of consumer goods. Conversely, companies may retreat from globalisation policies and increase the resilience of their manufacturing processes by increasing supplier numbers and holding higher stocks of raw materials and finished goods. The costs of moving from "just in time" to "just in case" manufacturing would most likely be passed on to consumers through higher prices. Labour shortages in some sectors could persist should workforce participation remain low while rising house prices may also affect inflation data, particularly in the US, where rental costs account for approximately 40% of the inflation index.

Fiscal easing, monetary easing, demographics, as workforces shrink relative to ageing populations, and decarbonisation goals may all contribute over the longer term to rising inflation. Some commentators believe lower Chinese wage costs have contributed to lower prices globally as companies have moved manufacturing to China. As the chart below shows, the proportion of the Chinese population accounted for by those in work has been falling for some time, potentially leading to higher wages and a diminished labour cost advantage.



Equities in Asia excluding Japan and emerging markets underperformed, rising 3.53% and 4.99% respectively in sterling over the quarter. The People's Bank of China kept interest rates on hold in June but monetary policy tightened as credit growth slowed in response to concerns of overheating in China's property and financial sectors.

In early July, fears of Beijing intervention in quoted technology companies resurfaced as Chinese app stores were ordered to remove the app of the ride-hailing company, Didi, following Didi's US flotation. The move revived memories of the delayed flotation of Ant Group, Alibaba's fin-tech business, after Jack Ma, Alibaba founder, criticised China's banks for stifling innovation with a "pawnshop mentality".

There are grounds to be positive on the outlook for equities over the coming months given the strong economic bounce-back fuelled by exceptional monetary and fiscal stimulus. At the quarter end, Brompton's strategies were holding equity investments following both growth- and value-oriented strategies. The UK stockmarket was trading on a low valuation and may outperform some overseas markets. In strategies that include bonds, fixed income allocations ended the quarter biased towards shorter-duration and inflation-linked investments because inflation may prove higher and more persistent than central bankers expect. Gold and gold equities should provide diversification and the potential for gains in an environment where inflation is typically above interest rates.

Important information

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