Markets Review - to end August 2021.

THORNTONS INVESTMENTS

Market Returns

(Total returns in £)	1 month	3 months	6 months	1 year
UK Equities	2.1%	2.5%	12.4%	23.6%
Global Equities	3.6%	9.0%	17.7%	27.2%
UK Gilts	-0.7%	2.8%	3.8%	-1.9%
UK Property	0.6%	3.4%	5.4%	8.0%
Gold	0.1%	-2.1%	6.2%	-10.7%
Commodities	1.1%	9.6%	16.4%	38.6%
Sterling	-0.8%	-0.8%	0.4%	3.4%

Returns to 31st August 2021. Source: Thomson Reuters

Market Overview

Many stock markets, although not the UK, edged up to new highs in August (with the US stock market double the level of its March low last year), propelled by dramatic recoveries in company profits being reported for the second quarter. Profits were up by over 100% in aggregate across Europe and not that far behind in the US. This, obviously, is set against the worst of Covid-19 lockdowns but has been robust enough to raise earnings estimates for the full year. However, cost pressures and supply issues are impinging everywhere, which along with weather related disruptions, have reduced economic indicators and sentiment.

Meanwhile the rising case numbers of Delta variant Covid-19 infections across Asia and the US, have led to the reimposition of movement and opening restrictions. Asian and Emerging stock markets have been significant underperformers this year due to slow vaccination programmes, but also the increasing crackdown by China on tech companies.

The major central banks continue to maintain full emergency measures, supplying ample liquidity which helps keep bond yields low and buoy stock markets. Inflation, though, is still rising, putting pressure on central banks to trim the amount of quantitative easing and their ability to keep bond yields ultra-low.

The dislocations to supply caused by the pandemic have been profound, with their impact now likely to run well into next year. Raw material and supply costs have jumped and whilst many of these should recede (the ‘inflation is transitory’ story), a good number may not before the end of the year. Looking at the cost of containment, such as in Australia, it is clear the only robust way out of the pandemic is through vaccination, which unfortunately will take a while yet on a global scale. The UK is in a strong position on this front, which will hopefully allow continued recovery whilst measures such as furlough are removed, and a positive background for UK companies; backed up by the spate of foreign bids this year.

Commodities have had a very strong start to 2021. Oil has settled above $70 per barrel, despite the possible re-introduction of Iranian production, as demand recovers and OPEC+ continues to restrict supply. Despite the recent drop in the price of iron ore, as China seeks to curb its rise, every commodity, oil, metals, grains have risen strongly since the first successful vaccine result was announced, rising by more than 30% in dollar terms and fuelling inflation concerns. Commitments to de-carbonise and promises to 'grow back better' are energising anticipation of a new era of infrastructure spending. Gold and silver have fallen back this year as economies reopen and recover, and the dollar has strengthened. However, they remain as classic hedges against inflation, currency debasement and the risk of monetary policy mistakes.

With the Bank of England and other central banks still employing their full range of quantitative easing (QE) tools, and an essential promise to do whatever it takes, bond yields remain compressed, despite a jump earlier in the year. Markets seem to be accepting of central banks' insistence that the rise in inflation will be temporary, although each economic data point is being watched keenly to see if it is not so temporary; input costs are currently rising rapidly. With government deficits still rising, central banks are required buyers of government debt, in order to keep the cost of debt low and prevent a collapse in bond markets. In this environment financial stresses are more acute and likely to keep market volatility elevated as there is no room for policy error.

While most property funds have reopened for dealing, some are winding up due to difficulties in offering sufficient liquidity and the uncertainty of 'price discovery' in an environment of changing demand and significant levels of non-payment of rents. REITs are largely at significant discounts to stated property values. Although it is too early to know how demand for office and industrial property will be affected, deals are being struck and there was little surplus prior to coronavirus, paid rental yields remain substantially above bond yields.

Companies are re-establishing dividends (UK dividends are now up 60% against last year) and forecast guidance, with recent trading reports much more positive in the main. Despite the positive news around vaccines and the inoculation programme, uncertainty remains, and many are warning on costs and supply chain problems. For some well-known High Street names, it is already too late. Some of the demise is down to structural decline as well as the impact of Covid-19, so there are likely to be other collapses, even once restrictions have been removed. This will create space for survivors and substitutes, which has always happened, but perhaps not at the same accelerated pace we are witnessing currently.

The political 'air' has felt a bit calmer recently, with the recent G7 conference helping international engagement. There was also broad agreement that fiscal stimulus, especially via infrastructure investment, was still required. One area where tensions have not diminished, is with China. There is growing discomfort, both in the West and in parts of Asia, with China's increasingly assertive actions. Given China's economic weight, confrontational escalation would have significant consequences. Germany has the next significant elections at the end of this month, and with Chancellor Merkel stepping down, there is a higher degree of uncertainty than usual; both for Germany and the EU.

Economic recovery continues but is being curbed by the contagious delta variant of Covid-19 and a raft of global supply chain issues. Aided by central bank support demand is still strong but is creating inflation as it encounters supply constraints. For now, markets are happy to live with the pressures caused by the crosscurrents, knowing that the supply constraints will ease in time. Central banks will then have to pull back from quantitative easing against a background of the debt mountain that has been built up during the pandemic. This will be tricky, whilst trying not to weigh too heavily on economic growth. In this environment investment selection needs to be taken carefully and will be a more important factor than in an era of constantly declining bond yields lifting all boats.

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Market Outlook

Equities	Stock markets have continued to edge higher, boosted by robust company results compared to the losses a year ago. However, with indices at record highs, there are also warnings about rising raw material costs and supply chain problems, particularly in microchips and transport. Global growth expectations are also being curbed as the contagious Delta variant of Covid-19 is causing restriction reimposition in countries less well vaccinated than here. Valuations can hold up whilst vaccination programmes catch up elsewhere.
Fixed Interest	Central banks continue to absorb record levels of debt issuance from governments and corporates, keeping the cost of debt very low. This has kept the UK government yield curve below 1% right out to 20 years and with investment grade bonds offering little extra yield, realistic investment returns are minimal. Bonds are susceptible to sell-offs on any concerns about rising inflation. High yield bonds are also sensitive to any deterioration in credit quality once government support is removed. Attractions are limited.
Commercial Property	Property fund difficulties persist, with high-profile closures and uncertainty over daily liquidity. Whilst the outlook for retail property remains problematic and uncertain for office property, deals have been struck. Industrial property continues to offer an attractive headline yield and risk diversification benefits where price reflects underlying value.
Alternative Assets	Infrastructure investment funds offer benefits for exposure to physical assets, often with attractive inflation linked contracts, and growth connected to improved connectivity and de-carbonising economies. However, as with private equity, there has been significant capital applied to these investments, reducing investment yields and increasing vulnerability to any rise in the cost of debt. Absolute Return strategies have shown some defensiveness but offer low returns and we continue to choose sparingly.
Cash	The 'safety' of cash is counterbalanced by zero interest rates and a lack of protection against inflation.

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