QUARTERLY INVESTMENT LETTER

NOW AND FOR FUTURE GENERATIONS

MARCH 2021

Executive Summary

Growth optimism has increased substantially in the first quarter of 2021, driven by US fiscal stimulus and large-scale vaccination. Investors have responded by pushing up government bond yields and rotating equity portfolios towards the most economically sensitive stocks and sectors.

Market winners of 2020, such as online retail and entertainment, have started the year on the back foot. While many of these businesses retain an enviable competitive advantage, the prospect of a resurgent economic backdrop has boosted the case for 'cyclical' stocks. Businesses in the financial, industrial and traditional service sectors have seen their share prices recover sharply following improved earnings expectations.

One year after the biggest deflationary shock in decades the threat of inflation has emerged. The risk that overheating economies and near zero interest rates fuel uncontrollable inflation is genuine, but it is not sufficient to justify defensive portfolio positioning.

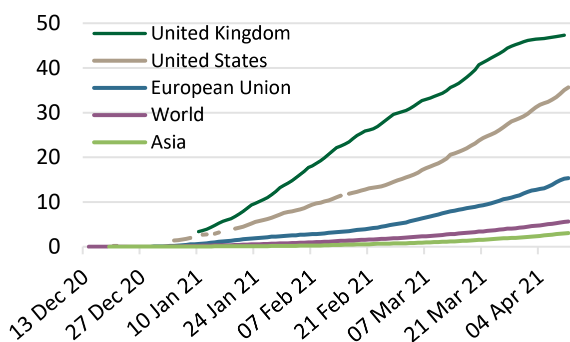
Our investment strategy favours a strong economic recovery in 2021 driven by a surge in consumer demand. Capital allocation blends managers that benefit from this theme with those that emphasise structural growth opportunities at a global level.

The risks to our outlook are constantly assessed, dominated by the potential evolution of the virus itself and uncertainty around future mutations. The good news is that vaccination efficacy appears robust against current variants in circulation, but we remain vigilant to an unfavourable development.

Introduction

Growth optimism has increased substantially in the first quarter of 2021, driven by US fiscal stimulus and large scale vaccination against COVID-19. Approximately 800 million vaccine doses have now been administered globally, at a rate of c. 18 million doses per day[1]. Whilst their distribution remains uneven the path to 'herd immunity', which in turn should mark a shift to more familiar daily life, has become shorter and clearer. For the US and UK in particular, the prospect of a sharp consumer driven recovery in the coming months is real (*see chart 1*).

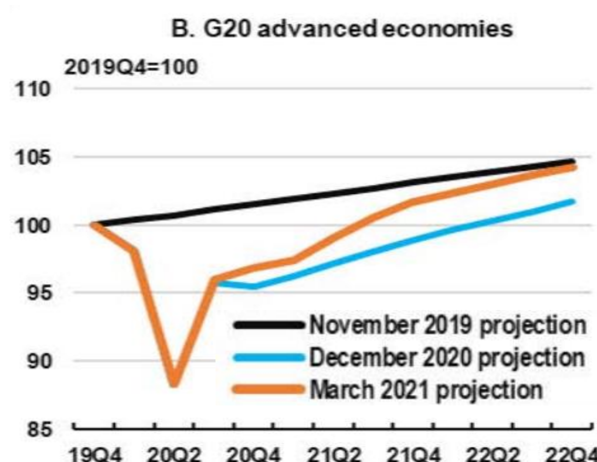
Chart 1: Vaccination by % population



Source: Our World in Data, 07 April 2021. Share of the total population that received at least one vaccine dose.

The passing of the American Rescue Plan Act by President Biden last month, totalling c. $1.9trillion of fiscal stimulus, has raised expectations further. Importantly for consumption, the bill targets low and middle income households with direct payments and extended unemployment benefits. When combined with vaccine-driven economic reopening, this highly expansive fiscal policy is expected to propel US growth rates sharply higher in the near term. The OECD recently revised their expectations for US 2021 economic growth to 6.5%, more than double the rate expected in December, which in turn has led to a sharp lift in the growth trajectory for the developed world (*see chart 2*).

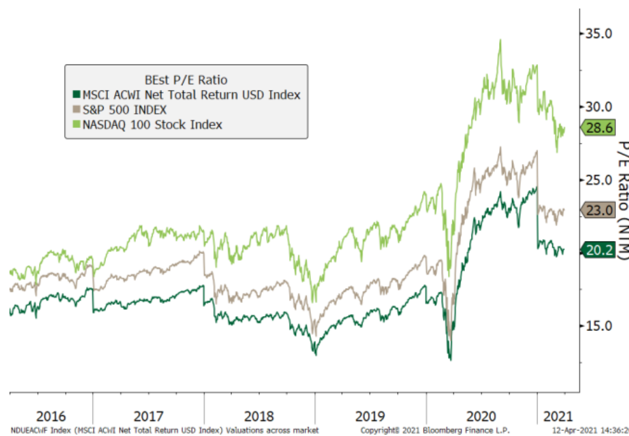
Chart 2: Growth expectations have been revised up



Source: OECD Economic Outlook, Interim Report, March 2021

Despite divergence across regions, the economic trajectory for the coming quarters is undoubtedly favourable. In turn, this should support further market gains. However, as we move into the second year of this market cycle, earnings growth will need to play a more important role. Valuations remain elevated on most common metrics with little scope for further multiple expansion (*see chart 3*).

Chart 3: A more expensive world



Source: Bloomberg, price to earnings (estimated) ratios, March 2021

This backdrop means a selective strategy is important. Our favoured approach is to combine opportunities which access those areas of the equity market trading on much lower multiples, i.e. 'value' stocks, with those generating above average earnings growth (covered in more detail below under 'how to allocate capital?').

[1] Source: Bloomberg, 12 April 2021.

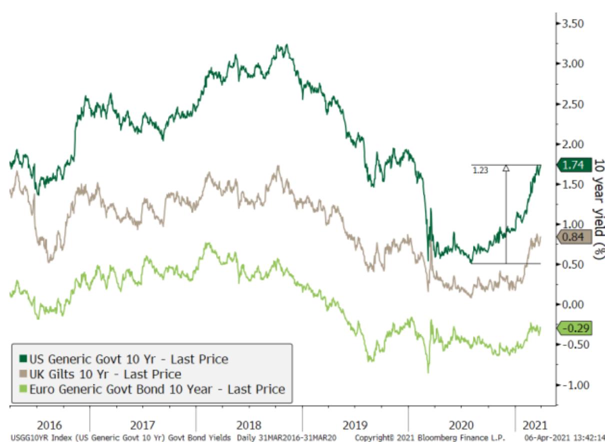
Furthermore, the backdrop we describe raises important questions and considerations for the longer term. In particular, whether efforts to reflate the global economy could have unintentional inflationary consequences, causing problems for financial and economic stability in the years to come.

The threat of inflation

One year after the biggest deflationary shock in decades the threat of inflation has emerged. Could the combination of resurgent consumer spending and highly expansive policy lead to overheating economies, fuelling persistently higher inflation, which in turn would force central bankers to raise interest rates? This concern has rattled investor's nerves in recent weeks, sending bond yields sharply higher (*see chart 4*) and contributing to the equity market rotation away from high growth technology stocks (*see chart 5*).

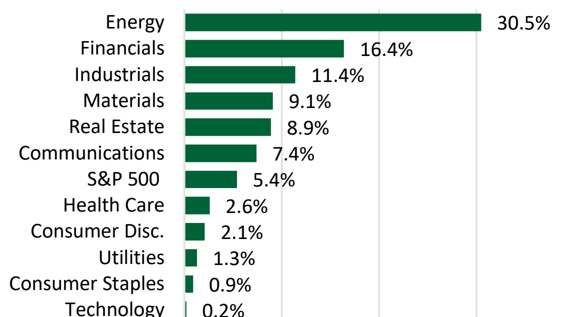
Whilst many of these businesses retain an enviable competitive advantage, the prospect of a resurgent economic backdrop has boosted the case for 'cyclical' stocks. Businesses in the financial, industrial and traditional service sectors have seen their share prices recover sharply following improved earnings expectations.

Chart 4: Bond yields have moved sharply higher



Source: Bloomberg, March 2021.

Chart 5: Technology stocks have been left behind



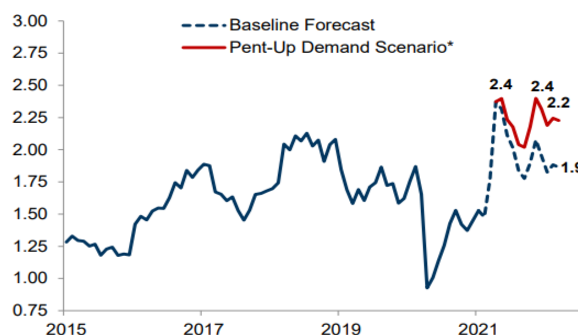
Source: Bloomberg, percentage figures as of 30 March 2021

Higher inflation in the near term is inevitable. Considering the economic freeze this time last year, when the oil price temporarily dropped below zero, just the passing of the calendar will be enough to see headline inflation rates rise (*see chart 6*).

The critical question is whether rising inflation will become a sustained trend, leading to a tightening in monetary policy and an end of the market recovery. In our view, there is little evidence of this scenario playing out before the middle of this decade.

The reality is that labour market tightening is unlikely in the short-term. Even in the US where growth expectations are the highest, the economy remains materially below its 'potential' having sunk into a deep hole during the peak of the pandemic. Jan Hatzius, Chief Economist at Goldman Sachs, argues that "*even the above-consensus recovery that we expect should leave output only slightly above potential. That would suggest inflation of slightly, but not dramatically, more than 2%*".

Chart 6: Headline inflation will rise in the short term



Source: Global Sachs Global Investment Research, April 2021.

We do not expect uncontrollable inflationary pressures to derail the economic or market recovery in the short term, and observed inflation rises will be driven primarily by 'base effects' and the recovery of energy prices. However the longer term balance of risk has shifted. Post-crisis policy is firmly in expansionary territory and, unlike in the years that followed the 2008 financial crisis, is not expected to pivot towards fresh austerity anytime soon.

In the US the focus has already shifted from pandemic-related relief to stimulus which creates new jobs. The recently announced American Jobs Plan outlines trillions of dollars of prospective investment for widespread infrastructure modernisation. This policy shift implies that the risk of inflation in the 2020s is more prominent than the risk of deflation. This is particularly the case if the vast expansion in fiscal spending leads to a more sustained depreciation in the US dollar – something that poses a meaningful risk should sentiment towards the reserve currency waver.

How to allocate capital?

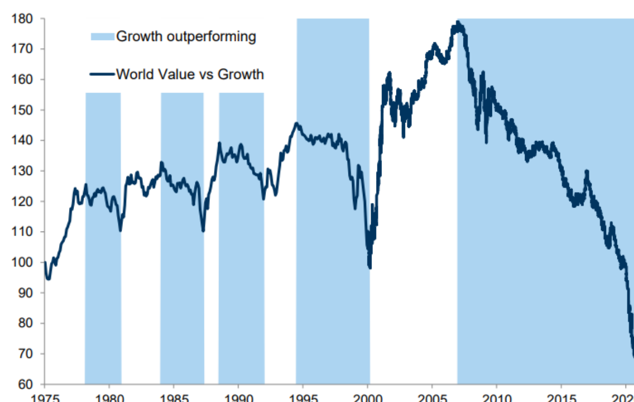
Our investment strategy favours a strong economic recovery in 2021 driven by a surge in consumer demand and ongoing expansionary policy. Resultant portfolio positioning continues to emphasise equities and credit over bonds and cash. Underlying strategies offer access to key opportunities that capture the potential for 'reflation[2]' to characterise the near term economic climate, as well as emerging structural themes. In particular:

The 'reopening trade'

In contrast to prior market crashes, such as in 2000 and 2008, the economic shutdown of 2020 led to the market leaders of the last decade (i.e. the 'FANG[3]s') benefiting. This came at the expense of those areas of the market that have lagged for several years (i.e. small cap, energy, financials, and industrials).

Perhaps the clearest illustration of this trend is in the relative performance of 'growth' stocks vs 'value' stocks. As shown below, the outperformance of 'value' this year is dwarfed by the magnitude of its underperformance in the prior period[4] (*see chart 7*).

Chart 7: Recent value outperformance is barely visible



Source: Global Sachs Global Investment Research, April 2021.

This dynamic has shifted in recent months, and we believe it has further to run. A key reason for this is the shift towards expansive policy and associated longer term inflationary risks. As growth accelerates and inflation expectations rise, bond investors demand higher yields and the fundamental case for 'cyclical' stocks improves. This market environment was absent during the years that followed the financial crisis.

The UK market typifies this opportunity in our view, offering a relatively high representation of stocks that fall into the 'value' category. In addition, after years of underperformance and consistent outflows by global investors, the economy can benefit from renewed fundamental tailwinds. A successful vaccination roll-out should see a particularly strong service-sector led recovery in the quarters to come, supported by a buoyant housing market and extended furlough schemes. Furthermore, the threat of a 'no deal Brexit' is firmly in the rear view mirror, following the securing of a relatively cooperative deal with the EU in December 2020. Rob Arnott of Research Affiliates argued in a recent note that "*In late 2020… UK stocks, and notably UK value, reached implausibly cheap levels relative to justifiably "fair" values of stocks in other developed economies… we began describing UK value as a new trade of the decade*"

[2] Reflation is broadly defined as a period of time when both economic growth and inflation increase.
[3] FANGs is a common acronym for Facebook, Apple, Netflix and Google.

[4] Past performance is not a guide to future returns. If the information is not displayed in your base currency, then the return may increase or decrease due to currency fluctuations.

We recently added to our preferred UK managers at the expense of US large cap allocations, increasing our bias to this theme.

Structural growth opportunities

A complimentary investment opportunity that we emphasise benefits from emerging structural growth trends. One example that we have tilted portfolios towards this quarter is in Asia. China and the surrounding region emerged from economic lockdowns much earlier than developed economies in Europe and North America, which is translating into strong earnings growth for 2021. Furthermore, the long term growth potential is significant. China's recent pledge to achieve net zero carbon emissions by 2060 opens the door for a vast economic transformation. Goldman Sachs estimate that US$16 trillion of clean infrastructure investment and c. 40million net new jobs are required to reach this goal, across the energy and transportation network primarily.

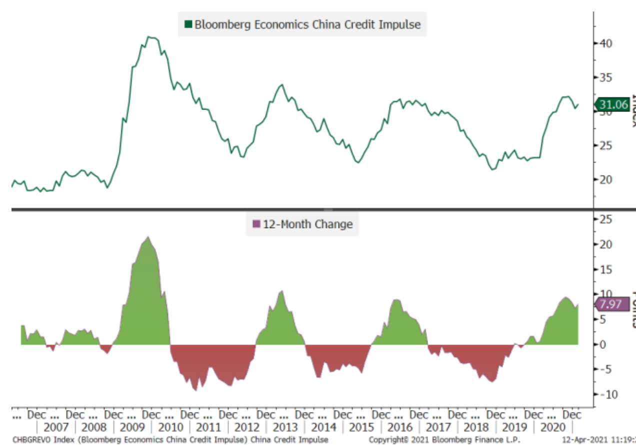
We recently allocated capital to a new manager focused on Asian growth themes, following a long period of assessment and due diligence. This manager has an impressive track record as an Asian equity specialist, and offers access to multiple structural growth opportunities, including those that arise from China's decarbonisation path. As we mentioned in our Investment Outlook last quarter, 'ESG[5]' factors are set to play an increasingly important role in capital allocation decisions, and this strategy is a case in point.

What are the risks?

The risks to our outlook are constantly assessed, dominated by the potential evolution of the virus itself and uncertainty around future mutations. The good news is that vaccination efficacy appears robust against current variants in circulation, but we remain vigilant to an unfavourable development.

Changes in the global credit impulse, i.e. rate of change of credit in the economy, is also critical. The expansion in Chinese liquidity was a key driver of capital markets during 2020, as its ebb and flow has been for several years. However, with the Chinese economy now recovering strongly the tailwind from fiscal expansion is likely to abate in the coming months (*see chart 8*).

Chart 8: Chinese credit impulse: turning lower?



Source: Bloomberg, March 2021.

Considering China's size and economic influence, this poses a risk for global growth in the second half of the year if the authorities opt to de-lever the economy too quickly. We do not see this as fatal for the market recovery, but worthy of close attention, as large monetary authorities adjust policy to suit post-lockdown recoveries.

Summary

Despite an increase in market volatility and a sharp rotation in leadership from last year, we have ended the quarter with healthy positive returns. In our view the outlook is favourable for risk assets, with the prospect of a resurgent global economy in the period ahead. We continue to balance portfolios across global opportunities and are monitoring developments closely.

As always, we hope you are safe and well.

SFIM Investment Committee
March 2021

[5] ESG is a common acronym for Environmental, Social and Governance.

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