KINGSWOOD

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Q2 | 2021

INVESTMENT OUTLOOK

SUMMARY

- This year's fiscal stimulus in the US has been considerably larger than expected
- A strong rebound in the global economy is now underway, led by the US
- Inflation will pick up sharply over coming months but much of the rise should be only temporary
- Interest rates look unlikely to rise for at least another couple of years in the US, UK and the Eurozone
- The outlook for fixed income continues to be poor with yields likely to continue to head higher
- Equity valuations are high but strong gains in earnings mean share prices still have some further upside
- Prospective returns remain higher for equities than for bonds and we maintain our constructive stance
- Within equities, we are positive on the UK and Asia and a variety of specific themes, including climate change

ECONOMIC AND MARKET OUTLOOK

Confidence in a strong global economic rebound this year has increased significantly in recent months. **Growth forecasts have been revised higher with the US leading the way.**

The fiscal stimulus in the US has been significantly larger than expected. The $900 billion stimulus at the end of last year was followed up in March by another $1.9 trillion package. Together, these amount to a massive 13% of GDP. On top of this, a $2.3 trillion 'American Jobs Plan' focused on infrastructure spending is now under discussion as well as a $1.3 trillion 'American Families Plan'. Both are ten-year plans and the immediate boost to spending is much smaller than from the first two packages. Moreover, both will be financed by higher taxes.

Whereas Europe, and most likely the UK, saw their economies contract in Q1, the US saw strong growth. Fiscal policy is supportive in Europe and the UK but not nearly as much as in the US. A €750 billion economic recovery plan should start to be implemented in the EU later this year. As for the UK, the March Budget was a 'spend now, tax later' affair. Support measures this year and next amount to some £65 billion or 3% of GDP but the corporation tax rate is to be raised from 19% to 25% in 2023.

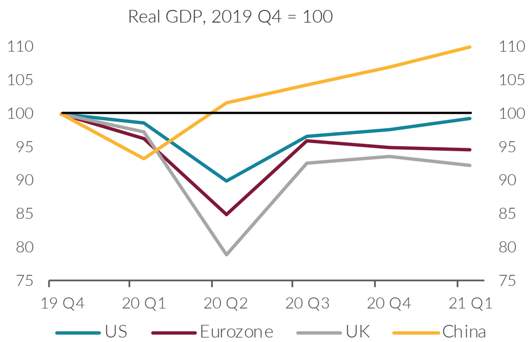
Fiscal stimulus is far from the only critical factor behind the economic rebound. So too is the vaccine roll-out. Over 50% of the population has now been vaccinated with a first dose in the UK, and this should also be achieved in the US and EU next month.

However, the picture in some emerging economies, most notably India, is much worse and poses a risk to the global economic upturn. The rapid spread of the virus in such countries increases the chance of vaccine-resistant variants emerging. Vaccines should be able to be tweaked to deal with any such variants but this would take time.

Monetary support remains critical. With one exception, the key central banks look unlikely to raise rates for another couple of years. In the US, the Fed intends to raise rates only when it achieves full employment and inflation is on track not just to hit 2% but actually exceed 2%.

The Fed will scale back its quantitative easing program well ahead of any rise but looks unlikely to start 'tapering' until early next year. In the Eurozone and the UK, the rather slower economic recovery means the first rate hike should occur rather later than in the US.

Europe and UK still a considerable way to recover unlike US & China



Source: Refinitiv

Only in China have the authorities already started to tighten policy a little. Strikingly, GDP in Q1 was already 10% above its pre-Covid level in China whereas in the US it was still 0.9% below. In the Eurozone and the UK, the shortfall remained as much as 5.5% and 7.7% respectively.

Inflation is set to pick up markedly over coming months and has already started to do so in the US. Headline inflation rose to 2.3% in March and the core measure, which strips out food and energy prices, increased to 1.8%. The Fed, however, insists it will look through this rise as it believes it will in good part be temporary. Some of the increase will be down to the rebound in oil prices from their lows a year ago and some down to post-covid supply-demand imbalances.

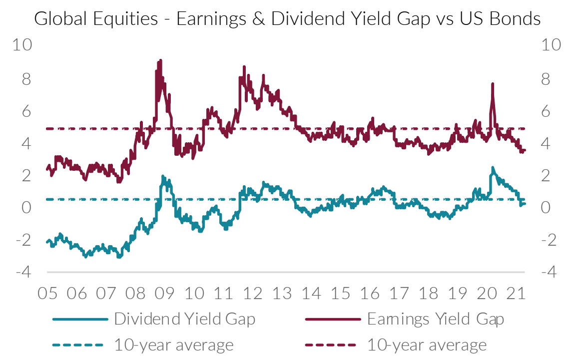
We continue to expect inflation to settle around 2-2.5% over the next year or two. Continued slack in economies, particularly labour markets, along with the shift to online retail, should help prevent a major rise. **Still, inflation risks are undoubtedly skewed to the upside.** The global monetary and fiscal stimulus is of unprecedented size and amounts to some $20trn, or more than 20% of global GDP. Central banks have also become more tolerant of a modest inflation overshoot and might struggle to contain the inflation genie if it were to escape the lamp.

The strong rebound in equity markets seen last year has continued. By the end of April, global equities were up 10% since the start of the year. These gains have been driven by hopes of a rapid recovery in corporate earnings on the back of the global economic recovery. Indeed, earnings have beaten expectations substantially in recent quarters. In the current US reporting season, earnings now look likely to end up 50% on a year earlier, well above the 25% gain expected at the start of reporting.

The positive news on earnings has meant that equities have been able to absorb a sizeable rise in government bond yields in recent months. Even if yields continue to trend higher as we expect, we believe the **very constructive economic and earnings backdrop should allow equities to make further progress.**

That said, a lot of good news is now priced in and further price gains are likely to be considerably smaller and slower than over the past year. That said, earnings growth will remain a positive force and should more than offset any downward pressure on valuations.

Equities no longer particularly cheap versus bonds



Source: Refinitiv

The forward-looking price-earnings (P/E) ratio for global equities remains elevated at around 20x, a 20-year high. As bond yields head higher and monetary supports starts to be withdrawn, P/E ratios are likely to come under some downward pressure. Indeed, following the recent rise in yields, global equities no longer look particularly cheap relative to bonds.

Meanwhile, talk of bubbles continues and there is undoubtedly frothiness in some stocks and parts of the market. However, we do not believe there is major reason for concern as a considerable amount of cash is still sitting on the side-lines, potentially waiting for a better home. With inflation worries increasing and equities providing considerably more protection on this front than bonds or cash, some of this idle money looks likely to end up in equities.

Prospective returns for fixed income continue to look poor and significantly lower than for equities. This is especially true for government bonds. 10-year yields in the US and UK have risen 0.7% this year, leading to losses for UK gilts of as much as 7%.

With the resurgence of growth and inflation over coming months likely to fuel overheating worries, **Government bond yields look set to continue their upward trend.** Still, US yields are now building in two rate hikes in 2023, despite Fed forecasts that suggest no change until the following year. So, the pace of increase in yields should slow significantly. Indeed, if yields were to rise too fast, central banks would very likely step in to reassure markets.

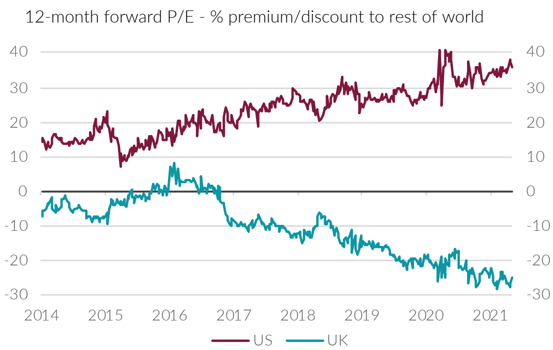
Developed market corporate bonds are only a little better placed as spreads over government bonds have contracted even further. They are down to the lows touched in early 2018 and have no real room to compress any more. While government bonds look set to deliver zero or negative returns, corporate bonds are expected to return no more than 1.5% or so over the coming year.

POSITIONING

We maintain a constructive pro-equity stance. Our allocation to risky assets generally, and equities more specifically, is a little higher than we would expect to have over the long term. We are also tilted within equities towards the more cyclical areas. This stance seems appropriate as we continue to believe equities should outperform bonds significantly, even if the upside is less than it was.

UK equities are one of our preferred areas. The key attraction here is their cheapness, with their P/E ratio 25% lower than the rest of the world. The UK should be a prime beneficiary if the rotation away from high 'growth' stocks towards cheap 'value' stocks continues. Strong and rising growth and higher bond yields and inflation certainly look conducive to further rotation.

Valuation divergence between US & UK equities looks extreme



Source: Refinitiv

In addition, the Brexit deal has left the UK looking rather more investible and the fast vaccine roll-out should ensure a rapid rebound in the economy. So far, UK equities have clawed back only a small part of their underperformance over the last few years.

Within our UK exposure, we retain a tilt to small and mid-cap companies. They have outperformed substantially over the past year but their cyclical and domestic bias means they should do particularly well from forthcoming economic growth. Their domestic focus will also be a help if the pound recovers further as seems likely.

We remain cautious on US equities, which have recently recovered much of their underperformance late last year. Valuations remain a concern, with the P/E ratio 35% above the rest of the world, and the US is an obvious potential victim of a further move to value. The US has also benefited recently from its fast economic recovery bounce and a strengthening of the dollar. However, these sources of support should fade as the European and UK economies rebound.

Finally, the taxation environment is becoming less favourable. President Biden has proposed a rise in the tax rate on dividends and capital gains from 20% to just under 40% for the highest earners and a hike in the corporation tax from 21% to 28%. The US is also promoting a global minimum corporate tax rate which would hit the tech giants given the size of their overseas revenues.

We are also still somewhat cautious on Europe. The slow vaccine roll-out has delayed economic recovery and equity valuations are not especially cheap. We believe other markets such as the UK will benefit more from the rotation towards value. Longer term, the underlying structural defects of the eurozone also remain a concern.

By contrast, we continue to favour Asia and emerging markets, particularly China. Their long-term strong growth prospects and relatively cheap valuations, along with China's growing share of the global equity indices, are the key attractions.

Recently, however, the region, particularly China, has underperformed and reversed last year's outperformance. This has been a result of the rotation in markets away from last year's winners as well as action by the Chinese authorities to tighten policy and crack down on the tech giants. We believe these headwinds should fade over coming months leading to renewed outperformance. Asia, it should be noted, will benefit from the huge growth stimulus in the US.

Finally, we are broadly neutral on Japan. Improving corporate governance and relatively cheap valuations remain helpful, as does the cyclical bias of the market, but the economic rebound looks likely to be a muted affair.

Thematic investing remains a strong feature in our client portfolios. We believe the case for allocating to long-term growth themes is all the greater in a post-Covid world. We have had exposures to technology and artificial intelligence for many years and plan to retain them. Their long-term growth potential remains very strong even if near term they face some headwinds from the rotation into value and a harsher tax and regulatory backdrop.

Climate change is another major growth area we are excited about, with governments, companies and investors ever more focused on the urgent need to address this issue. We also have an allocation to healthcare. Ageing populations and rapid biotech innovation are attractions as are cheap valuations.

Infrastructure is another theme we favour as it offers enhanced inflation protection and should benefit from increased government spending. Finally, we have an allocation to frontier markets which are benefiting from cheap valuations and hopes of a global rebound.

We retain a sizeable underweight to fixed income as prospective returns continue to look very limited. The majority of our exposure is to corporate bonds of relatively short maturity. One area looking relatively attractive now is emerging market bonds and we plan to make an allocation here.

We have only a relatively small holding in conventional government bonds. Not only are prospective returns very poor but they are also likely to provide less protection than in the past in a major risk-off move. However, we do have an allocation to inflation-linked government bonds in our medium to lower-risk portfolios, which would otherwise have little defence against a pick-up in inflation.

Alternatives which aim to provide moderate returns regardless of the moves in bonds or equities **continue to look attractive.** We already have allocations here and plan to increase our exposure further.

Lastly, **we have an allocation to gold.** The gold price has fallen back in recent months. However, with interest rates set to remain low and inflation likely to rise, we believe it will gain in value in the medium term. It should also provide a source of protection in the event of a major market sell-off.

MARKET VIEWS

	Previous view	Change	Current view	
Asset Class				
Cash	●	-	●	Unattractive with interest rates so low
Fixed Income	●●	-	●●	Yields to continue to trend higher from low levels and return prospects are poor
Equities	●	-	●	Strong global economic rebound means equities still have further upside
Liquid Alternatives	●●	-	●●	Considerably more attractive source of return and capital protection than government bonds
Commodities	●	-	●	Gold should offer protection against rising inflation and risk of another major sell-off
Property	●●	-	●●	Illiquidity is a major problem and retail and office property face significant headwinds
Fixed Income				
Government Bonds	●●	-	●●	Yields likely to rise further and prospect is for zero or negative returns
Inflation-linked Bonds	●	-	●	Valuations are expensive but offer protection against pick-up in inflation
Corporate Bonds	●	-	●	Spreads over government bonds are very low and prospective returns limited
Equities				
Regions				
UK	●	⇧	●	Valuations are cheap and should benefit from rotation away from growth into value
US	●	-	●	Valuations are high and should suffer from rotation to cheaper more cyclical markets
Europe	●	-	●	Vaccine roll-out has been slow and long-term structural problems remain
Japan	●	-	●	Economic rebound likely to be muted but market's cheapness remains an attraction
Asia/Emerging Markets	●●	⇩	●	Short term headwinds but strong long term growth prospects and cheap valuations
Themes				
Infrastructure	●	-	●	Offers enhanced inflation protection and a beneficiary of increased government spending
Technology & AI	●	-	●	Strong growth prospects but headwinds from value rotation and tougher tax/regulatory backdrop
Healthcare	●●	⇩	●	Ageing populations and biotech innovation are positives as are cheap valuations
Frontier Markets	●	-	●	Very cheap valuations are attractive as is structural reform and good demographics
Climate Change	●●	-	●●	Major area of growth and focus for governments, companies and investors
Small & Mid Cap Stocks	●	-	●	Cyclical bias means well placed to benefit from strong economic rebound

Our view reflects our assessment of the relative attractiveness of each asset class after taking into acccount its riskiness
Change = change in view over the last quarter

● = Positive ● = Negative ● = Neutral

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