KINGSWOOD

PROTECT AND GROW YOUR WEALTH

Q3 | 2021

INVESTMENT OUTLOOK

SUMMARY

- A strong global rebound is now underway and should not be derailed by the Delta variant
- Global growth should slow from here but even so remain well above trend into next year
- Inflation has picked up considerably more than expected but a good part of this rise should prove temporary
- Lift-off date has been brought forward but interest rates in the US and UK still look unlikely to be raised until 2023
- The outlook for fixed income remains poor, with government bond yields likely to head higher again
- Further gains in corporate earnings should mean share prices still have some additional upside
- Prospective returns continue to look higher for equities than for bonds and we maintain our constructive stance
- Within equities, we remain positive on the UK and Asia and a variety of specific themes, including climate change

ECONOMIC AND MARKET OUTLOOK

The strong global economic rebound anticipated by the markets is well underway. The US grew at a quarterly annualised 6.5% pace in Q2, a similar rate to that seen in Q1. Meanwhile, following contractions in the first quarter, the Eurozone and UK saw annualised growth as high as 8.0% and 21%, respectively.

The combination of fiscal and monetary stimulus, the reopening of the economies, pent-up demand – be it more now for services than goods – and excess saving are all contributing to the rebound. The global economy looks set to grow around 6% this year, more than recapturing last year's 3.2% decline.

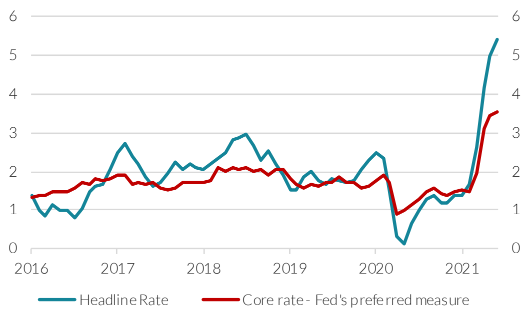
Even so, doubts have grown recently that the global recovery may not be as secure as first thought. The main worry relates to the rapid spread of the Delta variant. However, at least in the West, the extensive vaccine roll-out has weakened dramatically the link between infections and hospitalisation/mortality. While other countries have not been as gung ho as the UK in re-opening their economies, new restrictions have generally been quite limited.

In emerging economies, where vaccination rates are much lower, the Delta variant poses a significantly greater problem. All the same, while the global recovery may not be quite as strong as first thought, the Delta variant looks very unlikely to derail it. Businesses and individuals have become much better at coping with the pandemic and social distancing/ lockdown restrictions.

Growth is likely to slow considerably from the current very strong pace, as the reopening and fiscal boosts fade, **but should remain well above trend into the first half of next year.** Of course, risks remain. Most obviously, the continuing spread of the virus poses the threat of more vaccine-resistant variants emerging. Vaccines should be able to be adapted although it would take time.

Inflation, however, has been the biggest surprise of late. A spike higher had been expected, both on the back of prices (particularly oil) rebounding from the lows touched a year earlier and supply bottlenecks as economies reopened. But the increase, especially in the US, has been considerably greater than expected. The headline inflation rate is now running as high as 5.4%, while the core rate is up to 3.5% versus 1.5-2% prior to the pandemic.

US Inflation has picked up much more sharply than expected



Source: Refinitiv

The big question now is how much of this rise will prove short-lived. Most of the increase has been concentrated in a few specific areas, most notably used car prices, but there are some signs that the upward pressure may be broadening out.

In truth, it is too early to know whether this will turn into a major long-lasting rise in inflation. A key factor will be whether the shortages now being seen in the labour market feed through to a sustained increase in wage growth. The latter would prompt businesses to try and pass on the increased costs to consumers, thus providing the mechanism for the upturn to become more entrenched. A further concern is the bottlenecks in production processes that are causing shortages of a range of manufactured goods.

Inflation has also surprised on the upside in the UK, with the headline and core measures rising to 2.5% and 2.3%, respectively. Inflation is now expected to hit 4% at year-end, before retreating again next year.

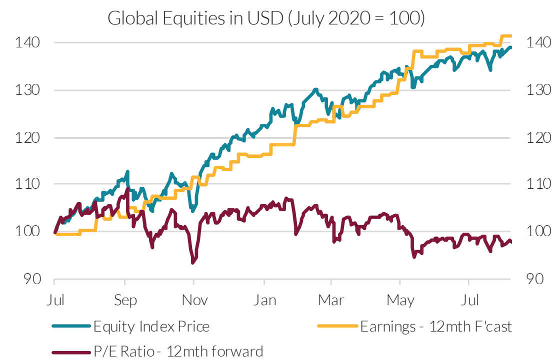
The major central banks continue to believe that the bulk of the rise will be temporary and **are still intent on tightening policy only gradually.** The Fed has effectively brought forward its forecast for the first rate rise but only to 2023 from 2024. As for tapering its QE-related bond purchases, this still looks set to start early next year.

In the UK, the BoE has turned a bit more hawkish and the QE programme is due to finish at year-end. However, the first rate increase still looks unlikely to occur until 2023. In the Eurozone, meanwhile, the ECB has switched from targeting inflation of below but close to 2% to a symmetric 2%. Rates there now look unlikely to be raised before 2024 at the earliest. A key question, therefore, is how aggressively central banks might react if higher inflation is more persistent than they currently expect.

Equity markets have continued to trend higher in recent months with global equities now up some 15% year-to-date in local currency terms. The driving force behind the gains has remained corporate earnings which have rebounded considerably faster than expected.

In the US, the Q2 reporting season just finishing looks set to see earnings up over 90% from the lows of a year ago. For the fourth quarter running, results are coming in well above expectations. At a global level, earnings should be a sizeable 25% higher this year than pandemic in 2019.

Corporate earnings have driven equity market gains



Source: Refinitiv

Earnings should continue to drive further gains in markets, although the upside is limited as growth will slow substantially over the coming year. Policy will also become less supportive, with central banks taking the first steps to scale back their massive stimulus. Continuing high levels of investor cash will compensate but only to some extent.

Valuations are likely to be another limiting factor as they may come under some modest downward pressure if bond yields head higher again. Indeed, the forward looking price-earnings (P/E) ratio has already fallen back from last year's 20 year high of 20-21x to 18-19x.

Within equity markets, the major factor driving both regional and sector outperformance has been the rotation between expensive 'growth' stocks and cheap 'value' stocks. After years of marked underperformance, value stocks saw a burst of outperformance starting last November on the back of vaccine optimism. However, this has gone into reverse over the last couple of months.

We believe value stocks should come back into favour again. Strong economic growth, rising bond yields and an abnormally large valuation gap between growth and value stocks are all conducive to a renewed rotation later this year.

The outlook looks considerably worse for fixed income than for equities. Government bond yields have fallen significantly since mid-May, unwinding much of their rise in Q1. This decline has occurred despite inflation surprising significantly on the upside.

Various technical factors have driven the bulk of the drop in yields although worries over the Delta variant have also contributed. Just as yields overshot on the upside earlier in the year, we believe they have now done so on the downside and expect **government bond yields to head higher again over coming months.**

With inflation worries unlikely to dissipate in a hurry, growth set to remain strong and central banks gradually becoming more restrictive, 10-year yields currently look too low at 1.3% in the US and 0.7% in the UK. A rise in yields in turn means conventional government bonds are likely to deliver negative returns over the coming year.

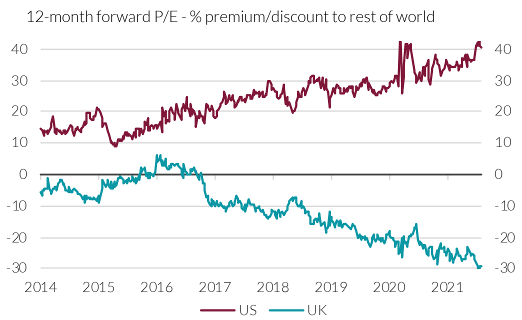
Corporate bonds should fare a little better, but even so prospective returns look set to be no more than 1-1.5% or so. The yield pick-up over government bonds has fallen to 1-1.25%, close to historic lows, and has no room to compress any further.

POSITIONING

We maintain a constructive pro-equity stance. Our allocation to risky assets, and equities more specifically, is a little higher than we would expect over the long term. This seems appropriate that equities should outperform bonds appreciably, even if the upside is no longer so substantial.

UK equities are one of our favoured areas. The key attraction here is their cheapness, with their P/E ratio now as much as 30% lower than the rest of the world. The UK has recently given back some of its outperformance since November as the rotation into value has gone into reverse. But it is well placed to benefit if, as we expect, value comes back into favour. UK equities have as yet regained only a small part of the underperformance seen over the last few years.

Valuation gap between US & UK equities has become more extreme



Source: Refinitiv

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 bias means they have some scope to outperform further on the back of the economic rebound.

We remain cautious on US equities, which have recently recaptured the underperformance of late last year. Valuations are the main concern, with the US P/E now some 40% higher than elsewhere. This gap is considerably higher than seen in the past, other than briefly last year. The US would also suffer from a resumption of the move towards value, just as it has benefited recently from the rotation back towards growth stocks and the technology sector.

Finally, the regulatory and taxation environment is becoming less favourable. President Biden has plans to raise the tax rate both on corporations and on dividends and capital gains. The OECD has also agreed a new minimum global corporate tax rate from 2023. If this is enacted, it would hit the US tech giants relatively hard due to the size of their overseas revenues.

We have become less averse to Europe now the vaccine roll-out has picked up speed, allowing the economic recovery to get underway. That said, equity valuations are not especially cheap and other markets should benefit more from a further rotation towards value. Longer term, the underlying structural defects of the eurozone also remain a concern.

We continue to favour Asia and emerging markets due to their long-term strong growth prospects and relatively cheap valuations. China's vast domestic equity market, is a fertile hunting ground for active stock pickers, is also a major attraction.

China, however, has underperformed this year, reversing last year's outperformance. This has been caused by a rotation away from last year's winners, relatively tight monetary policy and an intensification of the regulatory crackdown on sectors such as technology and education. Still, the authorities will not want to seriously undermine either the stock market or economic growth and their actions should now be largely complete and priced in. The longer-term attractions of China remain intact.

Finally, we remain broadly neutral on Japan. Improving corporate governance and relatively cheap valuations remain supportive, as does the cyclical bias of the market. However, the slow vaccine roll-out and muted economic rebound, have led to the market underperforming recently.

Thematic investing remains a strong feature in our client portfolios. We have had holdings in technology and artificial intelligence for many years and plan to retain them, even though they may suffer near term from a rotation back into value. Recent results have confirmed the strength of their growth model which should prove resilient to the rather harsher regulatory backdrop going forward.

Climate change is another growth area we are keen on, with governments, companies and investors all 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 the 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 developed market corporate bonds of relatively short maturity. However, we have recently switched a small part of these holdings into emerging market bonds where yields look relatively attractive.

We have only a relatively small holding in conventional government bonds. Not only is there the prospect of negative returns but they are also likely to offer only limited protection 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 only limited defence against higher inflation.

Alternatives which aim to provide moderate returns regardless of the moves in bonds or equities **continue to look attractive.** We already have a holding here and increased our exposure further in June with the allocation funded from fixed income.

Lastly, **we have an allocation to gold.** The gold price has stabilised around $1800/oz in recent weeks. However, with interest rates set to remain relatively low and inflation concerns likely to persist, we believe it will head higher in the medium term. It should also provide a source of protection in the event of a major market sell-off.

MARKET VIEWS

	PREVIIOUS VIEW	CHANGE	CURRENT VIEW	
ASSET CLASS				
Cash	🔴	-	🔴	Unattractive with interest rates so low
Fixed Income	🔴🔴	-	🔴🔴	Yields to reverse recent decline and return prospects are poor
Equities	🔵	-	🔵	Strong global economic rebound means equities still have some 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	🔴🔴	-	🔴🔴	Strong growth and higher inflation to drive yields higher and outlook is for zero/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	🔵	-	🔵	Relative valuations are very cheap and should benefit from renewed rotation from growth into value
US	🔴	-	🔴	Valuations are very high and should suffer from renewed rotation to cheaper more cyclical markets
Europe	🔴	⇧	🟡	Growth outlook has improved following speed up of vaccine roll-out but market not especially cheap
Japan	🟡	-	🟡	Economic rebound has disappointed but market's cheapness remains an attraction
Asia/Emerging Markets	🔵	-	🔵	Strong long term growth prospects and cheap valuations but regulatory crackdown a drag on China
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 focus for governments, companies and investors and has strong growth prospects
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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