JOHNSTON CARMICHAEL WEALTH

Market Update

April 2021

SQUARE MILE
INVESTMENT SERVICES

Macro Highlights

President Biden's US$1.9trn American Rescue Plan is approved by Congress. This is in addition to the two fiscal boosts approved by his predecessor in 2020. Further spending packages of US$3trn earmarked for infrastructure and healthcare/childcare are in the pipeline. With pent-up demand set to be unleashed by a successful vaccination programme and the US Federal Reserve signalling no interest rate rises until 2024, the US economy could run very hot over the next year. Both the OECD and the Federal Reserve now expect the US economy to grow by 6.5% in 2021 and this figure may prove conservative.

The UK's economy shrank by 9.9% in 2020, by some margin the biggest annual contraction since reliable records began in the 1940s and possibly even since the Great Frost of 1709. The independent Office of Budget Responsibility forecasts that the UK economy will rebound by 4% in 2021 and by more than 7% in 2022, aided by government borrowing of £355bn in the current financial year and a further £234bn in 2021/22. The main revenue raising measures announced in March's Budget included a jump in corporation tax from 19% to 25% from 2023 and the 'fiscal drag' created by a five-year freeze in personal tax thresholds. So, it is clearly Spend Now, Pay Later.

BOND YIELDS RISE ON FEARS OF REKINDLED INFLATION

With less-than-impressive vaccination rollouts and many countries having to impose new lockdowns in response to third waves of the virus, economic recovery in Europe is likely to lag the UK and the US in 2021. The medium-term outlook for export-oriented and industrial countries in Northern Europe is clearly rosier than for countries with more domestically focused and tourism-dependent economies.

China was the only major economy to grow in 2020, expanding by 2.3%. Thanks to draconian lockdowns in the early stages of the pandemic and a rapidly accelerating vaccination programme, economic growth of at least 6% (the official target) and possibly as much as 8% is expected in 2021. Indeed, such has been China's apparent success in subduing the virus, fears and warnings of both fiscal and monetary tightening are already mounting. This presents a stark contrast with other leading economies but could also be a harbinger for them too.

Bonds

Usually regarded as dull when compared with equities, bond markets were the main source of excitement and turmoil for investors in the first three months of 2021. Even though the Federal Reserve and the Bank of England have pledged to keep interest rates at rock-bottom, 10-year US Treasury bond yields almost doubled from 0.92% to 1.75% and 10-year UK gilt yields more than quadrupled from 0.20% to 0.85% as investors demanded higher returns to compensate for the risks of higher inflation and a deluge in supply to fund gaping fiscal deficits. When the yield of a bond rises its price goes down. Thus, indices representing the return of the broad gilt market were down by 7-8% over the three-month period, their worst quarterly performance since the late 1980s.

Perhaps perversely, corporate bonds performed better than supposedly safer government bonds. In fact, the riskier the bond was in terms of its perceived credit quality, the better its return! Low quality corporate bonds have return and risk characteristics that are closer to equities than government bonds, so it is perhaps not surprising that they have benefited from the anticipated economic recovery and rising stock markets. In addition, it is symptomatic of investors' desperation for yield and willingness to accept ever lower compensation for the risk of default.

Equities

Optimism about vaccination rollouts, economic recovery and rebounding corporate profits unsurprisingly fuelled another strong quarter in stock markets, with the UK market rising by about 5%. Overseas stock markets also advanced by similar amounts, although returns for sterling-based investors were reduced by the strength of the pound. The one, perhaps surprising, laggard was China, which was down by just over 3%. As noted above, this is the country in which fears of the fiscal and monetary punchbowls being withdrawn are most prevalent and powerful.

The quarter was also notable for a major rotation in investor preferences away from high-priced, fashionable 'growth' stocks and into cheaper, less exciting 'value' stocks. The former, and technology stocks in particular, have been the clear winners of the pandemic but their often dizzy valuations are the most sensitive and vulnerable to rising bond yields.

In contrast, value stocks, which appear cheap with reference to their cash flows or assets, have suffered most in the pandemic-induced economic slump and therefore offer the greatest potential for recovery in profitability in the near term. Whereas an out and out 'growth' portfolio was certainly the right way to be invested in 2020, we believe that a balance between quality (but not too high-priced) 'growth' and 'value' is more appropriate for 2021.

The quarter also featured two other events which are worthy of comment. The first is the Gamestop debacle, which saw an army of presumably largely amateur investors coordinate through a social media platform to propel the stock price of this struggling US video games retailer from US$20 at the beginning of the year to a peak of US$483 in a matter of weeks, before it fell back again to US$40. Professional and experienced investors ignore the power of social media at their peril and also the way that new technology has enabled a generation of young and thrill-seeking investors to access financial markets. The second is the recent implosion of a little known but very large private investment fund (Archegos) which has resulted in billions of dollars in losses for investment banks which were exposed to the fund. Archegos and its counterparties were undone by a toxic mix of complex derivatives and leverage and the abundant availability and cheapness of the latter is a direct consequence of the monetary conditions in which we live today. We need to stay alert to the excesses which may have built up in the financial system.

Even though yields on government bonds have risen, they remain lower than inflation whilst cash deposits continue to offer negligible returns. Equities therefore remain the only mainstream asset class through which investors can hope to maintain or grow their capital in real terms. We continue to caution, however, that returns in the years ahead will almost certainly be lower than investors have enjoyed over the past decade and investors should also expect those returns to be more volatile, particularly if bond yields continue to rise.

Currencies

The pound was the strongest major currency in the first three months of 2021, appreciating by 1% against the US dollar, by 4% against the euro and by about 8% against the yen and Swiss franc. This reflects expectations of economic recovery, not only due to the successful vaccine rollout but also the removal of Brexit uncertainty. The latter had weighed heavily on the currency in 2020. The strength of the pound eroded gains from international investments for UK investors in the quarter.

STOCK MARKETS RISE IN ANTICIPATION OF ECONOMIC RECOVERY

Defying a broadly held consensus (as often happens in currency markets) that it would be weak in 2021, the dollar has appreciated against all the major currencies except the pound so far in 2021. Investors may be worried about the spiralling debts of the world's largest economy but, for now at least, they are clearly attaching greater importance to the prospects for growth.

Alternative Investments

After a stellar 2020 in which its price rose by 24% in US dollar terms, gold has fallen by almost 11% in the first three months of 2021. Gold is often regarded as the ultimate hedge against inflation. However, even though bond yields have risen sharply so far in 2021 mainly because of fears of resurgent inflation, that inflation is yet to actually emerge.

In contrast, the price of Bitcoin has doubled in the first three months of 2021, having quadrupled in 2020. In a time of unprecedented money printing by central banks, we certainly understand the allure of an 'investment' in a cryptocurrency of which there is a finite supply. However, the price of bitcoin has also been extremely volatile (falling, for example, by almost 85% between December 2017 and December 2018) and unanswered questions remain about possible manipulation of its price, its use and its real value. For these reasons we regard it as a highly speculative investment which is wholly unsuitable for use in the portfolios we manage.

The commercial property fund sector remains under a cloud. Investors in approximately a quarter of the funds in the sector still cannot access their money and, following the bloodbath in retail property values, there are now also clearly questions about the value of office space in a post-pandemic world. Meanwhile, we still await the FCA to give its verdict on the blatant mismatch in liquidity between daily-dealing property funds and their underlying assets. Too much uncertainty remains for us to consider re-investing.

This document is issued by Johnston Carmichael Wealth in conjunction with Square Mile.

Where sharp minds meet

Aberdeen
01224 259373

Dundee
01382 411790

Edinburgh
0131 220 2203

Elgin
01343 548646

Forfar
01307 465565

Fraserburgh
01346 518165

Glasgow
0141 222 5800

Huntly
01466 794148

Inverness
01463 796202

Inverurie
01467 621475

London
0203 7144 350

Perth
01738 634001

Stirling
01786 459900

jcwealth.co.uk

Figures refer to the past and past performance is not a reliable indicator of future results. You may not get back the full amount of your investment.

Johnston Carmichael Wealth Limited is an associate company of Johnston Carmichael.

PKF Johnston Carmichael is a member firm of the PKF International Limited family of legally independent firms and does not accept any responsibility or liability for the actions or inactions on the part of any other individual member or correspondent firm or firms.

Disclaimer: While all possible care is taken in the completion of this document, no responsibility for loss occasioned by any person acting or refraining from action as a result of the information contained herein can be accepted by this firm.

Johnston Carmichael Wealth Limited is authorised and regulated by the Financial Conduct Authority.