TierOne

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World Economic and Market Outlook

SUMMARY

Despite the recent consensus view of a strengthening economic recovery and continued stimulative monetary policy, markets in 2021 have seen some of the strongest levels of style rotation in the post crisis period. This has demonstrated how easy it is for investors to be whipsawed and so suffer relative underperformance. The reason for this market volatility is not readily apparent at the index level and perhaps this underpins the importance of taking a longer term view as few investors would be able to successfully anticipate these moves and rotate portfolios in a pre-emptive rather than reactive manner. Risk management is an important part of investment and at times of uncertainty making strong market bets may be more a foolish undertaking than a demonstration of informed conviction. Successful active investment management is not always about having a strong view, but rather knowing when to and when not to exercise this. Stepping back and thinking about longer term thematic change, combined with economic fundamentals, allows you to see the valuation opportunities (or lack of) and market sentiment remain as pertinent today as before.

Markets have continued to front run the global economic recovery and have been prepared to look through second or third waves of Covid-19 lockdowns due to the belief that vaccine efficacy will result in eventual economic recovery. This is especially true of the developed versus the emerging world where, with the exception of North Asia, growth rates are now below those of advanced economies. Markets continue to focus on the prospects for recovery in the second half of this year and out into 2022 and beyond, encouraged by the step change in economic policy making combining fiscal supports with monetary stimulus.

The world is undoubtedly seeing the most dramatic policy shift that has occurred in the last 30-40 years with, for example, in the States Joe Biden increasing government's share of GDP to 25% versus the 20% pre-pandemic level. These types of Keynesian policies shows a belief in a trickle up rather than trickle down (stimulus via tax cuts) response. Markets have even been unperturbed by potential shifts in taxation. By US standards the Biden administration is advocating a significant re-distribution of wealth from companies and high earners favouring those with the greatest propensity to spend. Developed country governments and central banks now all favour higher wages for the lower paid. Thus, there has been a sea change in attitudes to fiscal policy away from the belief that government debt levels matter which ushered in a period of austerity post the Financial Crisis. While modern monetary theory (MMT) has not been as yet fully adopted, central banks have altered their thinking towards outcome based policies rather than being outlook focused, which is very different to what has occurred in the past 30 years.

Markets have remained relatively relaxed after a period of turbulence in February and March, due to the belief that inflationary pressures will be transitory. There are clearly strong arguments both in favour and against this view. For inflationary pressures to persist it will be necessary for wages to increase in line with price rises, as this would result in seemingly one off increases in prices to cascade through the system and permanently raise inflationary expectations. This remains the chief threat to financial market stability today. Unfortunately, as much of current economic policy can be best described as experimental, the precise outcomes have a significantly lower level of certainty than the continuation of more tried and tested macroeconomic policies. Forecasting has always been uncertain and the distinct events of the past two quarters, when the driver of equity market outperformance has arguably been solely down to movements in government bond yields, suggests the most prudent course for investors is to adopt a balanced approach to portfolio construction. Historically, investors would expect value orientated strategies to perform well when economic growth was accelerating, and although this proved true in the latter two months of 2020 following positive vaccine announcements and the first quarter of 2021, this does not explain the underperformance of value in the second quarter of this year. Value has underperformed even as economic growth rates and forecasts of economic profitability have improved.

The importance of stimulatory monetary policy on equity markets is well demonstrated by the two largest markets in the Asia Pacific region. China, despite a strong bounce back in growth and avoidance of a further Coronavirus induced lockdown, has seen its equity market underperform India, where despite a humanitarian tragedy investors this year have been rewarded with strong gains.

The January Outlook piece was titled 2021 A Year of Living Dangerously and for investors depending on relative performance this has been demonstrated by the strong style rotations this year. After value was in the ascendancy in the first quarter there was an abrupt reversal in the outperformance of value during the second quarter. Hence, the title of this Outlook 'The Last Will be First and The First Will be Last'. This inter-market volatility suggests that for most investors, extreme style views could be costly and the chances of successfully exploiting style rotation in a portfolio is unlikely. Overall, to date in 2021 economic fundamentals have improved, and even in areas such as South Asia where Coronavirus numbers have remained persistently high, arguably valuation opportunities and the more favourable demographics suggest exposure to the consumer story for long term investors will be profitable.

While market valuations remain above long term averages, a combination of a lasting economic recovery and historically low interest rates, gives support to equities especially when no other asset classes offer strong long term value.

June has seen a significant pick up in investor confidence, and when market sentiment is elevated there is always the potential for sharp setbacks on any adverse news. The influence of the retail investor cannot be discounted, and having been on a declining trend in the post WWII period, investment in the post pandemic era has shown that rising levels of private client market participation can alter the drivers of market performance. While this has been much commented upon in the States with younger investors favouring stocks showing price momentum and secular growth characteristics, it has also been seen in a number of Asian markets including India and has helped the outperformance of small caps in that country. This may well be a factor limiting the ability of value stocks to deliver sustained outperformance with these strategies seemingly dependent on a return to more traditional economic cycles which could yet emerge as a result of the dramatic policy shift now occurring.

Many professional investors like to argue that future returns will depend on stock picking, but this has not been the case to date in 2021 where the chief driver of returns has been the ongoing battle between structural disinflationary pressures and a cyclical upturn in the inflation rate. The growth versus value debate will continue to depend on whether the era of secular stagnation highlighted by Laurence Summers has ended or not. Overall, equity markets seem likely to be supported by the continued economic recovery and pro-growth measures but market leadership is likely to continue to rotate in a volatile manner.