JBWere

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Investment Update

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In our previous investment update (12 April 2021), we mentioned that even though some major equity markets now sit at, or near, all-time highs after the powerful recovery experienced over the past 12 months, it was still JBWere's view that further upside was likely over the coming year or so. That being said, we felt that the pace of market gains from here was now likely to be more moderate than what has been seen recently. It is this latter point we will discuss a little more in this update.

Before we begin, it is worth revisiting what has been driving equity markets higher over the past year, and especially over the past six months. Quite simply, it has been an expectation for a sharp recovery in economic activity (and corporate earnings) as the roll-out of effective COVID-19 vaccines gathers steam, together with ongoing central bank and government policy support. While it is fair to say that some countries are more advanced in their recoveries from lockdown than others (and clearly some parts of the world are still grappling with the tragic consequences of the COVID-19 pandemic), global economic data over the past few months has generally been consistent with this sharp acceleration in economic momentum. As these better growth prospects become priced in, longer-term government bond yields have risen from historic lows, steepening yield curves. And as a further clear sign of this positive economic momentum, the latest Q1 reporting seasons in the US and Europe has seen the majority of companies report earnings well ahead of market expectations, forcing analysts to once again upgrade their forecasts for future earnings.

This 'reflationary' backdrop (accelerating economic growth, abundant global liquidity, and steepening yield curves) has also created the conditions necessary to generate a marked shift in market leadership over recent months. After a year where 'stay at home' beneficiaries and sectors/regions that typically do well in a falling bond yield environment outperformed the broader market strongly, over the past six months or so, it has been more cyclical sectors (i.e. those whose earnings are more sensitive to the strength in economic activity), that have outperformed. More specifically, it has been the Energy, Financials, Materials, and Industrials sectors as opposed to Healthcare, Utilities and Staples that have led global equities higher. The Technology and Consumer Discretionary sectors, which both meaningfully outperformed the broader market last year, have also lagged.

To be fair, the rotation has not just been confined to cyclical versus defensive sectors. It has also been evident, for example, across small versus large cap stocks, so called value versus growth names, low quality companies versus high quality ones, and even across different regions. The New Zealand equity market (the NZX50), for example, has lagged other major equity markets this year, which given its relative defensiveness is perhaps unsurprising (although admittedly some idiosyncratic factors have also played a role). Beyond vaccines and policy support, "rotation" has arguably been the buzz word to describe equity markets this year.

Therefore, the key question, as we look towards the second half of this year and beyond, is how long these rotations may continue. In short, we think there is further to go in the near-term. In part this is because we still see some modest upside in longer-term bond yields, and it doesn't appear the strong growth recovery is yet fully reflected in market pricing given, analyst earnings revisions are still strongly positive. That said, we do see the rotation overall becoming more nuanced. The emergence of a few more cross-currents likely means that not only is market leadership set to be less consistent than what has been evident year-to-date, but broader market moves (as mentioned earlier) are likely to be more modest than the strong gains seen over recent months. We say this for the following reasons:

- **We are approaching a peak in growth momentum.** While we see global economic growth remaining at an elevated *level* for some time yet as economies continue to 'normalise', the *change* in growth is likely to peak shortly (although its exact timing is uncertain). For some major economies, like China, sequential economic growth has probably already peaked, and for the US it may not be too far away. For others, like Europe and other emerging economies, they have further to go. The trajectory of equity markets is a function of both the level and change in economic growth. History suggests that the strongest equity market returns (and the phase most supportive for cyclical sectors) are when economic growth is accelerating. As this growth acceleration

matures (the phase we are set to shift into over the second half of this year), equity returns are typically still reasonable, but increasingly less so.

- **The global liquidity impulse is also likely close to a peak**. Global liquidity is impacted by many factors, although more recently it has been dominated by central bank asset purchases (Quantitative Easing, or 'QE'). In response to the pandemic, major central banks ramped up these asset purchases at an unprecedented pace (for example, over 2020, the US Federal Reserve, European Central Bank, Bank of Japan and Bank of England together expanded their asset purchase programs by ~US$6 trillion). While we still believe it will be some time before central banks remove this stimulus, the pace of these purchases has naturally begun to slow and should slow further as economies reopen and recover. This shifting global liquidity backdrop also points to a moderating pace of equity market gains, and we suspect market leadership with it.
- **Only a transitory burst of inflation**. Rising longer-term government bond yields have largely been driven by a meaningful rise in market-based inflation expectations (or breakevens). In the US, 10-year breakevens now sit above ~2.4%, implying that the market expects US CPI inflation to average 2.4% over the next decade, which is the highest in eight years. Given our views that a nascent spike in inflation will only prove temporary (as we also discussed in our more recent investment update), these breakevens are arguably approaching an upside limit, meaning that the further modest bond sell-off (which we expect) will be led by higher real yields. Historically, rising real yields result in a less clear-cut picture for cyclicals' outperformance and increased odds of a broader equity market wobble.

In addition to the above factors, we could also include the likes of potential corporate and personal tax changes (as proposed by the Biden Administration), stretched positioning and investor sentiment, and high valuations (creating less room for error) as other possible issues that could cause some waxing and waning in market performance over the second half of this year. We should emphasise that we retain a constructive stance towards equities overall, especially relative to fixed interest. However, after a strong run, we believe it is only natural that the risk/reward for equities is now less positively skewed than it was as we move into a different phase of the market cycle.

So, what does this mean for the MAS Funds? As we've mentioned in previous updates, given our constructive stance towards equities overall, especially relative to other asset classes, we made the active decision last year to increase the exposure to growth assets within the MAS Funds to modestly above their strategic targets. That modest overweight remains in place today, and we continue to be comfortable with that position. That said, as a prudent way to manage risks, we are consistently rebalancing portfolios to ensure that relative market movements do not see Funds drift meaningfully above these modest overweight equity targets. We also maintain a high degree of flexibility and diversification within Funds to ensure they can withstand what we expect to be a more volatile, but still positive, backdrop for markets over the second half of this year and beyond.

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