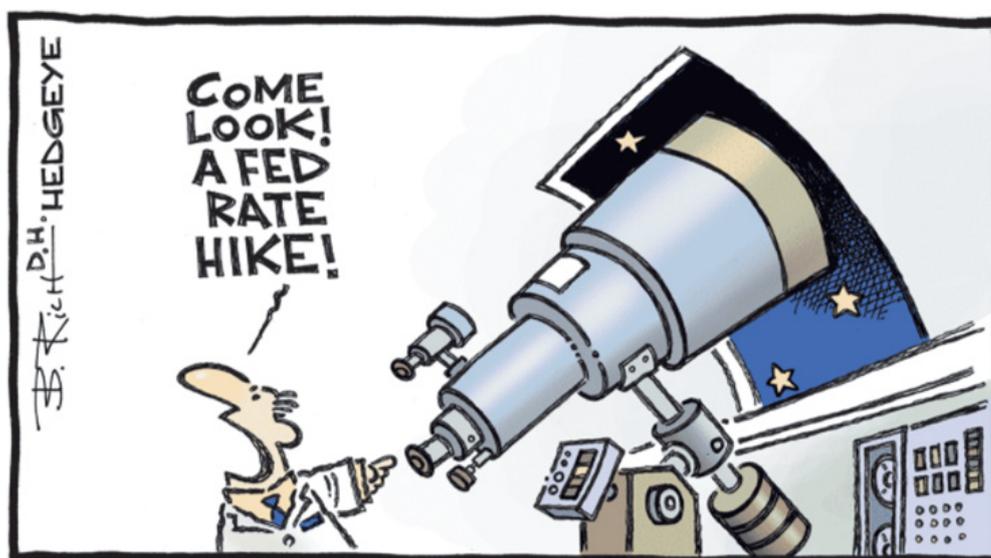


Introduction and Market Overview

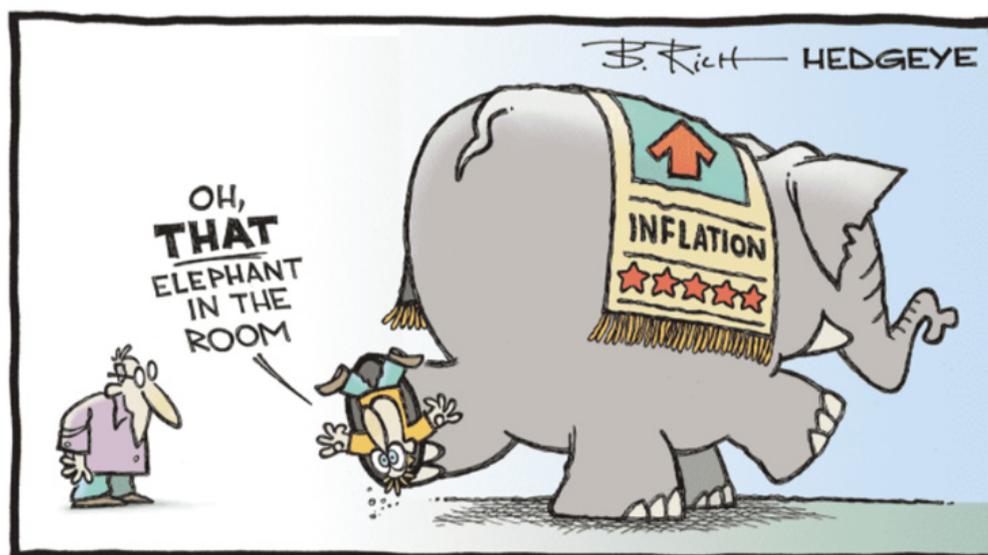
Having performed strongly in 2020 on the expectation of an economic recovery, investment markets are now trying to front-run the next phase of the cycle. The twin drivers of huge policy support, and expectations grounded in the belief that vaccines would come, propelled market valuations in the latter part of 2020. Now there is some attempt to front-run what many think is the next stage of the cycle – higher inflation and possible monetary tightening if inflation is stubborn for a longer period of time.

Currently the inflationary pressures look short term. Oil prices have risen significantly from where they were 12 months ago and there is expected to be increased demand and constricted supply for a few months to come. GDP growth in the developed economies will be higher this year (beyond Q1) than at any time since the 1980s. It will be higher than most market participants have experienced in their careers. It will be higher than most policy makers have faced. The idea that central bankers will sit back as nominal growth surges is not something that traditional investors and commentators would expect. It is therefore little wonder that bond yields are moving up alongside a surge of news on the traditional effect of rising inflation – such as when central banks will hike rates or taper their bond buying. For the moment, the prudent position to take is to expect yields to move slightly higher still, but central bank guidance will keep the drama in check. Remember, the current monetary and fiscal policy is not remotely “normal”, so maybe the effect on markets will be different too.

The US Federal Reserve (FED) has reiterated that 2023 is the most likely date that rates will start to rise. It needs to be a strong message over the coming months because inflation is evidently going to be higher in the next few months and demand straight out of lockdown could surge. We expect it will be quite a game of brinkmanship between the markets and the central banks. The European Central Bank will need to do more to resist contagion. They are already, but they are also making their policy framework more rigid. This will make for an interesting June meeting.



One can be forward-looking and short-sighted at the same time. Indeed, even 10-year inflation expectations are very sensitive to the current underlying state of the economy, as influenced by business surveys. The February manufacturing survey index (PMI) was its highest since 2008. These surveys can be pretty good at predicting inflation a few months ahead and we agree that consumer prices will accelerate into 2021, but it is premature to see in these indicators signals of a shift to a new inflation regime.



However, inflation expectations also take on board judgment calls on the policy stance. The FED's pledge to tolerate inflation overshooting its 2% target is an important shift. It seems sensible that the FED will maintain a dovish communication mode during the imminent acceleration in inflation, thus strengthening the credibility of their "Average Inflation Targeting" framework. This should push inflation expectations higher.

Asides from talk of inflation and rate hikes, the first quarter also saw a UK Budget. The budget fitted into the broader policy narrative of central banks as Chancellor Rishi Sunak made some concessions to those in his party concerned about the size of the UK budget deficit and the increase in outstanding debt by pre-announcing an increase in the tax take. However, the benefits of that to the public accounts will not be seen until 2023. In the meantime, there was another £65bn of emergency funds announced with the extension of the furlough scheme, the stamp duty partial holiday and other measures. The Office for Budget Responsibility estimates that the budget deficit will decline this year – from 13.3% of GDP to 7.6% next year largely on the back of the increase in GDP growth.

The key to the extended recovery remains central banks keeping financing costs low. The policy agreement does not seem quite as joined up in the UK as it is in the US, but keep in mind the Bank of England has not entirely closed the door on negative interest rates. We cannot see the Bank of England changing policy anytime soon despite the improved outlook for the UK economy. For governments, borrowing costs are well below expected nominal growth so there is an opportunity to reduce debt to GDP ratios in the next few years even with aggressive fiscal stimulus today. For now, the message from central banks has to be "Keep Calm and Carry On". Tightening is not on the cards yet, there is more recovery to come and the rise in bond yields is totally for the right reasons.



In the UK, our progress in vaccinations of all adults by July has been right on track, although supply issues are starting to raise their heads. As we move through the UK Governments phased return from lockdown, different sectors are starting to reopen through April and May. Further positives can be seen in corporate earnings growth that should support a better 2nd quarter in 2021. The 20-25% increase in earnings that is expected for 2021 is not out of line with fundamentals, given how much earnings fell in the first half of last year. As growth is expected to remain strong into 2022, this means that there is still upside to earnings forecasts. That should be a key support for our positive stance on equities. Our discretionary portfolios have been quite active this quarter, moving away from the consensus overweight to technology and focusing more on new opportunities in stocks that will benefit from the reopening of economies throughout the year.



Our current economic cycle is marked by vaccine development and deployment (even in the face of new variants), rising immunity and falling infection rates, and a sequential lifting of social mobility restrictions and the commensurate increase in economic activity. The nuances are provided by differences in the speed at which this all happens between countries, the additional policy support that goes along with it and the extent to which the pent-up demand accumulated is realised in actual spending. The US is leading the way on most counts of a recovery, with the UK (delays in vaccine supply from India not withstanding) driving vaccinations forwards. Other countries are in their wake. The passage of the \$1.9trn COVID-19 recovery stimulus bill in the US is a huge reason for the expected acceleration of the US economy. Joe Biden's stimulus package hands out \$1,400 cheques per adult, with \$350bn for city development, \$170bn for schools and \$100bn for public health. A middle-class family of 4 will be around \$12,000 better off from all this stimulus. There is no precedent for this in American history.



Some transitory increase in inflation is likely. We have had disruptions to supply and demand in the last year and the expectation is that demand will come back quickly. So, in some parts of the economy – travel and hospitality – prices could rise a lot. This hump in inflation in Q2 will coincide with a boost to US household income coming from stimulus checks and with the further re-opening of the US economy as vaccinations are rolled out rapidly across the United States. The transfer of wealth from global savers to American consumers via the guarantee of the US federal government should be tremendously powerful. Some of the cash might go into savings plans, some of which will go into equities. Talk of rate hikes now is all speculation. What is clear is that central banks are loath to run the risk of snuffing out a recovery in order to counter early signs of inflation. They seem much more likely to wait for a sustained shift up in inflation before tightening and as we expect inflation to be short term for now, we remain confident on the outlook for equities moving forwards. The important point, is that the equities that do well in 2021, may well be the ones that suffered most last year.

Portfolio Review 1st Quarter 2021

Global Income Opportunities

Equity markets started the year on a positive note, but at the same time we were seeing a continued rise in global cases of Covid, a new South African variant of the virus, and new lockdown measures being announced. There was also uncertainty about what impact a Democrat-controlled Congress would have on markets, particularly tech stocks. Against this uncertain backdrop we felt it prudent to take a little risk off the table. We therefore sold the holding of L&G Global Real Estate Dividend Index Fund. With growth and inflation looking set to increase this year, particularly in the US where the Democrats winning control of the U.S Senate had cleared the way for a larger fiscal stimulus under Joe Biden, it meant it was not an ideal environment for this type of fund. This made it a good candidate to sell to reduce risk, especially as we were able to book a gain on the sale.



The proceeds from the sale were used to introduce a new fund into the portfolio, the **Montlake Crabel Gemini Fund**. This is a defensive fund, that aims to have a very low correlation to equity markets and therefore adds to portfolio diversification.

Later in the month we made a further change to the portfolio. We introduced an exposure to the **Invesco Nasdaq 100 ETF**. The Invesco fund offers exposure to the 100 largest non-financial companies listed on the Nasdaq Stock Exchange, which is heavily weighted towards technology companies. The fund counts Apple, Microsoft, and Amazon amongst its largest holdings. The price of technology stocks, including Tesla, Apple and Facebook suffered a sharp correction towards the end of January, as continuing lack of forward guidance outweighed strong quarterly results. Investors also appeared concerned about the threat that rising bond yield could pose to growth stocks generally (and technology stocks in particular) following the Democrats win of two pivotal Senate elections and therefore securing control of the chamber. We took the view that much of the bad news was already incorporated into the price of the technology stocks following the selloff, and with exposure to technology being fairly low in the portfolio we took the opportunity to increase it.

The new purchase was funded by completely selling a relatively defensive equity fund from the portfolio: **Trojan Global Income.**

During March we conducted a further fund switch in the portfolio as the vaccine rollout meant economies can gradually reopen. Following a period of short-term market weakness we took the opportunity to buy a favoured fund that was a little too expensive earlier in the year.

To fund the new sale, we have sold the **VanEck Gaming & eSports ETF**. This fund tracks an index of companies that generate at least 50% of their revenue from video gaming and/or eSports, which is a sector that has been a clear beneficiary from a world in lockdown. Whilst we still like the long-term theme of this fund and may well reintroduce it again at some stage in the future, we acknowledge that the ETF has seen strong inflows over the past year. These flows may move in the opposite direction over the short term, which may well put downward pressure on the price.

We have replaced the fund with the **Baillie Gifford Global Discovery Fund**. Baillie Gifford as a house have an investment process focussed on selecting growth stocks, with this fund offering exposure to global companies with a relatively small market capitalization. The stated mandate of the fund is to outperform (after deduction of costs) the S&P Global Small Cap Index by at least 2% a year, and it has been successful in achieving this objective in the past. The fund has been a particularly strong performer over the past year, but a sharp correction in the price over the past month has allowed us to open the position at a significant discount to its recent highs. The fund does not pay an income, which may appear an odd choice given the income focus of your portfolio, but we feel the diversification benefit of this fund more than compensates for its lack of yield. It is also worth pointing out that the VanEck fund that we sold also did not pay an income.

It has been a particularly interesting quarter as market leadership has changed quite quickly, and we have been pleased that we could rotate parts of your portfolio efficiently in line with this.