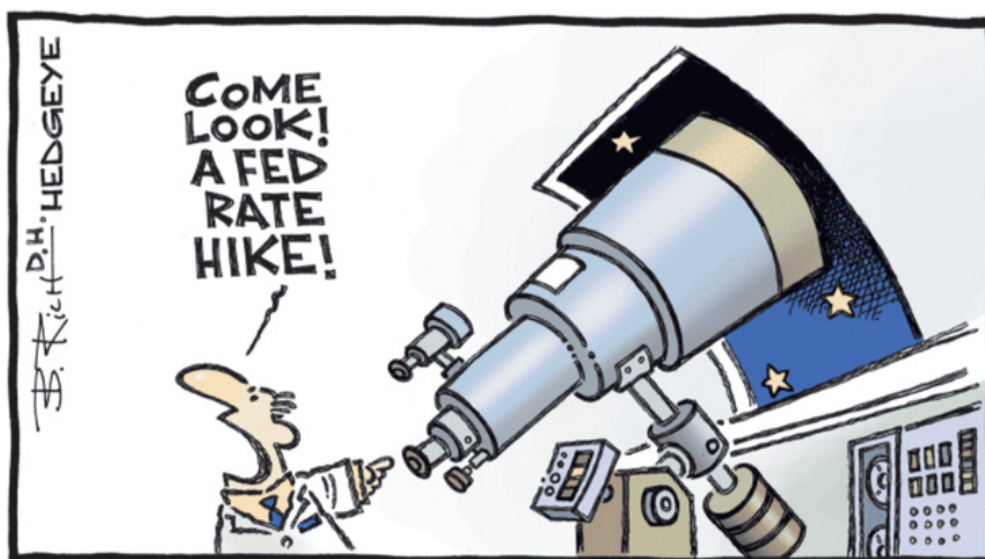


Introduction and Market Overview

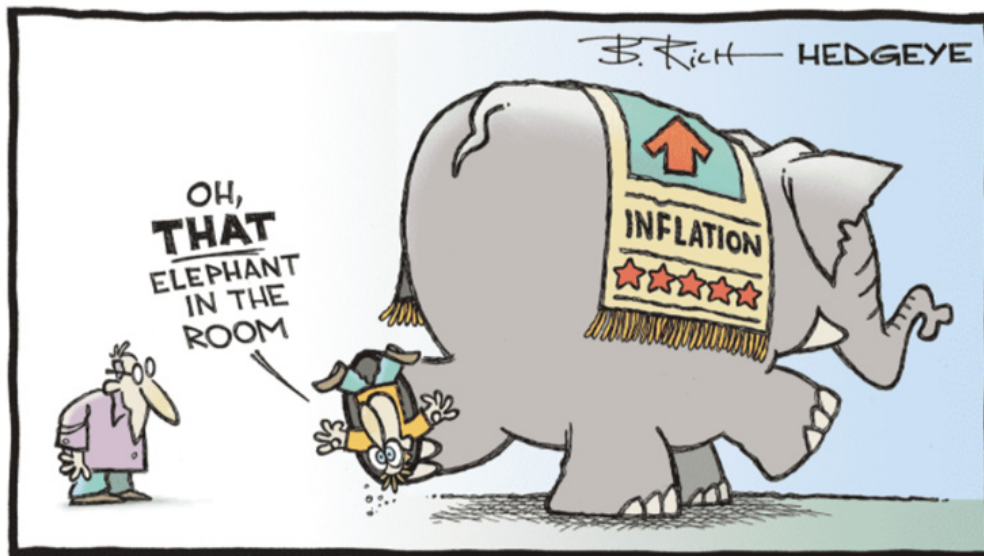
Having performed strongly in 2020 on the expectation of an economic recovery, investment markets are now trying to front-run the next phase of the cycle. The twin drivers of huge policy support, and expectations grounded in the belief that vaccines would come, propelled market valuations in the latter 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

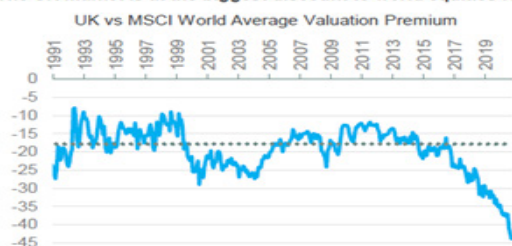
Strategic Growth ESG

The good performance of the portfolio in the fourth quarter of 2020 continued into 2021 so we decided to rebalance the portfolio towards the end of January. This ensured that we took profits from the positions that have done well, and top-up those that have underperformed. The holding of **Baillie Gifford Positive Change** had performed particularly strongly, rising by over 15% during the fourth quarter of 2020, and then increasing by more than 10% in the first three weeks of January. We cut exposure to the fund by c. 30% during the rebalance. We also cut exposure to the **iShares Global Clean Energy ETF** (by c. 43%) following a period of extremely strong performance, which will have been partly due to an expectation of increased spending in this space following Joe Biden becoming president in the US, and with the Democrats also taking control of Congress.

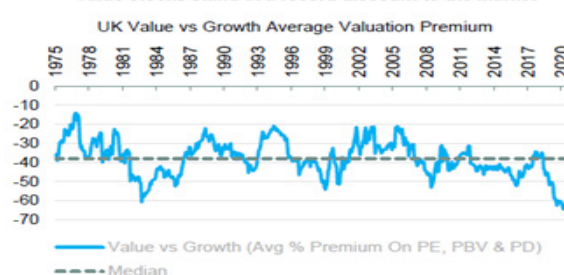
We used the opportunity to increase exposure to UK equities that are classed as showing 'value'. There are many different definitions of what represents value but generally it is interpreted as shares whose price is relatively low versus their fundamentals (e.g earnings and book value). This contrasts with 'growth' stocks, which generally have higher growth in their earnings, but whose prices are typically much higher in relation to their fundamentals.

Over the very long term value stocks have outperformed growth stocks, but the opposite has occurred over the past decade or so, which in the UK has pushed value stocks to stand at a significant discount to the market on some measures. On top of this UK equities were also looking relatively cheap compared to the rest of the world.

The UK market is at the biggest discount to world equities for 30 years



Value stocks stand at a record discount to the market



Source: RWC

There are some signs that the recent trend of growth outperformance may be reversing. Value stocks offer exposure to sectors and industries that were hit hardest by the economic downturn caused by Covid-19, such as energy and banking. These are the areas of the market that are starting to outperform as global economies begin to recover, but whose performance over the past year still stands at a significant discount to sectors such as technology that have done the best. Further reasons to favour value stocks is that they have historically outperformed when an economy is in a reflationary environment when bond yields are rising, which we are also seeing currently.

Exposure to UK value stocks has been achieved via the purchase of the **Schroder Responsible Value fund**. The fund is actively managed, which we feel to be important for this type of exposure. The managers focus on companies that have certain value characteristics and follow a responsible investment approach by using the Schroder Responsible Value UK Equity Fund Responsible Investment Policy, a process by which companies are vetted against certain responsible standards. The Responsible Investment Policy applies investment restrictions on companies involved in military products and services, non-military firearms, pornography, tobacco, gambling, alcoholic drinks, high interest rate lending and human embryonic cloning. The investment manager also assesses companies on their environmental and social impact as well as the strength of their corporate governance.

With the vaccine rollout progressing well around the world, and an end to lockdown in sight, there were further signs that the tide was turning from the early pandemic winners to other cyclical industries that tend to do well when economies are in recovery mode, which the Schroder fund has a higher exposure to. This can be seen to some extent in the relative performances of the Schroder fund and the Baillie Gifford Positive Change fund that we have reduced.



30/03/2020 - 30/03/2021 Data from FE fundinfo2021

We also took the opportunity to liquidate the holding of L&G Cyber Security. The fund tracks the performance of a basket of companies that are actively engaged in providing cyber security technology and services. It has enjoyed a very strong performance during the short time that we held it, rising by over 20%, so we decided to take profits and sell. A further reason for selling is that it has a high exposure to US equities, and with a strong bias to 'growth' stocks.

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