

Quarterly Markets Review

Q2 2021

A look back at markets in Q2, when stocks made further gains and the US Federal Reserve hinted at future policy tightening.

- Global equities advanced in Q2, supported by the accelerating roll-out of Covid-19 vaccines. Growth stocks outperformed more lowly valued parts of the market.
- Government bond yields saw divergent performance. US 10-year yields fell (meaning prices rose) while yields rose in Europe. Corporate bonds outperformed government bonds.
- Commodities gained with energy again the strongest component.

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US

The second quarter was strong for US equities, and indeed the S&P 500 reached a new all-time high in late June. Almost all sectors made gains over the quarter.

The Federal Reserve's (Fed) rate-setting meeting brought no change to policy but its projections indicated that interest rate rises could come in 2023. This seemed to wrong-foot some market participants, though subsequent comments by Fed officials sought to allay any worries over tightening monetary policy too quickly.

Overall, the economic picture remained rosy. Q1 GDP grew at 6.4% (quarter-on-quarter, annualised), which was modestly lower than the consensus of 6.7%. Growth in consumption was especially strong. Industrial activity as measured by US composite purchasing managers' index (PMI) moved from 59.7 in March, to a (flash) composite reading of 63.9 in June. The PMI indices, produced by IHS Markit, are based on survey data from companies in the manufacturing and services sectors. A reading above 50 signals expansion.

Inflation data, unsurprisingly, received a lot of attention. In May, core consumer price index (CPI) inflation rose from 3% to 3.8% year-on-year - the largest increase since June 1992, with the "reopening theme" a big driver.

In late June President Joe Biden also secured a deal on an infrastructure package worth about \$1 trillion to upgrade roads, bridges and broadband networks over the next eight years. The agreement fell short of the \$2.3 trillion infrastructure spending plan announced in March, and did not address the social safety-net spending proposed in April.

Tech giants like Apple, Alphabet and Microsoft made strong gains over the quarter. By sector, energy, IT, communication services and real estate were amongst the strongest areas of the market. Utilities and consumer staples lagged.

Eurozone

Eurozone shares gained in the quarter, supported by a strong corporate earnings season and an acceleration in the pace of vaccine roll-out in the region. Many European countries saw Covid-19 infections fall over the quarter and were able to loosen restrictions on social and economic activity.

Rotations in the market between growth and value areas saw a mixed group of sectors lead the gains. The top performing sectors included defensive areas such as consumer staples and real estate, which had lagged in Q1 as investors focused on more economically-sensitive areas of the market. However, information technology was also among the top gainers in Q2, while utilities and energy were laggards.

Quarterly earnings for Q1 were generally very robust across the board, with the exception of the healthcare sector.

Economic data pointed to a strong rebound in activity in Q2. The flash Markit eurozone composite PMI rose to 59.2 in June, its highest level since June 2006. Eurozone inflation was estimated at 1.9% in June, down from 2.0% in May. The European Commission signed off on the first of the national recovery plans which will receive funding from the €800 billion Next Generation EU fund. Spain and Portugal were the first countries to have their spending plans approved.

UK

UK equities performed well over Q2, although beneath the strong headline figure the quarter was mixed. Markets were largely driven by lowly valued and economically sensitive sectors during April and May, continuing a trend in train since November which has been beneficial to the UK. Amid improving sentiment global fund managers reported being “overweight” the country for the first time since 2014.

Small and mid cap (SMID) equities outperformed during this phase. Among them were domestically and internationally exposed SMIDs set to benefit from recovering global and domestic economies. The UK economic outlook brightened considerably as GDP forecasts were upgraded while the Bank of England said it was to slow the pace of quantitative easing.

The market, however, struggled over June amid a rise in Covid-19 infections and falling inflation expectations. Defensive large cap equities were very much in favour in June, a trend amplified as sterling fell against a very strong US dollar. The healthcare and consumer staples industries performed resiliently over the month. While energy also performed well in June, in the main lowly valued and economically sensitive sectors did not. Financials performed poorly as market interest rates fell – the UK’s banks and insurance companies, which dominate the sector, typically benefit as rates rise, as they had in Q1 due to inflationary concerns.

A number of the domestically focused areas which had performed very well on re-opening hopes also fell back quite sharply in June. This was partly due to concerns around the impact of the delta variant of Covid-19 on re-opening plans. Retailers and travel and leisure sectors in particular performed poorly as the UK government delayed the date to further lift social distancing laws.

Japan

Japanese shares underperformed other developed markets in Q2. Although the rate of Covid infections in Japan remained markedly below most other countries, the persistent increase in cases led the government to delay lifting the state of emergency until 20 June. This, together with initial slow progress in the vaccine roll-out, further damaged the credibility of the Suga administration. Any re-imposition of the state of emergency in the near term would be politically very difficult ahead of the planned opening of the Olympic games on 23 July.

Towards the end of May there was a substantial acceleration in the vaccination rate, as bureaucratic and logistical problems seem to have been overcome. Japan is now capable of administering one million vaccinations per day.

The corporate results season was completed in May with the majority of companies reporting numbers in line with, or slightly ahead of, consensus expectations. The number of companies reporting profits below expectations has been significantly lower than normal in each of the last two quarterly earnings seasons.

Economic data released recently has reflected short-term negatives rather than the capacity for a faster recovery in the latter part of the year. Industrial production data was weaker than expected, primarily as a result of curtailed auto production due to the global shortage of semiconductors. This also had an impact throughout the auto supply chain. Despite the rise in global inflation expectations this year, Japan’s data continues to show mild deflation due to several on-off impacts.

Asia (ex Japan)

The MSCI Asia ex Japan Index recorded a positive return in the second quarter amid continued investor optimism for a return to economic normality and an end to the Covid-19 pandemic. However, stocks were more muted towards the end of the quarter as a resurgence of Covid-19 infections and lockdowns due to the delta variant curbed investor optimism somewhat. A stronger US dollar also weighed on returns in June, while a more hawkish tone from the US Federal Reserve and growing concerns over inflation further weakened sentiment.

The Philippines was the strongest index market in the quarter, while Taiwan and India also achieved positive gains during the quarter. China and Hong Kong also achieved modest gains during the quarter. By contrast, Pakistan was the weakest index market. The country has seen rising rates of Covid-19 infections during the period and its low vaccination rate has led to fears that the country could be hit by another wave of the virus. Indonesia and Thailand also ended the quarter in negative territory. Healthcare and industrials were the best-performing sectors during the quarter, while real estate and communication services were weaker.

Emerging markets

Emerging market equities registered a strong return over the second quarter. This was despite a sell-off in May as higher-than-expected US inflation renewed concerns over the timing of global monetary policy tightening. Brazil was the best-performing market in the MSCI Emerging Markets index, with currency strength amplifying gains. Central bank actions to tighten policy in the face of rising inflation, an acceleration in vaccine roll-out, an easing in fiscal concerns and renewed reform progress all boosted sentiment.

The CE3 markets of Poland, Hungary and the Czech Republic all outperformed as the outlook for economic recovery picked up. Higher crude oil prices were supportive of Russia and Saudi Arabia. India also outperformed slightly, despite suffering a surge in Covid-19 cases. Chile and Peru were among the weakest markets in the index, negatively impacted by political uncertainty. Egypt lagged, primarily due to weakness from CIB. China, where regulatory concerns broadened beyond the technology sector, and South Korea posted positive returns but underperformed the broader index.

Global bonds

US Treasury yields declined over the quarter, with the 10-year falling from 1.74% to 1.47%, retracing some of the large move higher in Q1. The broad backdrop was a continued pronounced rebound in economic activity with annualised inflation rates rising well above target to levels not seen in over a decade. This is at least in part reflective of very low year ago comparisons, and investors began to speculate as to whether current levels would continue or prove transitory. As the quarter continued, US activity data started to moderate from elevated levels.

The Federal Reserve (Fed) policy meeting in June was keenly watched and in the event saw a hawkish shift in tone. The open market policy committee essentially indicated through their “dot plot” projections that interest rates will likely rise earlier than expected. This provided insight to the Fed’s tolerance to an inflation overshoot, removing the market’s assurance of infinite policy support. The 2-year yield rose following the meeting and the 10-year yield fell, with the curve flattening. For the quarter, the 2 to 10-year yield curve flattened by 36 basis points (bps).

European government bonds underperformed the US, amid growing optimism about the region’s recovery and accelerating vaccination programme. Data points, particularly for manufacturing, were strong through the quarter. The German 10-year yield rose from -0.29% to -0.20%, France’s from just below zero to 0.13%. The Italian 10-year yield rose from 0.67% to 0.82%.

The UK 10-year yield fell from 0.85% to 0.72%, following a sharp rise in the previous period.

Corporate bonds performed well, outpacing government bonds. Both global investment grade and high yield credit produced a total return (local currency) of 2.4%. US investment grade rebounded well following the decline in Q1. Investment grade credit was helped by falling yields, while high yield benefited from the economic recovery and positive fundamentals, including low expected default rates. Investment grade bonds are the highest quality bonds as determined by a credit rating agency; high yield bonds are more speculative, with a credit rating below investment grade.

Emerging market (EM) bonds (US dollar denominated) had a strong quarter, led by high yield, while EM currencies performed well despite a pullback in June.

The Refinitiv Global Focus index, which measures balanced convertible bonds, advanced by 2.1% in the second quarter. Stock markets saw a rotation out of tech stocks into what is perceived as value, or perhaps more accurately the “Covid losers”. Consumer names, leisure, and travel were in demand. The convertible bond universe therefore benefited only partially from the tailwind offered by stock market gains as tech and disruptive consumer names fell out of fashion. June saw another reversal of this trade, back towards tech.

Commodities

The S&P GSCI Index achieved a robust performance in the second quarter. This was largely as a result of strong growth in energy prices and as the global roll out of Covid-19 vaccines continued to spur investor optimism for a global economic recovery in 2021. Energy was the best-performing index component, driven by strong performances from crude oil and natural gas as global economic activity continues to rebound after the Covid-19 pandemic. Brent crude and gasoil also achieved strong gains on the back of higher demand.

The industrial metals component also advanced during the second quarter, driven by sharply higher prices for aluminium, lead and nickel. The agriculture component also achieved a positive performance in the second quarter. The price of sugar and coffee were both sharply higher, while wheat, Kansas wheat and corn were also higher in the quarter. However, the price of soybeans was marginally lower in the period. The precious metals component achieved a modest gain in the quarter, with higher prices for both gold and silver. Livestock was the worst-performing component in the second quarter, driven by lower prices for live cattle and lean hogs.

The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested.

Overview

Total returns (net) % - to end June 2021

Equities	3 months			12 months		
	USD	EUR	GBP	USD	EUR	GBP
MSCI World	7.7	6.8	7.6	39.0	31.7	24.4
MSCI World Value	4.7	3.8	4.6	37.9	30.6	23.3
MSCI World Growth	10.9	9.9	10.7	39.7	32.3	25.0
MSCI World Smaller Companies	5.0	4.0	4.8	52.9	44.8	36.7
MSCI Emerging Markets	5.0	4.1	4.9	40.9	33.5	26.0
MSCI AC Asia ex Japan	3.6	2.7	3.5	39.6	32.3	24.9
S&P500	8.6	7.6	8.4	40.8	33.3	25.9
MSCI EMU	6.8	5.8	6.6	37.5	30.2	23.0
FTSE Europe ex UK	8.4	7.4	8.3	37.3	30.1	22.8
FTSE All-Share	5.7	4.8	5.6	35.8	28.6	21.5
TOPIX*	-0.8	-1.7	-0.9	23.8	17.2	10.7

	3 months			12 months		
	USD	EUR	GBP	USD	EUR	GBP
Government bonds						
JPM GBI US All Mats	1.9	1.0	1.8	-3.5	-8.6	-13.7
JPM GBI UK All Mats	1.8	0.9	1.7	4.6	-1.0	-6.5
JPM GBI Japan All Mats**	-0.1	-1.0	-0.3	-2.9	-8.0	-13.1
JPM GBI Germany All Traded	0.5	-0.4	0.4	3.4	-2.1	-7.5
Corporate bonds						
BofA ML Global Broad Market Corporate	2.7	1.8	2.6	5.6	0.0	-5.5
BofA ML US Corporate Master	3.6	2.7	3.5	3.6	-1.9	-7.3
BofA ML EMU Corporate ex T1 (5-10Y)	1.2	0.3	1.1	10.3	4.5	-1.3
BofA ML £ Non-Gilts	1.8	0.9	1.7	13.9	7.8	1.8
Non-investment grade bonds						
BofA ML Global High Yield	2.6	1.6	2.4	15.6	9.5	3.4
BofA ML Euro High Yield	1.4	0.5	1.3	16.6	10.4	4.3

Source: Thomson Reuters DataStream.

Local currency returns in Q2 2021: *-0.3%, **0.3%.

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