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Quarterly Investment Update

APRIL 2021

The growth and inflation surge is here

The theme of the quarter was reflation. Not only were signs of economic recovery becoming very visible for all to see - from green shoots to firm growth - but a big debate has been unleashed about the growing signs of inflation in several economies and what reaction it will trigger from policymakers.

A primary driver in the market was the return of inflation expectations, especially in the USA. In general, a series of data releases in the US and Europe served to underline the view that the worst of the pandemic is over if measured in narrow economic terms. In Europe, the continued effect of the pandemic is still being felt in the more consumer-facing sectors. However, in the manufacturing sector, there are strong suggestions that industry has begun to cope with the worst of the effects from movement restrictions.

In the US, the economy is going from strength to strength, given some very robust reading from several indicators over the quarter. The overall PMI level rose steadily from a high 60 to an even higher 64, leaving it in record territory. In the labour market, the abject losses suffered in 2020 have been replaced with a solid rebound. In March alone, more than 900,000 new jobs were added in the US.

Global equity markets had a very good start to the year. The MSCI World Index was up 5.04% for the quarter, with every major market posting gains. The S&P 500 was up 6.17%, the Nikkei was up 6.93%, and the previously-lagging European market (Eurostoxx50) rose 10.78% over the quarter.

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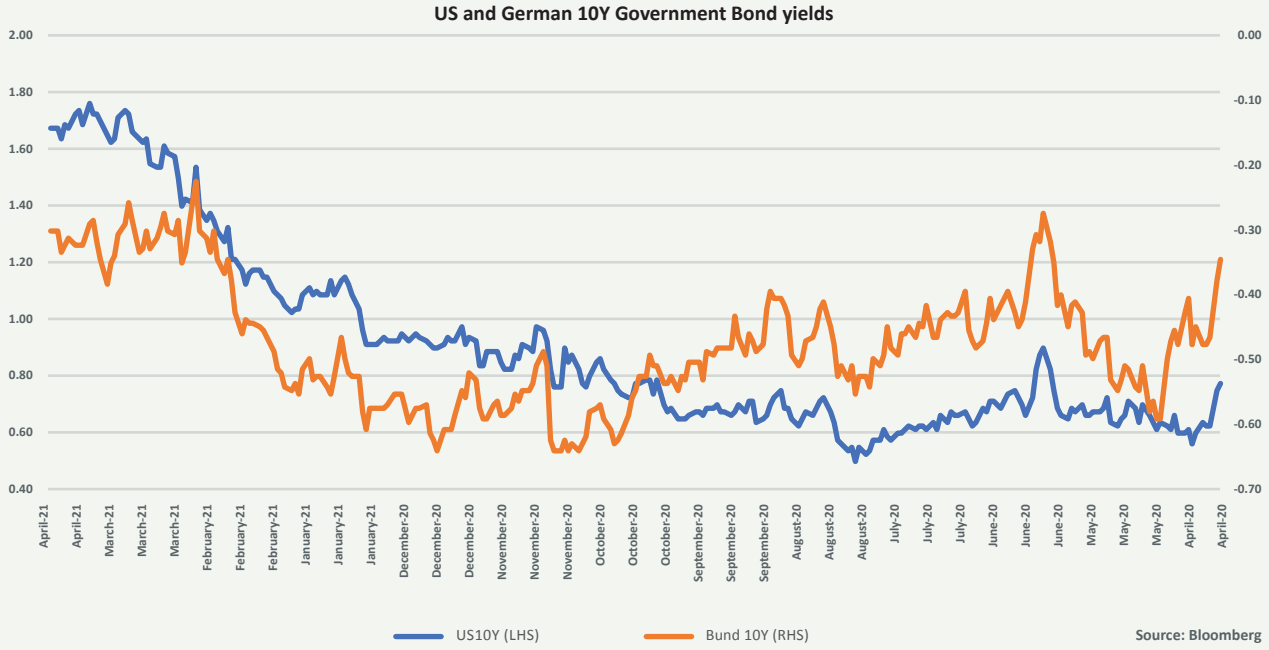
Market Focus

Global fixed income

Bond markets generally had one of the poorer quarters in recent memory. The rise in US treasury yields drove a slew of negative returns across bond indices in Q1. Of note was the fact that lower-quality credit performed better than higher quality.

Leading the way lower was the US 20+ Year sector, which was down 13.92% for the quarter, followed by the overall Treasury Index with a loss of 5.49%. Over the quarter, the outright 10Y Treasury yield rose sharply, from 0.91% to 1.74%.



Where US yields have been steadily rising from their lows, German yields have been rising to a much smaller extent and have stabilised around -0.3% for the last two months. The gap between Bunds and Treasuries widened out by more than 0.5%, which is the same as the move seen in the final quarter of 2016, but after that, the biggest move since 1993.

The overall state of the credit market is much better than the negative return numbers the quarter would suggest. The US Corporate Credit Index was down 4.65% for the quarter, a slightly better outcome than the matching government index of the same maturity - illustrating that losses were driven by interest rates and spread widening. Global high yield bonds only shed 0.95% during the quarter, and US high yield managed a small gain of 0.85%, according to index data provided by Barclays and Bloomberg.

In emerging markets, several factors conspired to cause negative returns. In US Dollar-denominated bonds, the main driver of a -3.48% return was the rise in underlying yields. As is the case in other credit markets, the underlying fundamentals have not worsened in tandem with returns.

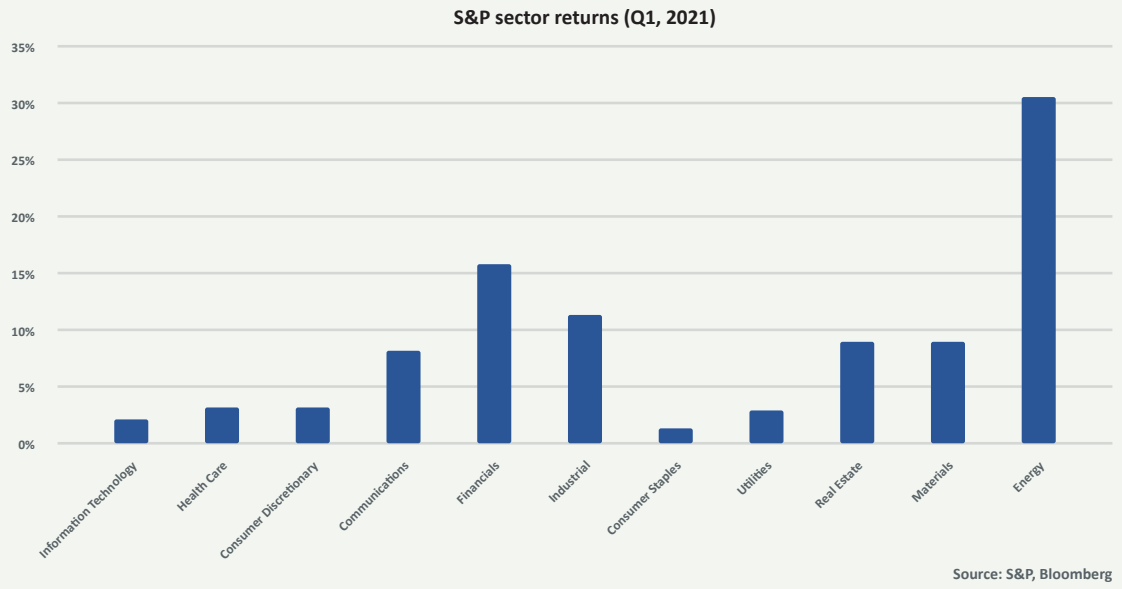
Local currency bonds were hit not just by higher yields but also by the firmer US Dollar and some questionable policy actions in select countries, notably Turkey and Brazil. The overall index was down for

this asset class by -3.71%, although there was very evident dispersion of returns, with some countries delivering strong returns on a standalone basis.

US

Several factors contributed to positive sentiment towards the US. After a poor effort containing the virus, it has done a much better job rolling out the vaccine program. This creates the possibility of an early re-opening of the economy and a surge in consumer spending and domestic travel. Furthermore, the Biden Administration has delivered a strong government spending support package and is in the process of finalising a further $2.25 billion in infrastructure investment. Adding fuel to the fire is the Federal Reserve's relaxed attitude to the expected return of inflation in the economy. It has signalled that it is not of the view that any interest rate hikes are necessary this year, nor is there the need to re-examine its ongoing QE (bond purchasing) policy. Both of these bits of signalling to the market have made it clear the Federal Reserve is not in the mood to stand in the way of the recovery.

A feature of the quarter in US equity markets was how some of the trends that had been in evidence through 2020 were reversed. The strongest performer in the S&P was the energy sector, racking up a return of 30.84% for the quarter, followed by financials which gained 15.9%. By comparison, the previously high-flying info tech sector scraped a 1.97% return. Investors were very focused on signs of a global recovery, higher prices in the energy complex and the perceived undervaluation of the sector after lagging for the whole of 2020. Equally, the more "old-school" DJ Industrial Index was up 8.29%, compared to the Nasdaq's gain of 2.96%.



UK

The UK has done exceptionally well in accelerating its vaccine roll-out, and this may well pay dividends in the quarters to follow. However, in Q1, UK stocks lagged behind their European counterparts for a number of reasons. The Euro weakened against the US Dollar, which provided a strong impetus to its market with

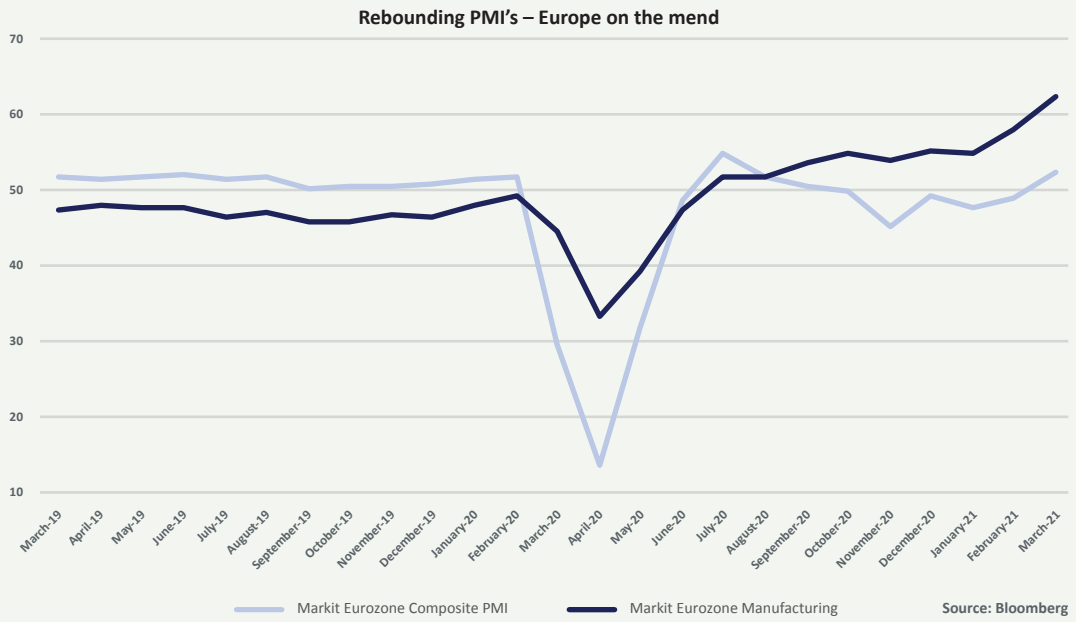
large exposure to export earners. By contrast, Sterling strengthened over the quarter from 1.3670 to 1.3780 to the US Dollar. Finally, the European market was the beneficiary of a rally in bank and financial shares, which helped it chalk up further gains.

In the gilt market, UK yields were not immune to the global theme of rising rates. The yield on the 10Y gilt rose from 0.2% in January to 0.84% by March-end that caused a negative return on the overall index of -1.81%.

Europe (excluding UK)

Despite being the laggard when it comes to vaccine roll-out, European equities nonetheless performed well. Towards the end of the quarter, the signs were still mixed: growing infection rates in some countries but encouraging signs, specifically in the manufacturing sector, to offset the continued drag being suffered in the services sector. European manufacturing performance is quite notable and suggests that industries have largely found ways to cope with the effect of the pandemic. The economy is well set for a continued recovery should the services and consumer sectors follow the lead set by manufacturers. The chart shows how strong the European manufacturing sector has rebounded. The PMI reaching 61.9, the highest in several years and far above the level it was languishing at before the onset of the pandemic.

With the noted signs of recovery in the European economy, the equity market rallied. The overall market was up by 10.78%, with most of the regions tallying between 9% to 11%, with the leader being Sweden at 17.99% and the laggard the UK with 4.97%.



Japan

The Japanese market was broadly in line with other major markets worldwide, rising 6.93% over the quarter. This was despite a plunge in activity in January, fed by a surge in Covid cases that undermined consumer spending and mobility as movement restrictions were re-introduced. Even so, the general tone

in the Japanese economy is one of steady progress. Labour market conditions have improved with the first increase in real wages in 12 months, which in turn has helped to improved sentiment gauges among consumers and small businesses.

Asia (excluding Japan)

Asian equity markets had a mixed quarter. The previous edge it had held by being predominantly better at containing the pandemic seemed to be diluting as other regions catch up. There was also serious controversy and animosity at the global political level between the USA and China. This weighed on Chinese stocks in particular, with the CSI 300, Shanghai and Shenzen indices all losing from 0.89% to 4.79% over the quarter.

The strongest of the Asian markets was Singapore, which had been lagging before as its STI Index is laden with property and retail exposure. As these sectors recovered, it helped the index return a very strong 11.75% in the quarter. Over the same period, Taiwan posted a gain of 11.69%, the Korean KOSPI gained 6.64%, and the Nikkei rallied by 6.93%.

Other emerging markets

With US bond yields rising and global equity markets performing well, the same could not be said for emerging market equities. The overall MSCI Emerging Markets Index rose 2.21% in the quarter, but it was characterised by diverging performance across countries. In Brazil, the Bovespa dropped 2%, compared to the 13.21% return for the commodity-laden South African market, or 8.12% for Vietnamese stocks.

Currency

The rise in US yields, outpacing those in Germany and the major currencies, drove a counter-consensus rally in the US Dollar. The previous notion of a weaker Dollar due to a surfeit of bond supply and money creation has been outweighed by the yield advantage now. The Japanese Yen weakened against the US Dollar from 103.25 to 110.72, and the Swiss Franc dropped from 0.8852 to 0.9436 over the quarter.

In addition to the yield advantage, the allure of the traditional safe havens was eroded as the pandemic damage started to move into the rear-view mirror. Focus is rapidly shifting to the more upbeat narrative of stronger global growth and a reset of inflation expectations to pre-pandemic levels.

Commodities

Commodity returns for the quarter was a decidedly mixed bag, split between gold and silver on the one hand and just about everything else on the other. Rising US yields would undermine to an extent the demand for haven precious metals, as would less concern in markets about the risk of further pandemic damage. Gold was down -10.04% for the quarter, and silver -7.52%. Base metals, by contrast, are reflecting increasing global demand for commodities as the growth cycle picks up steam. Iron ore, aluminium and copper all posted double-digit gains, with iron leading the way with a 20.43% increase. The energy complex was also a beneficiary of returning demand - WTI crude rose 21.93%, and jet fuel was up 16.83%.

Conclusion

As we noted in December's commentary, one of the risks facing investors was the possible divergence in market performance as different countries deal with the pandemic hangover in different ways. It is proving to be an accurate assessment, and the expectation is that the divergence could continue or even deepen.

Policy response in several economies has been critical and looks to have settled the world onto a strong growth path, especially in the developed world. The impulse of policy has been to trigger a return of inflation to levels seen before the pandemic. Asset prices, bonds and equities, are responding, but it is not clear how far the adjustment has to run. In equity markets, a return to value investing could be in the offing. In bonds, longer-dated government bonds appear risky, but credit should be reasonably well-supported. Commodity prices could likewise be the subject of a demand surge as growth recuperates. These are expected to be the main themes for the rest of the year.

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