THE FRY GROUP
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Quarterly Investment Update

JULY 2021

Inflation shines a light on Fed policy

The focus in the second quarter centred on the market interpretation of how the Fed will respond to inflation. There are two elements to the debate. First, there is the issue of whether the strong rise in prices seen thus far is going to "stick" or be "transitory". Second, it will turn out to be pivotal just how the Fed will respond to inflation. For now, the Fed is espousing the transitory view and pushing out expectations for interest rate increases into late 2022 or 2023.

This cycle is so different from many previous ones in many ways, specifically regarding how much liquidity has been added to the financial system and how low official interest rates have been for a prolonged time. The Fed faces a big challenge to return policy setting to normal, almost irrespective of how much inflation enters and stays in the system.

The second quarter continued to deliver a string of economic data releases from around the globe that supports the view that economies are mostly on the mend, and in many cases, in full expansion mode. Nowhere is this more in evidence than in the USA. In parallel, Europe's success in rolling out its vaccine programme, enabling it to open up its economy gradually, is having the desired effect.

By contrast, the signs are that after a strong start, Asia is starting to lag as its economies remain largely closed or partially locked down. Vaccination rates are lagging in some countries in the region, negatively impacting the prospects for faster recovery.

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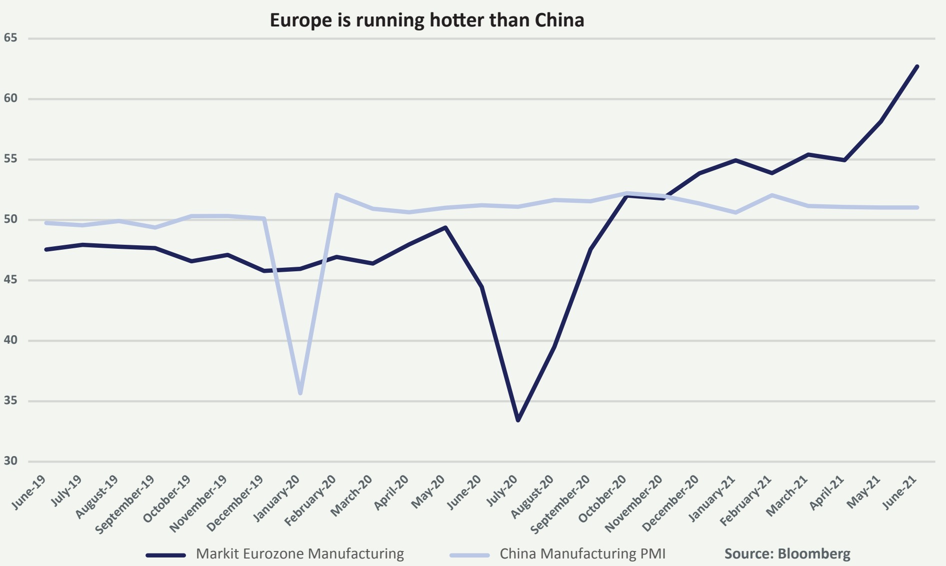
European recovery takes hold

The message is unmistakable. As measured by manufacturing PMI's, the Covid hit in China was earlier and milder than in Europe. However, the European recovery has been much stronger and running hotter than in many previous expansions.



Global equity markets had a good run overall for the quarter. The MSCI World delivered 7.7% in USD terms, with the US and European components adding 8.8% and 7.8%, respectively. Japan lagged badly by coming in essentially flat. In emerging markets, there was wide divergence, with Russia the winner at 14.31%. The Shanghai Index gained 5.37%.

Market Focus

Global fixed income

After a very difficult first quarter, bond markets had a much better time in the second but lagged far behind the strong equity market. In Q1, the surge in bonds yields drove prices lower; in Q2, the process reversed to an extent, bringing some respite to a battered asset class.

In the final meeting of the quarter, the Fed changed its view slightly on how it will respond to inflation. While it acknowledged that inflation pressures were visible, it still views these as temporary, and the stated aim remains to keep policy loose for the foreseeable future. The reaction in the US Treasury market was for the yield curve to flatten sharply (this happens when the yields on long bonds drop and shorter-dated yields rise).

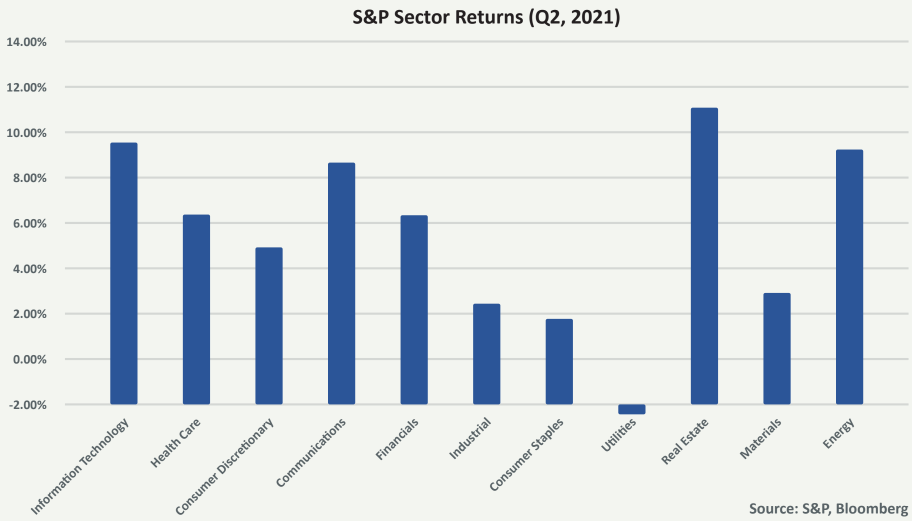
There were gains across the board for all fixed income asset classes, led by the 20Y Treasury Index that gained 6.8% in USD terms. Corporate, high yield and emerging market bonds were all in a range of 2% to 3%, with the laggards turning out to be the overall US Treasury market and the UK gilt market, rolling out 1% returns each.
Even though credit markets did not perform as well as the very long end of the curve, they did nonetheless beat government bonds of similar maturity as the credit indices. As the current economic cycle progresses, the fundamental outlook for credit remains sound enough. New issuance is strong in most markets with the caveat that the customary summer lull awaits. A growth tailwind makes it possible for most firms to safely meet interest

and capital commitments. Nonetheless, with yields low and credit risk spreads not very generous, it is hard to foresee how credit will remain anything other than a stable source of (relatively low) income.

US

Events in the fixed income market and on the Fed's policy front played into the equity market as well. For the first part of the quarter, the rotation trade into value and related areas did well, only to reverse towards the end. As the market weighs the Fed's next move, an earlier shift to less loose policy is viewed as crimping a future expansion. As a result, the big winner from 2020, information technology, staged a comeback to post 11.56% for the quarter, beating materials which saw its strong run tempered by the Fed. The return of tech is likely the result of the investor's continued willingness to pay up for the certainty of the revenue stream. This feature proved indispensable in 2020.

Energy continued to perform well in the context of oil prices remaining firm on global markets, and there was also a noticeable uptick in the returns from real estate. It would appear the market is starting to discount the increasingly strong price action seen in the property market in the US. Furthermore, the re-opening of the economy is good news for retail outlets facing a struggle to generate profits until recently.



UK

The UK equity market performed credibly in the quarter, with the mainline FTSE 100 gaining 5.63%. This was below the overall MSCI world figure of 7.9%. The difference could be ascribed to the fact that the UK market carries somewhat less by weight of the technology stocks that made a comeback in the second half of the quarter and helped propel the USA-heavy MSCI to stronger gains.

GBP was quiet over the quarter, appreciating from 1.3780 to 1.3830, a modest gain of 0.35%. With bond yields still in very low territory and not showing the same degree of strength as US markets, UK gilts were a laggard in the performance stakes, gaining 0.6% in the quarter.

Europe (excluding UK)

The early signs of economic recovery spotted in Q1 appear to be materialising as hoped and expected. Not only has the manufacturing sector weathered the storm, but several broader indicators in the service sector are indicative of a solid economic recovery. Admittedly the policy response from governments across the region has not been as aggressive as has been the case in the USA. However, the gradual opening of most economies on the back of a quick vaccine roll-out is driving growth momentum.

After a very robust equity market run in Q1, it was always difficult to maintain the pace. Nonetheless, the Eurostoxx 50 Index added 5.6% over the period. All the major markets in Europe posted roughly similar gains, with the standout performance coming from the French CAC40 with 9.1%. The EUR gained a bit more than 1% against the Dollar, rising from 1.1730 to 1.1860.

Japan

The Japanese market ran into headwinds in Q2, in line with the rest of Asia. Domestic activity remained muted compared to the rest of the world. Some of the supply chain constraints that are becoming visible in global trade harmed Japanese exports. There was little movement in the currency over the quarter, as the Yen moved from 110.72 to 111.11. The Nikkei 225 Index dropped by 1.24% in total return terms, by far and away the worst performer in the developed world.

Other emerging markets

Outside of Japan and China, markets had a mixed time of it in the second quarter. The gyrations of the US bond market had less impact in this region; rather, the driver still looks to be progress on the re-opening front for the various economies. The Singapore STI posted a total return of 0.08% for the quarter, as the economy was still effectively closed. Hong Kong seemed to be on a similar path, delivering a small gain of 2.75%, compared to the much firmer outcomes in Korea (7.7%) and Australia (8.5%).

Currency

The USD largely failed to maintain the momentum it displayed in the first quarter of the year. One measure of the Dollar's overall strength is the global average rate as calculated by the DXY index. By this measure, the Dollar rallied by more than 3% in Q1 before receding quite sharply in April and May before making something of a comeback towards the end of the quarter. Even so, it ended lower by 0.85% over the period.

Commodities

The broad commodity complex posted gains, on average, in Q2. One of the few decliners was platinum, which dropped 9.4%. In contrast, gold and silver rose by 3.65% and 7%, respectively. In base metals, there were gains for iron ore (25.7%), copper (6.42%) and aluminium (14.72%). The consensus in these markets is that supply is struggling to keep up with demand. Initially, the blame was put on supply chains in distress trying to adjust to Covid, but a strong expansion looks to be putting some additional upward pressure on base metal prices. Energy prices rose strongly. WTI crude oil was at $73.47 per barrel at the end of June, compared to the $59.16 at the start of the quarter. Jet fuel rose in tandem.

Soft commodities kept the broad uptrend intact. Coffee, onions, cotton and maize all rose between 6% and 60%. This is significant, as many emerging countries feature spending patterns that are far heavier in food and soft commodity weightings than in developed markets. The clear implication is for higher inflation here too.

Conclusion

The broadly positive assessment of global risk markets (equities and credit), expressed previously, is still on the mark. Very strong policy support globally, combined with at least some successes in vaccination, has made for a strong recovery. The USA and Europe, in particular, are proving to be the success stories for now, and barring a sudden spike in the pandemic's severity, for the rest of the year also.

Equally, the view that growing divergence can drive asset class performance has been largely vindicated, as the Covid response is becoming a dominant theme across markets with clear winners and losers, both in relative terms and occasionally even in absolute terms. This phenomenon is likely to persist for the rest of the year. There appears to be a growing ideological difference in how countries and regions deal with the virus. Of course, it has already been the case that the rewards for one strategy (full containment) dilute very quickly in the face of changing circumstances (new variants) or the inability to pivot quickly (vaccinate fast once containment has been achieved). It may still be a big gamble to open economies early, and much can still happen on the virus front. However, the trend in place is for open economies with strong vaccine strategies to be the outperformers.

The one joker in the pack remains the weirdly low government bond yields across the globe. For the near term, central banks would appear to hold the upper hand in controlling the direction of the curve; further inflation confirmation may bring this to an end, and portfolios remain positioned to take advantage when that happens.

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