ROCQ CAPITAL

First Quarter 2021

Financial markets underwent a significant shift during the first quarter of the year, as bond yields rose quickly. While still low in absolute terms, the degree of increase was notable and has had knock-on effects on other financial assets including equities. The benchmark US 10 year government bond yield ended the quarter at 1.74% having begun it at 0.91%, while the equivalent UK yield rose from 0.19% to 0.83%. The driver of this was optimism about the recovery of economic activity later in the year, combined with governments willing to spend large amounts on infrastructure programmes and other stimulus measures.

Investor sentiment has been supported by improving economic data, particularly in the US and UK. Employment has remained strong and successful vaccine rollouts have sparked optimism about accelerating economic growth. The new Biden administration has been particularly active in announcing large new spending programmes. Its $1.9tr Pandemic Relief Bill in March continued many of the schemes already in place and in comparison to the stimulus measures brought in during the 2008/9 recession is significantly larger in absolute terms and relative to the drop in economic output seen over the past year. A new infrastructure package will see further spending of a similar magnitude, if passed, albeit offset by corporate tax hikes.

Taken together, government stimulus programmes at a time of recovering activity are expected to lead to higher levels of inflation that central banks are unlikely to stand in the way of. The US Federal Reserve in particular has stated it will tolerate higher price levels without raising policy rates, even if the employment picture continues to improve. The low fixed coupons paid by government bonds are therefore less attractive in such an environment, and these assets fell in value during Q1. The UK government bond index returned -7.2% and the equivalent US Treasuries fell by 4.3%, which are both sizeable drops by their usual standards.

Government bond yields act as the market's anchor as the risk-free rate, so rapid or large changes in their level can have ramifications elsewhere. In the first quarter, we saw a dramatic rotation away from more growth-orientated stocks such as those in the technology or clean energy sectors and towards traditional equities such as banks and natural resources companies which are more sensitive to the stage of the economic cycle. Industries such as renewable energy have benefited from very low yields for some time as their future, uncertain returns are discounted at a low rate. During Q1 many such stocks were sold off aggressively without this support.

These shifts occurred below the surface and for the quarter as a whole headline equity market performance was positive in most regions, driven by the more cyclical, cheaper constituents. In GBP terms, the MSCI World index gained 3.4%, the FTSE 100 rose by 3.9% and the US S&P 500 added 4.6%. Emerging markets lagged, with the MSCI EM index rising by only 0.8%. Credit markets suffered from the rise in yields, with GBP corporate bonds falling by 4.7% at the index level.

Outlook

The movement of markets during Q1 suggests investors are positioning for higher levels of economic growth and a rise in inflation to accompany it. Whether inflation proves transitory or more long-lasting is a matter for debate, and so far, asset prices are arguably not indicating that anything more than a traditional cyclical recovery is under way. Having been in a low inflation, low growth environment since 2009 a change of market 'regime' may provide challenges but ultimately should be fairly positive for many types of equity investment. We have some exposure to cyclical strategies, but continue to see merit in the more reliable equity funds that have done well in recent years – these tend to hold higher quality companies with pricing power, which may be a beneficial feature if inflation returns in a sustained manner. Otherwise we would reiterate our comments from our previous quarterly outlook; that some trends seen in 2020 are unlikely to reverse and where we can access themes such as e-commerce we expect to continue to do so, particularly in Asia and US where many of the leading companies are listed. The UK market also looks interesting as it is relatively undervalued and features plenty of financials and other cyclical industries which are poised to perform well if life returns to something more like normal from the summer onwards.

One feature of the first quarter was some notable activity in assets such as small, loss-making US stocks (e.g. Game Stop) which attracted much media attention in January and February. Cryptocurrencies such as bitcoin were also very volatile. While our investments do not include these markets, such activity amongst individual investors and hedge funds may be instructive that there are some excesses in markets resulting in speculative and risky behaviour. A prudent approach to asset allocation including a focus on well-developed investment processes is important to ensure that our portfolios are not buffeted by these forces.

We have retained our fixed income holdings through the quarter and our focus is likely to remain on flexible strategies that we feel are capable of navigating these challenging markets. Alternatives can also play a part here, as relative strategies may work well when there are large dispersions between performance of different sectors, which is what we would expect when markets are volatile or undergoing changes. As a result, we feel our current asset mix is appropriate for current conditions, although we need to be vigilant particularly in our bond investments.