ROCQ CAPITAL

Second Quarter 2021

The continued roll out of COVID-19 vaccines supported the further rally of global equities during the second quarter. After a brief interlude, growth stocks returned to recent form and outperformed value stocks. Bond yields diverged in direction with US and UK medium and longer yields falling, whilst yields in Europe rose slightly as investors were tempted into locking in the significantly positive US yields at the expense of the negative yielding European equivalents.

Economic data was generally very positive. US inflation data was recorded at the highest level for over a decade whilst Q1 GDP data showed the economy growing at 6.4% (q-o-q, annualised) and a jump in the purchasing manager index (PMI) to over 60 in June flash numbers confirmed the positive trend. Europe saw the composite PMI reach 59.2 whilst inflation was estimated at 1.9%. Mostly this has been driven by governments continuing to ease restrictions on movement and allowing consumers to visit restaurants and shops again, spending the savings that have been made over the last 18 months or so.

At their June meeting, the US Federal Reserve held policy steady although did take some market participants by surprise by suggesting an interest rate rise could happen as soon as 2023 given the big inflation print, although a quick clarification to communications rid markets of concerns that monetary policy could be tightened too soon. The debate between how much of the excess inflation is transitory and persistent continues apace, with the Fed appearing to err on the side of caution that it is mainly transitory and will, given a short period of time, fade back towards the 2% target.

Having been the subject of so many news reports for so long, Britain's departure from the EU now captures relatively few headlines although negotiations on trade deals still persist. As more certainty appears, M&A activity has notably picked up. Private equity buyers, loaded with dry powder from pension funds seeking returns to meet their targets, have driven the M&A rate to over 2x the level pre-COVID-19. Supermarket Morrisons has been the most newsworthy bid so far, with an initial bid of £5.5bn being turned down before accepting a bid of £6.3bn. The latest valuation may still not turn out to be enough with other bidders reportedly showing interest, so much so that the stock market has now driven the share price up significantly beyond the current bid price.

The strong run up of the Pound, which started in early 2020, peaked at $1.42 at the end of May, before falling to $1.38 at quarter end, boosting overseas equities returns in the month. The MSCI World index rose 7.3%, driven by strong US equity performance with the S&P 500 up 8.2% whilst the Eurostoxx 50 (+4.6%), FTSE 100 (+4.8%) and Nikkei 225 (-1.8%) were relative laggards in comparison. MSCI Emerging Markets gained 4.4% in comparison.

Having seen "meme" stocks such as GameStop dominate headlines in Q1, other volatile, niche areas including cryptocurrencies, Special Purposes Acquisition Companies (SPACs), and non-fungible tokens (NFTs) caught the eye of speculators interested in making a quick buck. On a larger scale, the Archegos family office blow up at the end of the first quarter shows that it's not just retail investors willing to use the abundance of capital and liquidity available to them to take incredibly high-risk positions.

Outlook

The spread of the 'delta' COVID-19 variant is undoubtedly a concern. Cases in the UK have accelerated dramatically over the last weeks, whilst Israel has reported a notable fall in the efficacy of the Pfizer vaccine against delta infections, although in both cases hospital cases remain low.

Whilst inflation numbers might suggest the Fed should consider raising rates sooner rather than later, particularly if one views the inflation as more persistent than transitory, the labour market is still a little way behind. Recent non-farm payrolls have been somewhat disappointing, despite demand for labour being higher now than before the pandemic, 16 million Americans are available for work but not working (unemployed, underemployed, or discouraged from seeking) with vacancy numbers less than half that. Those vacancies could be rapidly filled as support for the unemployed begins to fall away. An increase in job growth could see a return to trend by early next year rather than mid-2023, creating an overheating of wage inflation, at which point the Fed seems likely to act.

Generally, inflation appears likely to settle higher than pre-COVID-19 levels, although only in part due to COVID-19. The pandemic has seen supply chains move from just in time to just in case, and we think that will remain. Added to that, higher dependency ratios in most markets as companies refocus their employment needs, continued government spending, and the cost of transition to a lower carbon economy will provide a floor. The ability of technology to deflate prices through automation and artificial intelligence though, should equally provide a cap on the increase.

With global growth likely to remain above trend into 2022 we remain enthusiastic about equity holdings in companies with pricing power and high returns on capital, whilst not as volatile as more cyclical names, they may offer protection should inflation levels pick up and still providing strong returns if inflation remains muted. In previous commentaries we have noted that trends that were picked up in 2020 are unlikely to reverse and we maintain exposure to e-commerce and technology themes across the equity space. UK equity exposure provides an interesting alternative with cyclical industries that stand to benefit from a return to normality, combined with attractive valuation levels which are started to be noticed by third parties, notably private equity buyers who have significant 'dry powder'.

Volatility in fixed income markets is likely to remain higher so we remain most comfortable in shorter duration holdings or, via Alternatives, in strategies that are able to quickly and efficiently move duration around in the case of significant moves in sovereign yields.