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world of change

Multi-Asset Strategy Quarterly

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Foreword

Jimmy Elliot
Head of Multi-Asset

Welcome to our latest Multi-Asset Strategy Quarterly. In this edition, Philip Saunders looks at how the Fed's tentative steps to withdraw stimulus may impact markets in the coming months. Sahil Mahtani assesses Europe's new 'strategic autonomy' and what it means for investors, and strategist Russell Silberston reviews the policy announcements by the major central banks over the past quarter. Finally, we close with a succinct summary of our higher conviction asset class views, beginning with equities, moving on to fixed income, currency and closing out with commodities.

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Market observations

Philip Saunders
Co-Head of
Multi-Asset Growth

The Chinese punch bowl and the last dance

William Martin, the then Chairman of the Federal Reserve Board (Fed), commented in a speech to the New York Bankers Association in October 1955, that "the Federal Reserve...is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up". The fact that the Fed after its recent Federal Open Market Committee (FOMC) meeting was now actually "thinking about removing emergency monetary accommodation" rather than "not even thinking about thinking about raising rates" (10th June 2020) came as an unwelcome surprise to markets and also as a reminder that the Fed still took its role as chaperone seriously. Well, this party has well and truly warmed up. The economic and market rebound from the extreme pandemic uncertainties of last March has surprised the great majority of market participants, including the Fed. Of course, this was largely the result of a huge injection of liquidity and fiscal support and the scale of the global 'punch bowl' this time has been truly breath taking. G4 central bank[1] balance sheets alone have been expanded by almost US$10 trillion in just over a year and are up six-fold since 2008 to sustain the illusion of normality.

So, markets are now on notice that the level of support will start to diminish, first in the form of a reduction in the level of quantitative easing (QE) and ultimately increases in official interest rates. The Fed is currently continuing to inject at least US$120 billion a month into the system. The changes will be well telegraphed – possibly as early as August at the annual Jackson Hole policy symposium – and subject to underlying economic conditions at the time. Many investors still bear the scars of the 'taper tantrum' in 2013 – the Fed's previous exercise in 'soft landing' markets and the economy. On that occasion, the FOMC, under its then chair Ben Bernanke, had switched abruptly from 'QE infinity' in November 2012 to tapering in May 2013. Of course, the Fed will have learnt from this experience and the initial reaction might be more muted this time but notwithstanding, policy sensitivity is surely set to become progressively more acute. Given that financial conditions are even looser than they were in early 2013, the shift in financial conditions that the Fed must catalyse is in some sense even larger.

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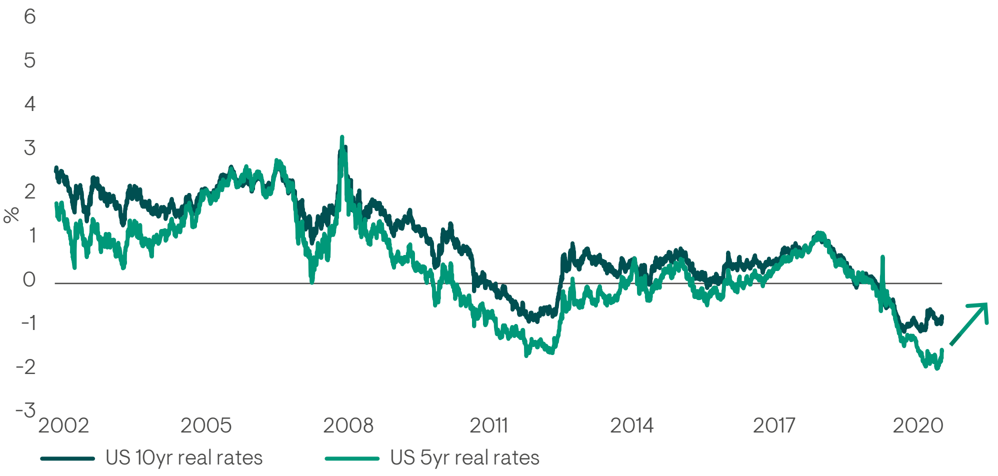
1. The Fed, European Central Bank, Bank of England and Bank of Japan.

The Fed appears to have pivoted and we are moving past the point of maximum liquidity



Source: Bloomberg, Ninety One as at May 2021.

But peak global liquidity may have been passed already. While market participants remain fixated on what the Fed might do and more importantly when, China's central bankers have already moved decisively to take away their equivalent of William Martin's punch bowl and are clearly focused on stabilising the country's overall debt levels, which remain uncomfortably high. True, China was the only major economy that grew in 2020 and moreover its policymakers used other, more orthodox means than QE to support economic activity, but China's economy is now twice the size it was at the time of the taper tantrum. In fact, since the Global Financial Crisis, global economic and market 'mini' cycles had already become highly correlated to China's 'stop go' credit cycles during the last full cycle. On each occasion, just when emerging market growth more broadly looked to be about to enjoy a sustained cyclical upswing, demand turned down sharply and emerging market assets performed poorly.

So, liquidity tailwinds are in the process of shifting to become headwinds and the key judgement to be made is the extent to which these changes in liquidity conditions at the margin will impact markets. Despite avowedly much better 'fundamentals' in a heavily financialised system, we would argue that this could be material and all the more so given that valuations are high across the board indicating that the recovery is 'in the price'. Credit spreads in high yield bonds are back at their all-time lows and equity risk premia have compressed dramatically, even taking into account the relative ebullience of the earnings rebound. Global growth momentum has peaked and, led by China, is likely to have palpably decelerated by the end of 2021 and into the first half of 2022. Risks are now increasingly skewed to the downside. Certainly, interest rates are still set to remain low and liquidity abundant in an absolute sense, so markets could go on to make higher highs, but it feels right to be at least starting the process of banking profits and moderating risk levels. Within equities this would imply a reduction in reflation trade beneficiaries, including emerging markets, and an increase in reasonably priced 'quality'. Life at the margin and then more generally could be about to get a lot tougher. A time to remember the salutary tale of ex-Citigroup CEO Chuck Prince who notoriously observed back in July 2007 "when the music stops, in terms of liquidity, things will be complicated, but as long as the music is playing, you've got to get up and dance". He left the company a few months later.

Thematic viewpoint

Sahil Mahtani
Strategist, Multi-Asset

Europe's new 'strategic autonomy' and what it means for investors

For the first time since the early 1990s, a consensus is emerging about the EU's purpose. Faced with a growing number of internal and external challenges, Europe's leaders and policy chiefs have converged on a concept called 'strategic autonomy' as the response to Europe's problems. The phrase implies more debt mutualisation, more industrial policy, and more defence spending—potentially very relevant for equity and fixed income markets. Behind the new orientation stands the old idea that a strong state is one that is not dependent on others. Or, as EU Council President Charles Michel has put it, "less dependence, more influence."

European economic policy has always been characterised as a compromise between Germany's ordoliberal tradition—a broadly free-market tradition that tolerates more state regulation than the Anglo-Saxon model—and French dirigisme, in which the state is the most important economic actor. However, the growing number of internal and external threats is pushing Germany much closer to the French worldview.

Several factors are driving Europe to pursue 'strategic autonomy'. The main four are: (i) a growing recognition of the diminishing weight of EU members in the world; (ii) countries are 'weaponizing interdependence'; (iii) export-led growth is increasingly difficult due to closed Asian economies; and (iv) the EU needs to bolster its defence. The common thread in all of this is a growing understanding of the threat posed by China, and less trust in the Atlantic alliance.

'Strategic autonomy' is a game changer for debt mutualisation and for moving beyond the north south division that has paralysed EU politics in the last decade. Creditor countries now see EU fiscal spending not just in terms of resources but also in terms of geopolitics. Austerity pushed Greece into the arms of non-European powers, and the mistake will not be repeated again. The climate transition is also driving a major loosening of purse strings.

The second major consequence of 'strategic autonomy' is a heightened shift towards industrial policy. The most important political actor in this shifting debate has been Germany's Bundesverband der Deutschen Industrie (BDI), or Germany's federation of businesses, which is much more sceptical of China than it was in the 2010s. The shift in European economic policy can be grouped in four broad segments: state aid, level playing field, innovation policy and supply chain security.

Finally, the third major consequence of 'strategic autonomy' is a significant shift in the EU's defence posture. This is likely to drive a significant shift in the defence market, and perhaps major consolidation.

For investors, the key market developments to watch, at this early stage, are the risk premium on Southern European assets relative to the core, which are expected to stay at their historic lows, and depending on the effectiveness of EU fiscal union, perhaps even shrink further. For industrial policy, the key tools to watch are state aid, level playing field, innovation policy, and supply chain security, and the impact on large companies. For defence spending, the key things to watch are defence sector consolidation. In all scenarios, 'strategic autonomy', or a policy like it, is expected to remain important to Europe given the permanent and growing external vulnerabilities of the continent.

To review the full research paper discussing Europe's 'strategic autonomy' in full, click here.

Policy review

Russell Silberston
Strategist

The Fed's change of tone

Having been resolutely dovish in the aftermath of its recent monetary policy review, the US Federal Reserve (Fed) has become incrementally more hawkish in recent communications. Specifically, focus has turned to the risk management of recent upside surprises to inflation prints and the possibility these lead to expectations becoming separated from the 2% target. The Fed's central view is that the unprecedented conditions of opening an economy after a global pandemic is creating supply bottlenecks and large spikes in some prices but that these effects will fade with time. As such, it would be unwise to slow the economy prematurely by raising interest rates or pulling back on asset purchases. However, in a series of recent speeches, members freely admit that, given the unique circumstances, their analysis may be wrong, and were this the case they have the tools to bring inflation back down. In practice, this commitment should limit the upside to the level of implied inflation in bond markets.

The second communication change was focused on the level of asset purchases, which have been running at US$120 billion a month and will continue "until substantial further progress has been made toward the Committee's maximum employment and price stability goals". But with inflation comfortably above target, albeit temporarily, the housing market booming and the labour market slowly but surely normalising, the focus of June's Federal Open Market Committee meeting shifted toward defining what the vague "substantial further progress" test actually means in practice. This is a debate for up and coming Committee meetings, but it is a clear signal that the starting pistol has been fired for the Fed to begin thinking about tapering asset purchases, while stressing this process will be "orderly, methodical and transparent" with an aim of avoiding the 'taper tantrum' experienced in 2013. Whilst being dependent on economic data outcomes, we expect the Committee to preannounce its plans in September, with the actual tapering starting around year-end and lasting for 12 months.

According to the Hutchins Centre Fiscal Impact Measure, having boosted economic growth by 8.6% in the first three months of the year, fiscal policy turned into a modest headwind in the second quarter, detracting 0.7% from growth. We flagged this as a major risk in our January edition, and continue to expect policy will be increasingly negative going forward as emergency spending is unwound.

China sticks to her guns

China continued with her 'consistency, stability and sustainability' mantra during the second quarter. Economic growth has clearly slowed in recent months, but this simply reflects base effects from last year's blockbuster performance, coupled with some specific and targeted macro-prudential measures that are seeking to take some of the froth out of the housing market and aid the deleveraging of local government financing. Beyond this, the People's Bank of China (PBoC) kept liquidity neutral, in line with the need to stabilise debt to GDP at its current level. Looking forward, there is little reason to expect any major change in Chinese monetary or fiscal policy; growth and money supply are slowing to more sustainable levels, and whilst producer price inflation is certainly very high, there is little sign of this feeding through to consumer prices. Policy will therefore be focused on strategic sectors, such as complex manufacturing investment and rural development, whilst continuing to ensure that excess leverage is addressed by targeted measures.

ECB sees a turning point

European Central Bank (ECB) executive board members felt confident enough in the eurozone economic outlook to state that "we have reached a turning point", buoyed by a fast roll out of COVID-19 vaccinations (after a very shaky start), strong economic survey sentiment and an expectation that fiscal and monetary policy will continue to provide strong tailwinds to this recovery. Financial markets, of course, had come to much the same conclusion and were forcing bond yields and the euro higher.

With the ECB's Pandemic Emergency Purchase Programme seeking to ensure financial conditions are compatible with the economic outlook, its multi-dimension reaction function becomes harder to determine, but in June the Governing Council decided to continue purchasing assets at much the same pace as that enacted in March, this being approximately 80 billion euros per month. However, at this pace the 1.85 trillion euro 'envelope' will be exhausted before its envisaged end date of March 2022. As such, it is only a question of time before the ECB is forced to slowdown the pace of purchases in the coming months. In the meantime, the central bank continues to supress bond yields, ensuring governments are able to fund themselves favourably during a time of crisis.

At the end of May, the EU ratified the 673 billion euro economy recovery facility, a central plank of the Next Generation EU Fund, and so began a historic programme of jointly issued debt. Whilst small in the context of US and Japanese fiscal responses, it still feels the EU has taken a step that would have been unthinkable just five years ago.

No reason to expect Japan to deviate

After several years of aggressive monetary policy easing, in March the Bank of Japan (BoJ) moved to ensure it could continue to provide enough accommodation going forward without increasing the negative side effects of its actions further. In practice, this can be thought of as 'less is more' and makes policy nimbler and more reactive to financial conditions rather than being permanently operating. This was further enhanced in June by rolling over the favourable bank loan scheme for a further six months to March 2022. These loans, along with holdings of short-term treasury bills, has been one of the fastest growing items on the BoJ's balance sheet, with outstanding bank loan amounts standing at 129 trillion yen at the month end, an increase of 80.5 trillion yen since December 2019. Looking forward, with inflation expected to remain low for several months and the economic outlook lacklustre, there is little reason to expect the BoJ to deviate from its current path, which has seen its balance sheet grow by 0.6% per month post-March, a pace in excess of inflation.

Bank of England considers a different route

The Bank of England became far more optimistic about the economic outlook in May, revising its expectations for 2021 GDP up to 7.25% from the 5.00% expected in February. This, of course, was in reaction to the rapid vaccination programme, looser fiscal policy and a better economic outcome than originally feared from the first quarter lockdown. The Monetary Policy Committee (MPC), however, remains firmly focused on the medium-term outlook, rather than the large dislocations in both supply and demand that are washing through the UK as we come through the other side of the pandemic. As such, minutes from the most recent MPC stated that "policy should both lean strongly against downside risks to the outlook and ensure that the recovery was not undermined by a premature tightening in monetary conditions". However, with the UK having underperformed other major economies in recent years, we expect pent-up demand to assert itself over the coming years, and with limited supply capacity, the Bank may well be forced to tighten monetary policy earlier than other policymakers.

One outstanding action point from the MPC's 'to do' list is its exit strategy from quantitative easing. Pre-COVID, it committed to not reduce the size of its balance sheet until Bank Rate reached a level from which it could be reduced meaningfully. This level was deemed to be 1.5%, but an assessment is currently being undertaken to determine if this needs to be lower. It is therefore possible that the UK takes a different 'Pandexit' route, by hiking Bank Rate once or twice and then focusing on allowing its holdings of gilts and corporate bonds to mature, thereby shrinking its balance sheet. We expect to get clarity over this issue in the coming months.

Summary of high conviction asset class views

Growth Bonds

Despite stronger EM growth and inflation, a more benign environment for US inflation and a subsequent reduction in US rate hike expectations is likely to support EM LC. Valuations have continued to improve, in particular real interest rates on both an absolute and relative basis are now scoring very positively whilst roll and carry is close to historical levels, increasing the bar to negative returns. Favourthose areas that have nominal and real rate advantages to DM, as well as attractive carry dynamics as these should continue to benefit from deeply negative real interest rates in DM and aggressive central bank policy.

Positive — Indonesia, Mexico, South Africa, Peru, Colombia, Brazil, Russia, Chile
Negative — No conviction views at present

Sector Equity

Prefer asset light compounders with structural growth underpinning although increasingly wary of high valuations in some areas. Substantial opportunities which benefit from accelerating structural change in cyclical industrial, technology and consumer sectors. Pharmaceutical and Consumer Staples sectors offer an attractive combination of high quality and reasonable valuations.

Positive — Materials, Industrials, Cyclical Tech, Staples, Financials, Pharma, Healthcare Tech
Negative — Energy, Telcos & Utilities, Real Estate, Media & Online Retail, Consumer Goods

Defensive Bonds

The outlook is now more mixed for defensive bonds with divergence between markets apparent. A large repricing in inflation premia centred in the US and the dollar bloc has led to a significant repricing in yields which offers steep curve shapes and attractive carry in areas such as Korea and the Dollar Bloc. Europe and UK have yet to see the same repricing suggesting there remains room for yields to move higher. Inflation premia is at the point of peaking in the US and should begin to fall as price momentum turns negative in the coming months, supporting a negative view of US breakevens and real yields.

Positive — China, Australia, New Zealand, Korea
Negative — Germany, US Breakevens & Real Yields

FX

Divergence among the majors has diminished as the downturn in China's credit cycle has been quicker than expected. CNY has been downgraded from positive to neutral as a result of reduced asymmetry. In the near-term, very easy Fed policy and constructive global growth momentum should place some downward pressure on the US dollar – particularly as Europe's cyclical recovery catches up with the US. High real yielding and cheap EM FX should be supported in such an environment.

Positive — EM, GBP
Negative — USD, NZD (funding currencies)

Credit

Credit valuations are rich across the board with spreads continuing to tighten. HY spreads in particular are back to pre-covid levels with CCCs at their tightest levels in both absolute and relative basis. Consensus estimates are calling for continued strength in to 2Q21, with EBITDA expected to be significantly higher than 2019. All credit asset classes bar US HY have seen net inflows with loans the outperformer. New issuance pace has fallen in IG although remains strong.

Positive — No conviction views at present
Negative — No conviction views at present

Regional Equity

Asian region has structural tailwinds and robust micro fundamentals although risk of a more pronounced slowdown in China has increased. Increasing signs of a broadening recovery across EM, supported by commodity prices. US benefits from further evidence of resilient capital allocation and the greatest breadth of opportunities. Cyclical growth catchup in Europe ex UK offset by structural headwinds and expensive valuations.

Positive — Japan, Asia ex Japan, US
Negative — Europe ex UK

Commodities

Commodity prices have been on a stunning run, with demand recovering from the pandemic very strongly, companies have struggled to restock and thus shortages for many commodities have caused a sharp uptick in prices. However, we do not see reason for concern. All of our company engagements over the past quarter, in addition to analysing various economic data sets, encourage us that demand remains relatively robust across the spectrum of metals, agriculture and energy. From a macro-economic perspective, gold prices look set to be rangebound as monetary policy starts to tighten and US inflation moderates into year end. Nevertheless, gold equities look good value as margins and cashflows remain strong overall and, with very low debt levels, they can provide good shareholder returns as well as diversification.

Positive — Metals and Agriculture
Neutral — Oil and Gold

Equity views

Concerns around the Chinese monetary policy emerged in the first quarter of 2021, but given the lags between policy tightening and a slowdown in growth we maintained a positive view on the growth outlook through the year, along with our maximum positive view on Asian equities. However, the Chinese credit impulse has come off quicker than expected, suggesting there is a limited period of support for growth in the region going forward. The environment for emerging markets is likely to remain positive if global financial conditions remain loose and liquidity abundant, but there is some debate around how long this benign environment will persist with the increasing risk of a USD squeeze as growth and inflation momentum slow. Other risk factors that have emerged include the deteriorating competitive dynamics within the Chinese internet sector, the increasing regulatory pressures from the Chinese government and the rise in China's Producer Price Index, which is causing margin pressure for consumer goods companies. As a result, we have moderated our view on Asian equities from maximum positive.

Another market that has attracted our attention is the UK, which we have upgraded to neutral from negative, reflecting the strength of cyclical momentum and the widening valuation discount to other markets. The UK screens well even as the very strong base effects from a year earlier have faded somewhat and the next phase of recovery is expected to be particularly dynamic. The successful vaccination roll out should allow for a more complete reopening after extended phase of severe restrictions. The makeup of the UK market is aligned with positive sector views, given large exposures to materials, financials, consumer staples and pharmaceuticals. We believe the quality of the median UK company is much better than the market cap weighted indices and UK small and mid-cap markets offer better opportunity sets than large caps and lower sensitivity to GBP.

At the sector level, we have downgraded industrials to positive from maximum positive due to the increased evidence of peaking growth dynamics in the US and China. Demand for short-cycle industrials tends to be the strongest at the start of a new cycle and given we are moving towards the top of the global growth cycle this is also the area which will first see weakness as the cycle turns. As a result, we downgraded and removed Japanese factory automation companies as a recommended position. This sub-sector had been the highest conviction within industrials and a large driver of the maximum positive view on the sector overall, hence the marginal downgrade. We note that this is just the first of the cyclical downgrades but that current global momentum should continue to support other long-cycle cyclicals for the time being.

Cyclical technology has been upgraded to maximum positive from positive on the basis of supply and demand analysis, which suggests that a further significant period of cyclical strength remains likely in the semiconductor market in particular. Recent market concerns around peak profitability and overinvestment in semiconductor and tech hardware supply appear to be overdone as demand exceeds supply and the long lead times that exist in the market before supply can increase. Our positive fundamental thesis on memory semiconductors continues to play out with demand remaining very broad and robust at the same time as supply discipline has become entrenched. Companies have reported an acceleration in underlying growth and incremental upgrades to revenue and profit guidance. Supply-demand dynamics remain positive as, even with increased capital expenditure, new output is only coming online in 2022. The market has started to look ahead to the timing of a cyclical peak and subsequent slowdown, but our analysis suggests that the cycle is more durable than some feel, with the supply–demand balance likely to remain tight for the next 12 months. If history proves to be an accurate guide, there are likely to be a further two-to-three quarters before DRAM (dynamic random-access memory) prices peak, with share prices reaching highs immediately before this peak in prices; therefore, we see potential for significant further upside from here. Valuation de-rating has provided an opportunity to increase exposures, with memory semiconductor producers and semiconductor equipment companies preferred positions.

Fixed Income views

Expectations for inflation have risen rapidly over the past 12 months, with market participants now expecting a sustained move higher in inflation over the medium term. This move higher has coincided with increasing CPI prints as a result of supportive base effects and strong demand from economic reopening, which have acted as strong tailwinds to expectations. However, we would note that these factors will begin to washout in the coming months and therefore we are now at the peak for US inflation releases. As a result, these factors are likely to act as a headwind to market expectations with it increasingly difficult for inflation to continue to surprise higher meaning the market's expectations for US inflation are likely to moderate in the coming months, which also is likely to limit the extent to which US bond yields can rise and may even see them fall from here.

As the global economic recovery matures, we have also begun to see central banks discuss an exit from emergency policies, most notably the Federal Reserve (Fed) which In June communicated that it has begun discussions on when to end its quantitative easing programme. Our view is that we have likely approached the peak for central bank accommodation, particularly in the US and this incremental shift towards tighter policy over the coming months is likely to put pressure on interest rate expectations. As a result of our view for lower inflation and increased interest rate expectations, we believe US real interest rates will move higher from their current record low levels.

Government Bonds: Our US macro scores continue to move in favour of fixed income from very negative levels, reflecting the tighter policy scores, the approaching peak in inflation momentum and the slowing positive momentum for growth. Our view is that the scores should continue to move more positively and are likely to be positive for US government bonds in the coming months. We maintain our high conviction negative view on European yields. Data continues to improve with regards growth as the economy recovers from the pandemic, and also inflation as base effects and stronger demand lead to strong price pressures. Structural valuations remain expensive, and the flat curve is also reflective of very low carry, limiting the opportunity to generate returns from taking short positions. In line with our view on European fixed income, we remain negative on the UK reflecting the potential for a catchup in inflation premium, as well as higher long-dated real rates as the economy opens up. Despite a more positive view on Chinese bonds, valuations are close to fair value. Instead, we prefer other markets where there is a high sensitivity to the Chinese outlook but with greater risk premiums such as Australia, New Zealand and Korea.

Emerging Market Local Currency: The improving emerging market (EM) growth backdrop and higher inflation prints has seen EM central banks shift towards a more hawkish stance and put pressure on EM local currency yields. However, this has led to increasingly attractive valuations, whilst steep curves also mean that roll and carry remain close to historical levels of attractiveness which increases the bar to negative returns. As a result of the increased risk premia available and more benign environment for US bond yields, EM local currency fixed income should be supported over the next six months and we maintain our positive view. However, we acknowledge that many EM markets remain dependent on the global liquidity backdrop and this positive view is likely to change once central bank policy shifts decisively towards a removal of accommodation.

Emerging Market Hard Currency: The outlook for credit ratings has remained better supported by improving terms of trade, a recovery in growth and fiscal expectations across EM. The team's preference remains for high yield names where spreads have failed to compress to the same degree as higher rates bonds.

Developed Market Credit: The dynamic which has been in place for the past couple of quarters remains with strong macro and improving quality scores (consisting of factors such as ratings trends, dispersion and distress ratios which will likely lag moves in price) being offset by demanding valuations. Spreads continue to tighten, bringing Investment Grade (IG) to all-time tights once adjustments have been made for rating and duration. High Yield (HY) presents better value with high dispersion between the quality end of the section and riskier names, with the latter now very tight. Generally, results have been good with the deleveraging trend continuing within corporates. Markets have been well supported with strong flows even in the face of increased issuance.

We remain neutral on HY and IG due to negative valuation and neutral fundamentals. The Fed has begun to wind down its corporate credit programme although we do not view this as a negative for credit for several reasons. Firstly, the programme was small relative to the overall market size and has been in effect since the wide in credit spreads all the way to the tights. The Fed has also been very clear in its communication surrounding tapering. Elsewhere, the ECB has been intervening in the credit markets throughout the cycle, whereas these measures by the Fed have been targeted to the Global Financial Crisis and this latest period, suggesting it is an emergency tool. As we move into 2022, the negative blend of macro and growth dynamics is likely to lead to a further downgrade in the outlook for credit.

Currency views

The Chinese yuan has been downgraded to neutral from positive. We had a maximum positive view on the yuan from the middle of last year as China moved ahead of the rest of the world in terms of recovery from the pandemic and with the PBoC shifting to a neutral policy stance. However, as it became clear that the tightening the authorities have carried out is focused on credit channels, which tends to be less positive for the currency, we reduced our view to a single positive earlier in the quarter as a result. These dynamics have continued to progress with the credit impulse declining faster than expected, which has led to a further downgrade to neutral.

Over the short term, we continue to believe there is scope for some US dollar weakness due to divergence in the growth momentum in the US versus the rest of the world, which should lead to greenback underperformance. Looking further out, however, there are concerns around the impact of China's tightening and how this feeds through to global growth. We also remain cognisant that the US dollar is likely to be upgraded over the next six months, which would also have implications for EM positions.

We have added a long position in the Japanese yen versus the euro as a hedging position given its high correlation to the Chinese credit cycle and global growth outlook. This cross has tended to perform well when global growth is weakening, as we expect to occur later in the year. We remain positive on EMFX in the near-term given the easy policy stance of the Fed and abundant global liquidity environment. Current accounts remain supportive with imports failing to recover as strongly as expected. However, bottom-up ideas are harder to find given idiosyncratic risks and overextended valuations in many markets. The Mexican peso and Indonesian rupee remain favoured.

Commodity views

The end of June marked the strongest 12-month run for commodity prices in the Bloomberg Commodity Spot Index's 30-year history. The index rose 55% in the year through June, passing the previous high of 54% set between July 2007 and June 2008. This naturally causes some investor concern, as the rapid price appreciation in that period preceded the Global Financial Crisis of 2008 and 2009. Should we be worried that another synchronised global slowdown is around the corner?

While a large part of this question should be answered by the macro-economic framework presented elsewhere in this Quarterly, the perspective we can offer from commodity markets is that we have not observed an oil price shock such as we did then. In fact, oil price spikes have been observed in the run-up to most recessions over the last century. Given that front month futures in Brent crude oil are only back to around the ten-year average (~US$75 a barrel), we don't see a systemic risk coming from the energy complex yet. That said, we have observed how very large price increases in many commodities have fuelled the broader inflation measures over the last few months, especially as base effects have been meaningful given the COVID-driven lows in March to May 2020. Steel and iron ore prices have now far exceeded previous all-time highs, copper broke through its previous record price set in early 2011 and lumber prices ran up to nearly twice their previous all-time highs until a sharp retreat through May and June.

To a large extent, the recovery has had a consumption rather than a construction-led narrative. The long-awaited 'fiscal stimulus through infrastructure spend' has not really arrived yet and demand for many commodities was actually driven by households spending less on leisure activities, eating out, and travel, and more on physical goods, tangible assets and improving living standards. COVID has accelerated newer parts of the economy such as digitalisation and e-commerce. This has given rise to the need for more data centres, distribution centres, warehouse space and investment in logistics. Transport bottlenecks have caused artificial shortages in some markets and probably fuelled price rises in a few cases. But what about real underlying demand today, given the elevated levels in many commodity prices? As a general observation, from speaking to over 50 companies in the last three months and analysing various economic data sets, we see demand as relatively robust across the spectrum of metals, agriculture and energy.

The aforementioned data for the BCOM Spot index has its limitations, given that it only goes back to 1990. During the calendar year of 1973, other commodity indices more than doubled, largely driven by a huge move in energy prices. So, history tells us that there have been more rapid gains and what is interesting is that the seven-year period that followed 1973 saw roughly a further tripling of commodity prices. Short of drawing a full comparison between the drivers of that age and today, we can say that the global economy has shown the ability to cope with rising raw material prices for longer periods of time, although there has been particular sensitivity around oil as the key energy source in the post-World War II era.

We generally see demand remaining strong through the rest of the year, although we are aware that temporary slowdowns and destocking cycles could occur. The Chinese government has attempted to remove speculation in commodities such as steel, iron ore and copper. Most of these attempts have had limited success and prices rebounded in the days and weeks after measures were introduced. At the same time, demand in Europe and the US for the likes of steel and aluminium has been exceptional. While we think 'construction demand' will be required soon to take over from 'consumption demand' as the latter eases, we don't expect significant corrections in key commodities if the construction piece, which will be linked to government-sponsored infrastructure projects, takes longer to commence. Overall, there have been many investments and buying decisions that have been postponed in the last six months simply because customers could not get their hands on material. So, if we do see looser markets and improved availability of commodities, there may be pent-up demand ready to take advantage, which in turn will support prices. Currently we may be in a classic restocking cycle, but as the energy transition begins to pick up pace with its vast infrastructure needs, precedents are hard to come by and prices could well settle at much higher real levels than recent history would suggest.

General risks. The value of investments, and any income generated from them, can fall as well as rise. Past performance is not a reliable indicator of future results. **Specific risks.** **Currency exchange:** Changes in the relative values of different currencies may adversely affect the value of investments and any related income. **Emerging market (inc. China):** These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems. **Commodity-related investment:** Commodity prices can be extremely volatile and significant losses may be made. **Default:** There is a risk that the issuers of fixed income investments (e.g. bonds) may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss.**Equity investment:** The value of equities (e.g. shares) and equity-related investments may vary according to company profits and future prospects as well as more general market factors. In the event of a company default (e.g. insolvency), the owners of their equity rank last in terms of any financial payment from that company.

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