MARKET BACKDROP
A review of what's happened in markets recently

MARKET OUTLOOK
Looking ahead to the coming months

SPOTLIGHT ON
Inflation

The view

Spring 2021

architas

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Welcome
to The View – Spring 2021

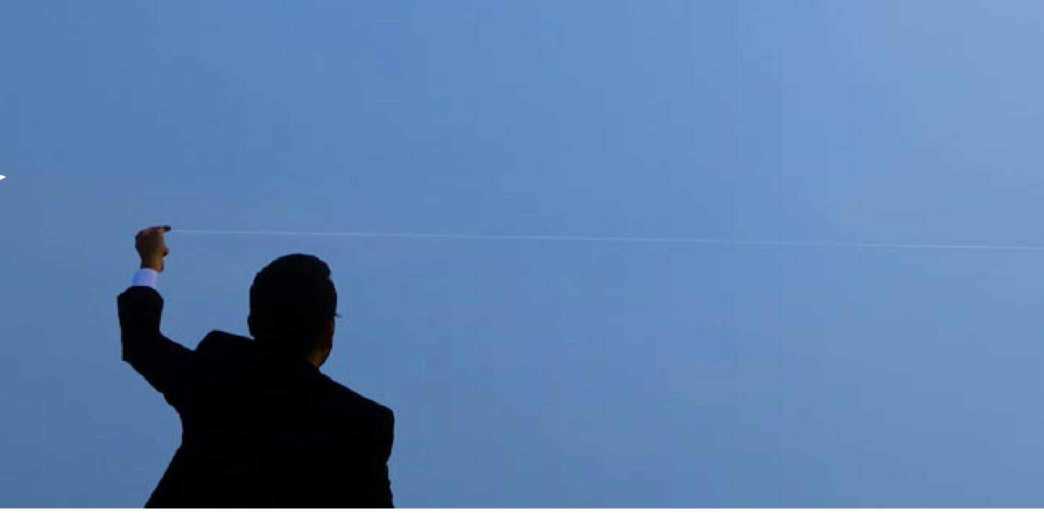
The Spring edition of The View provides a step-by-step guide to how the political and economic environment has driven financial markets, and what this means for your investments.

Companies and consumers are all reporting feeling more optimistic. This and the repairing global economy suggest that inflation could be on the rise. We delve into why inflation happens and what it means for your investments.

When you invest, you're exposed to many different types of risk so understanding the main categories of risk are important. Here we explore a few basic risks that can prevent investors from reaching their goals.

The bond yield curve is often given the qualities of a crystal ball, predicting the path of economic growth, inflation and interest rates. But what is this curve, and can it really map out the future?

Jaime Arguello
Chief Investment Officer



Market BACKDROP

In the first three months of 2021 equities powered ahead despite encountering volatility. Cyclical stocks – those sensitive to economic momentum continued to lead, at the expense of growth stocks, building on outperformance that began with positive vaccine news in November of last year.

The key propellant was a boost to the global economic outlook from continued monetary policy support, an uptick in vaccine supply and distribution, and ample corporate and consumer cash waiting to be deployed. The massive scale of stimulus in the US and globally caused considerable nervousness over inflation. This hit fixed income in what was a brutal quarter for global government bonds.

ECONOMIC FACTORS

Historic US stimulus plan boosts US. The US raced ahead in terms of fiscal support and as a result is likely to be the fastest-growing developed economy in 2021. With the approved $1.9 trillion American Rescue Plan set to supercharge the US recovery as Covid-19 restrictions are lifted.

Inflation concerns. Despite policymakers broadcasting a very positive view on it. After many years of dormancy inflation is set to explode. Or so we are told. Bond investors have been in retreat with Treasury yields rising, reflecting the sell-off. And stock markets are on edge.

RISKS

Risk rotation. Coronavirus has been overtaken for the first time since the early days of the pandemic more than a year ago as the top risk that keeps investors up at night. Inflation and an unruly rise in borrowing costs like that seen during the 2013 'taper tantrum' are the key risks that could unsettle global markets.

The backlash against globalisation. The blockage of the Suez Canal by one of the world's biggest container ships was a physical reminder that supply chains have become a dangerous source of vulnerability. As governments battle the pandemic and face up to rising geopolitical tensions, a new mantra of resilience and self-reliance is becoming ever more popular.

FINANCIAL MARKETS

A cyclical rotation. Investors poured into cyclical value stocks away from last year's much-loved technology-heavy growth stocks. On a regional level, US stocks provided robust returns and European equities headed towards their pre-pandemic peak as investors cheered US president Joe Biden's $2 trillion infrastructure plan to kickstart the world's largest economy.

Fixed income instability. Bond markets were spooked by a resurgence in inflation. With government and corporate bonds returns plummeting in their worst start to a year this century. High yield and emerging market debt benefited from investors' renewed appetite for risk providing slim but positive returns.

CONCLUSION

Early-2021 has been encouraging. With global pandemic related monetary and fiscal support measures estimated at over $20 trillion, or more than 20% of world GDP. This massive stimulus, along with the vaccine roll-out, is the reason for the expected strong bounce in economic growth over coming months.

Although risks clearly remain against an often-uncertain backdrop. As the stimulus support is also the cause of considerable nervousness over inflation which led to the recent sell-off in government bonds. And that is not even considering any Covid-related setbacks.

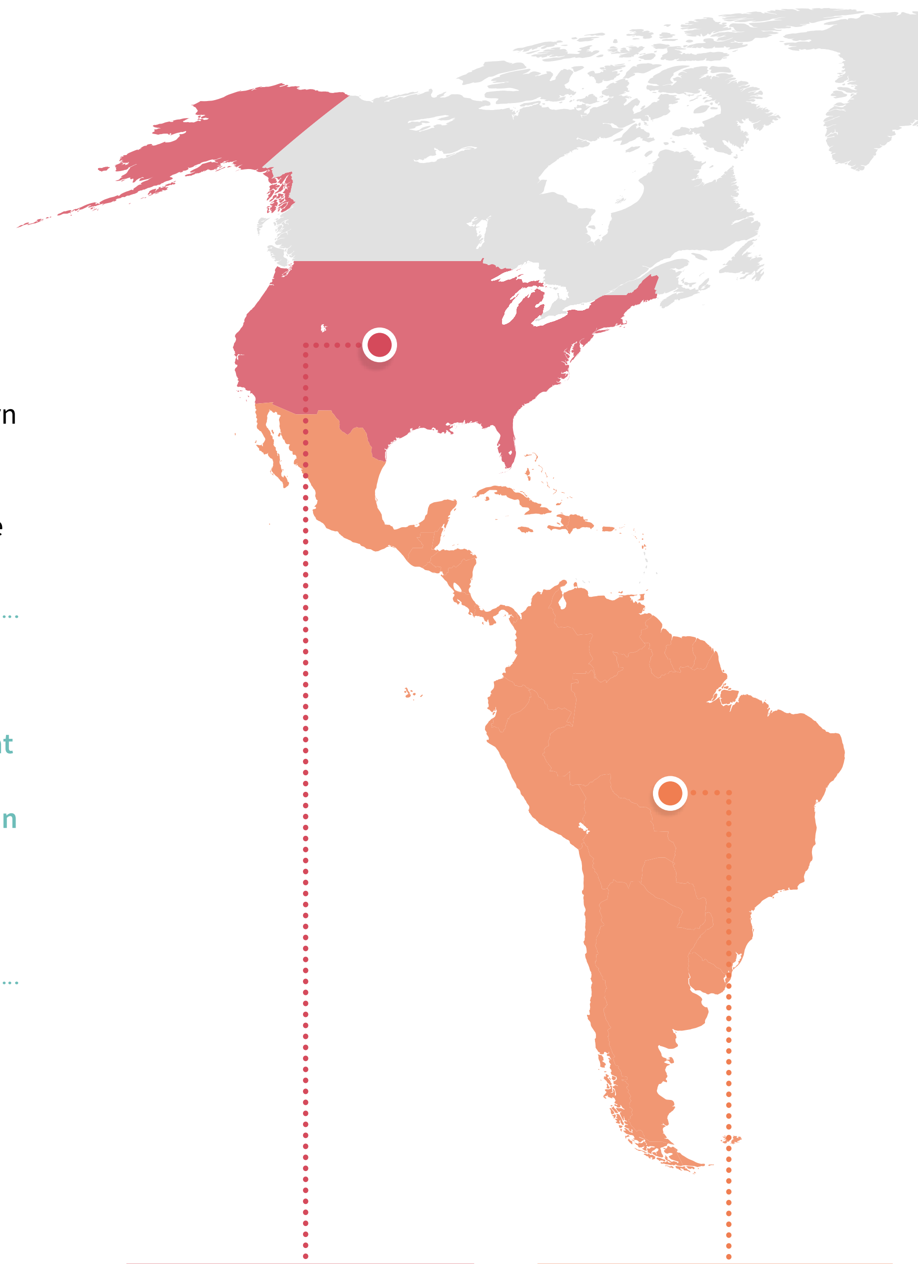
While investors are regaining their confidence, we believe that this year's turbulence reinforces the importance of being diversified across a range of different asset classes.

Market OUTLOOK

The outlook for the global economy continues to grow in strength with the return to 'normality' tantalisingly close. However, the divergences in regional vaccine rollouts still need to be overcome and could provide longer-lasting challenges.

It was this expected pick-up in economic activity combined with President Biden's large fiscal stimulus spending package that spooked markets worried about rising inflationary pressures. However, we remain confident that central banks will maintain their accommodative monetary policy for an extended period.

Although along the way there could be an uptick in market volatility, particularly if inflation concerns continue. Based on history, investors should hold tight and keep eyes on the longer term. As ever, we believe that being diversified across a range of different asset classes is the best approach to take.



UNITED STATES

STOCKS (Negative) BONDS (Neutral)

- Although the US economy is booming due to unprecedented stimulus, we think that there are better opportunities elsewhere. US stocks are expensive.
- Post-pandemic inflation worries remain with potential for more selloffs. However, they do hold relative attractiveness for investors seeking out higher-yielding safe haven assets.

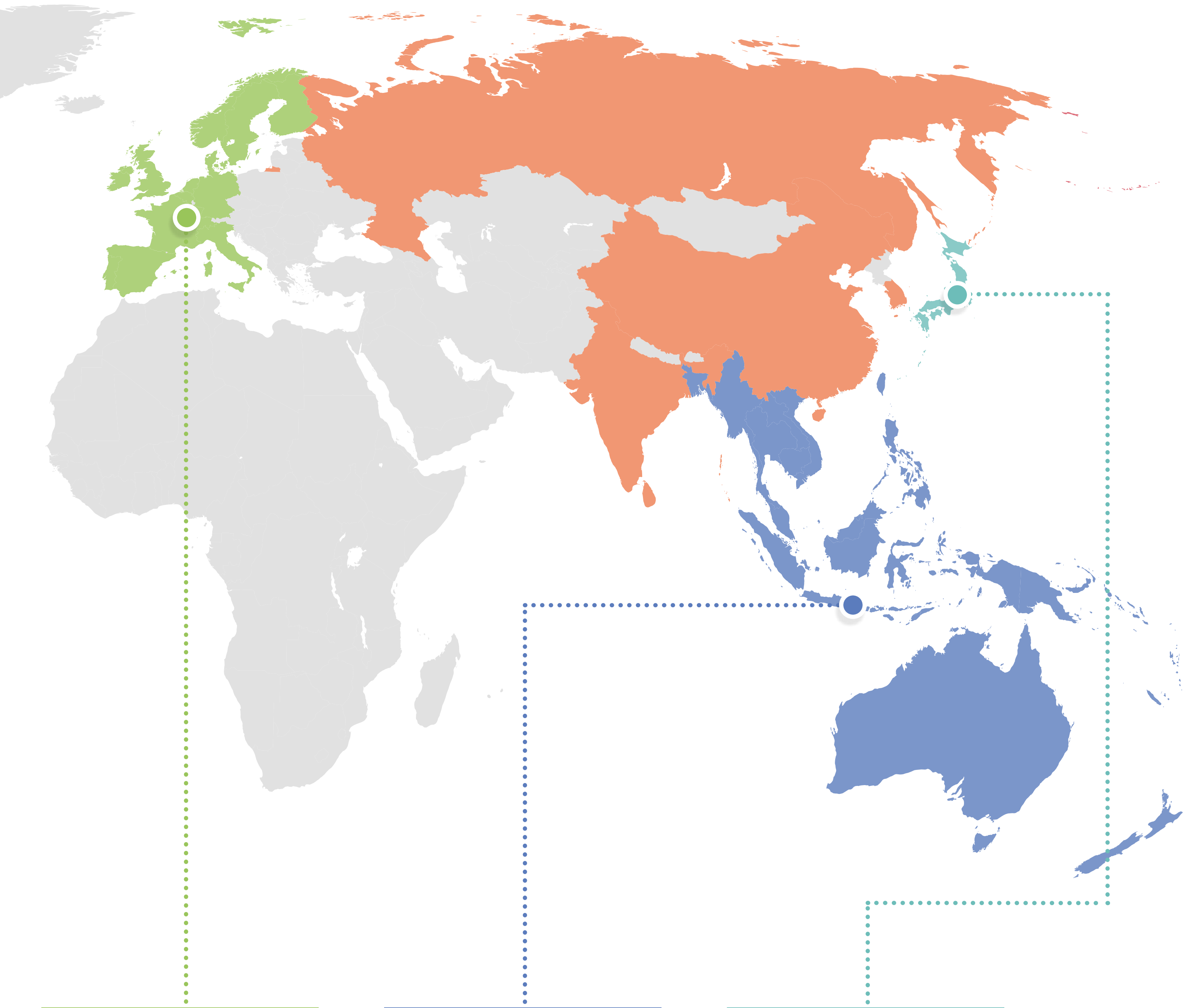
EMERGING MARKETS

STOCKS (Positive) BONDS (Neutral)

- We are reasonably optimistic as the combination of attractive valuations with a positive macroeconomic trajectory all bode well for performance relative to other markets.
- This asset class is more at risk than others from contagion linked to higher US bond yields and so we remain cautious until the current market nervousness subsides.

KEY

- Positive
- Negative
- Neutral



EUROPE

STOCKS BONDS

- We have become less optimistic about European equities. Valuations are on the expensive side compared to historical averages. Especially as the slow vaccine roll-out is prolonging the pandemic.
- Overall, we remain neutral with a preference for corporate bonds over government bonds as these are better positioned to benefit more directly from monetary stimulus.

ASIA PACIFIC

STOCKS

- The region's economy is set to grow significantly as a whole. This will be driven overwhelmingly by a surge in economic growth from China.
- But the prospect of rising inflation and US Treasury yields has somewhat dampened sentiment despite prospects of calmer US/China relations.

JAPAN

STOCKS

- Japan is well-positioned to benefit from a global economic recovery. One challenge for Japan's exports is the global shortage of semiconductors weighing on auto production and exports.
- Low Japanese confidence in vaccines has delayed the approval and rollout. Pressure remains to reduce infections before Japan welcomes the world for the Summer Olympics.

SPOTLIGHT **ON...**

Inflation

The pandemic has led to far greater cooperation between governments and central banks. Governments can borrow and spend, in the knowledge that they won't put pressure on the interest rates because central banks will stop that from happening. This has resulted in a powerful stimulant to the global economy.

At the same time industrial firms, service companies and consumers are all reporting more optimism in the future. This cooperation and these positive sentiment indicators all suggest that the global economy is on the way to repair but it also means that inflation could be on the rise.

Here we ask what is inflation, why does inflation happen what does it mean for your investments?

WHAT IS INFLATION? (AND DEFLATION)

Inflation is a sustained upward movement of prices for goods and services in an economy. Or too much money chasing too few goods. Think overall prices—not the price of a single good. According to this logic, if a central bank prints too much money, or makes it very easy to borrow money, by keeping interest rates low then prices will rise.

The other side of the coin to inflation is deflation. A condition that economists fear. When the prices of goods and services fall. And because deflation expectations make consumers wait for future lower prices, this reduces demand and slows growth.

WHAT ARE THE CAUSES?

There are four main reasons:

1

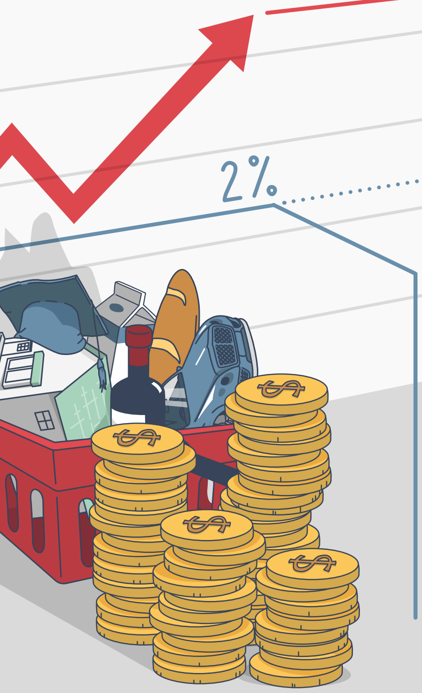
An increase in demand:
When demand outpaces the supply of goods and services. Often when an economy is in recovery and the unemployment rates are falling.

2

An increase in costs:
Hikes in production costs from increases in the prices of commodities such as oil and food, or natural disasters.

THE INFLATION RATE

The inflation rate is generally estimated using the consumer price index (CPI). It is defined as the change in the prices of a basket of goods and services that are typically purchased by specific groups of households. Inflation is measured in terms of the annual growth rate with a breakdown for food, energy and total excluding food and energy.



AN INFLATION TARGET

To avoid extremes of inflation (like deflation), most central banks try to keep it around 2%. To stop inflation rising they can increase interest rates, making it more expensive for everyone to borrow money, which slows the economy and lowers inflation. Or provides room for central banks to cut in the event of a recession.

3

An increase in the money supply:
If the total value of money available in an economy increases. This has an upward burden on prices.

4

Inflation expectations:
Inflation expectations can also lead to a hike in the prices of goods and services through wage demands.

EFFECTS OF INFLATION ON INVESTMENTS

Most people understand that inflation increases the price of their groceries or decreases the value of the money in their wallet. And over time, it can take a bite out of your investment returns.

Inflation's influence on select asset classes 1990 – 2020

US large-cap stocks	↗
Developed market stocks	↓
Emerging market stocks	↓
Investment grade bonds	↓
Inflation-linked bonds	↗
Property	↑
Commodities	↑

↑ Strong positive
↗ Positive
↓ Strong negative

HOW TO DEFEND YOUR PORTFOLIO AGAINST INFLATION

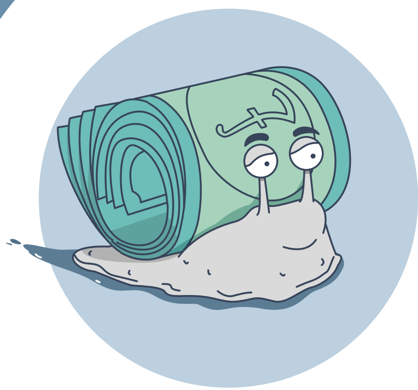
Although, inflation might be beyond your control. There is one technique in an investment portfolio that can help to address the threat of inflation to help preserve your investments and savings from its effects. This is diversifying your portfolio through asset allocation.

For example, investors might increase asset classes such as commodities, property and inflation-linked bonds, with a careful selection of equity assets and decrease bonds and cash.

Importantly, diversifying your portfolio may help you shield your money against inflation, although it doesn't guarantee protection against losses.

AN INTRODUCTION TO UNDERSTANDING RISK

When you invest, you're exposed to many different types of risk. While various statistics often define risk, the broadest definition of risk to investors is failing to achieve their investment goals. There are a few basic risks that can prevent investors from reaching their goals:



Liquidity risk

Defined as the risk of being unable to sell your investments at a fair price and get your money out when you want to. To sell the investment, you may need to accept a lower price. You might also experience delays in selling the investment. And, in some cases, it may not be possible to sell the investment at all.

Market risk

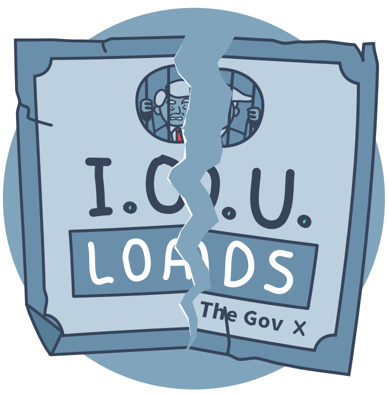
This refers to the risk to investments from movements in market prices such as stock prices, foreign exchange rates, interest rates and commodity prices. This could mean a loss in the value of your investments. The best-known strategy for reducing market risk is creating a diversified portfolio consisting of multiple asset types that behave differently to each other in times of market stress.

Concentration risk

Your portfolio can often be at a greater risk of loss if it is focused solely in the same sector, asset class or geographic location. This is because when an unexpected event occurs, in the short-term, markets often do not discriminate and all assets within an asset class or sector can suffer losses. You can offset this risk when you diversify your assets; you spread the risk over different types of assets, sectors and geographic locations. Or in other words, don't put all your eggs in one basket.

Inflation risk

The risk that your investments will buy fewer things, so-called ‘purchasing power’ because the value of your investment fails to keep up with inflation. Inflation erodes the purchasing power of money over time – the same amount of money will buy fewer goods and services.



Credit risk

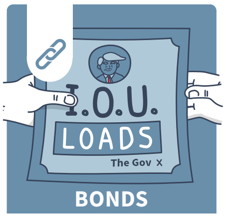
Credit risk applies to debt investments like bonds. It is the risk that a government or company that issues a bond might run into financial difficulties and won’t be able to pay their debt obligations. Credit risk is calculated based on the borrower’s overall ability to repay a loan.

Why is risk important?

Investors show varied approaches to risk: some are relatively adventurous and others more cautious. Also, another critical factor is the importance of the goal (an investor might be able to take more risk with investments for a dream holiday but less risk with investments for children’s education). There are many ways to classify the risks an investor is willing to take. Cautious investors are prone to worry about their finances and might want to avoid more speculative investment areas. An adventurous investor may perhaps invest in higher-risk assets, such as stocks, and avoid lower-risk investments such as government bonds.

Strength:
Low market risk

Weakness:
Affected by Inflation Risks



Strength:
Lower market risk

Weakness:
Affected by Credit Risks

Strength:
Low liquidity risk

Weakness:
Affected by Market Risks

Strength:
Lower market risk

Weakness:
Affected by Liquidity Risks

Strength:
Can reduce inflation risk

Weakness:
Affected by Liquidity Risks

This is why investment experts recommend investing in a diversified portfolio spread across different investments so that you’re not reliant upon a single investment for all of your returns. The key benefit of diversification is that it helps to minimise the risk of capital loss to your investment portfolio.

The yield curve

WHAT'S THE BIG STORY?

The US Treasury bond yield curve is sometimes given the qualities of a crystal ball, predicting the path of economic growth, inflation and interest rates. But what is this curve, and can it really map out the future? We take a look at how the yield curve is drawn, what that picture represents and whether these mystic powers stack up in reality.

First a step back. Governments issue bonds as a way of financing their investments. The bond or loan will be repaid over a fixed period, depending on the scale of the project, or the interest rate the government wishes to pay. The time frame could be as short as 3 months, or as long as 30 years. The interest rate on a short-dated bond is typically low. A longer dated bond pays a higher rate, rewarding investors for the risk that things might change over time.

A graph plotting the current interest rate or yield of a range of government bonds, from short to long dated, will normally show a steadily rising pattern. Join the dots and you've drawn a yield curve. But the shape of that curve is not set in stone, as the bonds are actively traded in a market. As the economic backdrop changes, the curve can look either steeper or flatter. And it's that shape which gives a clue as to the market's economic expectations, both good and bad.

In the years just before the pandemic, we saw a few episodes where the US yield curve moved away from its natural gentle rise, tipping downwards at the longer-dated end of the bond market. It's known as an 'inverted yield curve'. It looks uncomfortable and is often taken as a signal that growth in the future will be lower than growth today. Or even that the economy could tip into recession, ringing alarm bells in the equity markets.

This year the alarm has been raised by a steeper yield curve. Yields on long-dated US bonds have risen very sharply, while short-dated bond yields remain anchored close to zero. What does this tell us? One message is that US fiscal stimulus could cause the economy to overheat, fuelling inflation and forcing interest rates higher. A secondary message is that the US Federal Reserve (Fed) plans to finance the recovery with ultra-low interest rates. All may be open to interpretation, but what's crystal clear is that the Fed remains calm, happy to look through a temporary inflation spike to more normal times ahead.

Understanding bond yields

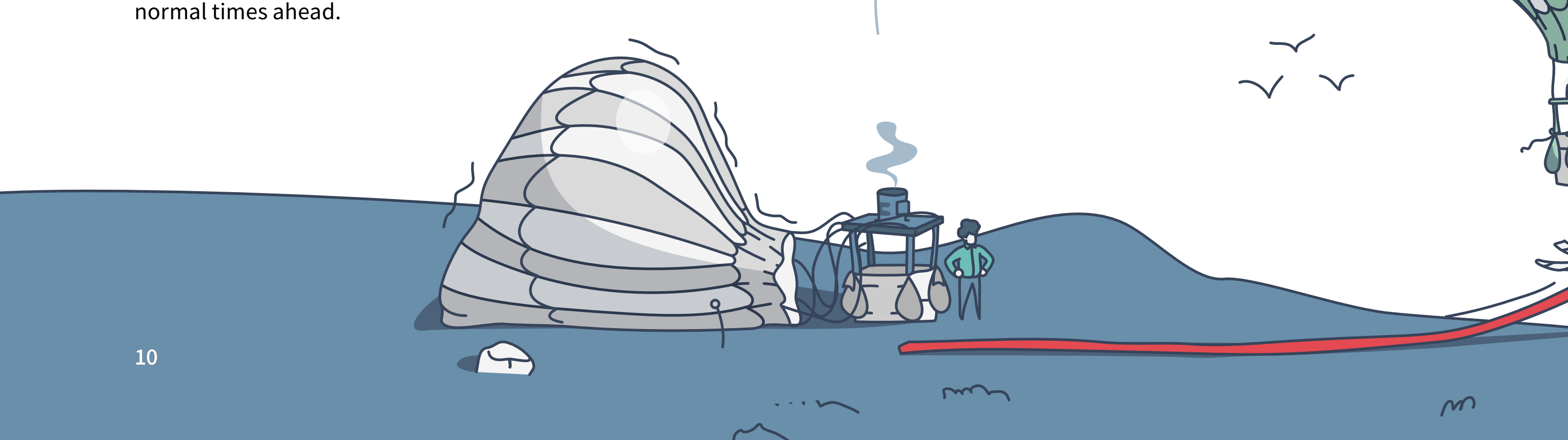
Yield is the anticipated return on an investment, expressed as an annual percentage. It is a critical concept in bond investing because it is the tool you use to measure the return of one bond against another. Enabling investors to make informed decisions about which bond to buy.

The link between price and yield

The yield's relationship with price can be summed up as: when price goes up, yield goes down and vice versa. Technically you'd say the bond's price and its yield are inversely related.

Can high yields and high prices both be good?

A main point of confusion is often around how high yields and high prices can both be good when they can't happen at the same time? The answer depends on your point of view. If you're a bond buyer, you want high yields. A buyer wants to pay $800 for the $1,000 bond, which gives the bond a high yield of 12.5%. On the other hand, if you already own a bond, you've locked in your interest rate, so you hope the price of the bond goes up. This way you can cash out by selling your bond in the future.



The influence of interest rates

The factor that influences a bond more than any other is the level of prevailing interest rates in the economy. When interest rates rise, the prices of bonds in the market fall, thereby raising the yield of the older bonds and bringing them into line with the newer bonds being issued with a higher coupon. And, when interest rates fall, the prices of bonds in the market rise, thereby lowering the yield of the older bonds and bringing them into line with the newer bonds being issued with a lower coupon.

When are rising yields an issue?

Can yields and long-term rates rise too much before they begin to become a risk for stocks? In theory, yes, but typically only if a rise in rates begins to choke off economic growth. Rising yields will likely inject more volatility into financial markets as investors debate when central banks will be forced to tighten monetary policy.

Facts & Figures

QUARTERLY DATA

US stocks	UK stocks	Asian (but not Japanese) stocks	European (but not UK) stocks	Emerging market stocks	Japanese stocks
6.2%	**6.2%**	**4.6%**	**3.5%**	**2.3%**	**1.2%**
S&P 500 Composite Index	FTSE All-Share Index	MSCI Pacific excluding Japan Index	FTSE All World Developed Europe excluding UK Index	MSCI Emerging Market Index	TOPIX Index

Global high yield bonds	European corporate bonds	US corporate bonds	Emerging market bonds	Global government bonds	UK corporate bonds
-0.1%	**-4.6%**	**-4.7%**	**-4.7%**	**-5.5%**	**-5.7%**
ICE Bank of America ML Global High Yield Bond Index	Bloomberg Barclays European Corporate Bond Index	Bloomberg Barclays US Corporate Bond Index	JP Morgan Global Emerging Market Bond Index	FTSE G7 Index	Bloomberg Barclays Sterling Aggregate Bond Index

To highlight the unpredictability of markets, the table below details the performance of global equity and fixed income indices over the past five years (in dollar terms).

This table demonstrates how volatile markets can be, and shows the benefits of diversifying your investment, or in other words, not putting all your eggs in one basket.

Index percentage growth (%)	1 Apr 20 - 31 Mar 21	1 Apr 19 - 31 Mar 20	1 Apr 18 - 31 Mar 19	1 Apr 17 - 31 Mar 18	1 Apr 16 - 31 Mar 17
US stocks	56.4	-7.0	9.5	14.0	17.2
European (but not UK) stocks	50.2	-12.3	-4.4	16.8	11.6
UK stocks	41.0	-22.4	-1.2	13.6	6.1
Japanese stocks	36.1	-9.6	-10.9	18.9	13.2
Asian (but not Japanese) stocks	54.1	-23.6	4.7	8.6	18.5
Emerging market stocks	58.9	-17.4	-7.1	25.4	17.7
Global government bonds	0.2	7.5	-0.8	7.1	-3.4
Global high yield bonds	25.7	-8.3	3.2	6.7	13.8
US corporate bonds	8.7	5.0	4.9	2.7	3.3
European corporate bonds	16.5	-5.6	-6.6	17.0	-3.8
Emerging market bonds	14.3	-5.3	3.5	3.3	8.8
UK corporate bonds	8.8	2.5	-3.5	13.0	-6.4

Past performance is not a guide to future performance. Rebased in US dollar where appropriate, i.e. all index returns are recalculated based on exchange rates to give returns for a dollar investor. Source: Morningstar Direct, March 2021.

Important INFORMATION

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