UNIVERSUM
WEALTH

THE QUARTERLY PERSPECTIVE

TIME FLIES – BUT SO, IT SEEMS, DO MARKETS

5 July 2021

Recovery accompanied by inflation jitters

Equity markets have continued to benefit from ***rising global sentiment*** in the second quarter of 2021. Vaccine rollouts, reopening economies, more central bank stimulus and easing supply chain pressures (as companies race to increase output to meet pent-up demand) have driven markets and sentiment higher.

Yet, while the world economy heads toward the fastest year of growth in the 21st century, inflation concerns crept in to dominate headlines. Base effects, supply chain disruptions, fiscal support, pent-up demand and speculative demand for commodities have combined to push inflation higher. ***The burning question has been whether rising inflation will be transitory or more structural in nature. This is important as it would determine whether central banks raise rates sooner than expected – a particular concern for growth stocks already facing valuation concerns.***

After shrugging off inflation-induced tapering concerns, global equity markets ended the first half of the year well ahead of pre-pandemic levels. While these new highs may lead some to question the magnitude of available further gains, we believe that strong first quarter earnings will be followed by another strong earnings quarter, providing further support for equity markets. ***As economies continue to reopen, cyclical stocks still have potential to gain further, ahead of growth stocks. However, the unpredictable shift in the last few weeks between growth, value and cyclical simply emphasises the importance for a diversified approach to portfolio construction, by including both high quality growth and cyclical equity.***

Is inflation transitory?

It is understandable that investors question the nature of inflation after the US reported another record inflation rise in May, immediately after the strongest monthly increase in core inflation since April 2008. The real concern for investors though is whether inflation is more structural in nature, which will likely result in the Fed raising rates sooner than previously anticipated.

Milton Friedman said that "Inflation is always and everywhere a monetary phenomenon" and if left unchecked, the inflation "disease" can become terminal. So, while last year's depressed prices set the stage, and supply bottlenecks were met with pent-up demand, Friedman would argue that the primary inflation driver is still the unprecedented fiscal support central banks were providing households. However, we believe that since there are no structural constraints to increasing output, the current inflation concerns are likely to be transitory, especially as US wage pressures ease.

While reflation uncertainty will continue to be reflected as volatility in equity markets, the global economic recovery should be able to absorb increased demand through supply recovery, while productivity improvements will continue enabling companies to maintain competitive pricing – the global economy should therefore be able to manage inflation. That is why investors should look through the current inflation concerns and remain focused on longer-term secular trends driving growth.

However, the debate between the transitory or structural nature of inflation will no doubt continue, particularly as inflation is expected to accelerate in the next quarter.

Global equity markets *continue to surprise*

Global equity markets continued to rally strongly in the second quarter to end well back above pre-pandemic levels. While new record highs naturally raise concerns for investors, we expect global economic activity will continue to improve as we head into the second half of the year with vaccine rollouts continuing to gather momentum globally. Secondly, as the pandemic-induced supply constraints subside and major central banks keep monetary accommodation in place, inflation concerns should ease.

As a result, we expect equities will be driven by earnings growth rather than multiple expansion for the rest of the year. We anticipate that equities will continue to outperform bonds, albeit with lower return expectations than achieved since March last year.

Economies reopening create opportunities

Opportunities are present in regions that have lagged in terms of their vaccine programs, as reflected in the relative performance of Europe and Asia relative to the US. However, as their vaccine programs gather momentum the economic pace should also improve, supporting stronger earnings growth expectations. As such, regions like Japan could offer opportunities.

The cyclical energy sector will also continue to benefit as oil prices rise further as demand is supported by the economic revival broadening even further. This broadening economic revival should provide support for commodities in general, beyond 2021. China's investment-led recovery, driven by a metals-intensive infrastructure and manufacturing spend, is one of the long-term drivers.

Oil prices are highly correlated to inflation expectations. The energy sector has historically outperformed when US inflation (measured by headline CPI) has been rising. Exactly the environment we are currently in.

US markets remain long-term growth focused

In the US, all the major benchmarks reached new highs by the end of the second quarter. While rising yields pressured US equities, given their high technology and growth exposure, the growth in health-tech, fintech and greentech, will continue as 5G technology rolls out globally. This remains an equity friendly environment, where digital transformation trends have been accelerated by the pandemic. ***Yet, technological disruption and the fourth-industrial revolution (4-IR) is still in its infancy***.

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Diversification matters

By region

UK equity markets still offer cyclical exposure at reasonably attractive valuations, but the strength of the pound continues to weigh on a market with **high foreign revenues and earnings**.

Europe, on the other hand, remains well positioned to benefit from global economic activity normalising further, given the region's **high exporting and cyclical companies.** While previously being behind other developed markets, Europe has strongly improved their pace of vaccinations, which coupled with central bank support, is likely to improve earnings expectations as global economies reopen. Similarly, **Japan** will also benefit from a recovery in global activity and trade.

By asset class – include alternatives!

Most investors should include alternative investments in their portfolios to improve their return profile and improve the diversification within their portfolios. An environment of **low rates and rapidly changing technology**, offers private market investors a broad range of investment opportunities to achieve this allocation in their portfolios.

We deploy listed investment vehicles focused on private equity, which have a superior liquidity profile compared to traditional private equity vehicles, to capture these benefits.

Additional diversification is achieved in our multi-asset portfolios by including **real asset exposure**, such as **commodities and infrastructure**.

Infrastructure – the 'foundation' of a growing economy

Infrastructure as a real asset class includes investment in facilities, services and installations that are **essential for economic productivity** so that societies may function and prosper. These assets span a wide variety of industries and sectors and are normally classified as either economic or social in nature.

As the fourth-industrial revolution (4-IR) has continued to drive innovation, infrastructure assets have had to diversify as well to include assets like data and distribution centres.

Why invest in infrastructure?

Infrastructure assets are particularly well suited to investors that have long-term liabilities, such as retirement funds and insurance companies. They are regarded as a comparatively low-risk asset class due to their longer-term investment horizon.

The key benefits include **improved portfolio diversification** as these assets typically have a low correlation with other asset classes over the long term. Their long-term nature also **reduces expected volatility** as they are less influenced by short-term market sentiment. Their typical monopolistic and essential service nature imply they have very little competition and stable demand, even through periods of economic uncertainty. The fact that these assets operate for many years and are less likely to become technologically obsolete, combined with long-term contracts, ensure **stable and predictable long-term cash flows** for investors.

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The usual complexity, cost and long-term nature of these assets provide a **high barrier to entry**, which ensures they can sustain their competitive advantages for longer. Once operational, these assets' operating and maintenance costs are low relative to the revenues they are able to generate. Many of these assets are also linked to inflation through regulation or agreements, while those without a contractual inflation link typically have strong pricing power, which ensures they can provide a similar **inflation hedge.**

One of our key investment themes within infrastructure is water. As the world's population continues to grow, limited natural resources such as water are placed under significant strain. The problem lies in the fact that the most significant challenges relating to the management of our scarce resources are most prevalent in regions that face the highest population growth.

Unfortunately, these issues are not limited to these regions. In the US, an estimated 27 billion litres of treated water is lost each day due to a water mains break every two minutes, according to the American Society of Civil Engineers (ASCE). Fortunately, "water utilities are improving their resilience by developing and updating risk assessments and emergency response plans, as well as deploying innovative smart water technologies like sensors and smart water quality monitoring." It is for this reason why long-term investment opportunities in water are likely to remain valid and attractive for decades.

Given the many factors involved and the long-term investment horizon, we advise investing in a well-diversified investment vehicle that offers global exposure to the entire water value chain.

Performance

Our multi-asset class (MAC) portfolios achieved returns up to 5.4% in USD during the second quarter of 2021. ***Returns vary depending on the currency and risk profile of the portfolio.***

This was achieved on the back of an overweight to global equities, given our belief in the long-term earnings growth remaining strongly supported by structural changes that were simply accelerated by the pandemic.

Overall, we believe that greater-than-expected stimulus and improving vaccine rollout globally will continue to drive the preference for equities over bonds for the remainder of the year, despite any valuation concerns.

Within equities, we acknowledge the shorter-term benefit of exposure to more cyclical sectors and regions, as the global economic recovery builds momentum. However, for longer-term investing we remain relatively overweight secular growth, despite the recent setback across the technology sector.

In the long-term, secular growth will outperform cyclical, as companies continue to benefit from the productivity gains achieved through digital transformation and investors benefit from the resultant best long-term growth prospects.

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Table 1: Effective portfolio returns to 30 June 2021

Effective returns (%)	3 months	1 year	3 years*	5 years*	Inception*
Multi-asset class (MAC) portfolios					
MAC USD Cautious	4.4	16.0	8.4	8.0	8.9
MAC USD Moderate	5.0	22.1	9.4	7.8	9.3
MAC USD Growth	5.4	27.4	10.5	8.9	9.8
Specialist portfolios					
Global Equity	7.3	38.7	22.8	23.8	20.2
Innovus	9.0	63.0	30.5	36.6	33.8
Precious Metals Yield	7.5	-0.5	15.8	7.6	20.8

* Annualised returns

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