Tavistock Wealth
Investment Outlook

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Q3-2021
QUARTERLY PERSPECTIVES

Welcome to the Q3-2021 'Quarterly Perspectives' Publication

12-Month Review

Over the last year the investment team have delivered strong risk-adjusted returns during a period of considerable uncertainty and market volatility. Relative to the peer group, all but one of the ACUMEN Portfolios significantly outperformed their respective IA sector, with some of the funds making the top ten and ACUMEN Portfolio 7 ranked first out of 173 competitor funds. This strong performance also bolstered our inception-to-date rankings where four of the funds now appear in the first quartile.

	12-MONTH PERFORMANCE					ITD
Fund	**IA Sector**	**Performance**	**IA**	**IA Quartile Ranking**	**Position**	**IA Quartile Ranking**
ACUMEN Portfolio 3	0 - 35%	4.52%	6.97%	4	49/58	4
ACUMEN Portfolio 4	20-60%	14.87%	13.13%	1	37/155	2
ACUMEN Portfolio 5	20-60%	20.19%	13.13%	1	7/155	1
ACUMEN Portfolio 6	40-85%	25.07%	17.48%	1	12/173	1
ACUMEN Portfolio 7	40-85%	27.50%	17.48%	1	1/173	1
ACUMEN Portfolio 8	Flexible	30.64%	19.67%	1	13/142	1

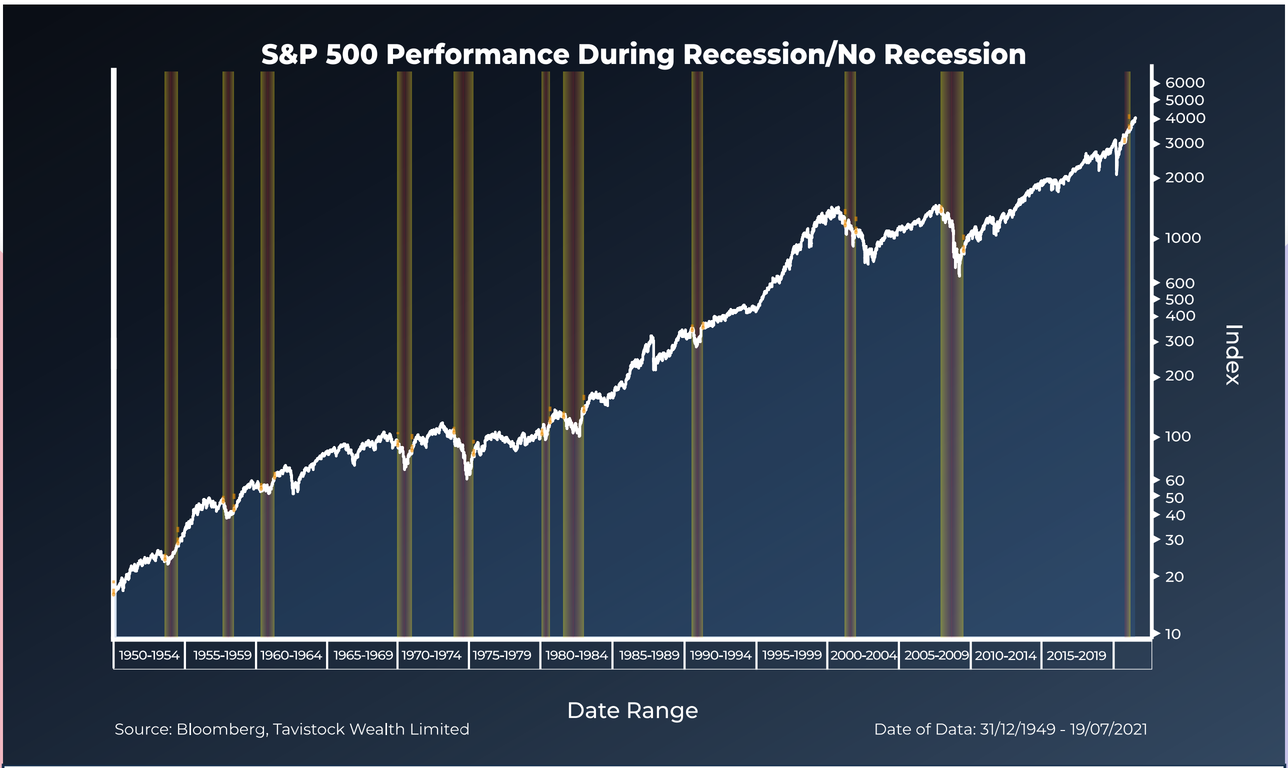
Performance: Rolling one-year and inception-to-date as of 30th June 2021.
Source: Lipper for Investment Management, Tavistock Wealth Limited
Footnotes:
The IA Sector was updated in April to reflect the most appropriate sector subject to internal (Tavistock & IFSL) review

Key Themes

2020 was a year of extremes. We witnessed a global pandemic, an ailing economy and yet generous capital markets with bumper returns across equity and bond markets. Because Covid-19 represented an external shock to the system, for all the uncertainty, there was, perhaps paradoxically, a strength of conviction in the economic recovery to come. Markets moved quickly to price in that road map and never looked back.

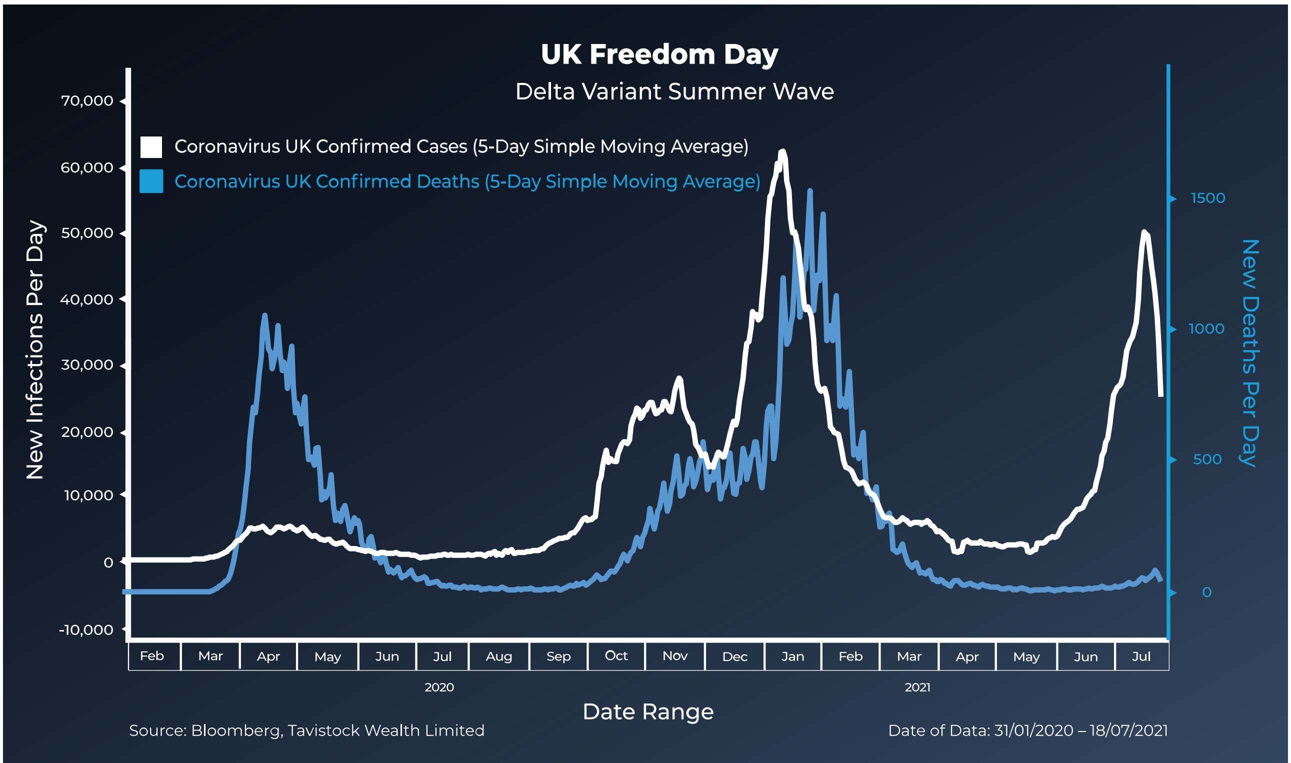
Today, with valuations at all-time highs, and economic recovery peaking, that sense of clarity is now behind us. Markets once again find themselves at a critical juncture. This is evident from the wide range of views clogging my inbox every day. If there is one thing market strategists can agree on… it is that they do not agree.

Uncertainty creates opportunity, and with that in mind, let's turn to our outlook for the next 12-months. The good news is the global economy looks strong. Economic growth going forward will be driven by consumption, given excess savings, a pick-up in corporate capital expenditure and fiscal policy which continues to work its way through the system. Monetary policy is also likely to remain supportive. Whilst some of the smaller central banks are turning hawkish, and there is rising concern the Fed may tighten earlier than expected, our view is the Fed's clear focus on full employment and social policy objectives means it will not tighten policy any time soon. Therefore, we think the global economy is poised at the start of a new multi-year cycle, with slim chance of imminent recession. Historically, such periods are conducive to strong equity market performance.



The S&P 500 tends to fall during, or just prior, to periods of recession.

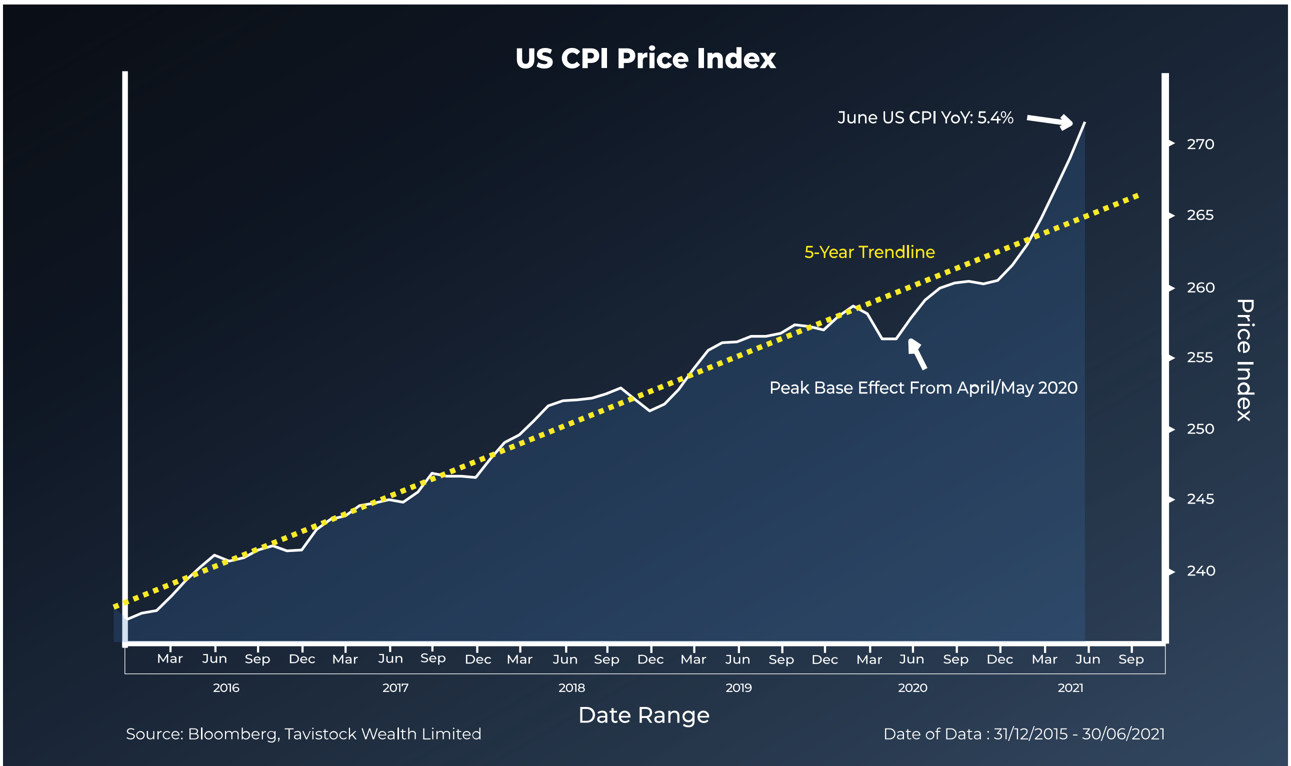
Our bullish outlook rests on the assumption that, ultimately, we will overcome the virus. Whilst that might be true over the next few years, it's almost impossible to say what will happen over the next few months. The current litmus test for that is England's 'Freedom Day', which saw the Government lift most remaining Covid restrictions across the country. As the test case for a global stage, it is reassuring, therefore, to see mortality rates remain low, even as new cases pick-up, in what is now the third wave of the virus. We hope to see these low mortality rates persist, and this pattern replicated in the US and elsewhere, where Delta has become the dominant variant only recently.



The UK mortality rate remains subdued even as new cases pick-up. The hope is this trend can be replicated elsewhere although we are mindful of the fact the UK has higher vaccination rates than the US, where vaccine uptake has become increasingly political.

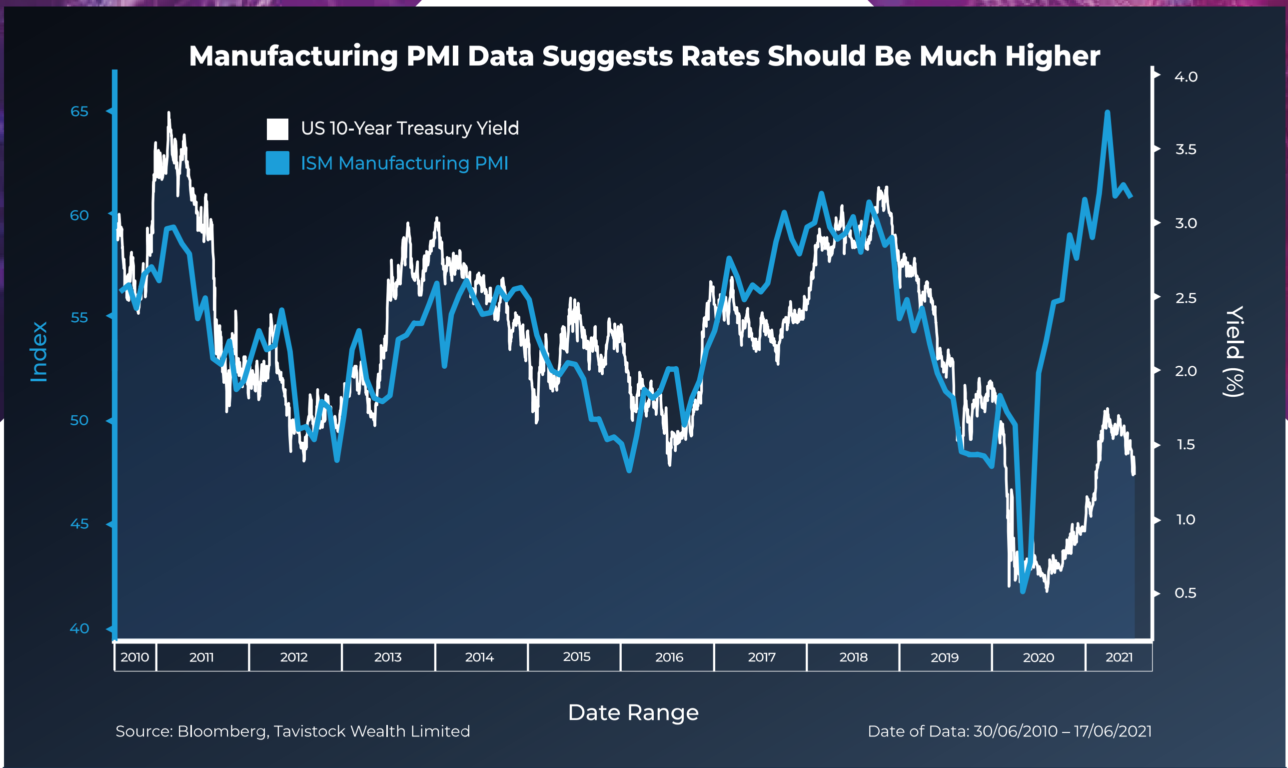
The combination of strong growth, and constrained supply, has led to a jump in inflation. There is ongoing debate about whether this inflation is transitory, as central banks would have us believe, or something longer lasting. In my view, we are now approaching an important potential inflection point with this inflation story. To see why, consider the following analogy… if you look back over the last 10 or so years, low levels of inflation have been a permission slip, or a driver's licence for central bankers to do as they please. Now, we have central banks, particularly the Fed, driving 200mph on a 70mph motor way, thinking they still have that get-out-of-jail-free card of low inflation. However, if price levels, at a wholesale and a consumer level continue to rise as they are, then central bankers could get 'pulled-over' by the market. To provide some numbers, most recently we've had month-on-month US CPI at 0.9%, the highest level since 2008 and more than double what was expected at 0.4%, and the lesser-watched producer price inflation at 1%, versus 0.5% expected. These are aggressive price increases and they do not include the so-called base effect from one year prior.

The concern is inflation is only just starting to pass-through to the consumer economy and if these price rises get baked-into expectations, they can become self-fulfilling. To provide some anecdotal examples from earnings season, earlier this month Jamie Dimon, CEO of JP Morgan Chase, said inflation would likely prove worse than the Fed thinks and Hugh Johnston, PepsiCo CFO, went one step further by categorically stating the food and beverage company would be increasing prices to offset rising costs.



US inflation has risen dramatically in June, to reflect a 5.4% year-on-year increase in prices, way above the 5-year trendline.

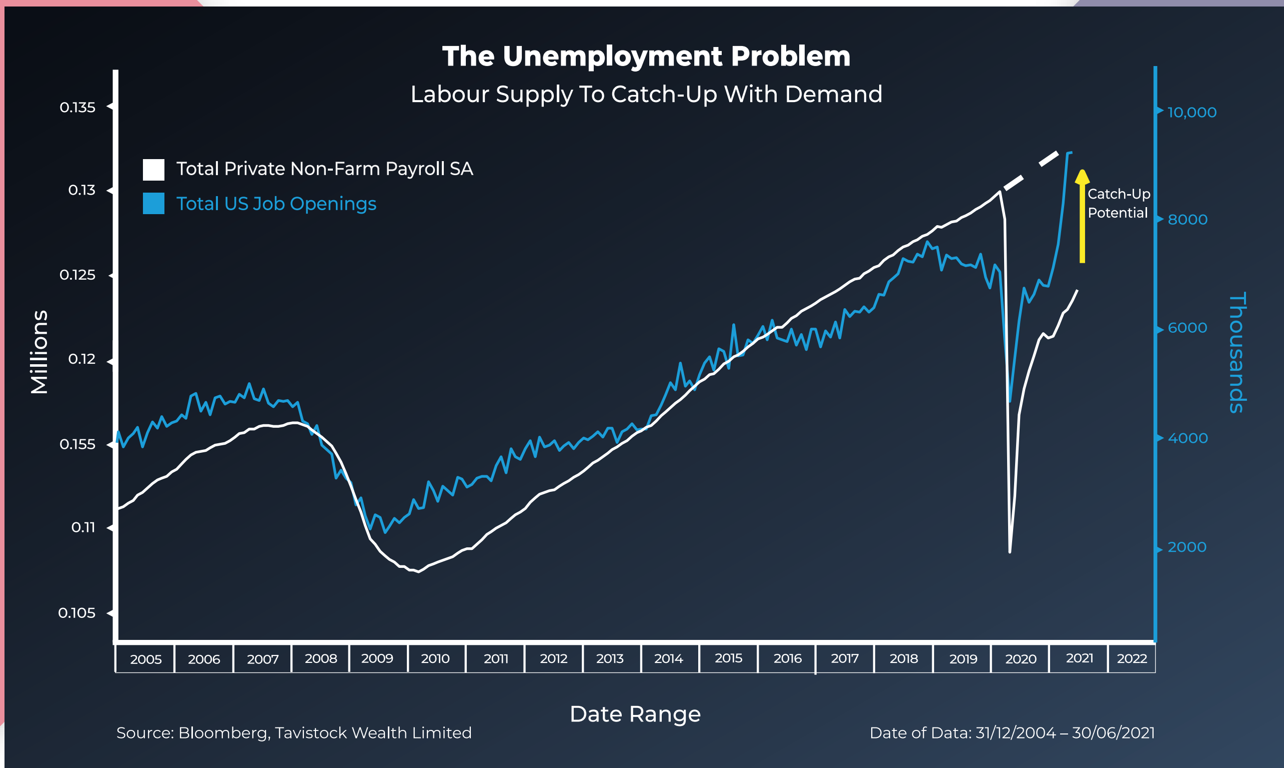
At present, the market believes everything the Fed tells it, but if we do get another month or two of elevated CPI readings, we think that ability to control the narrative, and accompanying timeline, gets taken away. If the market does choose to call the Fed's bluff, then we could see a repeat of the first quarter when bond market rates adjusted rapidly higher. Based on the historical relationship with the ISM Manufacturing PMI index, below, we think the 10-year Treasury yield could rise back towards 2% by the end of the year.



The close correlation between the ISM Manufacturing index and the 10-year Treasury yield suggests, absent Fed buying, yields should be much higher.

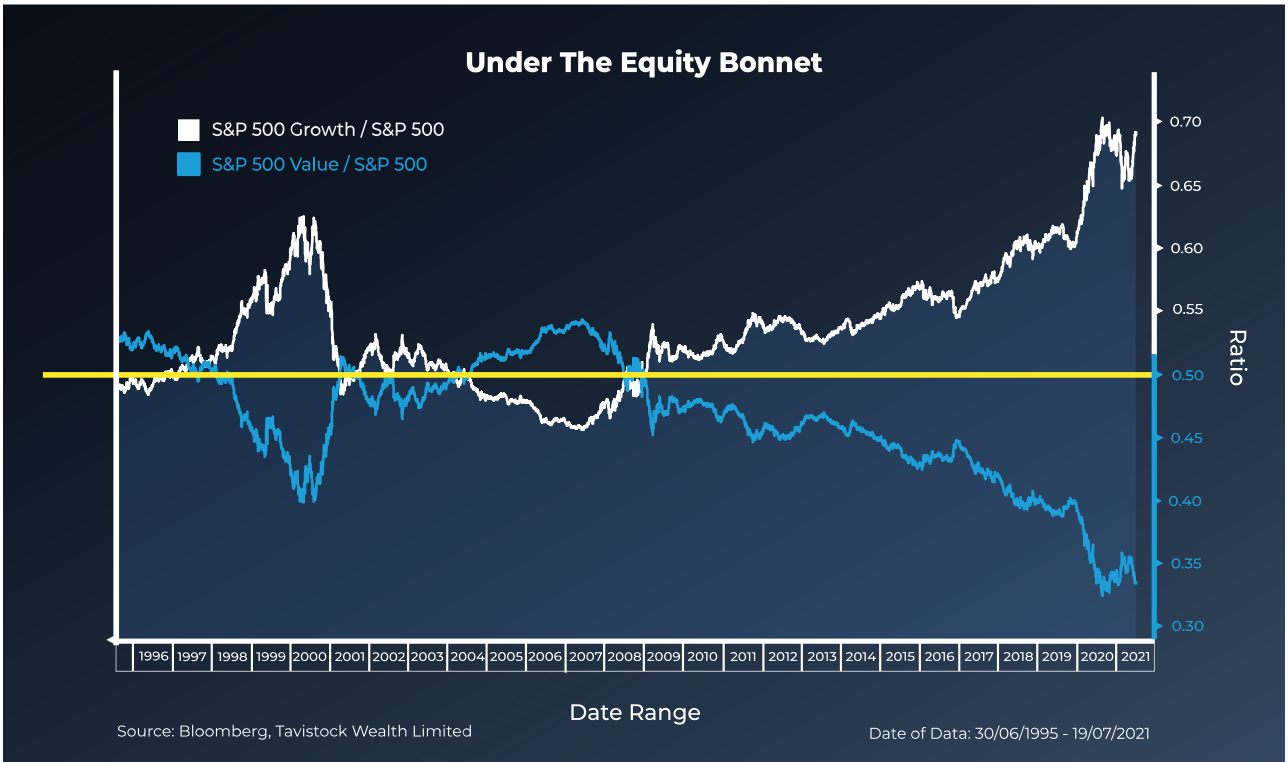
What is interesting is over the last month or so we've seen the exact opposite of that. Bond markets are pricing in a very pessimistic scenario. There are several reasons for this: (i) fear that the spread of the Delta variant will postpone a full reopening of the global economy, (ii) concerns over a hawkish Fed mistake, (iii) technical factors, such as pension funds rebalancing from equities into bonds, or summer illiquidity, (iv) the notion we are at 'peak' inflation, and (v) a growth slowdown driven by China. Absent some further catastrophic mutation of the virus, and reasonable concerns over Chinese growth, we think many of these factors are overdone or temporary in nature.

If we are right about yields, then a reasonable question to ask is when we might start to see a pick-up? One metric, that I think could catalyse this move higher, over and above inflation or stronger than expected economic growth, is labour supply. Labour demand has come back strong. In fact, it looks like job openings, at around 9 million, are at record levels and now back to their prior trend. Labour supply, however, continues to lag. This is due to competition from government transfer programmes (cheques in the post), school closures (keeping parents, particularly working mothers, at home) and ongoing coronavirus fears. Given many of these programmes are closing, and as the economy continues to reopen, and the virus continues to recede, we see labour supply rising to meet demand. The pace at which this happens, will to some extent dictate the market reaction. To get back to prior-trend growth, by the end of this year, would necessitate a million new jobs added each month. That unlikely, albeit not impossible outcome, would really spook the bond market and push up long-term yields rapidly. Perhaps more realistically, we will see 400 or 500 thousand new jobs each month. That would take us to the prior trend by the end of 2022, which incidentally is when markets have priced the first-rate hike.

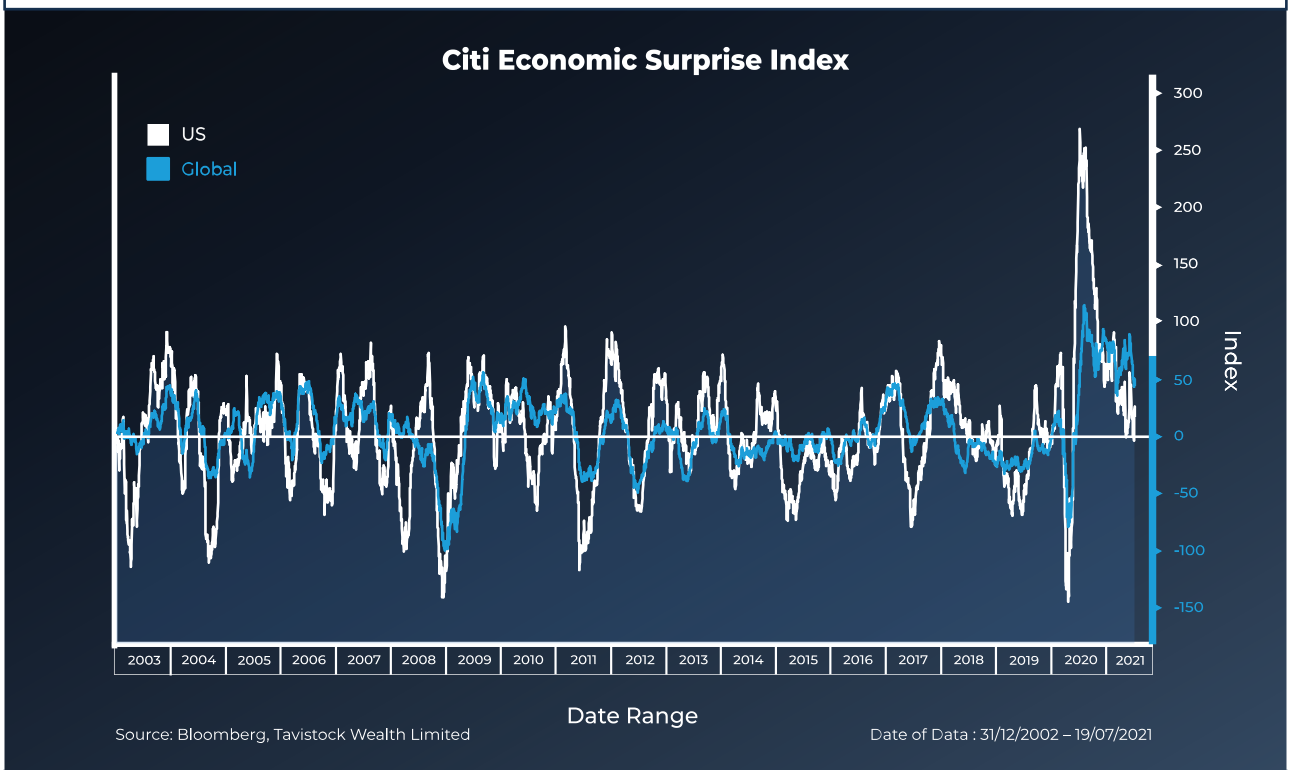


Total US job openings have now reached the pre-Covid trend. We expect labour supply to pick-up going forward, boosting the economy.

Turning to the ACUMEN Portfolios, we remain overweight risk-assets. Strong economic growth, rising yields and moderately high inflation point to a resumption of the reflation trade, which unwound during the second quarter but should re-instate moving forward. Admittedly, US equity market prices are already very high, particularly this early in an economic recovery. With markets driven by the second derivative, we could see a period of consolidation as earnings growth rolls-over later this year, but we would view this as a healthy correction within a structural bull market. As such, we remain bullish equities overall, albeit less so than at the start of the year. Whilst we continue to like cyclical and value names, particularly the S&P 500 industrials and financials sectors, we have balanced this against new allocations to healthcare as well as global 'quality' stocks, which we define as those highly profitable companies that tend to exhibit strong fundamental characteristics including stable earnings, solid profit margins and strong balance sheets. There is some overlap here with ESG, which should continue to benefit from significant AUM inflows. Regionally, we remain underweight the US, in favour of alternative regions, like the UK, which is historically and relatively cheap and well placed to benefit from the reopening theme.



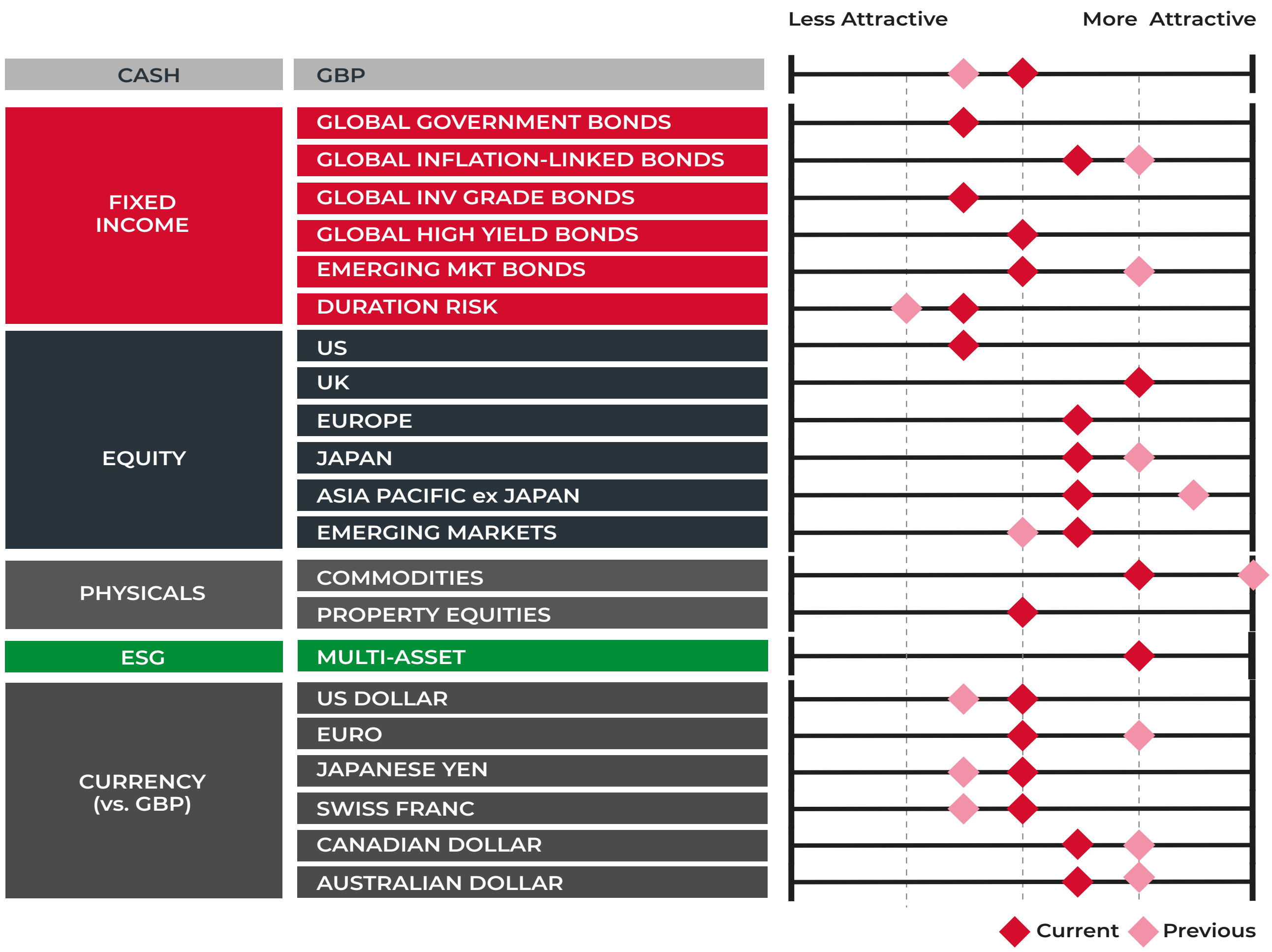
The rotation in US equity market performance, from 'growth' to 'value' was a big theme late last year and in early 2021. Over the last two months we have seen this trade unwind in the face of the growing Delta variant and associated global growth concerns.



The global economic recovery will continue but prove uneven. The US has been leading the charge, but we do see scope for growth to spill out and pick-up elsewhere going forward. This is reflected in the chart above of the Citi Global Economic Surprise Index, which shows the degree to which economic data is either beating (a score above zero) or missing (a score below zero) expectations.

Stock returns tend to be lower when growth is slowing down, but growth should remain way above trend and, historically, such returns have still outpaced bonds, where we remain underweight. In fixed income we favour inflation-linked bonds and high yield debt over investment grade credit with a preference for short-dated securities. We remain underweight long-dated nominal government bonds except in China where we think the pick-up in yield compensates for the additional risk taken. Finally, we like commodities which can deliver strong gains over the coming cycle and provide an inflationary hedge and additional diversification benefits.

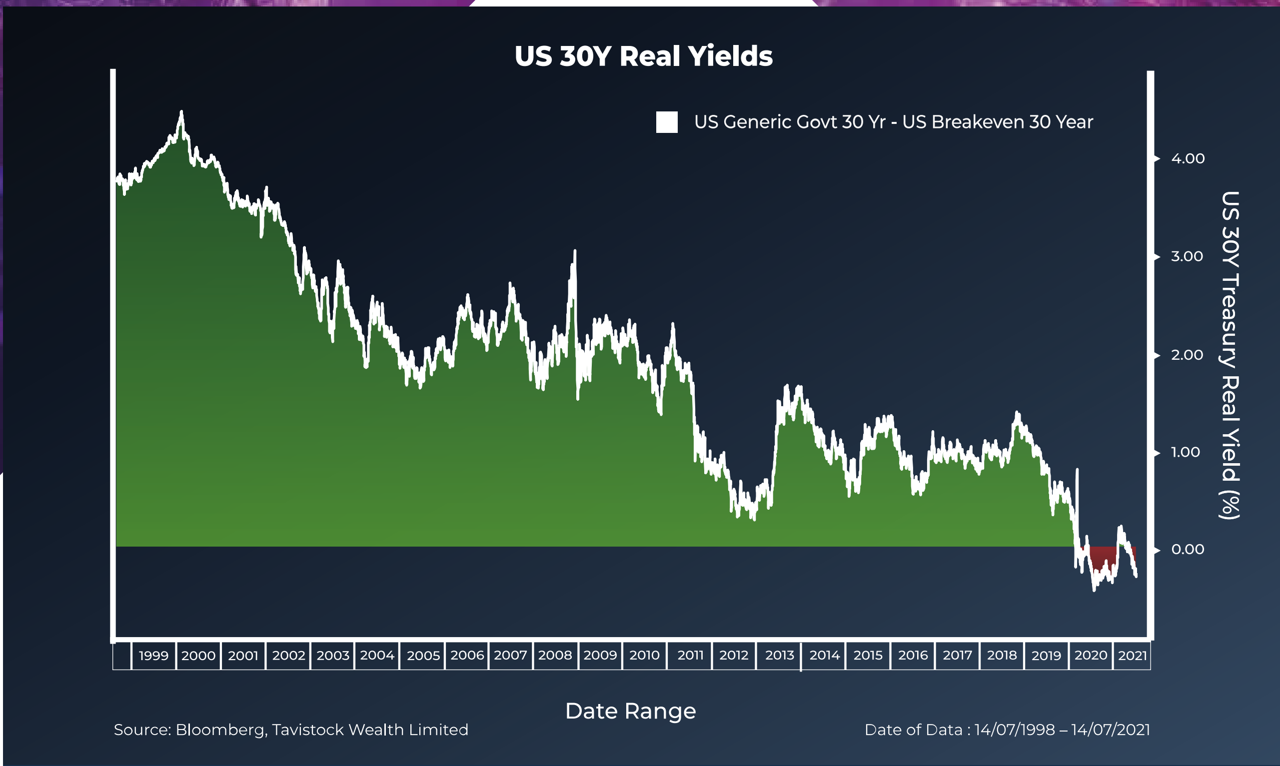
Asset Allocation Outlook



Fixed Income

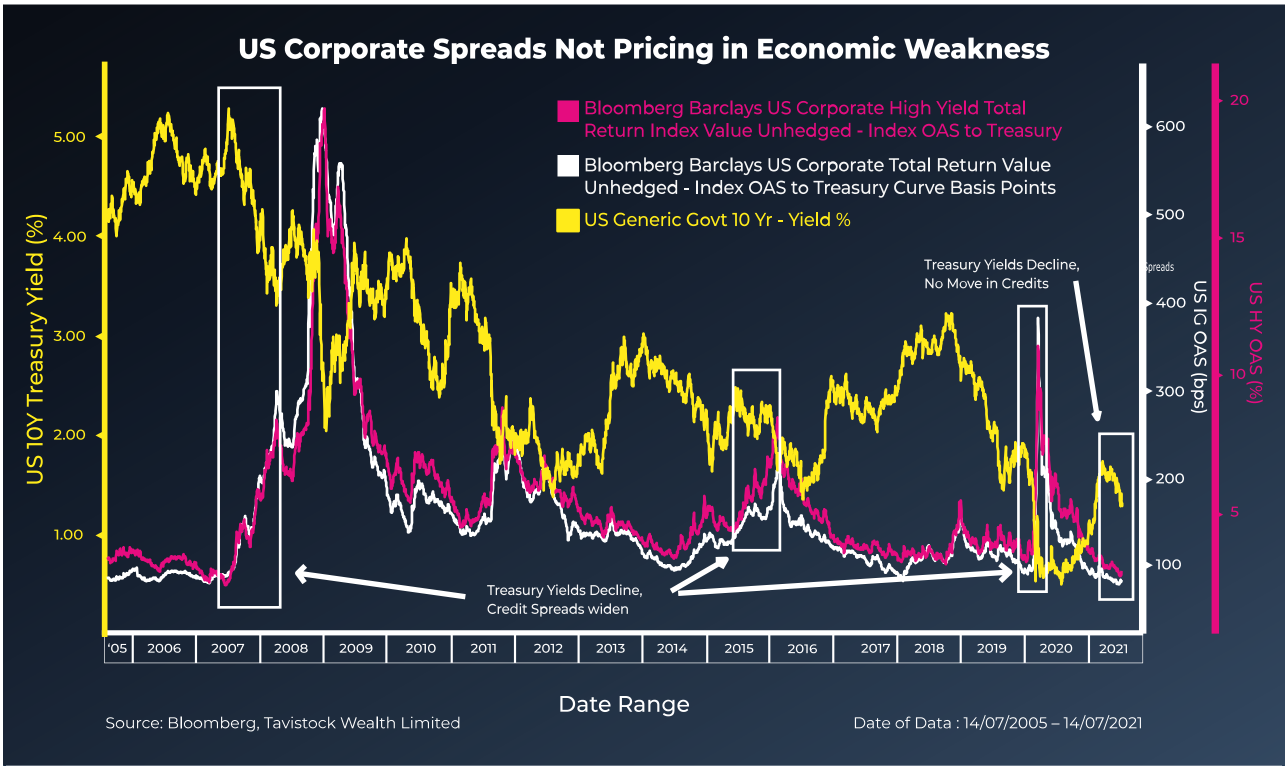
Inflation rhetoric has dominated financial markets since the beginning of the pandemic. During the most recent quarter these concerns have come to fruition. With only one US year-on-year CPI data point higher since the turn of the millennium, and yields as suppressed as they are, it is no surprise there is very little consensus as to how one should be positioned in fixed income.

Our view is that current yields on the majority of developed market government debt do not compensate investors in real terms. Looking at breakeven rates in the US, and the yield provided on longer maturity government debt, we believe that it is in largely uncharted, and in our opinion, unsustainable territory. Hence, we favour inflation protected securities in the US at the front end while underweighting longer maturity government bonds altogether.



Long dated 30-year US Treasury real yields (nominal yield minus inflation expectations) are negative.

The recent flattening of the US yield curve, with longer maturity yields falling on the back of weaker market expectations of economic growth, does not seem to be supported by the credit market. Economic growth concerns caused rallies in long-dated government bonds in 2007, 2015 and last year and in each instance credit markets supported this with corporate spreads rising. This has not yet happened with the recent rally in long dated government bonds. In fact, both investment grade and high yield spreads remain supressed at record lows. Hence duration remains our primary concern in investment grade debt while we favour higher-quality high yield exposures.



US high yield and investment grade option adjusted spreads have not yet risen alongside the rally in US Treasuries. Unless we see signs to the contrary, we believe the recent move in Treasury yields is overdone.

Within emerging markets, we have adopted a barbell approach with exposure to both hard currency debt and local currency Chinese government bonds. This allows us to participate in the pick-up in yield whilst also insulating the portfolios from risks posed to less stable emerging economies.

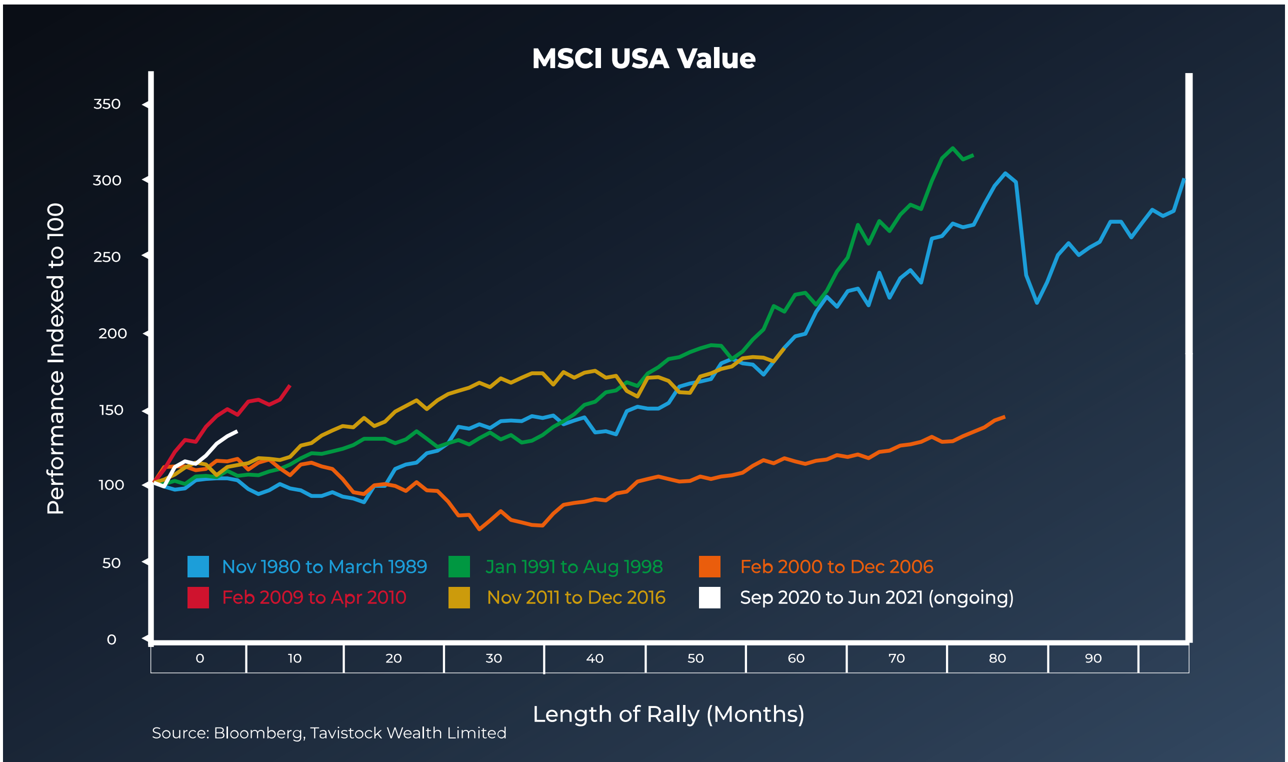
Equities

Global equities marked a stellar first half of 2021 with risk appetite fuelled by a tidal wave of liquidity and investors fixated on the highly anticipated economic resumption. The MSCI World posted gains for the second quarter just below 8% and the S&P 500 ended the halfway point of 2021 at a new record high.

The S&P500 delivered its second best first half performance in 20 years.

As we enter the second half of the year, large swathes of global equity markets are priced for perfection leaving little room for complacency. Given the risk of the Delta variant of Covid-19 in conjunction with inflationary pressures and the evolving policy response, we have tempered our cyclical overweight via taking profit on our S&P materials position in favour of a basket of global high-quality stocks. We may look to add more quality and defensive exposure, reverting to more of a barbell strategy, as market volatility evolves.

Emerging market equities offer attractive valuations versus their developed market peers which could be a driver of outperformance as investors search for value particularly if we see a softer dollar moving forward.



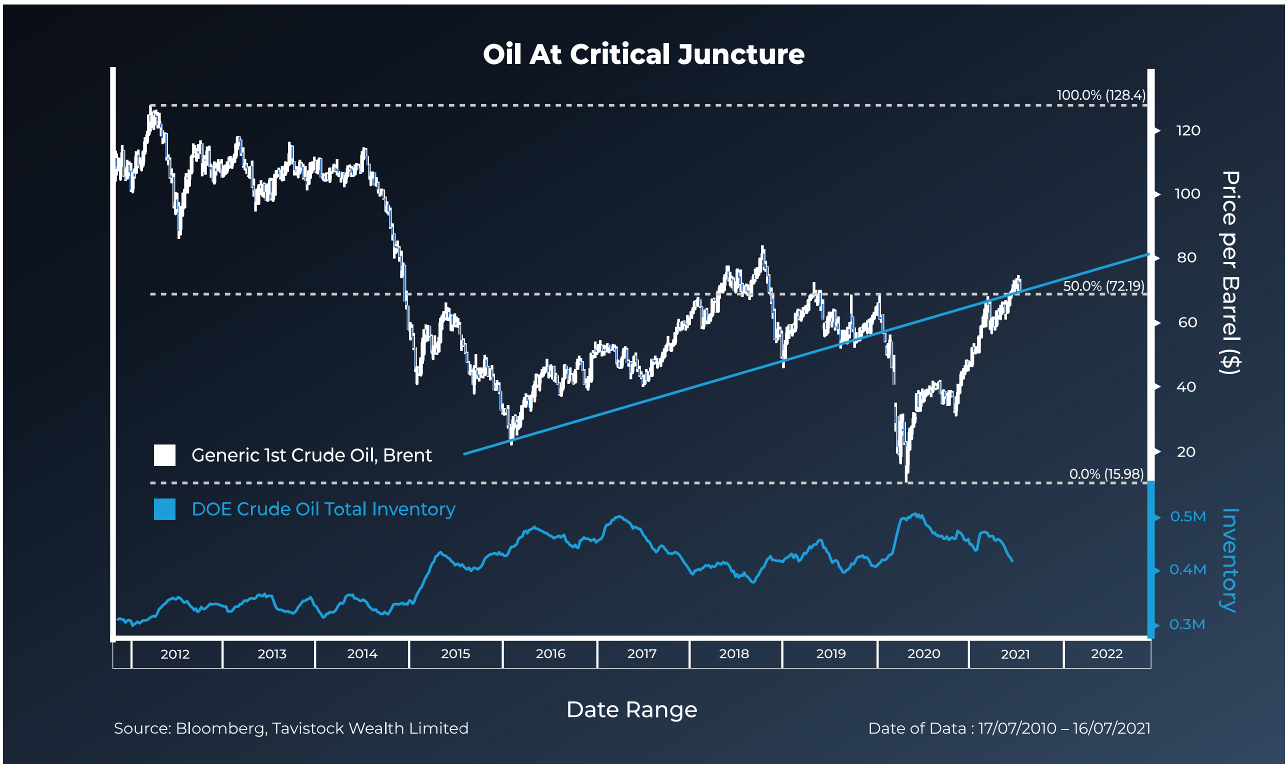
US value stocks have performed well this cycle. The recent unwind in value vs growth is consistent with the strength of this rally which has outpaced all but one of the other time periods shown. We continue to think value stocks can perform well over the longer term, given historical precedent and attractive valuations.

Physicals

In the Q2 Quarterly Perspectives, we described an environment for higher commodity prices, with a focus on oil. Physical demand continues to outstrip supply across the commodity curve. Inflation expectations marched higher through most of the preceding 3 months, with oil prices setting successive new highs. Prices reached $77 per barrel in July, and we now find ourselves at key support around $75. The taps of global demand are on, and supply remains curtailed; until recently, both OPEC vigilance and a reduction in corporate capex spending, especially by distressed shale producers, has tightened inventories. Whilst this recent rally may be over-extended, we believe this could entail an environment of higher-for-longer oil prices. We retain our exposure to energy-dominated Russian equities.

We believe that recent retracements in copper prices represent long-term buying opportunities. This is underpinned by higher-than-expected recent inflation readings, increasing structural demand from China and elsewhere, supported by our long-term conviction in a weaker US dollar. Copper has been under pressure from Chinese intervention in the form of promises against higher prices, but we believe this represents an undeniable tightness in markets and that intervention is a short-term solution. Copper continues to outperform in the portfolios. Gold has found support from a recent decline in real yields, as inflation has picked-up. With high volatility in equity and bond markets, it continues to provide a solid source of portfolio level diversification.

Property markets have continued to exhibit signs of a modest recovery, however growing disparities between physical assets and homebuilder equities represent continued volatility in the space. Further increases in house prices will feed through to inflation, further spurring on our current exposure to commodities.

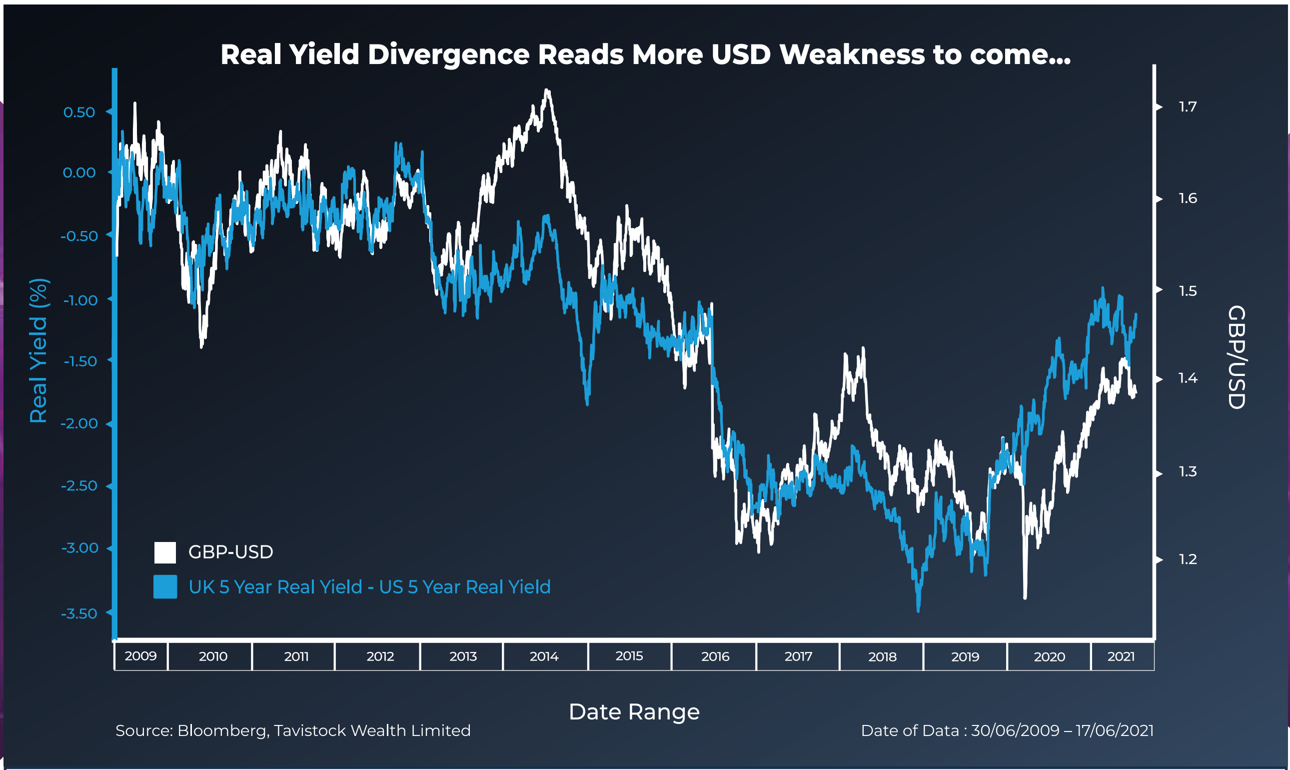


Oil inventories are approaching pre-pandemic levels having accelerated their decline through the second quarter of 2021. This has partially spurred oil to recent highs, but fears over the resurgence of the Delta variant as well as tapering inflation expectations may mean oil prices struggle to grind higher, with oil at a crucial technical level.

Foreign Exchange

The contentious talking point of Q2 was the shift in the Fed's tone regarding when they will pump the brakes on their stimulative spree. Monetary stimulation had been justified on the basis that inflation would prove "transitory" and nothing more, which helped ease the US dollar lower for most of the quarter in anticipation of the ongoing low-rate environment. However, a then hawkish twist took the market by surprise at the Federal Open Market Committee meeting on the 16th of June. This contributed to a revival in US dollar strength, as investors searched for attractive growth prospects. The scramble for growth led to the recent bond surge, suppressing yields below the key support level of 1.40% on the 10-year US Treasury yield. It is worth noting this aggressive bond move has suppressed US real yields significantly, particularly versus other developed market counterparts such as the UK. As shown in the chart below, this has contributed to our longer-term bearish view on the dollar, which faces ongoing pressure from a number of not insignificant headwinds including the expanding twin deficits and longer-term fiscal outlook. On a short-term horizon, the Covid-19 delta variant continues to dictate moves, alongside relative vaccination and mobility rates and diverging growth trajectories.

We see some scope for short-term US dollar strength as uncertainty remains high and investors seek safe-have assets. Within emerging markets, we have been extremely selective with our unhedged currency exposure; allocating to the Brazilian real, Russian rouble and Taiwanese dollar, regions whose central banks are set to lead the charge in raising their interest rates relative to their wider EM counterparts.

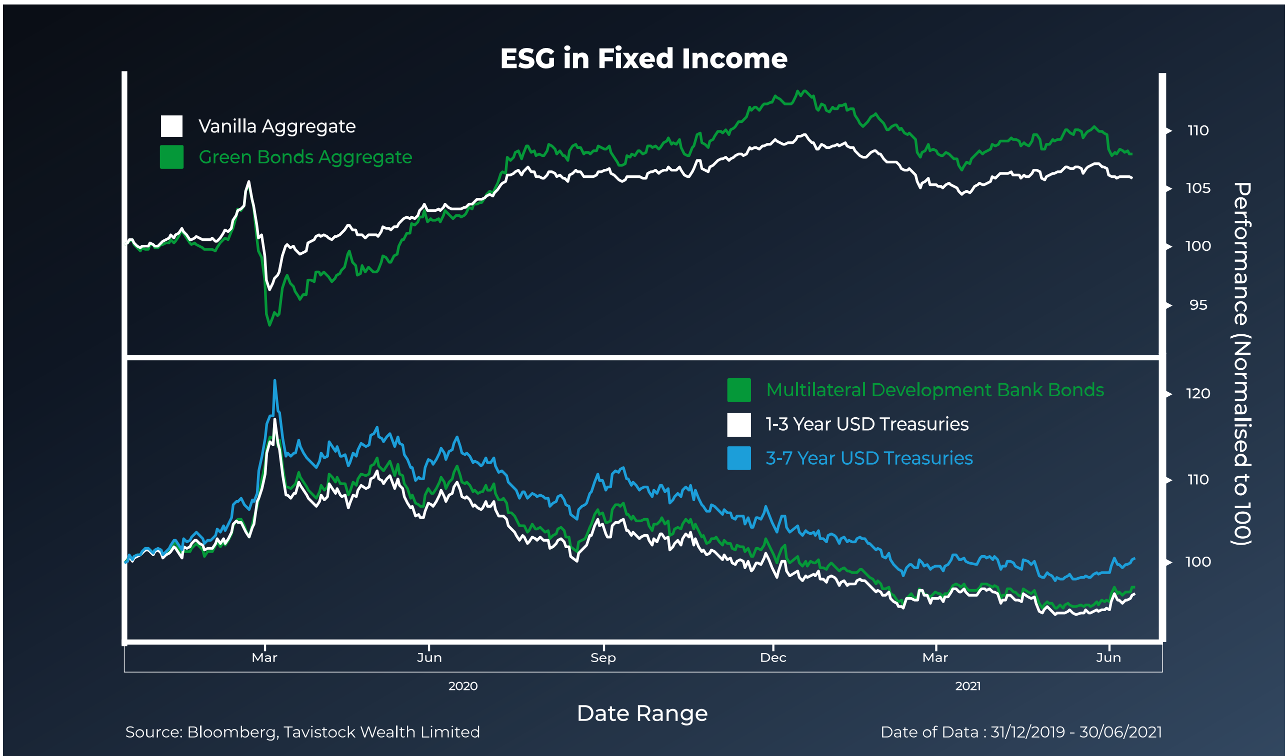


Relative real yields point to further upside in GBP/USD.

ESG Investing

In the first quarter, we complained that, for a variety of reasons, the integration of ESG and fixed income was less mature than that of ESG and equity. At that time, only 30% of the fixed income basket in our ESG proposition was ESG-labelled due to a dearth of high quality ESG-labelled fixed income ETFs. Since then, new fixed income methodologies have been introduced and several ETFs have grown in size, several times over. Consequently, more than 80% of the basket is now ESG-labelled. This is a positive step in and of itself. What is especially worth emphasising is that, unlike most passive investment strategies, using these new, now-larger fixed income ETFs, we are able to achieve some degree of impact and, thanks to new kinds of ESG data, measure this impact too. We have exposure to bonds issued by multilateral development banks; organisations' whose purpose is to provide support to emerging markets to bring about economic and social development at an affordable rate. In the ACUMEN ESG Protection Portfolio we also recently added exposure to a basket of green bonds, which are different to conventional bonds because issuers must explain how they will use the proceeds raised. Italy, for example, recently issued its first green bond; heavily oversubscribed, the proceeds will be used to help Italy achieve the objectives set out in the European Green Deal. Achieving impact is significant. Even more so when these ESG-labelled ETFs match the performance of their vanilla equivalents, as is the case for both multilateral development bank bonds and green bonds. This combination of tailwinds can explain why each of these ETFs has more than doubled in size since the beginning of 2020.

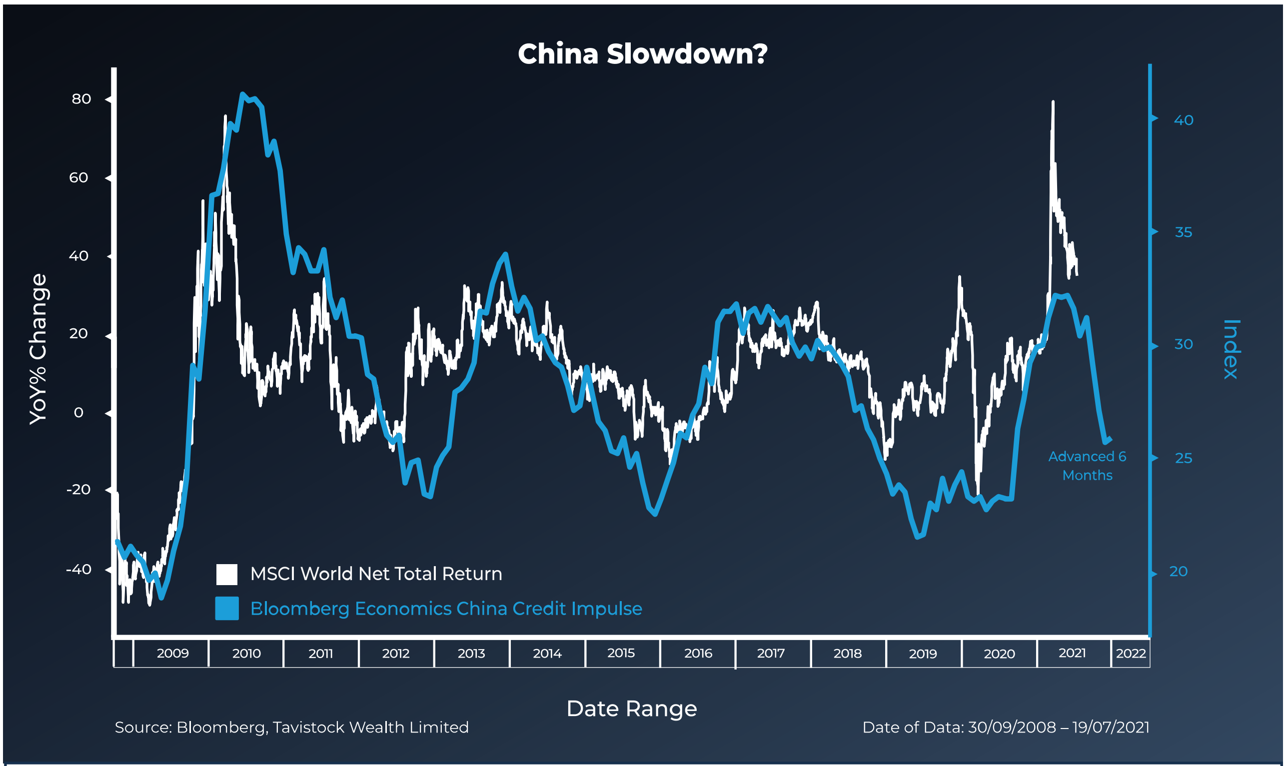
On average, each of the ESG-labelled ETFs in our fixed income basket has grown more than 5x over the same period. There remain plenty of ESG-shaped challenges for index and ETF providers to solve in the second half of the year and beyond. ESG methodologies do not always prioritise the best corporate citizens. Entire asset classes, like commodities, are mostly excluded from the ESG ecosystem despite their importance to the transition to a more sustainability-minded planet. And lending out underlying securities, which can reduce costs, is less common for ESG-labelled ETFs than their vanilla equivalents due to concern over the ESG data of the collateral put up by borrowers. The ESG ecosystem has evolved quickly in a short space of time. The integration of ESG and fixed income is a good example of this evolution. There is no reason to think that the challenges that do remain will not be solved in good time.



ESG-labelled ETFs match, or better, the performance of their vanilla equivalents, as is the case for both multilateral development bank bonds and green bonds.

Final Thoughts

In the key themes section, we mentioned one of the reasons for tumbling bond yields was growing concern over slowing Chinese economic growth. This is something we are watching very closely, not least because China will contribute the greatest amount, more than one-fifth, to global economic growth over the next five years, according to the IMF. With that in mind, it is interesting to note that China's broad credit and money growth has slowed noticeably. This is concerning given China's credit impulse tends to lead the business cycle and can be a reliable indicator of future market returns. Given the lag time, the effect of this slowdown could impact the third and fourth quarters of 2021. Further, this is happening at a time when the Chinese Communist Party seems hell bent on reigning in some of the capitalist excesses within its economy, specifically internet technology companies which have grown dramatically over the last decade, spawning a host of billionaire household names in the process. Whilst this is a key risk to our outlook, we remain hopeful. It is unlikely Beijing wants to engage in full-on deleveraging and the surprise cut to bank reserve requirements, effective July 15th, suggests policy may be less hawkish than expected.



China's credit impulse has historically proven a reliable leading indicator for the business cycle, and market returns.