

JUNE MONTHLY COMMENTARY

15 June 2021

In recent weeks, financial markets have delivered steady positive returns with government bonds, corporate credit and equities all making gains. Since mid-May, European stocks have outperformed the US. Sector performance has been mixed with less leadership from cyclically sensitive stocks and a recovery in technology names. US 10-year treasury yields have fallen back 0.15% to below 1.50%, the price of Gold is largely unchanged at \$1,865 and the Dollar index is modestly higher (+0.32%).

Market commentary remains intensely focused on the risk of persistently higher inflation and the reaction function of central banks. Despite another upside surprise in year-on-year (YoY) US inflation in May, financial market concern remains contained. The US consumer price index (CPI) rose 5% YoY in May, the fastest pace since 2008, driven largely by supply chain bottlenecks and reopening demand. For example, a semiconductor shortage hit new car production, resulting in a 7.3% month-on-month (MoM) increase in the price of used cars and trucks. This accounted for a third of the headline increase. Core CPI climbed to 3.8% YoY, up from 3% in April, reaching its highest level in nearly 30 years. Financial markets have not shown any immediate concern to the higher than expected price increases, US treasury yields and market implied inflation expectations have continued to edge lower. The somewhat counter intuitive reaction of the market may suggest a growing number of investors view the current elevated level of inflation as transitory - tied to the base effects and dislocations caused by the pandemic.

Outside the US, firming price pressures have also been evident. In the Eurozone YoY inflation rose to 2% in May and in the UK, CPI climbed to 2.1% YoY, up from 1.5% in April.

Recent US economic data releases have been mixed and shown signs of peaking momentum in the US recovery. The US labour market report fell short of expectations but showed an improved pace of job creation versus the stalling progress of April. Non-farm payroll data showed 559k jobs were created in May versus a consensus forecast of 650k and the 278k recorded in April. The rate of unemployment fell to 5.8%, but the participation rate also declined, suggesting many workers remain less than enthusiastic about returning to work whilst enhanced unemployment benefits are still available. Peaking momentum was also visible in US retail sales for May, which fell -1.3% MoM versus an expectation of -0.8%. Retail sales surged at the end of the first quarter as US households received another round of stimulus cheque, but the pace of demand for goods has subsequently slowed.

The most recent round of inflation and labour market data will give the Federal Open Market Committee (FOMC) plenty to digest at their June meeting (just starting at the time of writing). Although public remarks from the Federal Reserve (Fed) officials suggest no imminent change in policy and a patient tone on future guidance, updated economic projections and rate expectations may initiate discussions on the timing of tapering asset purchases which currently run at a rate of c. \$120bn per month. The Fed has recently taken a small step to rolling back one

of the emergency measures taken during the peak of the pandemic, announcing plans to start selling its \$14bn corporate credit holding.

Infrastructure bill negotiations with Republicans have been difficult and slow, but the Biden administration's fiscal ambitions have remained evident. In late May, the White House sent Congress its \$6tn budget plan for the 2022 fiscal year, projecting a deficit of \$1.8tn, significantly lower than deficits of the 2020 and 2021, but still nearly double the size of the pre-pandemic deficit. At the recent G7 meeting, the Biden administration led calls for a global minimum corporate tax rate.

London & Capital's asset allocation has remained relatively unchanged in Q2 2021, but changes in late 2020 and Q1 2021 have helped client portfolios to capture the upswing in markets this year. Higher allocations to equities and commodities, together with a focus on higher beta fixed income have enhanced returns. Although it is not our base case, portfolios are constructed to be resilient under a scenario of lasting higher inflation.

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