BERENBERG INVESTMENT REVIEW QUARTER 1 2021

Foreword

Dear Reader/client,

After the sharp market recovery in the second half of last year, volatility re-emerged as speculation moved from vaccine roll out to longer term economic policy. In equities there was a notable shift from lockdown winners to sections of the market more sensitive to economic re-opening and recovery.

This is positive. This time last year we were grappling with the unknown implications of the Covid pandemic - people were becoming seriously ill, economies around the world were collapsing in lockdown and equities were some 50% lower. We are not out of the woods yet a year later but there is clear momentum towards a resumption back to life pre-Covid.

Inflation and the interest rates have come to the forefront of market outlook. As we write in this quarterly, an easing of lockdown should lead to an economic rebound to support rising yields and inflation rates. Domestically we are optimistic that UK equities will move out of the shadows of Brexit uncertainty and, taken together with a successful vaccine roll out, this presents interesting opportunities not seen for some time.

It has been a promising start to 2021 and we continue to be watchful of any risk of derailment. Our portfolios need to remain adaptable to any change in circumstances.

Richard Brass
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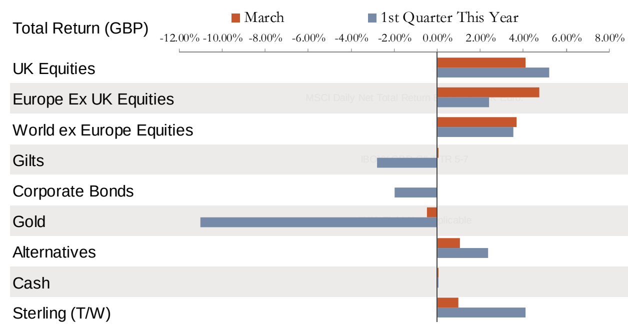
SECTIONS

- Overview and Q1 Asset Performance
- Biden's stimulus package clears final hurdle
- Value continues to be in style
- Vaccination programmes pave the road to recovery

Q1 asset performance

In January, in the US, the Democrats won de facto control of the Senate – having already gained the Presidency and retained control of the House – to complete a clean sweep. In addition to the optimism endowed by the Biden Presidential victory, this increased the expectations and probability of a large, additional fiscal stimulus. Continued – albeit localised – success in population vaccination against Covid-19 added to the optimistic mood.

Chart 1: Multi-asset performance (March and Q1 2021)



Source: Bloomberg Finance L.P.
Total Return in Sterling to Close of Business 31/03/2021

Justification came in the shape of improved business sentiment surveys – particularly in the manufacturing sector. Europe's (ex UK) tardiness in vaccination efforts meant that sentiment in the Service sector lagged that elsewhere.

This led to a sharp rise in real bond yields as well as an increase in inflation expectations, resulting in poor returns for bonds. Equities performed well, however beneath the surface was a rapid rotation from stocks which had been winners in lockdown, to those benefiting from reopening of the economy. Another way of putting this is a rotation from growth to value stocks. A rise in commodity prices also helped this dynamic, although the underlying cause was broadly the same.

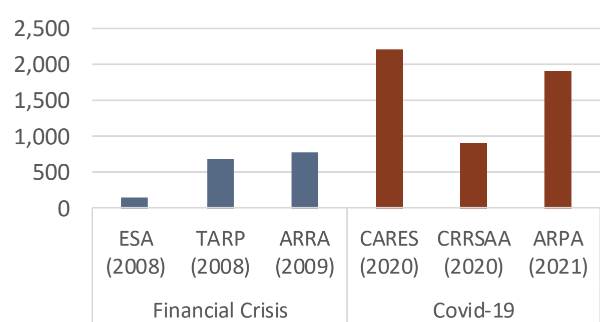
Biden's stimulus package clears final hurdle

Over the course of the first quarter, Biden's historic $1.9 trillion coronavirus stimulus package, dubbed the American Rescue Plan cleared its final hurdle by securing congressional approval, with the House passing the bill with a narrow margin of 220 votes to 211. The passing of the bill has led to upgrades in GDP growth estimates for the US, with consensus now expecting growth in the region of 6% for the nation.

The package itself targets several sections of the US economy in order to assist those most affected by the impact caused by the pandemic. This includes further direct payment to citizens, additional jobless assistance, benefit support for parents, grants for businesses, funds for vaccines and Covid-19 testing centres amongst other economic support. The road to finalising the deal was not clear cut however, as initial plans to almost double the US minimum wage by 2025 had to be removed from the bill after staunch opposition from the Republican Party as well as some moderate Democrats.

The package now brings the total fiscal response of the US to the pandemic to the $5trillion mark, which is about 27% of US GDP. This means the US has one of the largest stimulus packages as a percentage of GDP across the globe. Only Japan has committed to more stimulus as a percentage of GDP at around 55%, although figures for Japan include plans to promote carbon neutrality as well as including funding from private rather than public purses. The fiscal response has not only been large relative to other nations, it is also considerably larger than packages seen in the wake of the financial crisis, with the total response now over three times larger than post financial crisis stimulus measures.

Chart 2: Initial US stimulus package funding ($ billion)



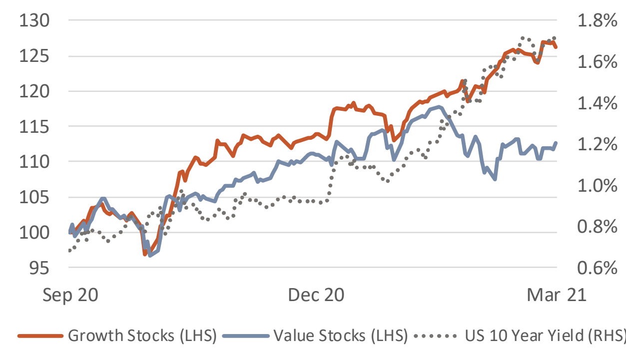
Source: U.S. Department of the Treasury

Value continues to be in style

Vaccination programmes continue to make ground across the globe, which partnered with continued fiscal support, seemingly points towards a sharp recovery in the global economy. However, the prospect of a rapid recovery supported by stimulus has stoked some concerns of inflation on the horizon, which could in turn lead to interest rate rises down the line. Although central banks have showed no sign of changing their stance anytime soon, bond market expectations of a less supportive future environment sent government bond yields sharply upwards over the quarter.

Both increasing expectations for potential future inflation as well as the prospects for an overarching economic recovery have driven investor preference from growth orientated segments of the market to the more economically sensitive value segments. We began to see this rotation towards the tail end of the fourth quarter and the magnitude of the rotation was exacerbated as yields on government bonds continued to rise. Bonds with a longer maturity saw the largest rise in yields, which meant that the overall yield curve steepened over the quarter which is typically indicative of rising inflation expectations.

Chart 3: Growth and value stock total returns (indexed at 100) relative to the US 10-year bond yield



Source: Bloomberg, MSCI Period: 30/09/2020-31/03/2021

From a sectoral point of view, this has meant that areas such as Financials, whose profits not only benefit from a strengthening economy in the form of reduced loan losses, but also from increased net interest margins as a result of the steepening of the yield curve. Energy, one of the most economically sensitive sectors, saw the strongest returns over the quarter as demand for oil should increase once economies move back towards full capacity. These two sectors form a large part of the UK stock market, which saw the region being one of the strongest performers over the quarter in sterling terms.

Less economically sensitive and higher valuation areas of the market, in particular Technology and Consumer Staples suffered as a consequence of this rotation. Although these sectors posted positive absolute returns over the quarter, they suffer proportionately more in rising yield environments, as more of their value is derived from cash flows far into the future than the lower growth parts of the market, which are more sensitive to short term changes in economic growth expectations.

Vaccination programmes pave the road to recovery

UK Prime Minister Boris Johnson unveiled a four-step plan towards completely ending Covid-19 related lockdown restrictions towards the middle of the quarter on the back of continued success in the UK's vaccination programme. The UK has now administered over 30m doses of the vaccine, covering 93% of individuals aged 50 and over, with the goal to offer the vaccine to all adults by the end of July.

In the US, President Biden initially sought to deliver 100 million doses of Covid-19 vaccines by his 100th day in office, however this target was doubled to 200 million at the end of the first quarter, with c14% of the entire US now fully vaccinated against the virus.

Progress has been made over the previous quarter in the development of further vaccines. UK trials of the protein based Novovax vaccine showed positive results for with an 89.3% efficacy rates of immunity against new variants of the virus. The Johnson & Johnson produced vaccine has gained approval for use within the US over the first quarter and looks set to be approved for use within the UK at some point later this year. This vaccine uses similar technology to that of the AstraZeneca vaccine, although it requires just one dose compared to two doses for other major vaccines.

While much of the developed nations outside of the European Union have seen rapid rollout of their vaccination programmes, some notable large emerging market nations such as Brazil and India saw increases in Covid-19 infections. Vaccination rates in these countries are in the mid to low single digits which could mean that this spike in cases continues in these regions for some time.

Portfolio Review

Q1 was a difficult period for our strategy, as our long held belief in quality balance sheets and strong earnings growth was out of favour relative to economically sensitive, but perhaps structurally impaired sectors like energy and financials.

Despite this, before costs we were able to outperform our benchmarks across all of our strategies. Our low duration assisted performance in bond heavy mandates, whilst equity focused mandates held their own.

In terms of changes, it was a busy quarter. Grifols, Beazley and Barclays all left the portfolios to top up pre-existing positions in which we have more conviction. We reduced technology in the US in favour of broader based large cap exposure, whilst in emerging markets we exited our broad exposure in favour of one more focused on Latin America, which should benefit from the economic growth uplift 2021 promises. Finally, we broadened our Sovereign exposure by adding the International Bank for Reconstruction and Development.

Outlook

The outlook remains encouraging for long term investment. Granted there are some set-backs in battling the Covid-19 pandemic – a slow vaccination programme in Europe, mutant variations and political interference in some areas – but these are likely to pass and were to be expected.

As well as increasing in-ways into vaccination, several other factors support a strong out-turn for global economic growth in 2021. Developments in the US in particular are favourable. Fiscal policy is highly supportive, if not aggressively so, whilst the Federal Reserve is still more concerned with reducing unemployment than it is in stymying inflation. Moreover, lockdown has resulted in pent up consumer demand as their savings rates have been forced up. Finally, the Biden presidency promises a calmer foreign trade policy which should support trade internationally.

Whilst inflation is touted as a potential party pooper, the outlook is not that severe. In 2021, we do expect inflation to rise, possibly above central bank targets but it is very unlikely central banks (with the possible exception of China) will react to this. Inflation is likely to calm in 2022, whereupon tightening conditions will begin with reductions in the pace of quantitative easing programmes.

This environment is supportive for equities, less so for bonds. Further supports for equities are increasing flows and improving fundamentals - rising earnings and falling valuations. Falling valuations will be driven by extremely strong earnings growth rather than rotation away from equities. For instance, expected earnings growth in UK equities over the next 12 months is over 40%.

There may be further bouts of rotation in leadership of the equity markets, but they are likely to be less pronounced now, as to believe otherwise would suggest growth expectations rising considerably from already handsome levels. Once valuations have come in from their extremes (high for growth sectors and low for value sectors), a more fundamental environment should ensue, which will reward stronger earnings growth. Indeed, in the short term, disappointment in actual growth relative to heady expectations is more of a risk.

Whilst the outlook is not great for bonds, and still requires a short maturity position, excess yield spreads are likely to predominate in returns from mid-year. Yield spread can be obtained from a number of areas, such as corporate, high yield and emerging market bonds.

We remain overweight in equities, with a preference for European and emerging market equities, the technology sector and companies with the capacity for structurally strong earnings growth. In bonds, we prefer spread and low duration.

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Important Information