Handelsbanken
Asset Management

July 2021

Strategy Review

Key takeaways

COVID-19 vaccination programmes are progressing well, though new variants remain challenging

Short-term inflationary pressures should fade as demand and supply forces begin to re-balance

Support from central banks and governments is ongoing, but the tapering of ultra-accommodative policies is on the horizon

Momentum in the global economy is set to persist for some time, though the pace of growth may be easing off

Given these slightly shifting dynamics, it seems sensible to modestly reduce some risk across our investment strategies

As we continue to leave the darkest days of the COVID-19 pandemic behind us, vaccination programmes are allowing economies to reopen across much of the planet. Meanwhile, herd immunity is on the rise (through a combination of vaccination schemes and prior infection), while hospitalisations and fatalities are broadly lower than in earlier stages of the pandemic. Taken altogether, this should mean that the COVID-19 virus becomes less of a driving force for human, economic and financial market health in the months ahead.

Economic growth rates appear to be peaking, but the recovery remains strong

While the world economy is still growing, the pace of economic growth has begun to show signs of slowing. However, some easing off was inevitable following the sharp rebound from 2020's economic lows, and it is important to note that the overall outlook for growth over the next 6-12 months still looks compelling.

Focusing in on the world's leading economy, growth in the US is set to be robust throughout 2021 and 2022. Injections of support from the US government have boosted incomes – a significant portion of which has yet to be spent. The US economy has long been driven by consumer spending, and while spending on goods has already surged in recent months, spending on services has also begun to pick up as US states reopen. We are likely to witness comparable stories in all regions as they leave lockdown behind, supporting growth over the summer.

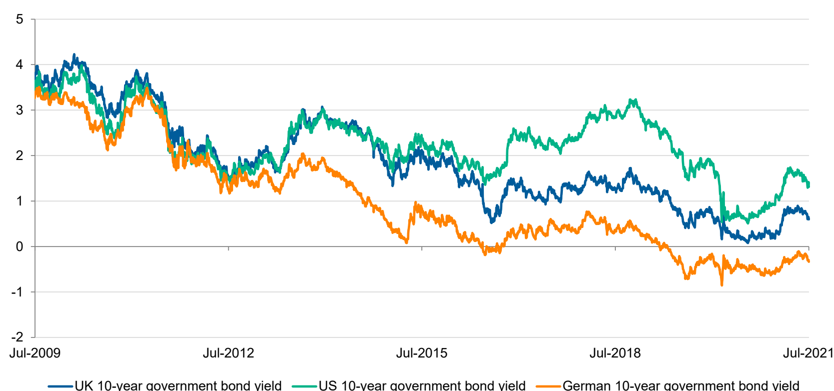
Inflationary pressures should be transitory

Against this backdrop, we continue to believe that short-term inflationary pressures should fade as demand and supply dynamics begin to rebalance. The primary driver of this burst in inflation appears to be centred on commodity prices; for more durable inflation, the costs of shelter and wages would also need to rise markedly, we currently see no evidence of this taking place. Bond markets (notoriously sensitive to inflation) appear relatively sanguine about the outlook for pricing pressures too.

Other signals – such as an improvement in the availability of skilled workers – also suggest we may be past the peak of some of the shortages and bottlenecks lifting inflation in the near term. In China – often referred to as the world's factory floor – inflation data already appears to be increasing at a slower rate. This has been attributed to the government's efforts to curb the aforementioned surge in commodity prices, and could be an early indication of the route ahead for inflation.

Bond yields have fallen back in recent weeks, signalling limited inflation fears

Yields on 10-year government bonds in the UK, US and Germany



Source: Bloomberg, Macrobond. Past performance is not a reliable indicator of future results.

Central bank policymakers are passing the baton

Having thrown everything possible at the COVID-19 crisis, the role of central banks in the economic recovery is likely to step back slightly in the period ahead of us. Over the medium term, we will see central banks passing the baton to consumers and businesses in order to progress to the next phases of economic recovery.

In the US, the Federal Reserve Bank (Fed) is signalling a gradual retreat from its quantitative easing programmes (its support for the economy through the introduction of new money into the US money supply). What's more, Fed policymakers recently pointed to 2023 as the likely beginning of interest rate rises, though this remains dependent on a material, broad-based improvement in US labour markets.

Meanwhile, across the Atlantic, the European Central Bank (ECB)'s recent policy review pointed to a slight but important change in its approach to managing inflation. The bank's policymaking committee will now tolerate an overshoot of its 2% target – following in the footsteps of the Fed. This means allowing inflation to 'run hot' without intervention into the foreseeable future.

Elsewhere, in China, the central bank has reduced its reserve requirement ratio (the amount of funds banks need to hold in reserve) for the first time since April 2020, in order to release more liquidity into its domestic economy.

Intriguingly, these moves by world central banks signal an element of divergence in approach following months of acting in concert. Some central policymakers (China) are evidently still pumping new support into the economy, while others (the US) look to ease off on their ultra-accommodative measures.

Are we moving to the next phase of the global business cycle?

The precise 'business cycle' stage in which we find ourselves is critically important to financial markets. When we talk about the global business cycle, we are referring to fluctuations in economic growth around a long-term trend, and there are lots of reasons to think that our current positioning is relatively early in the cycle (representing a period of economic expansion).

However, we believe that these early-cycle conditions will turn into mid-cycle conditions as growth begins to peak over the course of 2021 and 2022. In a more mid-cycle environment, central banks should begin to feel comfortable withdrawing stimulus, in turn allowing imbalances (particularly in supply chains) to normalise.

Under the bonnet in our investment strategies

Mindful of this potential shift along the business cycle, it seems sensible to modestly trim some risk across our investment strategies. This move should not be seen as the start of a major de-risking programme over the course of the second half of the year; instead, it reflects our observation that some of the factors driving our very risk-positive position over recent months may be beginning to ease off. We believe it is therefore appropriate to take risk levels down to a more neutral position versus our long-term average.

This slight development in our stance is based on the balance of risks in play for financial markets. The vaccination rollout is progressing well, though new variants are a challenge; support from central banks and governments remains in situ, but is likely to be tapered. Meanwhile, businesses and household savings are high, and we do believe that global economic momentum should persist for some time, while near-term inflationary pressures should begin to fade. However, share prices already reflect much of the positivity around economic recovery. Given this balance of risks, we believe a relatively neutral stance is prudent at this point.

Creative positions continue to play a vital role in driving financial returns

We retain our high conviction in creative 'return drivers' within our investment strategies. These are holdings in areas where financial returns are largely uncorrelated to wider financial markets or the economic cycle, and include positions such as music royalties and social housing.

Many of these 'alternative' asset types (i.e. investments beyond traditional asset classes like stocks and bonds) can also deliver compelling payouts to their holders. This is an especially attractive trait in a world of generally low yields.

Thematic stories are well-established among our stock market holdings

We also favour stock market themes like healthcare and technology. We took the opportunity to add to holdings in these areas during a pandemic-induced weak spot for stock markets in May 2020.

These are typically growth-focused businesses, underpinned by longer-term economic trends linked to debt, disinflation, and shifts in investor preferences towards more sustainable investment areas.

Emerging markets remain an important area of focus

Emerging market assets are an important feature of our strategies too, and we hold positions in both bonds and shares in key developing economies.

The wider reflationary environment should prove to be broadly positive for performance among these assets. Asian markets should also benefit from the ongoing pickup in demand among consumers in developed economies.

Given the prospect of further economic stimulus in the US, the US dollar should not become aggressively stronger from this point. This is good news for emerging market assets, which are often penalised by a stronger US currency, in part due to a tendency for emerging market debt to be issued in dollars.

Important information

Handelsbanken Asset Management is a trading name of Handelsbanken Wealth & Asset Management Limited which is authorised and regulated by the Financial Conduct Authority (FCA) in the conduct of investment business and is a wholly-owned subsidiary of Handelsbanken plc.

This document has been prepared by Handelsbanken Asset Management for clients and/or potential clients who may have an interest in its services. Nothing in this communication constitutes advice to undertake a transaction and professional advice should be taken before investing. Any observations are Handelsbanken Asset Management's commentary on markets and its own investment strategy. This material is not investment research and the content should not be treated as an offer or invitation to buy or sell securities or otherwise trade in any of the investments mentioned.

The value of any investment and the income from it is not guaranteed and can fall as well as rise, so you may not get back the amount originally invested. Past performance is not a reliable indicator of future results.

Registered Head Office: No.1 Kingsway, London, WC2B 6AN. Registered in England No: 4132340. www.wealthandasset.handelsbanken.co.uk
Telephone: 020 7045 2600