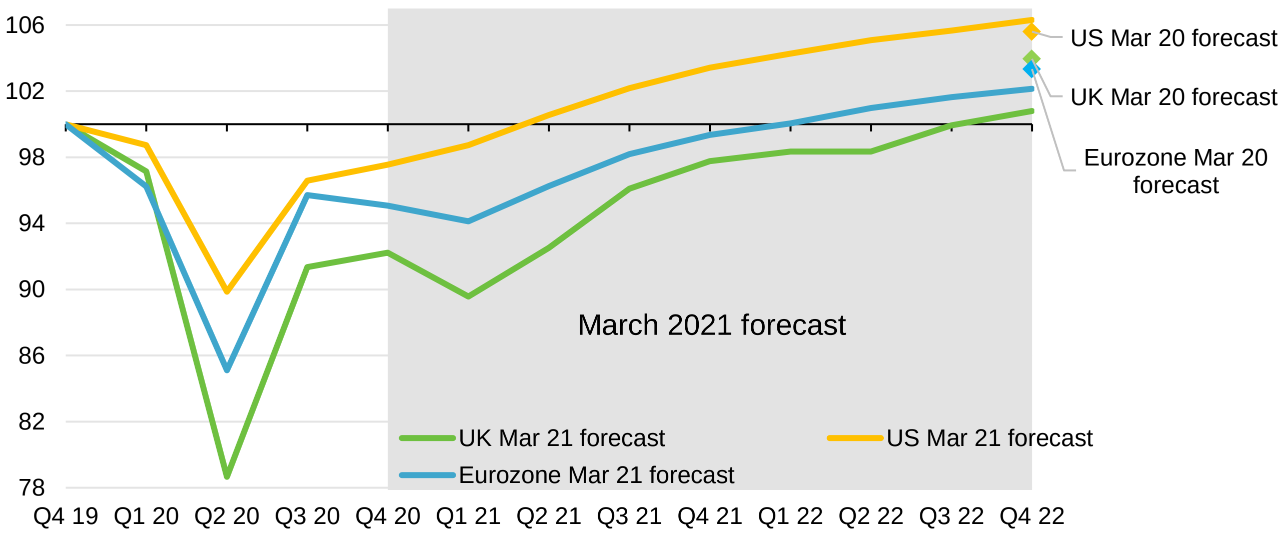
Capital Markets Update

Spring 2021

Yields in the major sovereign bond markets rose sharply to the highest levels for a year in the first quarter as the medium-term growth and inflation outlook was boosted by vaccine rollouts and the announcement of further US fiscal stimulus.

Near-term weakness is expected in Q1 given ongoing COVID-19 restrictions in many parts of the world. However, composite PMIs for March were strong across the US, UK and Eurozone. The services-led jump in the UK was particularly notable, while the surveys imply activity ticked up in the euro area and remained at levels consistent with expansion in the US. Business expectations of future output are very healthy across the board and the employment component has risen to a level consistent with expansion for both manufacturing and services in each of the three regions.

Chart 1: GDP output level, Q4 2019 = 100

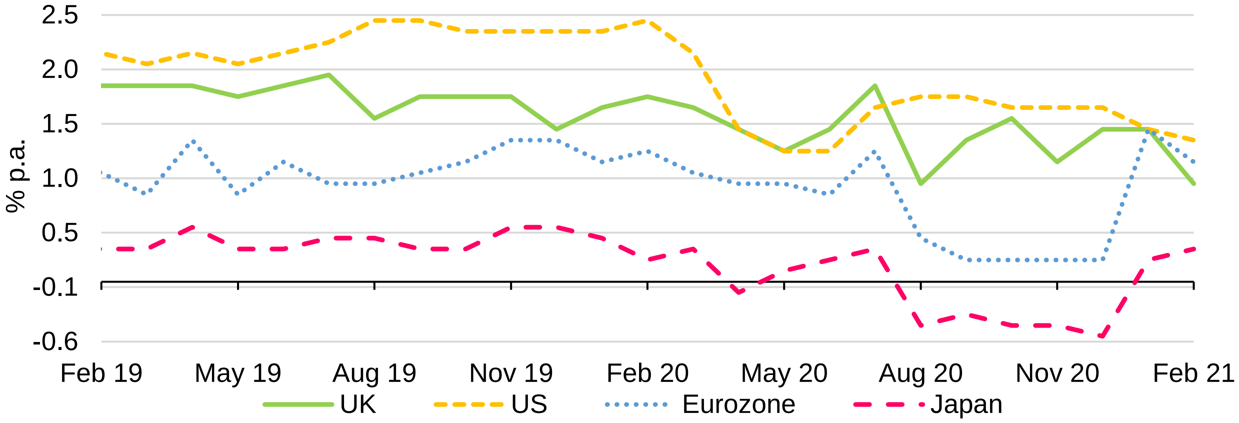


The $1.9tn US fiscal stimulus is expected to create a mini boom in the US, with output expected to regain its pre-pandemic path by the end of 2021 (Chart 1). Accumulating evidence of the effectiveness of vaccines also provides cause for optimism. Against this backdrop, a marked acceleration in global GDP growth is expected from Q2 as restrictions begin to ease. As a result, consensus forecasts for global growth in 2021 have risen to 5.3% in 2021, following a 3.7% contraction in 2020. While the improved consensus seems reasonable, a recent pick-up in global COVID-19 cases, which had plunged in January and February, highlights the potential risk of disappointment with regards the pace of re-opening and subsequent economic recovery.

Higher input prices also had a positive effect on manufacturing PMIs – partly driven by a recovery in oil prices, but also more general supply chain pressures, which may not clear up immediately as activity picks up.

Consumer price inflation remains subdued (Chart 2), but it is likely that these supply constraints will be compounded by a wave of deferred consumption as restrictions ease, leading to higher inflation in the short term. However, most forecasts do not expect these pressures to be sustained and central banks are likely to look through any near-term rise in inflation. While markets do not expect a sustained rise in inflation either, investors do not appear to think central banks will need to be as accommodative as they suggest: futures prices imply US interest rates will rise earlier and to a greater extent than members of Federal Open Markets Committee currently expect.

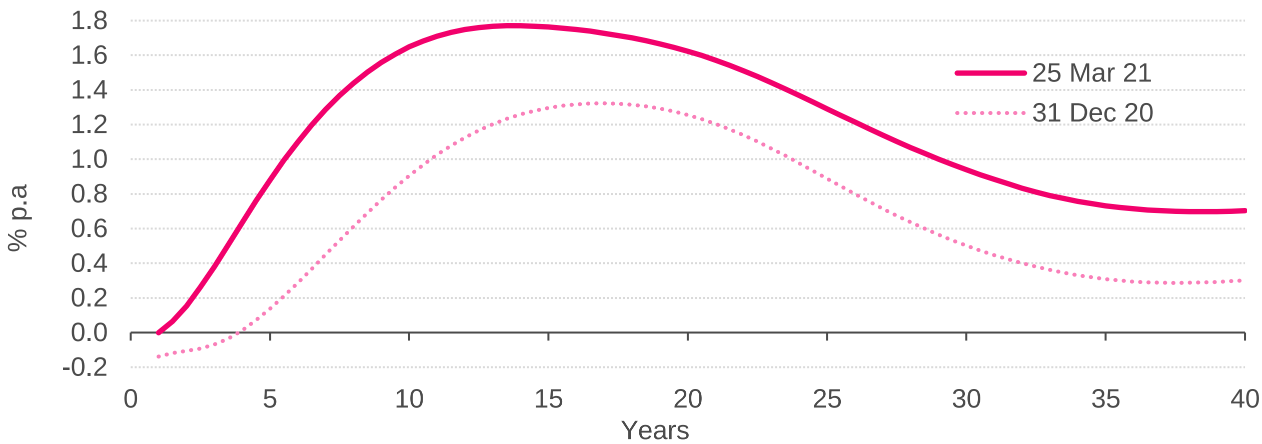
Chart 2: Core CPI inflation



Government bonds

The recovery in growth and inflation expected over the rest of 2021 has seen global sovereign bond yields rise substantially in the first quarter. The UK may have suffered a permanent loss of output during the pandemic but, on the back of a rapid vaccine rollout and an imminent substantial easing of restrictions, a strong bounce back is expected in Q2. An environment of strong growth and rising inflation is perhaps still a less supportive backdrop for gilt markets.

Chart 3: Instantaneous forward nominal gilt yields

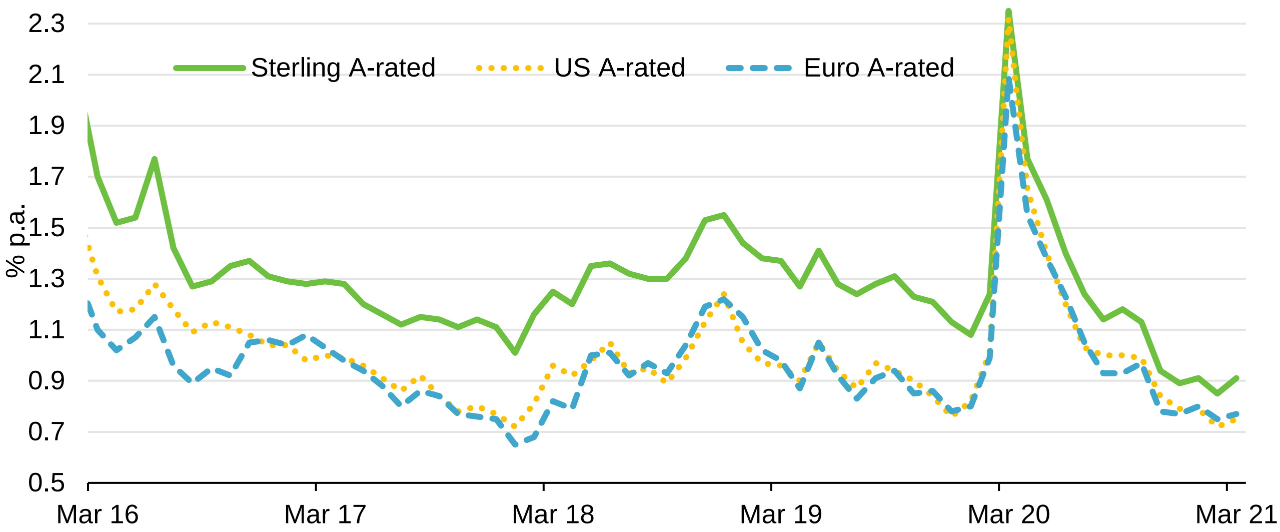


With expectations of negative interest rates having evaporated, front-end nominal yields are beginning to look more fairly valued. The path of cash rates currently implied by the market (Chart 3), rising towards 2% p.a. over the next 10 to 15 years, does not look unreasonable. It is less easy to argue that longer-term forward nominal yields represent reasonable value. Real yields also rose in the first quarter, but by less than nominal yields - implied inflation now looks very expensive at terms up to around 25 years, and only slightly less so thereafter.

Credit

Though investment-grade spreads were little changed and speculative-grade spreads continued to grind tighter in the first quarter, rising sovereign bond yields have weighed on total returns in fixed interest credit markets, which are negative year-to-date for investment-grade markets. Within speculative-grade credit markets, it is perhaps unsurprising that floating-rate loans have outperformed high yield bonds.

Chart 4: Global investment-grade corporate credit spreads

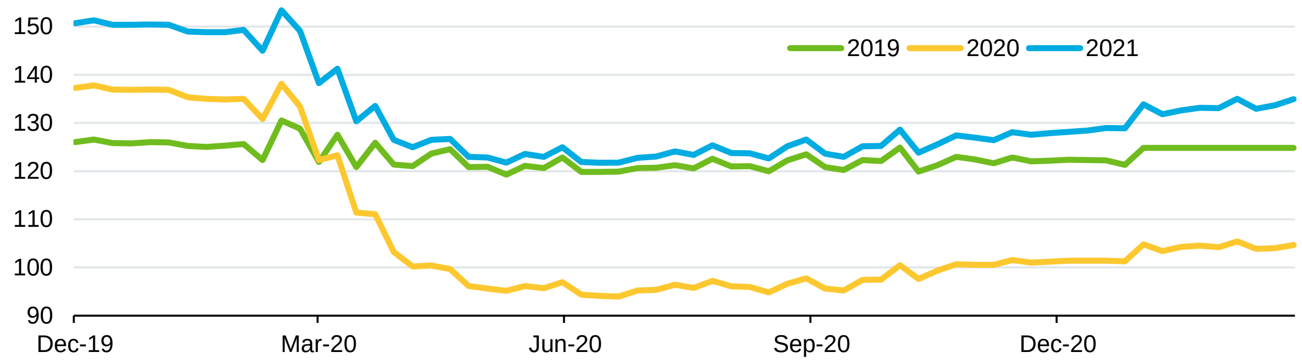


Corporate finances look stretched - leverage remains elevated and interest coverage is low, but the earnings recovery forecast should ease the strain. Indeed, recent data suggest defaults have already passed their peak and are on a declining trend – Moody's US high yield 12-month trailing default rate declined to 7.9% in February, from 8.3% in January, and is expected to average 4.7% in the fourth quarter of 2021. However, a robust recovery is already reflected in very thin credit spreads (chart 4) which remain well below longer-term median levels and provide little upside exposure to the economic recovery.

Equities

The improved outlook for the global economy supported global equities in the first quarter and is expected to provide further support over the rest of the year. The consensus forecast is for global earnings per share growth of 28% in 2021, which would leave full-year earnings around 7% above end-2019 levels (Chart 5). While global equity valuations remain elevated in absolute terms versus history, they look less demanding in the context of very low real yields: the spread of the MSCI World's cyclically adjusted earnings yield over the US 10-year real yield remains above longer-term averages. This valuation cushion, together with robust earnings growth, may provide some support to equity prices against downwards pressure from a further rise in real yields.

Chart 5: MSCI World full-year earnings per share

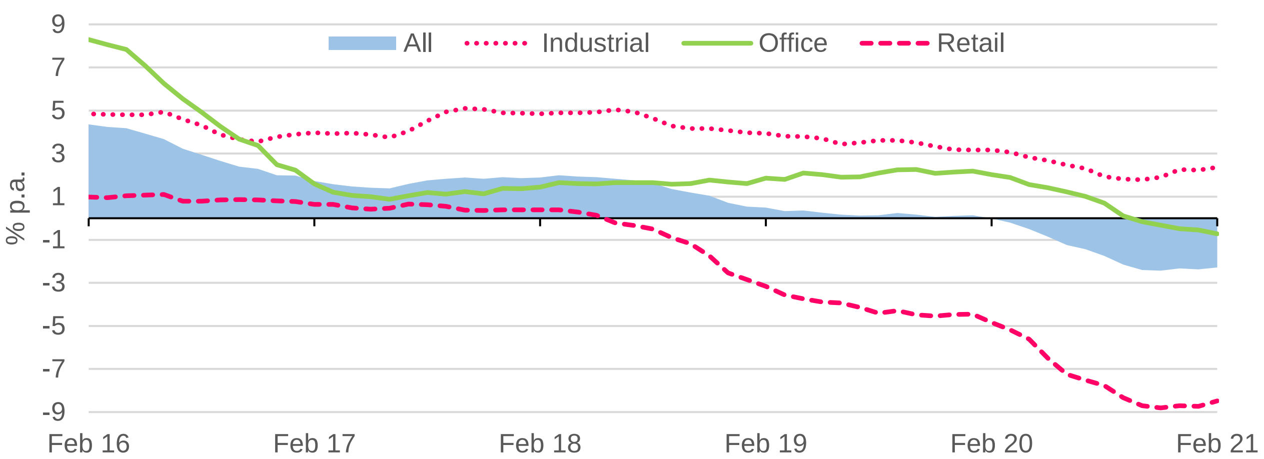


Although equities shrugged off the first-quarter rise in sovereign bond yields, the impact was seen in sector performance: oil & gas, financials, basic materials, and industrials were, in that order, the top performing sectors. Not only are last year's laggards delivering the most positive earnings surprises and stand to gain the most from a recovery in economic activity, their valuations are less reliant on strong future earnings growth than 2020's winners and therefore more insulated from the impact rising sovereign bond yields can have on valuations.

Property

The rolling 12-month total return on the MSCI UK Monthly Property index was -0.5% to end February, as income was offset by declining capital values. The retail sector has experienced the steepest declines, but office capital values have also fallen, with sharper falls experienced over recent months. An accelerated shift to online retail, and employers committing to more permanent flexible working arrangements, suggest retail and office capital values may remain subject to considerable uncertainty, even once restrictions are eased. In contrast, industrial capital values had recovered modest declines in the wake of initial lock-downs by the fourth quarter of 2020 and are now more than 5% above pre-pandemic levels.

Chart 6: UK commercial property real rental growth



Real rental growth has steadied over recent months after a sharp decline since the onset of the pandemic (Chart 6), although vacancy rates are rising. In aggregate, rents are lower than they were a year ago, with industrials being the only sector to deliver positive rental growth. However, monthly rental growth has improved across all sectors over recent months, while both rent expectations and occupier demand have also improved over the last quarter, albeit from very low levels.

Conclusion

Expectations of strong growth seem well-founded amid significant progress in vaccine rollouts, fiscal support on a massive scale in the US and potential deferred consumption once restrictions are eased. However, the balance of risks may be slightly to the downside. A rise in inflation is likely to be temporary, but there is a risk it persists. Following the rise in bond yields in the first quarter, the market-implied path of interest rates over the next few years looks reasonable because central banks are expected to be very cautious about tightening. However, longer-term nominal yields provide inadequate compensation for inflation risk and real yields still look very low.

Though the forecast recovery in earnings should prove supportive of corporate debt fundamentals, very thin credit spreads provide little upside exposure to the economic recovery. Equity markets are more directly exposed to the benefits of economic recovery and, while valuations remain high, they seem less stretched than those in credit markets against a backdrop of low real yields. The outlook for UK commercial property fundamentals has improved slightly, as the pace of rental declines has eased, but yields remain low versus history, and the retail and office sectors remain subject to significant uncertainty, even assuming a smooth re-opening.

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