Global Investment Strategy

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MUFG ASSET MANAGEMENT

Mitsubishi UFJ Asset Management (UK) Ltd. (Registered in England No 1842259)
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Investment Summary

The initial euphoria of lockdowns ending is over, now we have to find ways to live with Covid.

Vaccinations have provided justified optimism, and expectations have discounted a return to “normal” activity.

The next 12 months will be more taxing for markets as the bounce in activity and corporate earnings slows.

We still expect to see renewed socialising, travel and rising consumer confidence.

Inflationary expectations are uncertain, they have risen, but remain well anchored.

Central Banks have loosened their inflation targets, giving themselves room to keep policy loose for longer.

Led by the US, but joined by the ECB who can now allow inflation to rise above 2%.

The main target for the Authorities is growth, with fiscal policies also providing stimulus.

An end to loose money is being considered, yield curves are reflecting this.

Only in Europe is the short end of the interest rate curve negative.

However most yield curves do not suggest that growth or inflation will be strong for some while.

The consensus view remains: soft productivity growth in the future and lack of bold action in some quarters.

Equity markets are at highs, supported by strong earnings forecasts.

Equities already discount a return to normal economic activity, so pressure is on corporate earnings.

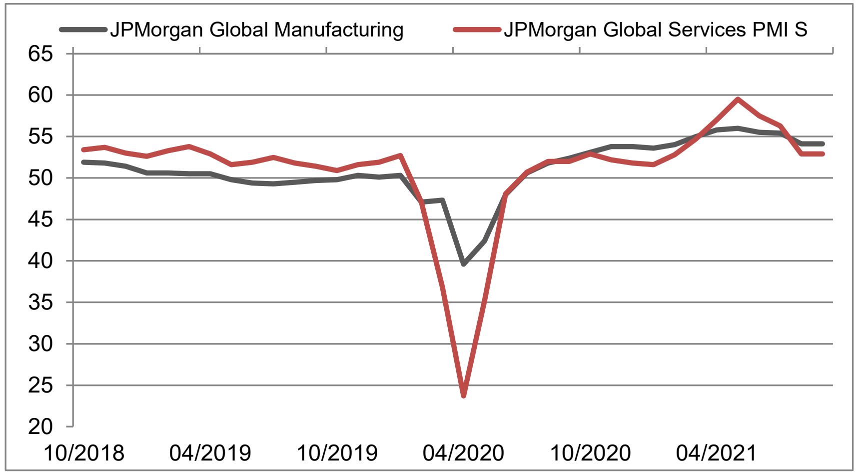
Is this the time to bite the bullet and buy cyclicals and value? And sell Covid winners like technology?

What is clear is that if growth becomes more prevalent, then there are cheaper ways to buy into it.

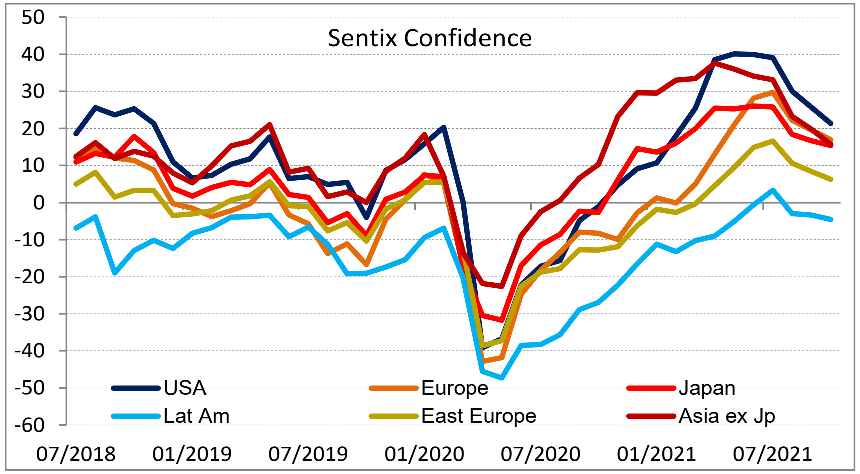
Growth and Inflation

Source: JP Morgan, Sentix, OECD, Bloomberg,

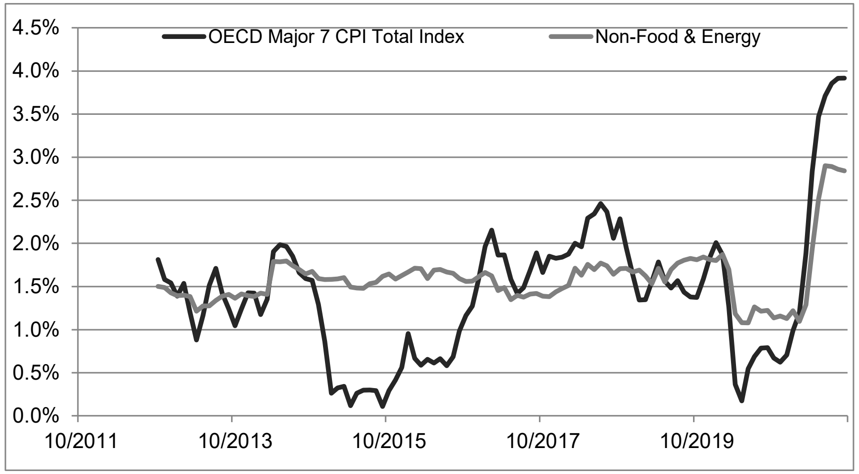
JP Morgan Global PMIs



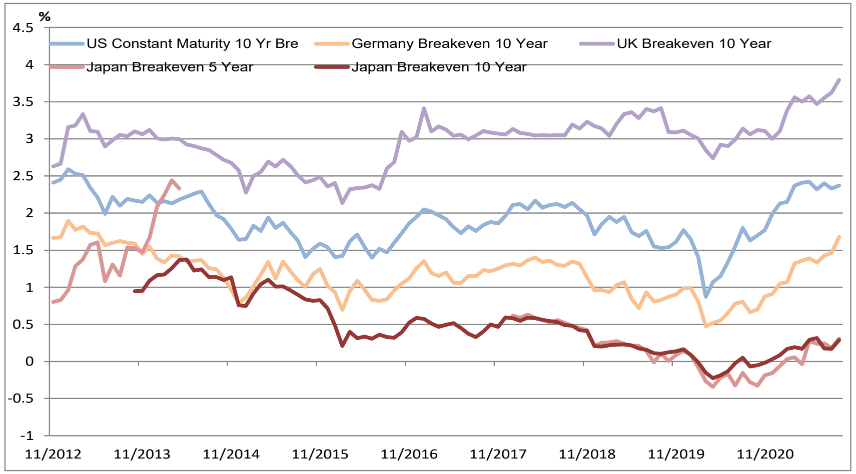
SENTIX Business Expectations Survey



OECD G7 Inflation



Implied Inflation from Index Linked Bonds



Commentary

What are markets telling us?

The Fed continues to roil bond markets, as this month the yield curve steepened sharply.

Inflation may now be higher for longer, but Central Banks continue to say this is only temporary.

Implied inflation from indexed linked bonds has risen to highs, so markets are aware of the inflation risks.

Economic expectations fluctuate, but as vaccination levels rise, so does confidence in the recovery.

Equities remain at high levels supported by strong earnings, while valuations are slowly improving.

For now markets are behaving as normal in an economic upturn;

But it will take time to understand all of the impact from the pandemic.

What are we thinking?

US action on monetary and fiscal policy is a game changer, and other jurisdictions are following.

Central Banks have little ammunition for the next downturn, but if inflation moves upwards they will embrace it.

It is now clear that 2021 was a year of rising growth; vaccinations are providing real hope.

For now we journey in hope, but markets will spend much time picking trends from volatile numbers.

The problem is that equities already discount a new high in profits, and real interest rates are negative.

Climate change and ESG will be an additional driver to investment trends globally.

The UK is finding out the true cost of Brexit.

Fixed Income

Fixed Income Strategy (1)

DURATION

We are short duration

No forward rates show countries having interest rates much above inflation targets in the long run.

The US fiscal package is a game changer since it eliminates the output gap.

High savings and wealth provide extra spending.

Fed have stated they will not hike rates until both inflation is above target and employment is maximized.

Here is the best chance for a shift in inflation expectations and higher market rates.

What about everywhere else? Australia and Canada should largely follow.

UK should too, since it is largely a service economy. Fiscal austerity has been delayed and likely will be again.

EU has a fiscal boost, but will be a laggard. That should not stop yields drifting upwards though.

Risks: COVID variants slowing spending, China rebalance, fiscal support can't last for ever.

SPREAD PRODUCT

Stronger growth is positive, but rich valuations and risks further out prompt caution.

The economic outlook, positive growth and supportive policies, favours spread product.

Despite this we have reduced our overweight for reasons given below:

Spreads have come in from 330 over to 100, basically back to the historically low Pre-Covid level;

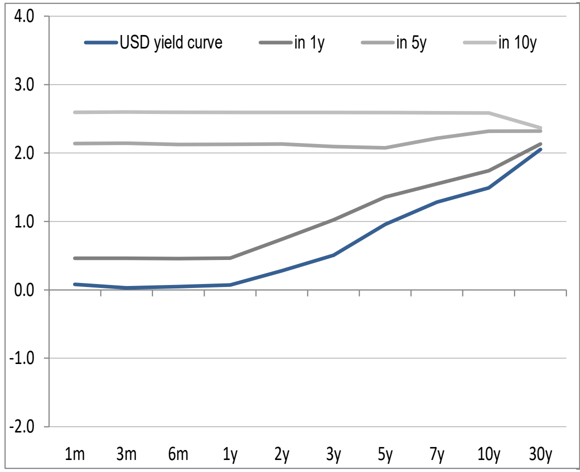
Governments are in weaker positions: debt levels are higher, monetary policy limited in efficacy.

US fiscal action accelerates the upturn, but raises the risk of volatility later as overheating becomes debated.

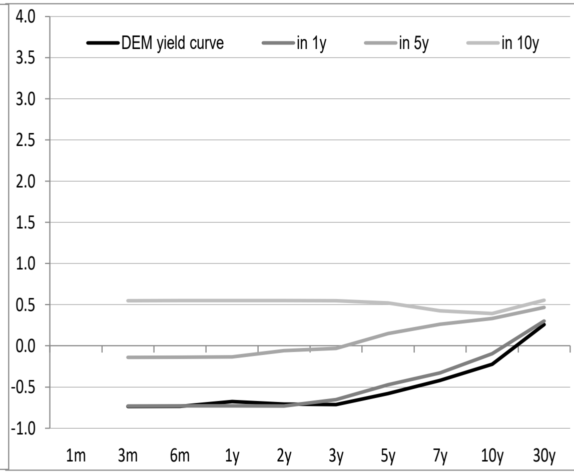
Forward Yield Curves

Source: Bloomberg,

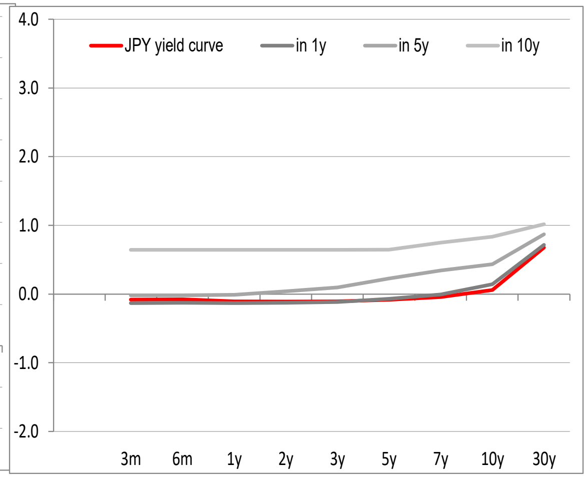
USA



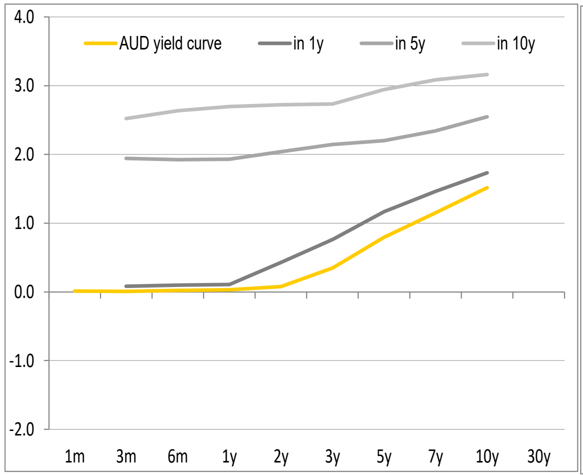
GERMANY



JAPAN



AUSTRALIA



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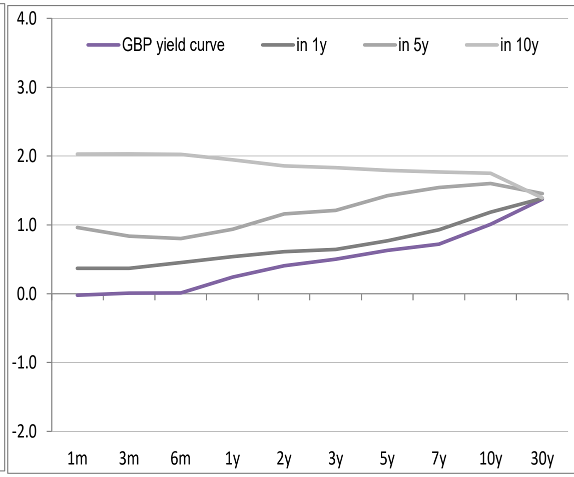
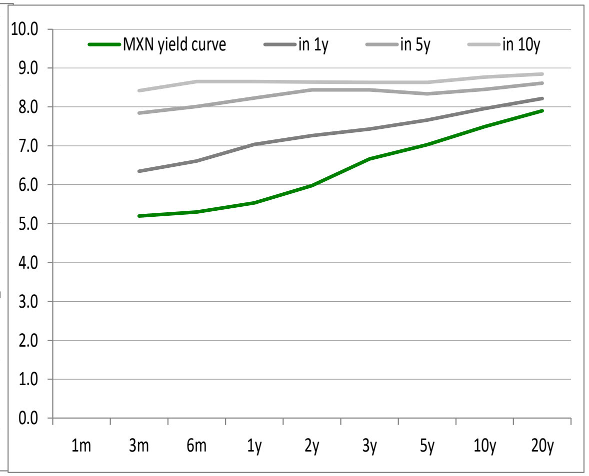


MEXICO



Fixed Income Strategy (2)

COUNTRY ALLOCATION

We have a slight preference for US over EU.

US forward curves put US rates in the distant future way higher than EU rates - in the long run that is wrong.

Central banks will not anticipate and will keep rates low until targets are reached.

Yield curves will be steep and the longer end where the action will be for some time.

Changes to inflation targets make nominal yield convergence less obvious, but the differences are stark.

CURRENCY

We have limited currency positions.

USD positives: stronger economy, higher long rates, will hike rates earlier.

USD negatives: current account deficit, overvalued, low rates and higher inflation not a good combination.

The Euro is cheap on fundamentals, but rates are not rising and risks around the EU persist.

If growth gains traction and inflation starts to rise the EU will not be eager to raise rates.

Equity

Equity Strategy (1)

GLOBAL

Global profit expectations provide strong support to equities, but momentum is slowing.

The pace in the rise of earnings expectations has slowed alongside economic optimism.

Cyclical growth is the key driver, lifting previous laggards, but perhaps a change is in the air?

Profit margins are at high levels, can these be sustained with rising prices and labour costs.

It remains that the real damage that COVID has done to the economy or businesses is uncertain.

With little room for disappointment we would not be rushing to buy equities.

Valuations have improved as strong earnings are reported.

P/Es are related to future earnings growth, confidence in which has improved.

The current historic P/E of 23.3x has fallen as share prices are off their highs and earnings flat.

Corporates have taken on debt while at the same time boosted cash balances to all time high levels.

Dividends need to grow as the cash is put to use.

Profit forecasts are not too excessive at present.

The next twelve months are now forecast to see 20% profit growth, which takes us to a new high.

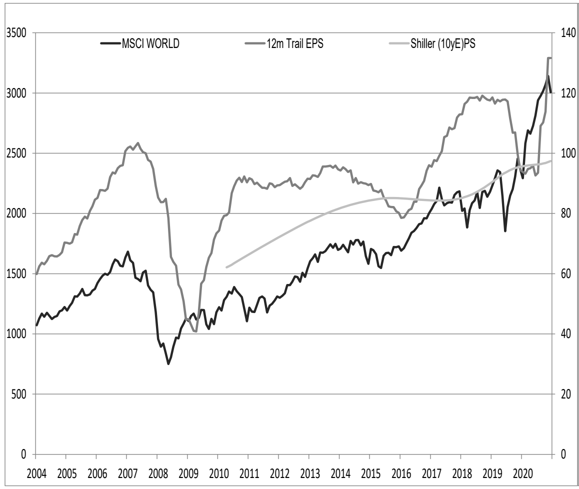
Currently forward earnings are at 161 on a P/E of 18.5x, but dividend yields are at lows.

It will be important to see how companies use their cash – return to shareholders? Invest? Or pay staff?

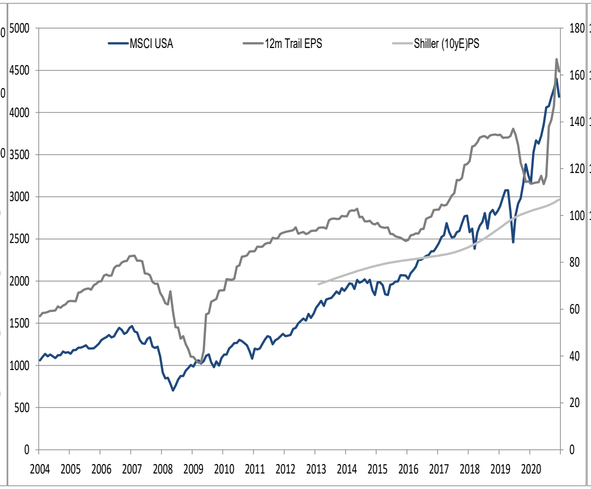
MSCI Equity Indices and Earnings (right hand axis)

Source: MSCI, Bloomberg,

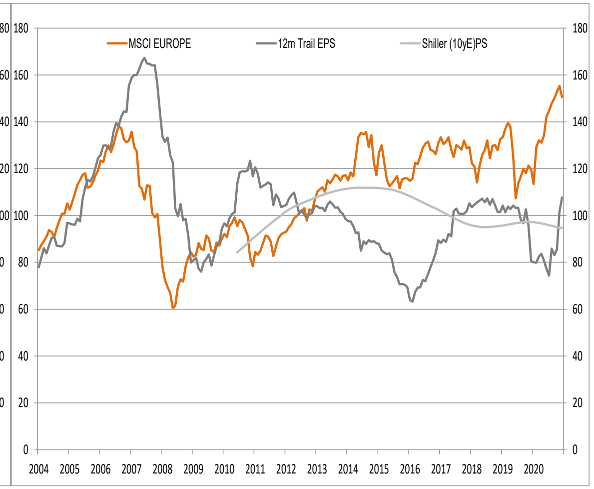
WORLD



USA



EUROPE



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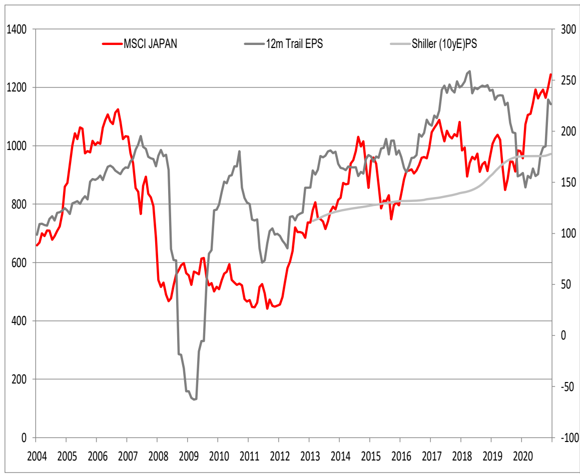
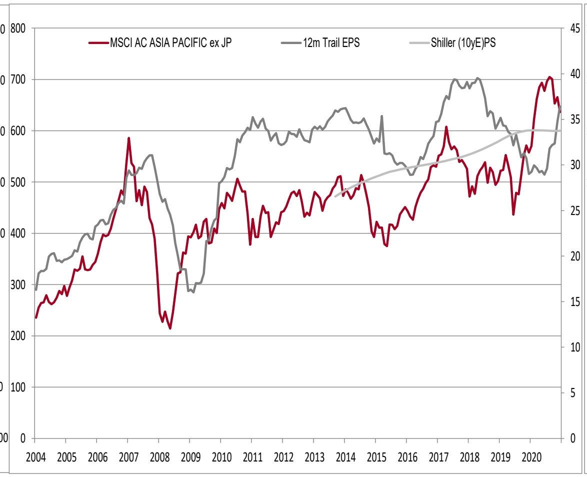
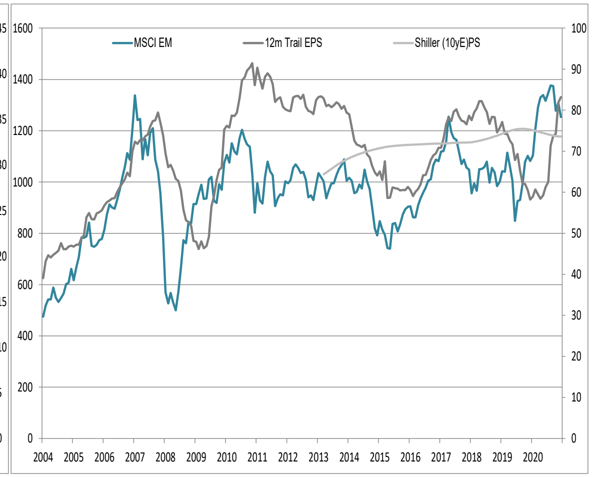


ASIA ex JAPAN



GLOBAL EMERGING



Equity Strategy (2)

SECTORS

Rising inflation expectations supporting Materials and Energy.

Materials and Energy are outperforming as investors seek inflation hedges.

The corollary is that interest rate sensitive Utilities are the worst performing.

Earnings continue to rise, while earnings forecasts move higher at a slower pace.

Consumer Staples and HealthCare are seeing a turn in relative earnings as cyclical growth slows.

This year, interest rate rises have proved to be short-lived, but this time may be different.

We would focus on cheap cyclicals, and avoid expensive stocks going into 2022.

FACTORS

US interest rate expectations rose sharply – hence Value >> Growth

As to be expected rising rates led to Value outperforming along with Dividend Yield and Large Cap.

Growth and Small Cap typically associated with economic recovery were weak.

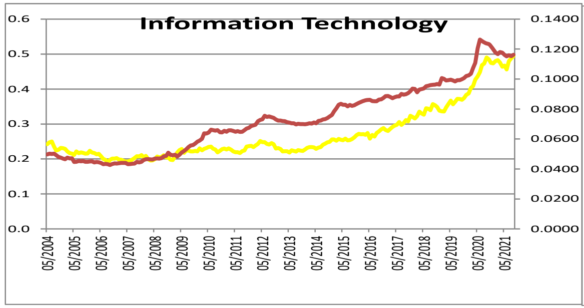
It is the change in Fed-speak, a more hawkish stance alongside rising prices, that has driven Value up.

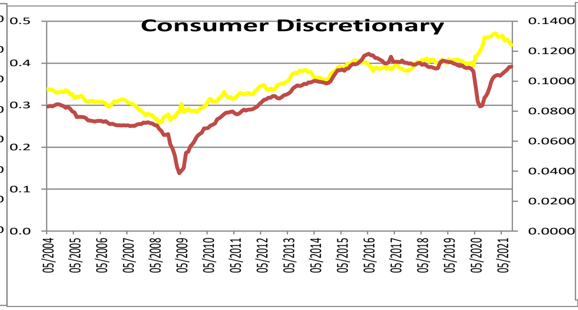
Earnings momentum is weakening, but remains an important influence.

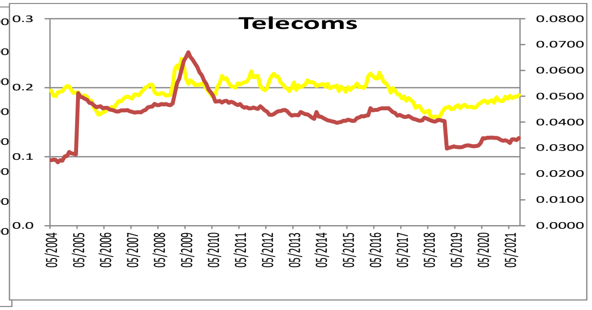
The rest of the year is likely to be quiet as investors consider 2022's economic activity.

Source: MSCI, Bloomberg,

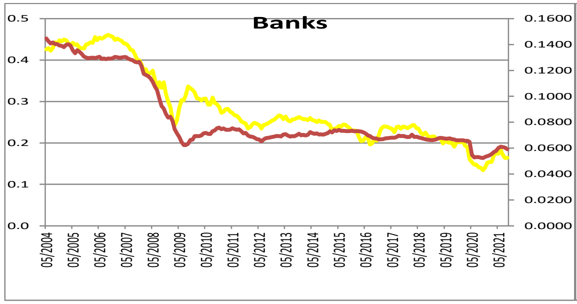
LEADERSHIP OVER?

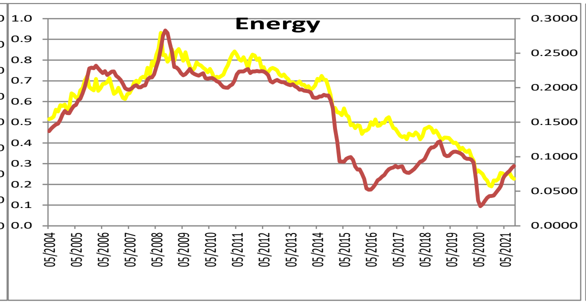


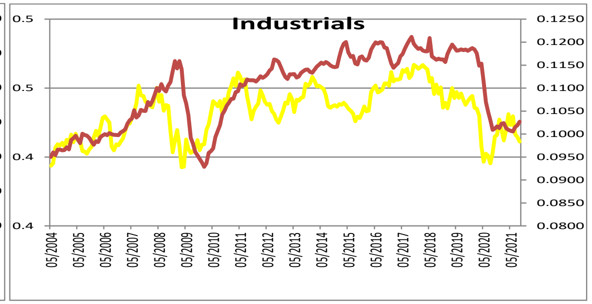




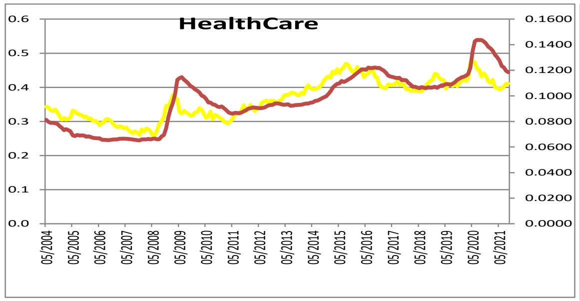
ON THE TURN?

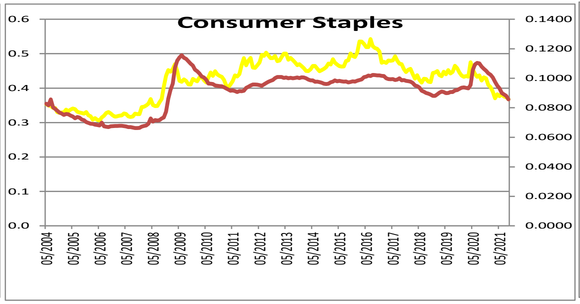


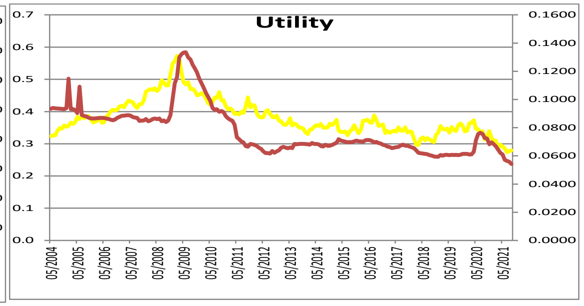




OUT OF FAVOUR



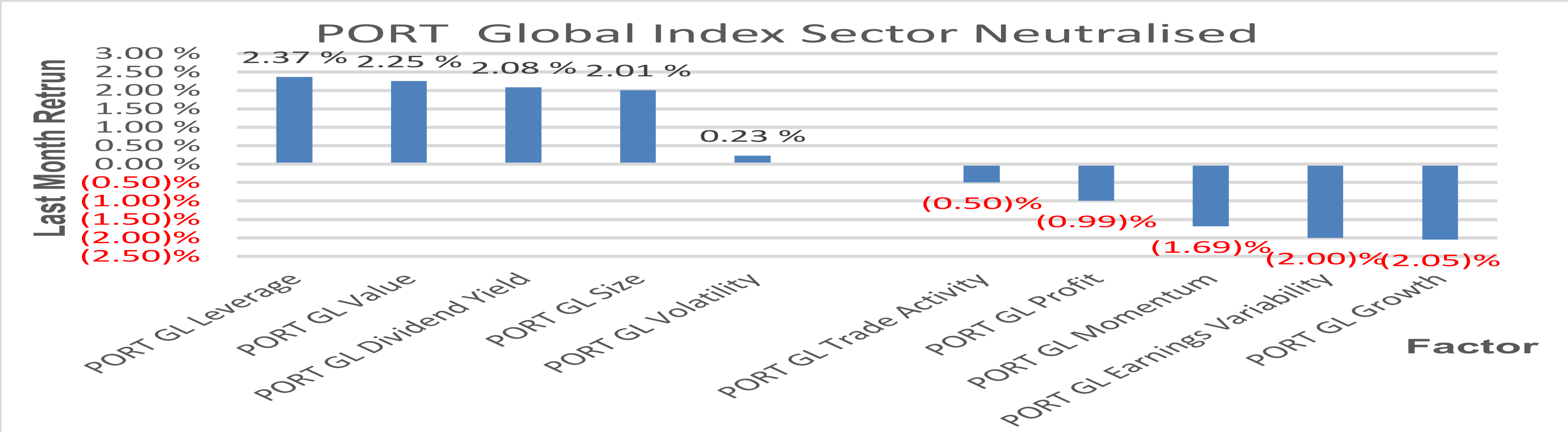




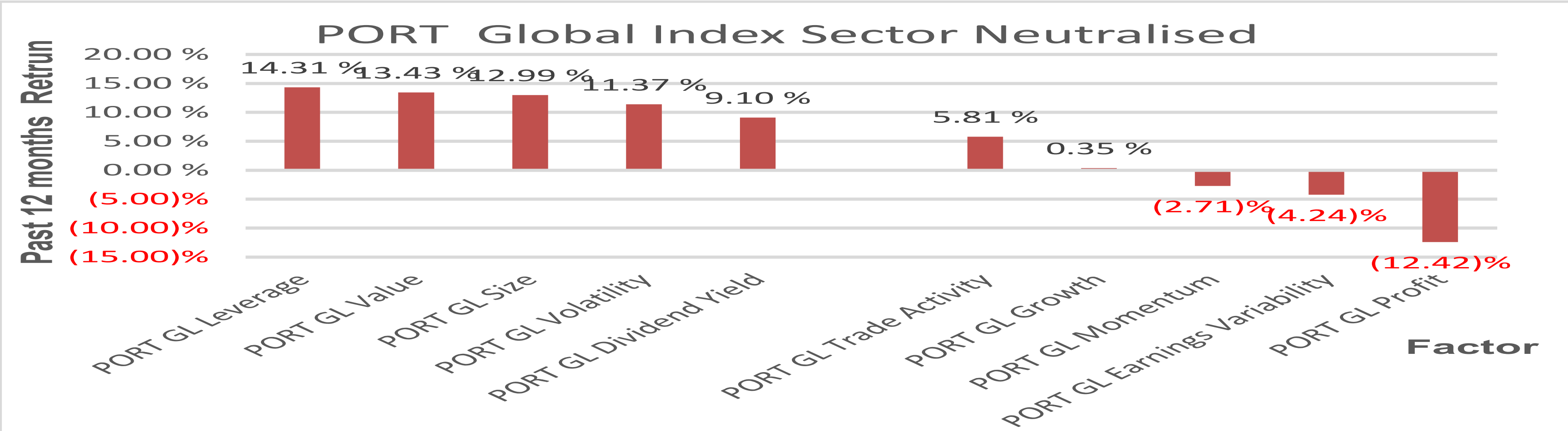
PORT Factor Analysis

Source: Bloomberg,

1 MONTH



PAST 12 MONTHs



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