SARANAC
PARTNERS

Investment Committee Update

May 2021

AT A GLANCE

- The global economy has moved into a period of strong growth, although there is a sense of 'rolling growth' regionally. China has had its surge already, the US is booming now, Europe will be next and Japan will follow.
- The duration of this growth period is important for financial markets and we suspect it will last longer than some predict – possibly into 2022.
- The only plausible reason for an interruption to this growth surge would be a re-emergence of Covid-19, lockdowns and restrictions.
- The growth in corporate earnings has been robust, surprising many. However, market reaction has been mixed, and cyclical and value sectors have performed much better than growth areas.
- Commodity momentum has been extreme and there is some concern it's overdone, but ultimately commodity prices do go up in periods of very strong growth.
- Inflation is now the preoccupation of markets. How transitory will it be, how high in the short term and does it prompt a shift in policy earlier than expected?

In this month's update we focus on rising inflation, the surge in the price of commodities and watching moves from the Federal Reserve (Fed) when it comes to interest rates.

STRONG INFLATION NUMBERS FOR THE SUMMER

The Consumer Price Index (CPI) report in the US was much stronger than expected – with a core rise of 0.9% – the biggest jump since 1981. The annual core CPI is now up 3%. But the base effects are important to take into account, as inflation numbers this time last year were very depressed in the midst of the pandemic, so we can expect a run of very strong inflation numbers over the summer.

Even though we know the current figures are distorted by 2020 prices, inflation breakevens have moved higher. 10-year inflation expectations are now up to 2.5% – the highest since 2013 – while two-year breakevens are up to 2.8% – a level not seen since 2005. The fact that short-term expectations remain well above longer-term levels implies that the market believes the Fed when it says the rise in inflation will be transitory. Certainly, shorter-term inflation measures have moved much more than the longer-term ones.

Despite moves higher in inflation expectations, bond yields – having moved higher in February and March – have been more stable. As a result, real yields remain very depressed, at -1%. The lack of reaction from bond market shows that investors generally remain sanguine over inflation prospects too.

Figure 1: Inflation expectations
Future expectations of inflation can be derived from markets and the forecast of what inflation will look like in five years' time has moved higher, up to 2.3%. However, this is still well below levels seen a decade ago.

Source: Saranac Partners.

The longer-term inflation outlook has implications for portfolio management. We know there is a short-term blip in inflation coming, but there are longer-term disinflationary forces such as debt, technology and labour's lack of bargaining power, which probably drag inflation back down. But there are potential catalysts for a 'regime change' in inflation to higher levels than we have seen over the past 20 to 30 years. Modern Monetary Theory (MMT) may be a game changer if adopted widely by western markets. Meanwhile, the slowing growth of the global labour supply, in particular in China, and the investment effort to de-carbonise the world's economy could have inflationary impacts too.

There are good arguments that the drive toward clean energy and infrastructure investment will underpin stronger demand for certain commodities, but this investment tends to happen over very long periods and the lack of a China-equivalent keeps us from the super-cycle view.

The team's view was consistent that a regime change in inflation still looks a long way off. MMT is far from becoming mainstream; automation and new labour markets (for example, India) probably limit labour supply issues; and clean energy investment will be a multi-decade effort. We believe the disinflationary forces in place over the past 20 years will prevail. But, ultimately, higher inflation for longer is now a legitimate tail risk, which wasn't the case last year.

COMMODITY PRICES CONTINUE TO HIT NEW HIGHS

As commodity prices continue to hit new highs, are there some signs of overexuberance? The longer-term supply and demand picture doesn't point to a super cycle but we can see specific markets where supply is likely to remain tight for a while, and copper is a good example. Oil supply looks to be much more elastic given significant OPEC capacity and the ability for US shale producers to ramp up production very quickly.

There are good arguments that the drive toward clean energy and infrastructure investment will underpin stronger demand for certain commodities, but this investment tends to happen over very long periods and the lack of a China-equivalent keeps us from the super-cycle view. Economics 101 suggests very strong growth leads to higher commodity prices, so even without the super-cycle argument, the prospects for commodities remain strong as we believe prices are not yet discounting the full extent of the economic growth surge ahead. Ultimately, commodities are deeply cyclical, but we do not think we have reached the peak yet.

WATCHING THE FEDERAL RESERVE

Watching the Fed is always a popular sport in markets, but never more so than now. Employment is clearly now the primary focus, while inflation targeting has moved to an average level, rather than a specific target. This is an important shift; average inflation targeting gives the Fed much more flexibility than a fixed target, so we expect it to resist a premature tightening of policy in the face of high inflation over the summer.

Forecasts for an increase of one million jobs earlier in the month proved dramatically over-optimistic, with only 266,000 added. Employment conditions in the US remain difficult and won't fully ease until vaccinations are complete, schools have reopened and generous additional unemployment benefits are removed – hinting to September at the earliest. Some states have already removed the additional pandemic-related unemployment benefit of $300 per week. The data for people voluntarily leaving their job is at the highest in 20 years – a sign of both very strong demand for labour (there's plenty of evidence that it is proving very difficult for companies to find suitable labour) as well the generosity of unemployment benefits currently.

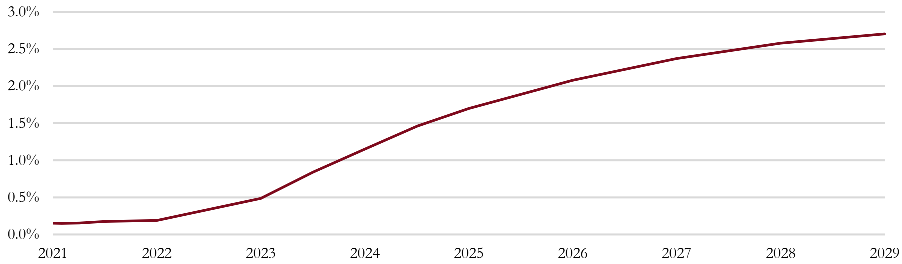
We believe the Fed has a clear chronological decision making process: Federal Open Market Committee (FOMC) statements will lay out the timing of the anticipated reduction in quantitative easing, then Fed asset purchases will be tapered over a period of time – most likely 12 months given prior experience – followed by interest rate hikes. We expect the Fed to introduce timing guidance over the August and September timeframe, quantitative easing tapering to begin by year end, and to finish by end 2022. Interest rate hikes could be a 2023 event.

We think that there is a very low probability that the Fed shifts its policy messaging any time soon, though views on the team are somewhat diverse, from 0% to 35% probability. What is clear is that a hike from the Fed no sooner than the beginning of 2023 is fully priced into market expectations. Any suggestion that this timeframe be accelerated and brought forward would be a negative surprise, implying either that the labour market has recovered sooner than expected, inflation is running much higher than forecast, or both.

April was a good month for bonds as yields took a step back and credit spreads tightened. But CCC spreads relative to BB+ have never been so tight, leaving very little point in taking additional credit risk today.

Figure 2: Federal Reserve interest rates

The timing of when the Fed will start to raise interest rates is a key variable for markets. Policymakers have said they not do expect to hike until early 2024. However, the market has moved forward its own expectations as to when monetary policy will tighten to early 2023.



Source: Saranac Partners.

PORTFOLIOS

Fixed income

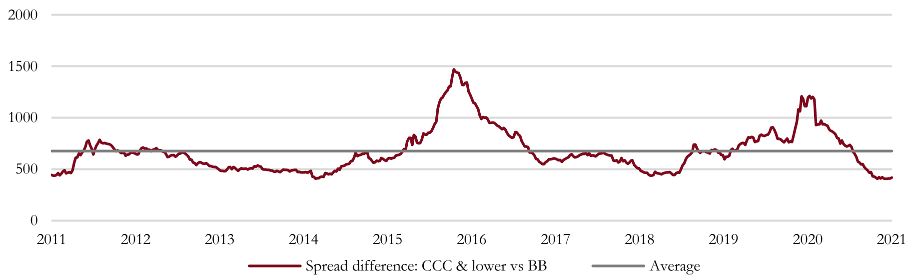
April was a good month for bonds as yields took a step back and credit spreads tightened. But CCC spreads relative to BB+ have never been so tight, leaving very little point in taking additional credit risk today. We favour a higher-quality approach to our credit risk. While we cannot make the case for narrower credit spreads, there is also little catalyst for any widening given the extremely strong economic backdrop and plentiful liquidity in place – refinancing debt is very easy.

The fall in real yields over the past month is hard to justify as inflation expectations have risen, but bond yields have not. Real yields have dropped back to their prior lows of -1% and this does not seem to reflect the economic reality of very strong growth. A rise in real yields from here would mean conventional bonds should outperform inflation-linked bonds.

Given the strength of the macro data, we think that bond yields should rise over the balance of the year, and US 10-year yields of 2% look sensible. Although it should be noted that this is a much smaller move than we have already seen this year. We are managing relatively little duration risk at the moment; the fixed income allocation in our multi-asset portfolios has a duration of about 4.7 years – well below the broad market average of 7.4 years – but are looking to take steps to shorten duration further.

Figure 3: Credit looks expensive

The additional yield offered by the most risky corporate bonds (rated CCC or lower) compared to high yield bonds with the best credit rating (BB) has never been smaller. A premium of just 4% for the riskiest bonds does not look high enough and we are focused on the better-quality issues in this market.



Source: Saranac Partners.

Second-quarter earnings are expected to be more than 50% higher than a year ago, but this will mark the peak in earnings growth this cycle.

Equity

The first-quarter earnings season has been one of the strongest on record with over 80% of US companies reporting profits that were better than expected. Europe also enjoyed a bumper period with over 60% of companies producing a positive surprise. Not only did company results exceed expectation, the degree to which they surprised was also unusually strong. US company profits were, on average, over 20% better than expected.

However, good news is not always met with a positive market reaction. Given how strong the macro data has been of late, notably in the US, a bumper earnings season had already been reflected in much of the market moves this year. It is interesting to note the disparity in share price reaction to these earnings reports: cyclical and value sectors such as financials, industrials and material companies all saw strong upward moves in their share prices on the news of their earnings. However, more growth-orientated sectors such as tech and healthcare actually saw negative price moves as they released their earnings reports.

This was a classic example of the old adage "it is sometimes better to travel than to arrive". The relative strength in performance by the tech sector this year had effectively already priced in this good news. However, this is not yet the case for the more cyclical parts of the market and we remain bullish on these types of company.

Second-quarter earnings are expected to be more than 50% higher than a year ago, but this will mark the peak in earnings growth this cycle. Second-half growth will still be very strong, but it decelerates from the second quarter. We looked at past periods in which strong earnings growth slows down from its peak, which suggests that markets may struggle to make much headway in the near term, in particular given very optimistic sentiment at the moment. However, prospects over the next 6 to 12 months look much better.

Figure 4: Earnings growth is peaking

The year-over-year growth rate of earnings is peaking this quarter, driven by the strong recovery but also the base effects of very depressed earnings in Q2 2020. While earnings should continue to grow strongly over the next 12 to 18 months, the rate of growth is likely to slow.

Source: Saranac Partners.

Currency

US dollar weakness has resumed, reversing the strength it enjoyed in the first quarter. This may well be correlated to the drop back in real yields in the US. Sterling saw a positive move on the back of the local and National Assembly elections as the SNP failed to win an outright majority, reducing the risk of another Scottish independence referendum, for the time being. And the idea of a chronological 'rolling' surge in growth across regions may see more support for the euro and the yen as we move through the year as European and Japanese recovery lags behind the US and China.

Recession or stagnation risks remain very low, and while we think inflation is temporary there has been a modest increase in the probability of a more dramatic regime shift in inflation, although that risk is also low.

Commodity

The price of gold has bounced nicely, driven by the drop in real yields in the US. But it pales in comparison to the moves in many of the industrial metals, and recently agricultural prices have also moved sharply higher. The diversification of our commodity exposure earlier in the year has been helpful as the commodity fund we bought has been able to take advantage of this broad participation in strong commodity prices across the space.

Portfolio changes

We are not making any material changes to our asset allocation as we think portfolio positioning accurately reflects the macro background and opportunities at the moment. Our scenario analysis is suggesting higher conviction in a longer period of strong growth; we have long held the view that a gradual slide back to a slow growth environment is likely but now we give as much credence to the possibility that growth will be sustained at a higher level for longer.

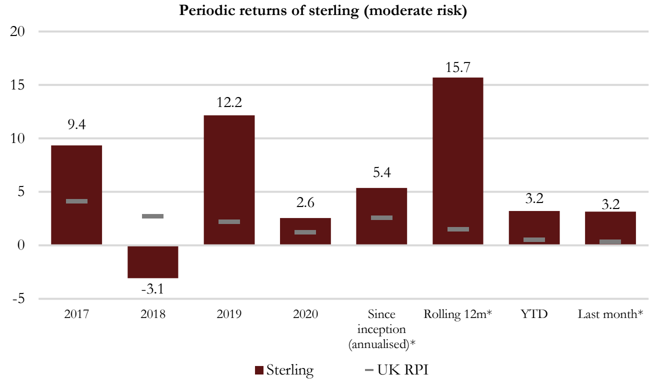
Recession or stagnation risks remain very low, and while we think inflation is temporary there has been a modest increase in the probability of a more dramatic regime shift in inflation, although that risk is also low. We are making some changes within the equity allocation, however. We are adding to our UK exposure, which has been very small over the past four years, and are doing so through a fund which focuses on value. The UK remains one of the cheapest markets globally, but the recent report from the Bank of England forecasts a robust 7.25% GDP growth this year and still healthy 5.75% growth in 2022.

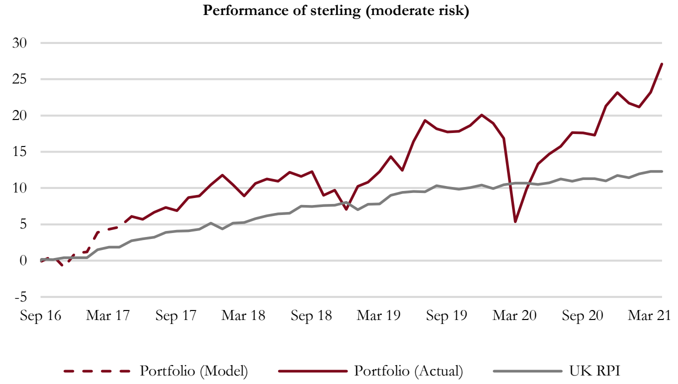
We are also introducing a new China equity fund to portfolios which specialises in Chinese mid-cap companies and is particularly focused on the evolving consumer spending trends domestically. This brings a new dimension to our emerging market equity exposure.

Multi-asset strategies

Performance as of 1 May 2021

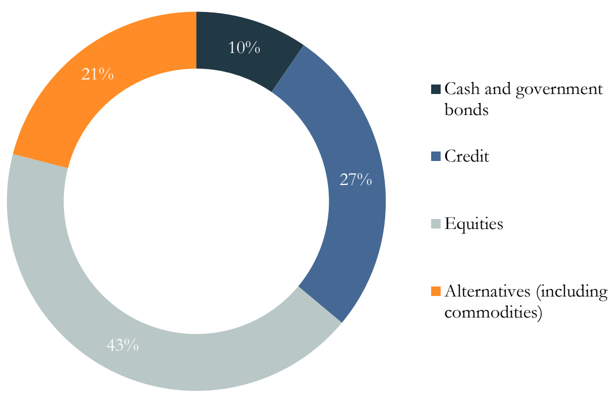
Returns (%)

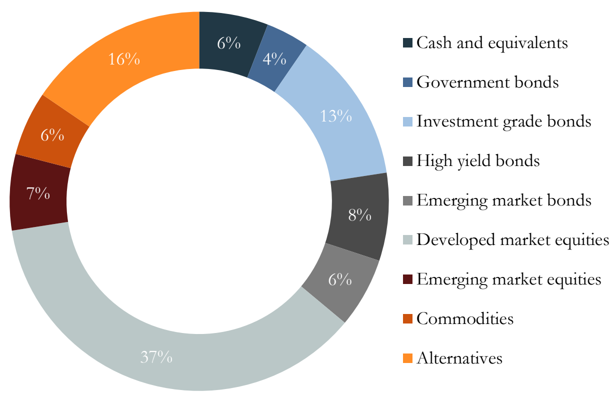




*End April 2021 for Sterling. End March 2021 for RPI (April data not available yet).

Asset allocation (average across all portfolios, %)

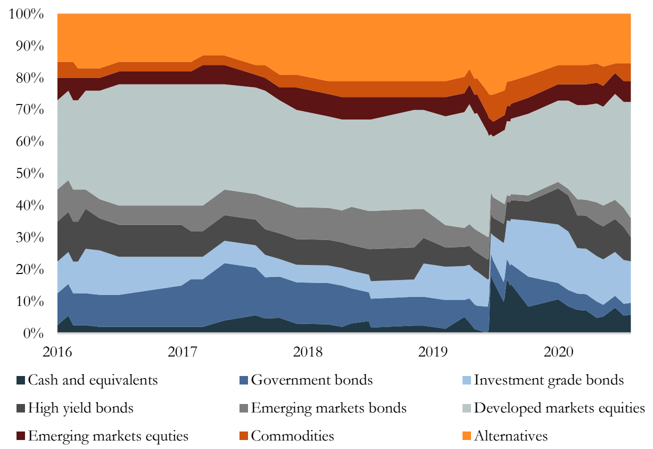




Changes over the past month (%)

	Sterling	Change
Cash and government bonds	**9.6**	**0.4**
Cash and equivalents	5.9	0.4
Government bonds	3.7	0.0
Credit	**26.5**	**-3.6**
Investment grade bonds	13.0	-0.8
High yield bonds	7.5	-2.8
Emerging market bonds	6.0	0.0
Equities	**43.0**	**3.3**
Developed market equities	36.5	3.3
Emerging market equities	6.5	0.0
Alternatives	**21.0**	**0.0**
Commodities	5.5	0.5
Alternatives	15.5	0.0

Changes over time (%)

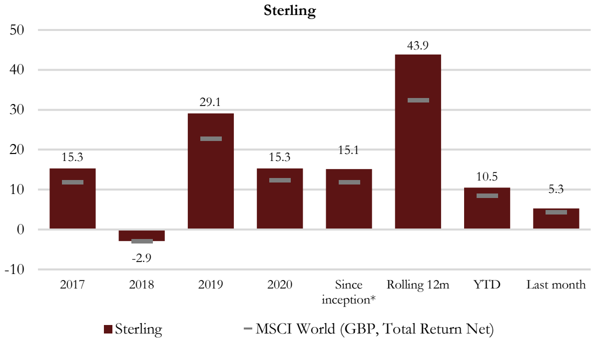


Performance figures from inception (28 September 2016) to end May 2017 are based on model portfolios, simulated from a full record of trading decisions and execution levels are readily available for review. Performance figures from June 2017 onwards are based on an aggregation of actual client portfolios whose mandate most closely follow the Moderate Risk model. Dividends have been included on an accruals basis in both cases. All performance is shown exclusive of fees as charging structures may vary. Your capital is at risk and past performance is not a reliable indicator of future performance.

Equity strategies

Performance as of 1 May 2021

Returns (%)



Euros and US dollar

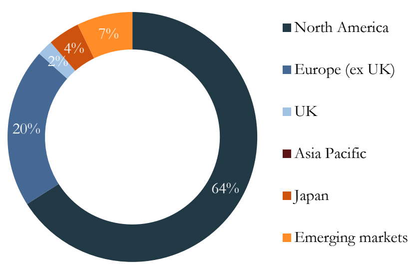
	2017	2018	2019	2020	Since inception*	Rolling 12m	YTD	Last month
Euros	10.9	-4.0	36.7	9.1	14.6	43.7	13.8	3.2
MSCI World (EUR, Total Return Net)	7.5	-4.1	30.0	6.3	11.3	32.2	11.6	2.2
US dollar	26.2	-8.6	34.2	19.0	18.2	57.9	11.9	5.7
MSCI World (USD, Total Return Net)	22.4	-8.7	27.7	15.9	14.8	45.3	9.8	4.7

*Since inception figures are annualised.

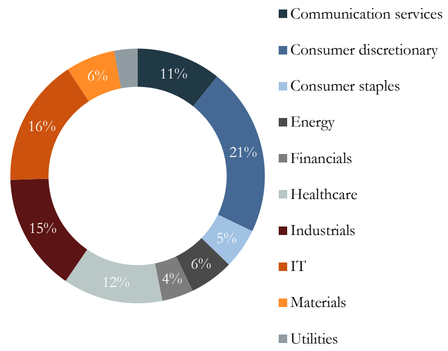
Top 10 holdings (%)

Holding	Weight (%)
ALPHABET INC-CL A	4.3
FACEBOOK INC-CLASS A	4.1
UNITEDHEALTH GROUP INC	4.0
DISCOVER FINANCIAL SERVICES	3.9
LVMH MOET HENNESSY LOUIS VUI	3.8
MICROSOFT CORP	3.8
FANUC CORP	3.6
DR HORTON INC	3.5
VISA INC-CLASS A SHARES	3.5
UNITED RENTALS INC	3.4

Regional exposure



Sector exposure

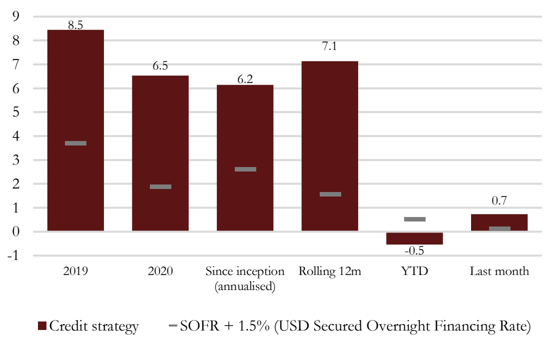


Performance figures from inception (1 January 2017) are based on a model portfolio, simulated from a full record of trading decisions and execution levels are readily available for review. Dividends have been included on an accruals basis. All performance is shown exclusive of fees as charging structures may vary. Your capital is at risk and past performance is not a reliable indicator of future performance. Actual fe.es paid by the client portfolios excluded. Fees may vary.

Credit strategy

Performance as of 1 April 2021

Returns (%)



	Credit strategy			Benchmark		
	USD	GBP (hedged)	EUR (hedged)	USD	GBP (hedged)	EUR (hedged)
Last month	0.7	0.7	0.7	0.1	0.1	0.1
Rolling 12m	7.1	6.9	6.2	1.6	1.3	0.7
2020	6.5	6.0	5.2	1.9	1.4	0.6
2019	8.5	6.6	5.3	3.7	1.9	0.6
Since inception	14.9	12.3	9.9	6.2	3.7	1.5
Since inception (annualised)	6.2	5.1	4.1	2.6	1.6	0.6

Asset allocation and performance measures

Issuer type	Weight (%)	Yield to maturity (bps)	Modified duration	Composite rating
Core IG allocation	**73.0**	**225**	**4.6**	**BBB**
Developed markets	52.0	212	4.7	BBB
Emerging markets	18.0	250	4.8	BBB+
Asset backed securities	3.0	298	3.1	A-
High yield satellite	**27.0**	**488**	**3.2**	**BB**
Developed markets high yield	12.0	398	1.8	BB-
Emerging markets high yield	2.0	971	5.7	BB-
Corporate hybrids	5.0	473	2.9	BBB-
Financial subordinated	8.0	510	4.6	BB+
Total portfolio	**100.0**	**296**	**4.2**	**BBB-**

Performance figures from inception 31/12/18 are based on an actual client portfolio whose mandate most closely follows the Diversified Credit Strategy. All performance is shown inclusive of fees. Since inception, the portfolio has experienced zero defaults. Your capital is at risk and past performance is not a reliable indicator of future performance.

16 St James's Street
London SW1A 1ER
+44 (0)20 7509 5700