CHARLES STANLEY

Monthly Market Commentary

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May 2021

In a month when a calmer market environment prevailed, positive returns for Sterling-based investors were hard to come by. Whilst most major equity indices made further progress in May, Sterling strength eroded these returns, with balanced portfolios ending the month little changed compared with the previous month end.

With the Bank of England reducing its pace of bond buying, the US Federal Reserve remained resolutely dovish (for now). As a result, Sterling rallied by 2.8% versus the US Dollar and gained 1.4% in trade-weighted terms. On a year-to-date basis trade-weighted Sterling was 4.6% firmer, a relative tailwind for a more domestically orientated asset-allocation approach. Aside from a rally and modest contribution from fixed income, European equities proved to be the main positive contributor to returns, with both UK and Eurozone indices benefitting from a greater amount of cyclicality relative to other markets and positive gearing to the reopening of the economy.

Elsewhere, precious metals partially reversed a poor run, with gold rallying 4.8% in Sterling terms (still 11% below the peak of last summer). In general, the backdrop of a weaker Dollar, rising inflation and strong global growth momentum were positive for commodities, with the Bloomberg commodity index rallying 2.7% in Sterling terms. This brought year-to-date returns up to an impressive 14.3%.

In general, equity returns aligned with this reflation theme. Energy and materials outperformed the broader market on the positive commodity price backdrop – and financials benefitted from expectations of future central bank policy normalisation as the global economy continued to recover from the effects of lockdowns. At the so-called secular-growth end of the investment spectrum, big tech continued to languish. However, there was some renewed investor interest in consumer staples and healthcare, which helped provide a degree of balance in investment returns.

As has been the case since the pandemic first started, equity investors needed to keep a close eye on central bank guidance, as unprecedented monetary stimulus has been a key driver of the impressive rally in equities from the lows seen in March last year. The focus remains firmly on the US Federal Reserve, which has so far remained resolutely dovish in the face of a strong pickup in inflation driven by supply-side bottlenecks as the economy reopens.

The key debate the US central bank is having is whether price rises are no longer transitory but instead becoming “sticky”. In particular, there needs to be an assessment as to whether tight conditions in the labour market – and the traded goods sector – will feed through into

broad-based increases in wages and inflation expectations, which are unlikely to reverse themselves without a less-accommodative policy stance.

This month's FOMC policy meeting will be closely watched for evidence that the Fed will guide the market to a less supportive policy environment (via reducing the pace of its bond buying), but we expect much more concrete guidance to be given after its July meeting.

Elsewhere, and despite some pushback from German officials, we expect the European Central Bank to continue its more-rapid pace of bond buying until September. A key focus of its current policy is to prevent a widening in peripheral sovereign-yield spreads, which could tighten financial conditions too early in the recovery.

Asia has had to deal with a resurgence of Covid-19 at a time when the People's Bank of China has been running a relatively tight monetary policy, primarily for macroprudential reasons. This combination has generally been a headwind for regional equity performance in recent months, but we expect better relative returns in the second half of the year as infection rates decline, mobility improves and growth differentials to developed markets narrow favourably. Elsewhere, we would expect the PBoC to ease back on its tightening bias ahead of the 100-year anniversary celebrations of the Communist Party later this summer.

As before, we expect equities will remain well supported by a combination of strong growth and corporate earnings momentum, aligned with strongly pro-cyclical policy support. However, as we head through the summer and central-bank discussions about pivoting less dovishly come to the fore, the environment could be less friendly for the reflation trade.

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