Psigma
Investment Management

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# View from Psigma

## Valuation Commentary

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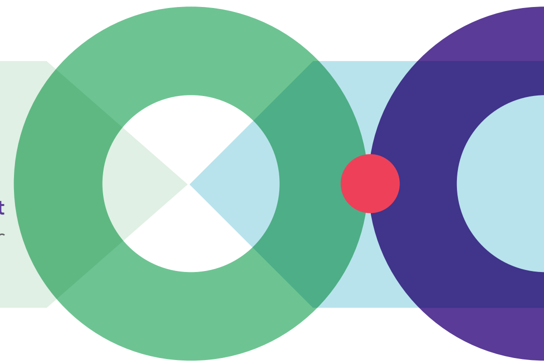

### A strong quarter for markets

The second quarter of 2021 was an unequivocally positive period for global asset markets. In stark contrast to the first quarter of the year, when selectivity was key and there were divergent fortunes for various investments, pretty much everything went up in value. Some of the positivity made perfect sense, as investors continued to enjoy the support of three key pillars which we had suggested would underpin financial markets and lead to healthy gains through the early part of this year: the economy continued to heal, governments continued to spray money around like confetti and central banks allowed the printing presses to churn out billions of dollars, pounds, euros and yen to pay for the governments' unchecked largesse.

### Conflicts and a conundrum

But there were also more surprising moves in certain investments that traditionally benefit from falling inflation and lower expectations of future economic growth. The conundrum presented by the coordinated move higher in traditionally conflicting assets has led to a great deal of confusion, and while we can all enjoy the progress made by our portfolios in recent months, there are certainly  a number of questions we have to think about as we head in to the second half of the year.

### The economy booms back

The biggest factor we need to analyse is how strong the economic growth of the world will be as we progress deeper into 2021 and the start of 2022. Every economic data point that we assess in the Western world is currently very strong. Consumer demand is high, companies are starting to invest in their businesses, confidence in most sectors is booming and housing markets are buoyant. There are clearly greater worries in certain emerging market economies, where the medical situations remain alarming and economic activity is often restricted due to vaccination rates that are lagging behind the developed Western economies. One area where we are having to devote a great deal of our attention is China, whose stellar economic performance led the global recovery from the COVID Crisis last year, but has started to slow noticeably, partly due to the fact that the government there is trying to clamp down on many of the excesses created by the fiscal and financial responses to the pandemic last year.

### Global economy and cruising altitude

In its simplest form, we liken the global economy to a four-engine jumbo jet, with the four engines being the US, China, Europe (including the UK) and the Emerging World. Right now, the US is firing on all cylinders, aided by insanely generous handouts from the government, China is operating solidly, Europe and the UK are finally healing, and the Emerging World should recover quickly as 2021 progresses. We therefore expect growth rates for the remainder of this year and the start of 2022 to be very impressive by comparison with the last few decades.

### Not all plain sailing

There are economic uncertainties further out in the next few years that concern us. Were China to lose control of its current balancing act between

economic progress and debt management, we would have to take a less progressive economic view. In addition, there are plenty of extremely optimistic projections (that have become the consensus expectations) where investors assume that the US government can keep on giving away free money with no consequences. Finally, for economies like the UK and Europe, where economic potential is low, due in no small part to our enormous debt piles and stultifying demographics, we find the current views around a "roaring twenties" economic scenario bizarre. Even if we will not know definitive answers to each of these questions for some years to come, what we know for sure is that we will have to keep very open minds on these and a range of other factors, and be prepared to change our views and adapt portfolio positioning if we are wrong.

## Lean on me

We remain constant in our view from the start of 2021 that the economic pillar should continue to support further gains in certain asset markets as we travel further through this uncertain year. In a similar vein, we have not adjusted our expectations for central bank activity; all major central banks will remain in supportive mode, by keeping interest rates at 0% (or lower in the case of Japan and Europe) and will continue to aggressively finance government spending through the financial alchemy that is quantitative easing (printing money to buy government bonds). Central banks will actively seek out excuses to persist with these policies (once they are done with the economic recovery, they will cite climate change and economic inequality as their next missions). Any excuses are just smokescreens for the reality obvious to anyone seeking out the truth: governments are out of cash and rapidly exhausting willing counterparties to finance their unchecked spending plans. To us, this dynamic seems unlikely to change any time soon. The days of austerity are banished to history; there is now pressure on governments everywhere to spend more rather than less, and ultimately somebody needs to finance this debt. The central banks are the only people who can perform this necessary but potentially destabilising function without causing massive economic and financial market disruption.

## Inflation? Anyone?

Whilst markets have been hinting in recent weeks that inflationary pressures should abate quite quickly, we are less sure that "sticky" inflation will not be the biggest problem ahead for central bankers and their intended indefinite loose monetary policies.

Central bankers are all singing from the same hymn sheet: they believe (or claim to believe) that inflation is "transitory" and will pass quite quickly when a full economic "reopening" has occurred and the distortions in global supply chains have been straightened out. They could be right, and we do believe that the high inflation rates we will experience will subside as the year closes out. However, we are far less relaxed about inflation further out, as inflationary thoughts are seemingly gaining traction in consumers and corporate managers' minds alike, which could well lead to persistently rising prices. Pressure points in the labour market are building, and we can all see clear evidence that the prices of everything we pay for are going up. Certainly, on the other side of the equation, structural disinflationary forces such as debt, demographics and technological advances pose obstacles to rising prices, which is why we believe that "inflation uncertainty" will continue to be a theme in the decade ahead. In basic terms, we can find sympathy in both the deflationist and the inflationist arguments, but we believe that inflation rates will be higher this decade than they were in the last.

## Portfolio positioning

Inflation continues to be the dominant factor that we think about when constructing our client portfolios. In very simple terms, we believe that the risk and reward potential of positioning our portfolios for inflation risks remains positive. Should inflation become entrenched, there will be few places to hide in financial markets, but we are embracing those investments that should be able to generate inflation-plus returns. These investments include inflation-linked bonds, gold mining shares, commodities, asset-backed securities and certain companies that would benefit from rising inflationary pressures. However, we are not putting all of our "eggs in one basket"; in the last three months, some of the better returns from our selected investments have come from those investments that do well when inflationary fears are low, such as "growth" companies and some of our higher quality fixed interest investments. 2021 has already clearly demonstrated the need for diversification in our investment strategies and we will persist with our balanced approach.

## Conclusion

2021 has so far played out close to the forecasts that we outlined at the start of the year. The global economy is reopening, and COVID-19 is hopefully becoming a backward-looking issue, even if certain

fears and restrictions still linger longer than any of us hoped for or expected. Global asset markets have responded positively to the growth backdrop and investors have been rewarded for taking risk in their portfolios. Central bankers continue to help finance governments' extraordinary spending plans and have demonstrated a willingness to look through rising inflationary pressures and focus on doing all they can to help the global economy heal. Such policies have been justifiable while the economy was suffering, but now economic activity is so obviously recovering they are playing with inflationary fire by keeping their emergency policies in place.

Inflation remains the central pivot of our investment philosophy, process and current positioning, but 2021 has shown that being entirely wedded to one view could lead to disappointment. We persist with our balanced and diversified approach, but recognise that the best way to help our clients meet their investment aims and aspirations is to find ways to protect against rising inflationary pulses. We know that the future is perilously hard to predict at the best of times, but in today's situation it seems harder than ever. However, we remain confident in our investment strategies and are prepared for the battles ahead. Given that football has been so in vogue over the last month, we thought the words of the world's best ever footballer Pelé were particularly relevant at this time: "The more difficult the victory, the greater the happiness in winning". Enjoy your summers and thank you for your support.

**Tom Becket**
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