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Q3 outlook: Summertime for investors?

We continue to favour staying long equities, and are prepared to increase our exposure in a dip, as investors bask in the sunshine of a global economy in mid-cycle.

Emiel van den Heiligenberg
Head of Asset Allocation

From a strategic perspective, the current market environment is increasingly challenging for asset allocators. We see four reasons for this:

1. Bond yields are low, so eventual interest rate increases would threaten total returns

2. The rally in equities from their trough last year has been extremely strong, with some valuations looking frothy

3. The correlation between bonds and stocks is turning negative

4. This economic cycle might be unusually compressed – we appear to have gone from early to mid-cycle within 12 months

We see several possible responses: more diversification through a greater focus on alternatives, like forestry; seeking steeper curves in markets where yields can still compress and bonds are still diversifying (like Korea and China); looking for alternatives to bonds as defensive assets – for example, in currencies and alternative risk premia.

In addition, in some of the portfolios we manage, we take a dynamic approach to managing risk through the cycle. Our investment framework, for example, helps us to take more market risk when we are early cycle – the moments when valuations are attractive and the economy just emerged from recession (we have just been in such a period). In later cycle periods, we become more cautious towards risk assets. We also believe more unconstrained, absolute-return strategies have become an attractive option to provide even more diversification in navigating the four mentioned challenges.

On the more tactical side, the trajectory of the pandemic still dominates our thinking, in particular the spread of the so-called Delta variant. There is a race between this variant and vaccinations in many developed markets, in which the UK appears to be outperforming as even though cases are increasing rapidly, hospitalisation and deaths remain low. Countries with lower vaccination rates, like Australia and including most emerging markets, may face new waves of COVID-19.

LGIM

Lower for even longer

The spectre of rising inflation is another issue very much in focus, as Chris discusses below. Here, we take comfort in the recent, moderately hawkish signals from the US Federal Reserve (Fed), which we see as bullish for risk assets.

This step by the Fed, in our view, lowers the risk that we will face high-inflation scenarios of the sort anticipated by some market commentators, which would force the central bank to step sharply on the monetary-policy brakes to prevent prices from rising out of control.

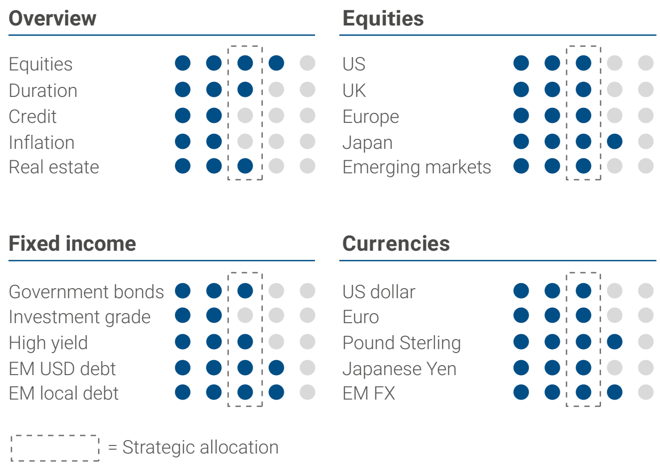
Indeed, the flattening of the yield curve indicates a continuation of the 'lower for longer' environment, given that a more active Fed in the short term should mean fewer rate increases and weaker inflation over the long term. We believe this is bullish for growth assets like equities in general and tech stocks in particular.

Earlier this year we talked about rays of light for the global economy; now the sun is truly out and we intend to enjoy it.

As a result, we continue to favour staying long equities and are prepared to increase our exposure in a dip, while also preferring this asset class to credit. Our confidence here is boosted by the positive outlook for the Q2 earnings season, which should underpin valuations, and investor sentiment, which we do not believe is extreme.

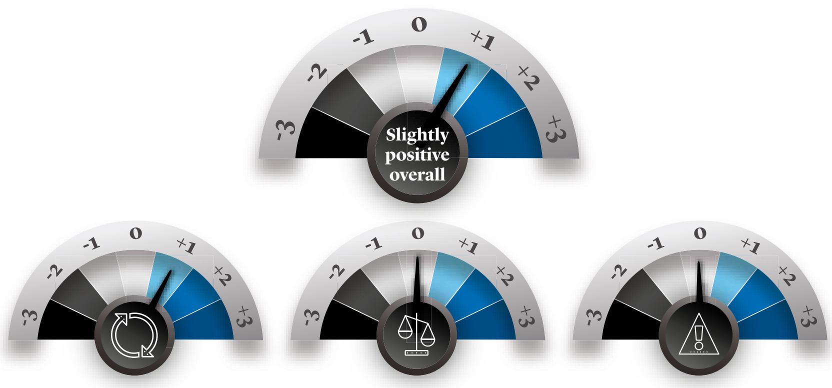
We are expressing this view through the themes of technology, as noted above, and 're-opening', whereby we still expect stocks that underperformed in the crisis to catch up. Elsewhere, we retain our negative bias towards inflation, towards which the market has recently moved.

Our key asset class views



This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 8 July 2021.
The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Summary of LGIM's asset allocation core view



Economic cycle

Coming out of recession is the most positive phase of cycle

Valuations

Relative valuations now less attractive

Systemic risk

Concerns around both political and credit risk

Source: LGIM. Views current as at 8 July 2021. Forward-looking statements are, by their nature, subject to significant risks and uncertainties and are based on internal forecasts and assumptions and should not be relied upon.

Economic cycle

- Rapid growth to continue, backed by extensive policy support
- Global economy set to return to pre-trend levels by 2023
- US to run out of easy expansionary space within 12 months

Valuations

- Absolute equity valuations are high but not stretched
- Relative valuations remain a positive factor
- Credit spreads now below average and less attractive

Systemic risk

- Troubled relationship between US and China
- Impressive institutional resilience in the last year
- Global debt burden only worrying if inflation re-emerges

Christopher Jeffery
Head of Rates & Inflation Strategy

Inflation: Waiting for the tiger to roar

After the torrid sell-off in global bond markets in the first quarter, commentators lined up to predict the end of the world's largest bond market in late March. As is often the case whenever a consensus emerges, markets subsequently refused to play ball.

The second quarter was, therefore, a tranquil affair: despite consecutive record-breaking months for core CPI inflation in April and May, US Treasury yields fell back by 27bps over the second quarter, as market inflation expectations subsided.

That same dynamic has played out closer to home. This was a quarter in which Andy Haldane, the chief economist of the Bank of England, warned about the "inflation genie" morphing into the "inflation tiger". But it's not much exaggeration to say that we've seen concerns building everywhere except in the bond market: long-dated gilt yields have fallen fairly steadily over the quarter.

We think there are three main factors at play in both the global and UK markets that help explain this dynamic.

1. The lack of an additional fiscal narrative

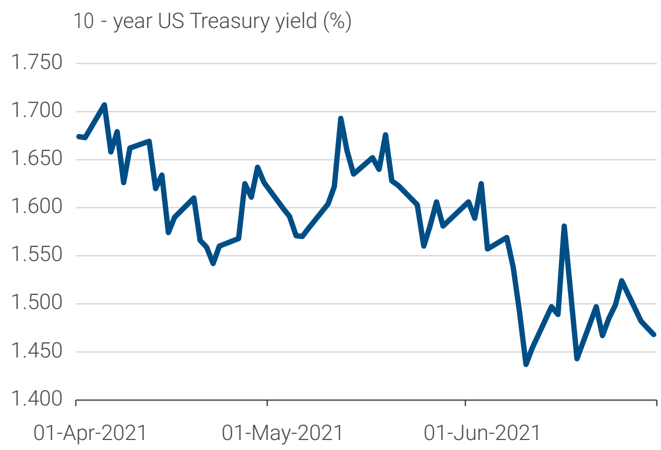
2. Supply shortages in the labour market

3. The change in tone from the Fed

On the fiscal side, significant and immediate stimulus in the first quarter has given way to haggling over infrastructure in the second. In the UK, we are now faced with the unwinding of various support schemes (furlough, stamp duty, business rates relief). As those fiscal buttresses are removed, we will learn about the structural stability of the recovery; there's a decent chance they reveal a few cracks in the foundations.

The last two US labour market reports have shown weak employment growth and strong wage increases, pointing to supply constraints. That fits with anecdotes of temporarily tight labour market conditions on both sides of the Atlantic.

Yields retreat



Source: Refinitiv, as at 1 July, 2021. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

The near-term pressure on wages does less to change the market's perception of inflation prospects than would headlines about record jobs growth and plunging unemployment rates.

FAIT accompli

And finally, we've had the change in tone from the Fed. "Flexible Average Inflation Targeting" was supposed to mean strategic patience in the face of near-term inflation pressures. Fed policymakers encouraged us to have faith in FAIT. Instead, promises to look through temporary price spikes have been watered down by bringing forward the likely timing of rate hikes into 2023. If we are seeing the end of the policy of benign inflation neglect, there is much less reason for the markets to worry about runaway inflation down the line, as Emiel notes.

Turning to the third quarter, we expect US labour market data to set the global narrative. If strong employment growth returns, global yields can resume their upward march. Regardless, we anticipate gilts will outperform, given that fiscal dynamics are changing more rapidly than elsewhere, and US breakeven inflation will continue to deflate as temporary wage and price bottlenecks dissipate.

Lars Kreckel
Global Equity Strategist

Retail investors and the 'meme' stock frenzy

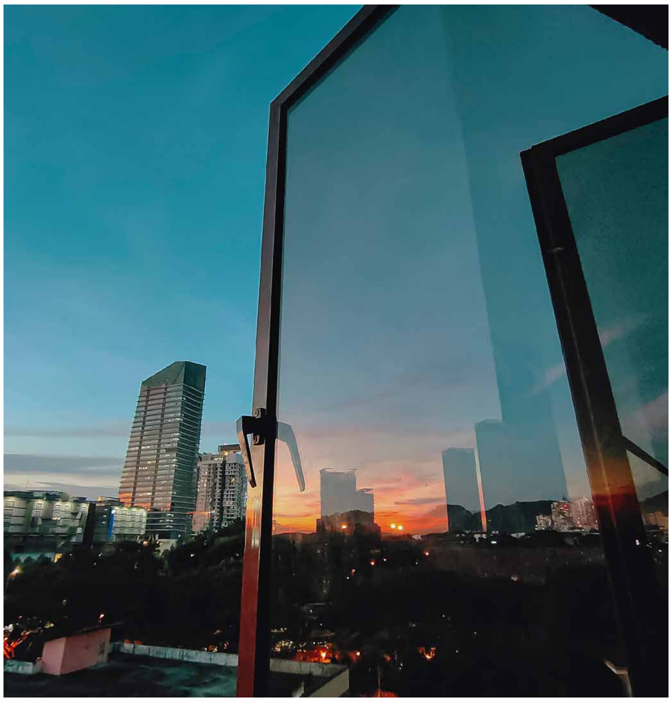
Retail investors have been piling into 'meme' stocks again in recent weeks, raising two key questions: How significant is this phenomenon? And what does it mean for the broader equity market outlook?

Regarding the first question, the extreme moves continue to be limited to a handful of stocks with no obvious signs of volatility spilling over into the wider market.

If you look closely enough, you can see the gyrations of stocks favoured by investors who communicate on Reddit, such as Gamestop* and AMC*, reflected in the relative intraday performance of US small-cap indices like the Russell 2000. But the large-cap S&P 500 index put together a long string of daily moves smaller than 1% in the last period of meme stock volatility, when those seen in the Russell 2000 were larger.

What's more, this most recent rally in retail favourites has been far weaker than the move we saw in the spring, both in terms of the magnitude of outperformance by the stocks involved and in terms of retail trading volumes. The share of Trade Reporting Facility volumes (seen as a proxy for retail activity) of overall US market volumes has stayed in the low-mid 40% range, which is far above pre-2020 levels, but a good bit below the nearly 50% mark regularly reached earlier this year.

Overall, it's still fair to say that the froth that was apparent in several retail-driven niches of the market in spring is much less of a concern today. This is also evident in SPACs (special purpose acquisition companies) where activity and prices have dropped a lot, and in the digital asset sphere, where cryptocurrencies like bitcoin have reversed recent gains.



Early days

With regard to the second question, if retail investors form a growing segment of equity flows, then we are still in the early part of this story.

The activity has so far been concentrated in investors who use platforms like Robinhood. These people tend to be younger and less wealthy than the traditional retail investor base. US households own just under a third of domestic equities, but the top 10% of households own almost all of that, according to Goldman Sachs.

Meanwhile, data from brokers show net purchases of equities this year by private clients, but the magnitude of these flows still pales into insignificance when compared with the previous decade's net selling by such investors.

So far, the increase in retail activity appears to have been driven by a small segment of investors involved in the meme stock craze. With data on private client flows suggest activity is spreading to more traditional retail investors, albeit slowly, we believe this theme remains much more of an upside than a downside risk for markets.

* For illustrative purposes only. The above information does not constitute a recommendation to buy or sell any security.

Chris Teschmacher
Fund Manager

Decarbonisation: seeking stratospheric growth

Decarbonisation was one of the biggest themes of 2019 and 2020. Rightly so, we would argue: with the 2021 United Nations Climate Change Conference (COP26) taking place in November, this could be another important year for decarbonisation.

Yet the action required to decarbonise the global economy is not just a social imperative; we believe it is also an opportunity to align portfolios with climate objectives and invest in a long-term growth market focused on effecting positive change. Indeed, an estimated $130 trillion of investment is needed to achieve global net-zero emissions (including $20 trillion by 2025)[1] – an essential investment in our future world but also an investment opportunity in itself.

So how can we invest in this theme in practice? The broad trend towards decarbonisation obviously spans many sectors, so we break it down into several categories:

Each of these categories will be subject to its own economic dynamics and idiosyncratic factors, but in combination we believe they represent the industries and technologies critical to meeting the world's net-zero ambitions.

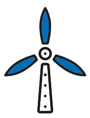
With that in mind, we have built a basket of approximately 25-30 stocks that are both relatively pure plays in each area and – for portfolio and risk-management purposes – have a decent market cap and liquidity; are more or less evenly weighted across the sub-sectors; and offer regional diversification.

ESG impact

Overall, our conviction in decarbonisation as a theme for the medium to long term is based on the potential benefits it can offer to a portfolio. In our view, these include:

- Exposure to a long-term secular growth trend. Renewables are set to account for 95% of the net increase in global power capacity through 2025, for example [2]
- Diversification potential, as the underlying stocks in the basket are generally smaller than the largest names in indices weighted by market capitalisation, and as the theme should be driven by secular growth dynamics rather than cyclical trends over the longer term
- Tangible ESG impact and alignment to the UN's Sustainable Development Goals (SDGs), such as 'Responsible Consumption and Production' and 'Climate Action'

Despite the bullish outlook, we must remain aware of the risks. Specifically, to help ensure our investment thesis remains valid, we will monitor that the global regulatory direction and investor flows remain supportive, that valuations in our exposure do not become excessive, and that market reaction to both macro and company-specific news around the theme does not turn negative.

 **Clean energy generation**	 **Storage batteries**	 **Commodities**	 **Renovation**	 **Picks and shovels**
• Solar • Wind • Hydrogen • Generation • Components	• Materials • Manufacturing	• Copper • Hydrogen • Lithium etc.	• Residential • Commercial	• Cables
e.g. Orsted* – Danish renewable energy company	e.g. Livent* – focused on lithium for the next generation of batteries	e.g. Turquoise Hill* Resources – copper mining	e.g. TopBuild* – a leading installer and distributor of insulation and building material products	e.g. Prysmian Group* – world-leading cable manufacturer

[1]Source: Legal & General, 2021 (https://www.legalandgeneralgroup.com/media/18405/lg-ar-2020_web-final.pdf).
[2] Source: IEA, 2020 (https://www.iea.org/reports/renewables-2020).
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