eden park
INVESTMENT MANAGEMENT

EPIM Brunel

Quarterly report – Q2 2021

Introduction

Welcome to the EPIM Brunel investment review. In this report we will be covering information and events that influenced performance during the second quarter of 2021.

Strong economic growth continued in the second quarter of the year, driven by stimulus measures, pent-up demand and the successful vaccine roll out. The US and UK labour markets also improved, although unemployment remained elevated. The spread of the Delta variant dented optimism, yet global equities produced positive returns as governments ramped up their vaccination efforts and lockdown restrictions eased.

Inflation was a key focus, particularly in the US where the core consumer price index (CPI) for May jumped by 3.8% year-on-year – the sharpest increase in nearly three decades. The Federal Reserve reaffirmed its view that high inflation is transitory, although it surprised the market by signalling interest rate hikes could come as early as 2023. Despite this, equities continued to perform strongly while longer-term bond yields retreated – perhaps reflecting a greater sense of certainty around central bank policy measures.

Business activity in the UK, US and eurozone is expected to keep expanding over the coming months, albeit at more moderate levels. Together with accomodative cental bank policy, stabilising bond yields and growing corporate profits, the overall outlook for equities is a positive one.

Market overview Q2 2021

- The $1.9trn Covid-19 stimulus package that was signed into law in March continued to drive strong US growth in the second quarter.
- US households have built up roughly $2.3trn in excess savings since the pandemic hit, and some of these savings will boost spending in the months ahead.
- However, signs are emerging that the US growth momentum is cooling. Continental Europe is catching up fast and while Japan remains a laggard, it is on the verge of picking up. This could act as a headwind on the dollar, which rallied in the second quarter despite the general risk-on tone in global markets.
- US mortgage rates are off their lows, which is moderating some housing indicators, yet the overall housing backdrop remains strong.
- US core inflation accelerated to 3.8% in May from the previous year, which was the fastest pace since 1992. Our view is that high inflation will prove transitory, with slack in the labour market keeping wage pressures in check.
- Even with a base case view that high inflation is transitory, the risk-reward backdrop for bonds is unappealing. The Fed's forecast of no rate hikes until 2023 acts as an anchor on bond yields, but it seems too early to believe that yields have peaked for the cycle.
- The US equity market saw strong gains in the second quarter and is now at the relative performance all-time high attained last September.
- Emerging Markets was the best performing equity region as the vaccine rollout started to gather pace and commodity prices rose.
- Globally, Corporate Bonds outperformed Government-issued Bonds.

The big picture in Q2

- Global equities performed strongly in the second quarter, rising by 6.6% as governments accelerated the roll out of Covid-19 vaccines.
- UK equities were up by over 5.6%, and overseas equities gained 7.2%.
- Within overseas equities, Emerging Markets outperformed with a gain of 10.2%, whereas Japanese equities fell by 0.5% as the government delayed the easing of lockdown restrictions. US equities rose by 8.6%.
- In Fixed Interest, Bonds rose 2.1% with Corporate Bonds outperforming Government-issued Bonds.
- The 10-year US Treasury yield declined over the quarter from around 1.7% to 1.5% as the latest Fed meeting reduced fears about the economy overheating. The UK 10-year Gilt yield slipped from 0.9% to 0.7%.
- Growth stocks staged a comeback in the second quarter as bond yields stabilised, although value stocks still outperformed.
- Property returned in excess of 10%, Gold was up almost 4.0% and Absolute Return added just under 2.0%.
- Commodities saw strong gains on the back of surging crude oil and natural gas prices.

EPIM Brunel performance

EPIM BRUNEL PERFORMANCE	Q2	2021 YTD	1yr	2yr	3yr	4yr	5yr	2020	2019	2018	2017	2016
Cautious Portfolio	3.00	2.13	8.59	11.65	17.29	21.36	29.91	6.72	11.24	-2.70	5.87	9.81
Income Portfolio	3.84	4.44	13.45	15.29	21.11	26.85	40.97	6.82	14.51	-4.20	8.08	12.28
Balanced Portfolio	5.12	7.63	19.47	20.76	27.18	35.08	55.69	7.84	16.58	-3.92	8.84	15.42
Growth Portfolio	5.82	9.74	24.98	26.44	32.62	46.13	73.90	10.30	18.39	-4.00	11.77	16.71
Global Equity Portfolio	6.53	11.47	29.32	29.16	35.54	51.11	84.01	10.00	22.13	-4.85	12.46	17.87

All figures shown above are calculated to 30 June 2021.

Performance Calculation: All income is reinvested. Performance is shown inclusive of underlying fund charges but gross of EPIM Brunel's investment management charge. Deduction of this charge will have the result of reducing the illustrated performance.

EPIM Brunel performance highlights Q2 2021

Asset Allocation

What worked and why?

Being underweight in bonds and overweight in North American equities were both beneficial for performance over the quarter.

What didn’t work and why?

Being underweight in Global REITs and overweight to Absolute Return were a drag on performance.

Fund Selection

What worked and why?

Fundsmith Equity and Baillie Gifford American outperformed as growth names rallied in the US.

What didn’t work and why?

We saw softer performance from the more defensive strategies of Blackrock Continental European and Newton Asian Income. The growth rotation in the US was absent in emerging economies and Fidelity Emerging Markets underperformed as value names benefited from rate hikes and stronger currency in the region.

EPIM Brunel Portfolio changes Q2 2021

Asset Allocation

The Asset Allocation Committee met on three occasions over the quarter. On each it was felt appropriate to keep the tactical guidance unchanged. Regional equity weights were adjusted as equity markets performed at different rates.

Fund Selection

Regional equity market performance drove some small reductions in the allocation to Asia and emerging markets and some increases in Europe and North America. In the MI Select Managers North American fund LM Royce US Small Cap Opportunities was removed in April. BNY Mellon US Equity Income was introduced at the end of June and JPM US Equity Income was reduced to accommodate it.

EPIM Brunel performance against benchmarks

- The Cautious model outperformed the IA Mixed Investment 0-35% Shares benchmark last quarter by 0.5% and rose by 3% in absolute terms.
- The Income model outperformed the IA Mixed Investment 20-60% Shares benchmark last quarter by 1.2% and rose by 3.9% in absolute terms.
- The Balanced model outperformed the IA Mixed Investment 40-85% Shares benchmark last quarter by 0.2% and rose by 5.2% in absolute terms.
- The Growth model outperformed the IA Flexible Investment benchmark last quarter by 0.7% and rose by 5.9% in absolute terms.
- The Global Equity model underperformed the IA OE Global benchmark last quarter by 0.3% but rose by 6.6% in absolute terms.

Investment outlook

Cash

We recommend retaining a small cash overweight. We want to have liquidity on hand so we can opportunistically add to positions in other asset classes in the event of corrections.

Bonds

With inflation expectations rolling over, investors relaxed with respect to Fed tightening prospects. Given that we're likely not far off the peak in global growth momentum, safe haven longer-dated bond yields have moved lower. It seems too early to believe that bond yields have reached their cyclical high. That peak typically doesn't happen until much closer to the end of the economic cycle, when labour market indicators stop improving. We believe there is lots of room for the jobs recovery to continue. That said, the debt to GDP ratio across the household, corporate and government sectors is either at or approaching new all-time highs. With leverage so high, the global economy is vulnerable to rising interest rates. This sensitivity suggests that any rise in bond yields will ultimately be self-limiting, and the peak in bond yields this cycle will be lower than we've seen in the past.

Global Equities

Central banks are showing no signs of easing off the stimulus gas pedal, and the corporate profit outlook is bright. We believe global equities can continue to push higher over the next 12 months, albeit with corrections along the way. In terms of signposts for reducing our equity allocation, we are watching the bond market closely. Since the correlation between Treasury yields and the S&P 500 turned positive in the late 1990s, the equity market has peaked after increasingly small rises in Treasury yields. The good news is that the threat from bond yields has eased, as they've dropped lower in recent months. Another signpost will be global consumer confidence, which often peaks just before a fall in global equity markets. There is still room for confidence to rise, but probably not much.

Alternatives

Given our expectations that real bond yields will move higher, we have a small underweight in Gold. An environment of rising real bond yields would not be great for REITs either. Risk/reward appears to be superior in other areas of the equity market. We therefore stick with a continued modest REIT underweight. Finally, we remain underweight Absolute Return. It would take a souring in equity market prospects for us to turn more optimistic on this asset class.

UK Equities

From late October last year until mid-June, value outperformed growth and the UK outperformed the global equity benchmark. The reason was that energy, banks, materials and insurance – all value sectors the UK is heavily weighted in – were strong outperformers. Since then, these sectors have lagged. Looking ahead, commodity prices should be supported if the dollar weakens anew as we expect. Meanwhile, UK financials such as banks need higher bond yields to outperform. It's probably too early to expect that we've already seen the cyclical highs in bond yields. The bottom line for UK equities is there's probably still a little more room to outperform as we move toward peak global growth. But like the cyclicals versus defensives trade, that window for outperformance looks like it's beginning to narrow.

US Equities

The structural demand outlook for tech/digital stocks, which the US is heavily weighted in, is attractive. However, there are several reasons to believe that now is not the best time to position for continued US outperformance. For one, as the global economy reopens, it would not be surprising to see the trend of tech spending relative to GDP reverse somewhat, as occurred in late last year. In addition, there's probably not much downside in bond yields. On the contrary, history suggests there is further upside as the cycle matures. Rising bond yields are a headwind for the relative performance of growth-oriented tech stocks. Meanwhile, global growth leadership is shifting away from the US to other regions.

Europe ex-UK Equities

The euro has corrected lower of late, which to a large extent reflects the market repricing of the timing of Fed versus ECB rate hikes. European FX weakness has weighed on common currency relative performance. Nevertheless, favouring the region still appears to make sense. It's rare that Continental European FX reaches a high versus the dollar ahead of a peak in global economic growth. Moreover, the outperformance of the region has been tiny relative to the global growth boom. Some catch up in relative performance seems likely, especially in the context of growth momentum shifting away from the US and toward Europe.

Japan

Japan remains far behind most of the rest of the developed world in terms of the share of its population who are vaccinated. However, the pace of vaccinations in Japan has accelerated rapidly. The relative growth backdrop will begin to shift in Japan's favour as the country catches up on vaccinations, which should provide some support to the yen and common currency relative performance. The Japanese market is heavily weighted in cyclicals, which should support Japan at a time of accelerating global growth momentum. This, combined with the more favourable currency backdrop, should see Japanese equity relative performance improve this quarter after a very rough Q2. While we wouldn't bet against Japan at this stage, we wouldn't position for outperformance either. For that to occur at a sustainable level, we would need to believe that domestic growth prospects relative to the rest of the world are set to improve. Currently, this is not the case.

Asia ex-Japan Equities

The deep correction in the consumer-oriented Chinese big tech sector, against a structural backdrop that should see consumer spending become an increasingly important growth driver, raises the question of whether now is a good time to increase weightings. We suspect not. The market is still digesting a much tougher regulatory stance toward big tech, which has major implications for the earnings outlook. Moreover, the latest action against ride hailing company Didi suggests that Chinese authorities have not yet finished their regulation drive. While lower share prices relative to the market are appealing, if that drop in prices is accompanied by a deterioration in growth prospects, then their valuation hasn't become more attractive. Against this backdrop, a weighting in Asia ex Japan that is consistent with performance that slightly lags that of the global equity market is justified.

Emerging markets ex-Asia

EM ex Asia has performed weaker than expected given the prevailing macro fundamentals. Part of the reason is that the region has been hit harder than most by the pandemic. However, regional growth momentum in much of EM ex Asia is expected to accelerate as the crisis subsides over the course of the year. This improvement should come alongside a growth deceleration in many other parts of the world, which should bolster the attraction of this very inexpensively priced region. Against this backdrop, and considering we expect oil prices to keep rising and the dollar to weaken anew, it is probably too early to abandon this position.

The value of investments, and any income from them, can fall and you may get back less than you invested.

Neither simulated nor actual past performance are reliable indicators of future performance. Performance is quoted before charges which will reduce illustrated performance.

Investment values may increase or decrease as a result of currency fluctuations.

Information is provided only as an example and is not a recommendation to pursue a particular strategy.

Information contained in this document is believed to be reliable and accurate, but without further investigation cannot be warranted as to accuracy or completeness.

We or a connected person may have positions in or options on the securities mentioned herein or may buy, sell or offer to make a purchase or sale of such securities from time to time. In addition we reserve the right to act as principal or agent with regard to the sale or purchase of any security mentioned in this document.

The opinions expressed are not necessarily those of Eden Park Investment Management.

This publication is for FCA authorised individuals only and should not be distributed in whole or in part to retail clients.

BDM3407_2107_0.4
Issue date July 2021