marketmatters

The story of the quarter has been one of equity outperformance relative to bonds and the themes dominating the market movements remain the same as in Quarter 1 2021, although the severity of their impact on the market appears to have muted somewhat in Quarter 2 2021. These themes specifically are: ‘The Great Reopening’; economic recovery; inflationary pressures; equity outperformance relative to bonds; and a change in which sectors are producing the strongest returns.

The narrative of the year so far has been one surrounding the ‘great re-opening’ of the global economies following months of lockdowns, which in turn has led to a large increase in economic, business and consumer activity. This narrative has then led to increased fears of inflation as there have been high levels of business and consumer demand for goods and services which have been in relatively tight supply due to the disruptions of global supply chains during lockdown.

So, what does this mean for markets? So far this year, within equities some of the most out of favour sectors during the lockdowns have performed the best, while equities in general also strongly outperformed bonds which have posted negative returns in 2021 so far - this can be seen in Figure 1 below.

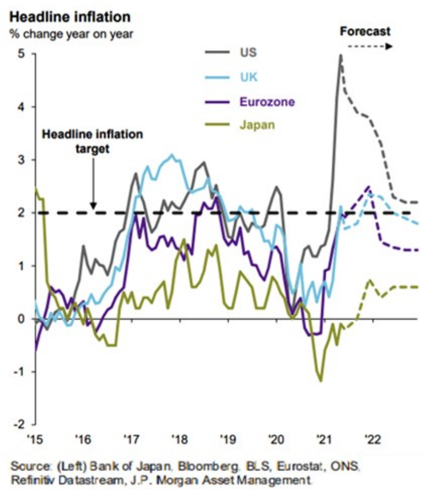
Figure 1

Typically, the sectors which benefit from rising levels of economic activity near the start of an economic cycle are grouped together as ‘cyclical sectors’ (Energy, Materials and Industrials), while equities which are less impacted by the economic cycle are classed as ‘defensive sectors’ (Consumer Staples and Technology).

Figure 1 shows us that both the cyclicals and defensives outperformed bonds over the year so far, with cyclicals posting the best returns, but also shows us that in Quarter 2 of 2021 this very prominent trend lessened a little with the defensive sectors closing the gap on the cyclical stocks during May and June.

Figure 1 also shows the prominent trend in bond markets throughout 2021 so far, specifically a trend of negative performance. Much of this performance is due to the increase in risk appetite for some investors as the global economic recovery starts to take hold and the increased fears surrounding inflation. Rising inflation expectations are negative for bond markets due to the link between inflation, interest rates and real returns.

Figure 2



When inflation expectations increase beyond the target levels set by central banks, the markets expect central banks to combat this by raising interest rates as too much inflation erodes away the purchasing power of businesses and consumers within an economy and erodes away real investment returns.

The raising of interest rates has the potential to impact how attractive various asset classes appear for investment - specifically, bonds typically fall in value when interest rates increase.

Looking at Figure 2, we can see that the expected increase in inflation has materialised in most of the major developed regions -- except Japan – and is either above or in line with the central bank’s target which is typically set at 2% per year.

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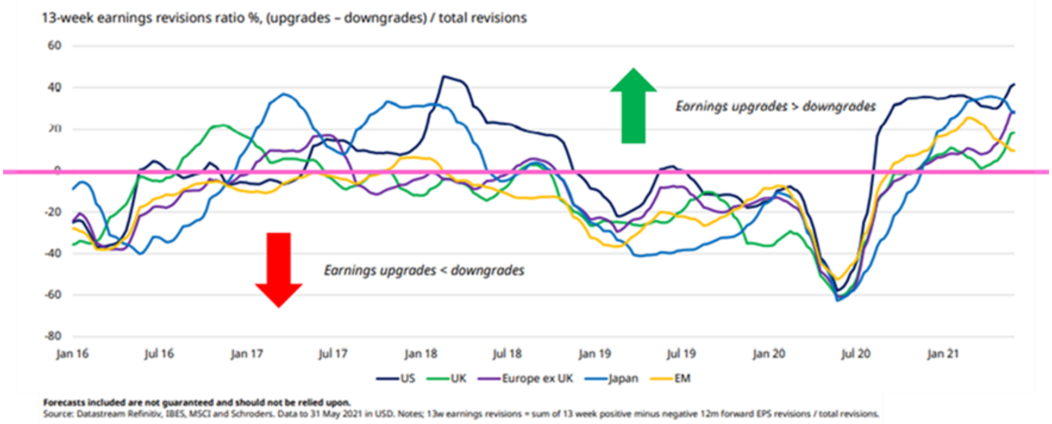
Whilst the rapid spike in inflation may seem a little worrying, one of the key things to take away from Figure 2 is the forecast for inflation going forward. Notably, inflation is set to decline from the levels we are presently experiencing, and this idea of the inflation being transitory is precisely what the central banks are positing.

Due to the central bank's insistence that the inflation will be transitory, they have been relatively reluctant to raise interest rates to fight off any of the higher levels of inflation we are experiencing as doing so may potentially hinder economic recovery out of the lockdown induced recession of 2020. This reiterated expectation by the central banks to keep interest rates low has then led to bond markets posting relatively flat returns in Quarter 2 2021.

It is also important to remember that not all inflation is bad and that, so long as there is a strong demand for goods and services, the price inflation companies are experiencing -- due predominantly to disruptions to global supply chains -- should be able to be passed onto the consumers without pinching corporate profit margins too much. This means that companies benefit from the strong demand of other businesses and consumers and there is potential for ***some*** inflation being positive for corporate earnings.

Figure 3



During the second quarter of 2021, we also witnessed another encouraging sign of recovery. Corporate earnings have been increasing and, as seen in Figure 3, the ratio of positive earnings upgrades, relative to negative earning downgrades has also been increasing in most regions around the world. Both of these positive corporate earnings trends have benefitted equity markets strongly throughout the quarter and throughout 2021 so far as the world returns back to some pre -covid normalisation of economic activity.

Portfolio Performance

The table below shows performance of our discretionary risk rated portfolios over the course of the last 1 and 5 years. The charts are based upon our existing discretionary models looking back and so only take into account the asset allocation and fund changes made since March 2017 i.e. since the models were created. The data beyond this follows the asset allocation for risk rated portfolios and uses the respective Investment Association Sector averages for the holdings. The table also compares performance against the FTSE All Share in order to demonstrate the importance of spreading risk through diversification. Whilst a direct comparison of our portfolios with an equity index such as the FTSE All Share is not like for like it does give an indication of volatility and performance differences on a risk-adjusted basis.

	Cumulative Performance (%)									
Name	Q1'21 - Q2'21	Sector	Q4'20 - Q2'21	Sector	Q2'20 - Q2'21	Sector	Q2'18 - Q2'21	Sector	Q2'16 - Q2'21	Sector
GDP 3 Historical IA Sector	2.4	2.4	2.3	1.7	7	7	13.2	11.7	28.5	20.6
GDP 4 Historical IA Sector	3.3	3.5	4	4.5	11.8	12.9	18	15.2	37.2	30.6
GDP 5 Historical IA Sector	4.1	4.8	5.6	6.6	16.6	17.5	23.3	21.4	51.4	45.8
GDP 6 Historical IA Sector	4.4	4.8	6.6	6.6	20.4	17.5	27.2	21.4	62	45.8
GDP 7 Historical IA Sector	4.9	4.8	7.6	6.6	24.1	17.5	30.7	21.4	73.1	45.8
FTSE All Share	6.3		12.4		23		7.6		37	

Source: Financial express Analytics data 30/06/2016 – 30/06/2021. Past performance is not a reliable indicator of future results. All figures given do not include any initial, on-going or product provider fees.

The sectors used as comparators with the portfolios are the respective Investment Association Mixed Investment sectors. Gemini's GDP 3 is compared to the IA Mixed Investment 0-35% Shares sector; GDP 4 is compared to the IA Mixed Investment 20-60% Shares sector; and GDP 5, GDP 6, and GDP 7 are compared with the IA Mixed Investment 40-85% Shares sector.

The value of an investment and the income from it could go down as well as up. The return at the end of the investment period is not guaranteed and you may get back less than you originally invested.

Asset Allocation and Fund Review

The investment committee reviewed the existing asset allocation models in conjunction with the recommendations and capital market assumptions put forward by our independent actuary, Dynamic Planner. As a result of this there were no changes made to the asset allocation models and the funds for those plans that receive our discretionary fund management (DFM) service during the second quarter of 2021. For plans held under our advisory service we are also not recommending any changes to the asset allocation models. For plans held under our **advisory service** we are not recommending any changes to the asset allocation models or funds for this quarter.