EQUITIES RISE AS ECONOMIC ACTIVITY IMPROVES

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Equity markets continued to rise in the second quarter, boosted by the ongoing improvement in the global economy. An increasing pace of vaccinations and more fiscal initiatives across several regions propelled equities higher, while a very strong first-quarter earnings reporting season also contributed to gains. Although the US Federal Reserve (Fed) indicated that interest rates could be increased in the second half of 2023, the central bank's ongoing accommodative stance supported markets.

In bonds markets, global yields were more stable during the second quarter, after the sharp move higher in bond yields during the first. US yields fell as inflation expectations declined, despite the higher-than-expected inflation readings. However, European yields rose slightly, as the region's economic prospects improved due to progress made rolling out Covid-19 vaccines.

US infrastructure spending is proposed

Having passed a $1.9trn fiscal package in the first quarter, US President Biden pushed ahead with more stimulus proposals in the second quarter, proposing two additional infrastructure-related packages. A $2.3trn American Jobs Plan is designed to invest in the country's infrastructure, while the $1.8trn American Families Plan will aim to ensure a more equitable society in the post-pandemic world. The plans also include proposals to increase corporate, income and capital gains tax rates to pay for the proposed spending, which initially caused some anxiety in the equity market. President Biden has tried to get Republicans on board with these plans, which has culminated in a scaled-down bipartisan infrastructure plan. This new proposal, combined with a desire among more moderate Democrats for smaller tax increases in the overall package, will probably result in the final infrastructure bill amounting to somewhere between $2–3trn rather than the $4.1trn initially proposed.

EU recovery fund to help peripheral countries

In Europe, fiscal rules have been suspended until 2023, enabling countries to run relatively large fiscal deficits in 2021. The overall fiscal deficit across the Eurozone is now expected to be broadly in line with 2020, at around 9% of GDP. In addition, the EU's NextGeneration Recovery Fund of €750bn is also about to be disbursed. The fund will incorporate support worth approx. 5% of Eurozone GDP over the next five years and will be concentrated in peripheral countries such as Italy, Spain, Portugal and Greece.

US inflation hits multi-decade high

The quarter brought the highest US monthly inflation since 1981, with headline inflation recently rising to 5.0% year on year, while core inflation at 3.8% year on year was the highest reading in 29 years. One of the most notable developments during the quarter was the growing fear of a sustained rise in inflation due to the unprecedented levels of policy stimulus, strong economic growth and recent spikes in global inflation readings.

CHART OF THE QUARTER

Global Equities

Source: ILIM, Bloomberg. Data is accurate as at 30 June 2021.

As a result, investors were concerned that the Fed would be forced to tighten monetary policy earlier and more aggressively than expected. But the Fed has consistently indicated that it believes the rise in inflation will be temporary, and is being caused by base effects and short-term bottlenecks associated with the reopening of the economy. Although the Fed has indicated that the next interest rate rises could take place in the second half of 2023 (compared to its previous forecast of 2024), this appears to have been driven by policymakers' increased confidence in the economic recovery.

MARKET ROUND-UP

Equities

The MSCI AC World equity benchmark rose 7.2% (6.6% in euro terms). The US rose 8.9% (7.9% in euro terms), as growth was strong on the back of large-scale fiscal and monetary stimulus measures. Europe gained 7.1% (7.3% in euro terms), as the outlook for the economy improved as more people were vaccinated. Japan lagged, rising 0.2% (-1.1% in euro terms), due to sluggish growth as restrictions were introduced to combat a new rise in Covid-19 case numbers. Similarly, emerging-market equities underperformed, rising 3.9% (4.2% in euro terms) due to the slow rollout of vaccines and rising infections across a number of countries.

Bonds

The ICE BofA Merrill Lynch Eurozone > 5-year sovereign bond benchmark fell -0.9%, while the German 10-year yield rose to -0.21%. An improving growth outlook across the Eurozone pushed yields higher, and several sentiment surveys reached new all-time highs as people anticipated a rapid economic recovery.

There appeared to be some divisions among European Central Bank (ECB) policymakers and uncertainty over the path of monetary policy. This too contributed to higher yields, with the German 10-year yield reaching a high of -0.07%. But subsequent confirmation by the ECB that it would maintain monthly asset purchases at the current, higher level helped to lower yields as quarter-end approached. Italian 10-year spreads widened slightly during the quarter to 103 basis points (bps) from 96bps on the back of this policy-related uncertainty and the announcement of a large fiscal package of €220bn by Prime Minister Mario Draghi. This raised the Italian fiscal deficit to 11% of GDP. Spanish spreads were more stable, declining 1bp to 62bps, while Portuguese spreads were 8bps higher at 60bps. Peripheral spreads found some support from the anticipated start of disbursements from the EU Recovery Fund.

European investment-grade corporate bonds rose 0.3%, while global high-yield credit rose 2.2%. Yields and spreads in both investment-grade and high-yield corporates declined after the ongoing improvement in growth and investors' ongoing search for yield in a low-yield environment.

Currencies and commodities

The euro rose against the US dollar to 1.1849. The euro was initially strong, rising to a peak of 1.2266 in mid-May on the improving growth outlook in Europe and uncertainty when it was thought that the ECB might tighten policy. The euro weakened through June as the US dollar rallied due to the Fed indicating that interest rates could rise in 2023 (previously, it had suggested rates that would not be raised until at least 2024).

Commodities rose 15.7% due to their sensitivity to global growth expectations. With growth forecasts firm, the demand outlook for commodities was positive and pushed prices higher. The oil price also continued to rise, with West Texas Intermediate increasing 24.2% as OPEC+ discipline remained firm. Gold rose 3.5% on a slightly weaker US dollar and declining US real yields following their rise in the first quarter.

MARKET SNAPSHOT

Market returns

Equity indices (€)	QTD Return (%)	YTD Return (%)	2020 Return (%)
MSCI Ireland	1.58	11.55	5.97
MSCI United Kingdom	5.03	16.11	-17.83
MSCI Europe ex UK	7.29	15.75	2.43
MSCI North America	7.99	18.81	10.64
MSCI Japan	-1.14	4.67	5.42
MSCI EM (Emerging Markets)	4.18	11.00	8.89
MSCI AC World	6.57	16.14	7.18
10-year sovereign bond yields (€)	**Yield last month**	**2020 Yield (%)**	**2019 Yield (%)**
US	1.47	0.91	1.92
Germany	-0.21	-0.57	-0.19
UK	0.72	0.20	0.82
Japan	0.06	0.02	-0.02
Ireland	0.16	-0.30	0.11
Italy	0.82	0.54	1.41
Greece	0.83	0.63	1.43
Portugal	0.39	0.03	0.43
Spain	0.41	0.05	0.46
Commodities ($)	**QTD Return (%)**	**YTD Return (%)**	**2020 Return (%)**
Oil (WTI)	24.19	51.42	-20.54
Gold (Oz)	3.52	-6.44	24.40
S&P Goldman Sachs Commodity Index	15.72	31.40	-23.72
FX rates	**Current**	**2020**	**2019**
U.S. dollar per euro	1.18	1.22	1.12
British pounds per euro	0.86	0.90	0.85
U.S. dollar per British pounds	1.38	1.37	1.33

Source: ILIM, Bloomberg. Data is accurate as at 30 June 2021.

OUTLOOK

The outlook for equity markets over the next 12 months depends on several factors, including central bank policy, inflation (both expected and realised) and the evolution of the Covid-19 pandemic. While equity markets are expensive in absolute terms, they remain attractive in relative terms, given the low yields available on assets such as bonds and cash. The current low level of bond yields, even allowing for recent rises, justifies higher-than-average valuations in equities. We believe global equities can trade on a 12-month forward price-to-earnings (P/E) ratio of 18.5–19.0 times one year from now. With strong economic and earnings growth forecast over the next two years, upside of around double digits in global equities is expected over the next 12 months.

As the global economy moves from the early growth to mid-cycle stage, we expect equity returns to be positive even as the pace of gains slows. The growth/policy mix should be supportive, even as the level of stimulus is reduced in 2022. Authorities are determined to ensure the recovery is complete and self-sustaining, meaning growth will be above trend even as momentum peaks in the middle of the year. The bias to growth and earnings forecasts is still seen as being to the upside, although the scope for positive surprises is less than it was at the beginning of the year.

Source: ILIM, Bloomberg. Data is accurate as at 30 June 2021.

THE MONTH AHEAD

Economic data and events to watch

1 July	Caixin manufacturing PMI (China, June)
2 July	US non-farm payrolls (June)
6 July	German ZEW economic sentiment index (July) Federal Open Market Committee minutes
9 July	UK balance of trade (May)
13 July	Core inflation rate
16 July	Bank of Japan's interest rate decision US retail sales (month on month, June)

20 July	GfK consumer confidence (UK, July)
27 July	US durable goods orders (month on month, July)
28 July	US Fed's interest rate decision US Fed's press conference
29 July	US GDP growth rate (quarter on quarter)
31 July	China's NBS manufacturing PMI (July)

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