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Markets in a Minute

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Markets rise as central banks play down inflation threat

Markets edged up over the past week as central banks in the US and Europe vowed to continue with their stimulus programmes and quashed any prospect of an immediate rate hike. That is despite the most recent inflation surveys in the US and Europe coming in higher than expected. Markets have not reacted badly to the news, as they appear to agree with the central banks' narrative that such spikes in inflation will be transitory.

Markets in China and Hong Kong outperformed during the past week, with sentiment buoyed by hopes of a continued economic recovery.

The final manufacturing purchasing managers' indices from the eurozone and UK both reached new record highs, suggesting the optimism about the economic recovery is well justified.

Last week's markets performance*

- FTSE100: +0.40%
- Dow Jones: +0.52%
- S&P500: +0.11%
- Nasdaq: +0.55%
- Dax: +0.66%*
- Hang Seng: +3.71%
- Shanghai Composite: +3.64%
- Nikkei: +1.58%

Data from close on Monday 24 May to close on Tuesday 1 June.

**Data from close on Tuesday 25 May to close on Tuesday 1 June.*

Share markets start week on positive note

Asian markets were open on Monday and edged higher, helped by strong Chinese manufacturing data suggesting its recovery is holding firm.

Most equity markets also rose yesterday after the long weekend in the UK and US, with cyclical sectors such as commodities, energy and banking leading the gains.

The cyclically orientated UK and European markets led the way on Tuesday, with the FTSE 100 closing up by 0.82%.

The pan-European Stoxx 600 rose 0.75% to a record high of 450.1. Germany's Dax was the standout performer, gaining 0.85% to 15,567.36. But France's CAC40 also hit its highest level since 2000.

In the US, markets were mixed on Tuesday, with the Dow up 0.13% at 34,575.31, while the S&P 500 slipped 0.05% to 4,202.04, weighed by big tech. The Nasdaq Composite closed down 0.09% at 13,736.48.

Companies geared to the pandemic recovery outperformed, as the US recorded the lowest number of new Covid-19 cases since March. Airlines and travel stocks led the gains, and the small-cap Russell 2000 rose by 1.14%.

Oil price strengthens

On the commodity front, Brent crude oil hit $71 a barrel after a meeting of the OPEC+ group said that improving demand would allow it to ramp up production.

Brent Crude Oil Prices (USD per Barrel)

Source: Refinitiv datastream

UK economic reopening on a knife edge

With cases of the Indian variant of Covid-19 (just renamed the Delta variant by the World Health Organisation) now rising across the country, there is increasing pressure on the government to delay the full reopening of the economy on 21 June. The decision is likely to be left until the very last minute, giving scientists and ministers time to assess as much data as possible - most crucially on the projected increase in hospitalisations and deaths. A final decision is expected on 14 June. Hopes were raised yesterday,

however, when the UK reported no new deaths for the first time since the pandemic began.

Around the world, the Covid-19 picture is mixed. Challenges include Latin America, which continues to see new cases accelerating, while outside the Anglo-Saxon economies, vaccine prevalence remains generally low.

The global economic picture is also more complex than it first appears, and it is worth spending some time assessing where we are in the economic cycle and what the various risk factors are for markets.

Eurozone business activity soars

We have already seen substantial gains in equity markets since the market began recovering last year. More recently, volatility has returned as investors fret about the return of inflation and a possible rise in interest rates. All this begs the question: where are we in the cycle, and what does it mean for share prices?

One way of assessing the cycle is looking at US consumer confidence. For the past 50 years, the mid-point in the economic cycle can be approximated by the point at which respondents to the US Conference Board's Consumer Confidence Index became more content with their present situation than they were optimistic about the future.

In the latest survey released last week, the overall index stood at 117.2, down marginally from 117.5 in April. The present situation index, however, rose from 131.9 to 144.3, while the expectations index, dropped from 107.9 in April to 99.1 in May.

This suggests that the key inflection point mentioned above has happened very early, and means it could be a relatively short economic cycle.

However, consumer confidence is far from the only factor in determining stock-market corrections.

What else can cause a market decline?

Our analysis shows there have been 17 sell offs of 15% or more in the S&P 500 since 1950. Of these, nine have been associated with recessions and eight have not.

Stock-market performance is usually closely aligned with corporate profits, and profits are driven by GDP growth, so the link is clear for recession-driven sell offs.

The other declines normally occur due to significant sentiment, or technically driven, reasons.

Despite the feelgood factor about corporate prospects right now due to the recovery, there are in fact some headwinds for profits. Global earnings are running ahead of global GDP, and profit margins are elevated. This suggests limited upside for profits, while GDP growth will be fast this year before slowing back towards trend over the next year or so.

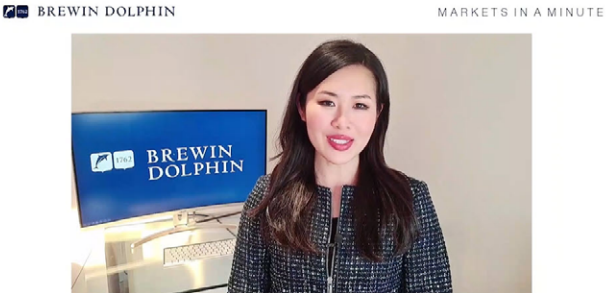
However, the overwhelming factor associated with recessions and meaningful growth slowdowns has been the interest-rate environment.

In almost every cycle, a meaningful growth slowdown has been preceded by Federal Reserve interest-rate hikes. And the median forecast by US Fed members is telling us that we won't get any rate rises until at least 2023. Therefore, a recession does not seem an obvious near-term threat.

Why we are staying bullish

So what could be the cause of the next out of cycle drawdown? The most obvious bout of volatility would come from the Fed's eventual acknowledgement of the need to taper its asset purchases (QE). Memories of the taper tantrum in 2013, when the US Fed last tried to hint it would aim to reduce its QE programme, can be disorientating. It seemed like a big deal at the time, but you would struggle to pick it out on an equity or cash bond performance chart today. And the Fed has laboured at trying to make the transition as smooth as possible. So that does not seem a likely catalyst for a material sell off. Especially as the Fed, ECB, BoJ and BoE are together expected to be buying assets for the remainder of 2021 at least.

Having said all of this, as we assess the asset allocation for our model portfolios over the next week, there is nothing overtly obvious to pose an immediate threat. The base case outlook for the global economy therefore looks very positive, with no prospect for a turn in the cycle anytime soon. Against that backdrop, equities will more often than not keep rising. And for that reason, we think it makes sense to stay bullish.



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