A Quarter in the Markets

Q2 2021

We are pleased to introduce our latest edition of 'A Quarter in the Markets', which provides an insight into financial markets from the Multi-Asset Solutions team at Santander Asset Management UK.

Key factors influencing markets

Vaccination programmes around the world accelerated throughout the spring, with Europe gaining ground on the US and UK. Emerging economies continued to lag on the vaccination front, although there was general improvement, and it appeared that infection rates in India reached a peak during this time. Many governments around the world began to ease COVID-19 restrictions once again, allowing business activity to rise.

During this time, stock markets performed well as a result of some positive news on the virus front and the resultant improvement in economic activity. However, the increase in consumer spending also raised the possibility of higher inflation in some countries, particularly the US, which could lead to interest rate hikes down the road.

So, what happened during the quarter?

Value companies: Companies that are currently trading below what they are worth and thus could provide a better return over the long-term.

The majority of global stock markets performed well over the second quarter, led by the US and Europe. Asia Pacific and the UK also had good investment returns, while Japan and China disappointed. Successful vaccination programmes and the return of business activity as countries re-opened played a major role in propelling markets forward. Early in the quarter, stock markets were boosted by strong corporate earnings from major technology, industrial and financial companies. This was soon tempered by fears of rising inflation as strong consumer demand and supply chain disruption caused prices to rise in the US. However, the US Federal Reserve (Fed) signalled that it would allow inflation to rise above its target in order to allow the economy time to recover.

In the early part of 2021, the so-called value companies, which struggled during the early months of the pandemic, performed well as economies started to open up. These include travel and leisure, mining as well as oil and gas companies. At the same time, shares in technology companies began to fall as investors felt they would experience a drop in demand. During the second quarter, this trend appeared to stop as technology companies rebounded and the momentum of value companies waned.

Bond markets delivered small positive returns over the quarter. Yields – which move in the opposite direction to prices – on benchmark government bonds jumped higher during the first three months of the year. This happened as investors moved out of bonds in anticipation of faster economic growth and rising inflation. However, the mood was somewhat more relaxed in the second quarter. Yields on benchmark government bonds in the US, UK, Germany and Japan, fell during this period as investors are likely to have shrugged off short-term inflation concerns after central banks signalled they would hold interest rates at low levels.

How did different economies react?

Heading into the second quarter, there were noticeable variations in how some economies were performing, with the UK and US doing reasonably well, while Europe struggled. Over the second quarter, Europe's economic situation improved as its vaccination programme caught up with the US and UK, and business activity rebounded.

In the UK, the government continued to gradually lift lockdown measures and this translated into solid growth in the services and manufacturing sectors during the spring months, with companies hiring staff at a high rate in June. The unemployment rate fell to 4.7% during this time from a peak of 5.2% in October 2020.[1] While the increase in demand in the economy was seen as a positive, manufacturers were also grappling with a backlog of orders and constrained production due to global supply chain disruption stemming from the pandemic. With consumer demand high and supply chains constrained, inflation also began to rise.

In April, Europe was facing elevated infection rates, a slow vaccination programme and a struggling economy. Over the course of the quarter, infection rates began to fall and governments were able to step up the vaccination rate, which provided a much-needed boost to its economy. As restrictions were lifted in May, economic activity accelerated, so much so that in June business activity grew at the fastest rate for 15 years.[2] By the end of the quarter, job creation in the trade bloc was strong, but high demand for goods and services, along with supply chain disruptions, created a backlog that pushed up prices and depleted warehouse inventories. Overall, both the manufacturing and services sectors saw steady growth over the month, with the inflation rate coming in at 1.9%[3] for the month, just below the European Central Bank's target of 'close to but below 2%'.

Since the beginning of the year, the US economy has been on a solid footing, with the corporate sector reporting strong earnings and economic growth coming in stronger than expected. The improved situation has resulted in steady job creation, with 850,000 jobs added in June.[4] The number of new unemployment claims for the final week of the quarter came in at 364,000[5] - the lowest since the pandemic began. With consumer confidence high and supply chains constrained, the core US inflation rate reached 3.8% in May, its highest level since the early 1990's.[6] During its June meeting, the Fed's Federal Open Market Committee decided not to raise interest rates despite inflation running higher than its target, stating it would not stop providing support to the economy until 'progress is made on reducing unemployment' and inflation is kept above its 2% target.

Much has been said about the strength of China's economy since it began its recovery from the pandemic midway through last year. While the world's second-largest economy has - for the most part - emerged from the worst economic effects of the pandemic, it is still feeling some of the fallout. Supply chain disruptions, weaker demand from its trading partners as they face rising infection rates, and a global shortage of computer chips have all taken their toll on China's manufacturing sector over the past few months. By the end of June, rising COVID-19 cases and higher costs for raw materials began to bite. Manufacturing activity in the country dipped to its slowest point for four months in June, owing mostly to rising costs, a global computer chip shortage and spiking infection rates, as well as weaker export demand.

Similarly, both South Korea and Japan faced slowdowns in their factory sectors late in the quarter. This was caused in part by disruption in the auto sector, which has been hit hard by the computer chip shortage. While Japan's manufacturing sector grew at a slower pace in June, confidence in the sector improved, as did sentiment in the services sector. Nevertheless, consumer confidence in Japan improved in June as state-of-emergency COVID-19 restrictions were eased.

What is the outlook for markets?

We have a positive, but cautious, view for stock markets and the global economy in the months ahead. Vaccination programmes are progressing around the world, which should help to contain COVID-19 infections and hospitalisations, and allow economies to re-open. We have seen higher inflation lately as consumer spending and business activity has picked up, but our current expectation is that this is a temporary rise due to the pandemic rather than a long-term trend.

At the present time, market volatility is fairly low, although with the Delta variant of the virus on the rise in many regions of the world, there will likely be some bumps along the way. We continue to monitor inflation, retail sales and manufacturing data to gain visibility of the global economy to ensure we can achieve optimal portfolio positioning moving forward.

Find out more

Listen **here** to the latest **Market Views** from our Head of Multi Asset Solutions UK, Stefano Amato, as he shares his thoughts on the main themes dominating markets.

[1]Office for National Statistics, Employment in the UK: June 2021, 15/6/21
[2]Markit Economics - Eurozone economy grows at fastest rate for 15 years, 23/6/21
[3] Trading Economics – Euro Area Inflation Rate, 6/21
[4] U.S. Bureau of Labor Statistics, Employment Situation Summary, 23/6/21
[5]U.S. Department of Labor, Unemployment Insurance Weekly Claims Report, 1/7/21
[6] Trading Economics, United States Core Inflation Rate, 5/21

Important Information