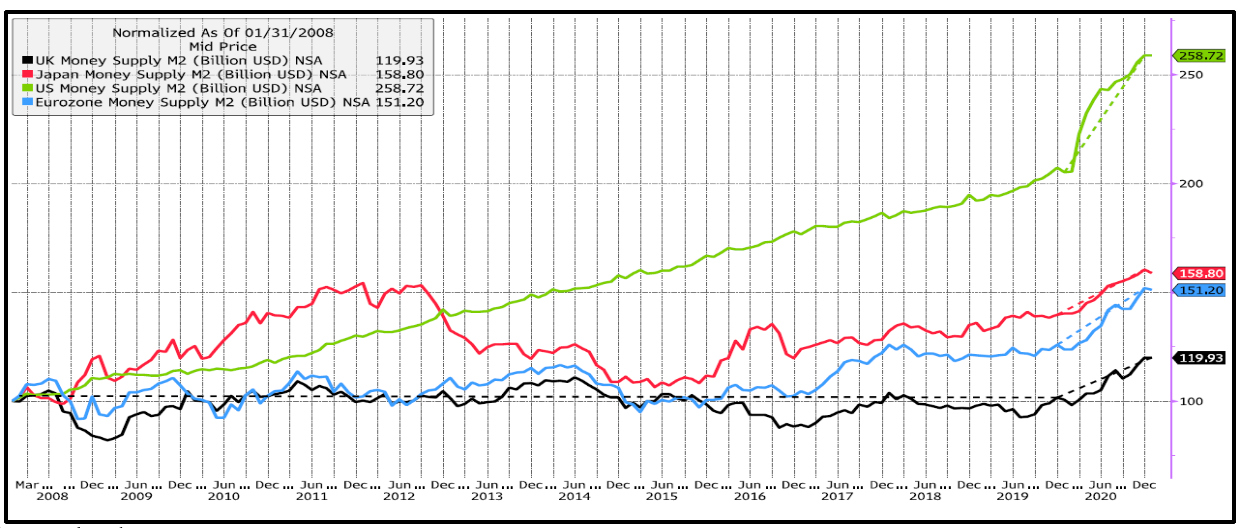
First Quarter 2021 Review: International Equities Strategy

Economic and Capital Markets Commentary

Decreased pandemic risks, low global interest rates, positive inflection in economic activity, strong consumer condition, and pent-up demand for goods and services has driven strong market performance during the first quarter with much healthier market breadth than 2020. We continue to see economic data improving throughout the year, and the strong performance of cyclicals relative to non-cyclicals persisting. At this time, we don't see a structural reversal of a trend that has favored growth since the Great Financial Crisis, but we do expect some further relative strength as the health crisis wanes, economies recover, rates move higher, and earnings improve in more cyclical markets.

This continued increase in breadth as the global economy discounts the prospects for strong cyclical growth in many developed markets through the remainder of 2021 and into early 2022 – perhaps beyond. The monetary and fiscal stimulus injected into the market by policymakers worldwide have primed the pump for expansion with some eye-popping actions, like the 21% increase in U.K. M2, a measure of money supply, from the start of 2020. This level of monetary expansion hasn't been witnessed in the U.K. since the 2003-2007 period with supply of money remaining virtually flat from 2008-2020. Or the insanely large fiscal packages – particularly in the United States. The U.S. has *already* approved fiscal response with deficit spending that exceeds 30% of its Gross Domestic Product to promote recovery in an economy that has only ~5% slack in its labor market. The magnitude of this response explains the unusually strong savings rates and retail sales experienced during a recession. On the chart below, the United States is also an outlier on the continued expansion of money supply since the last economic crisis, while monetary expansion in the United Kingdom, Europe, and Japan remained relatively benign in comparison.

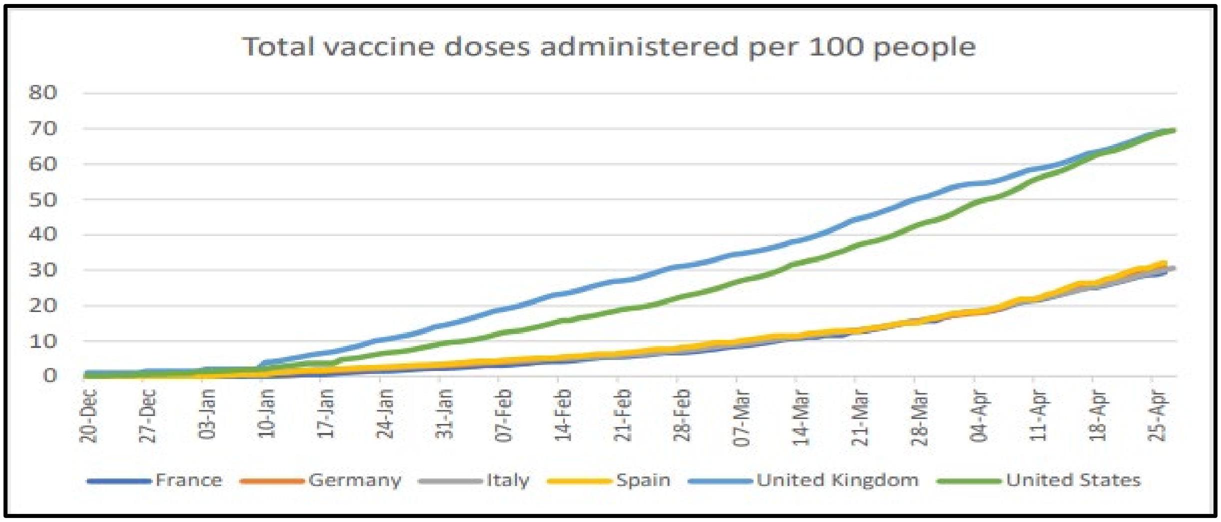


Source: Bloomberg LP

Resulting from the expectations for a rebound, value outperformed growth with cyclical sectors seeing the best performance. The top performing sectors during the quarter were Energy and Financials. Energy's strength came with the prospects for normalization after COVID's disruption in demand for transportation fuels. Financials rebounded from impaired valuations as prospects for profitability, reflected in interest rate outlook, and potential losses in credit came more clearly into view. This rotation, which really started in

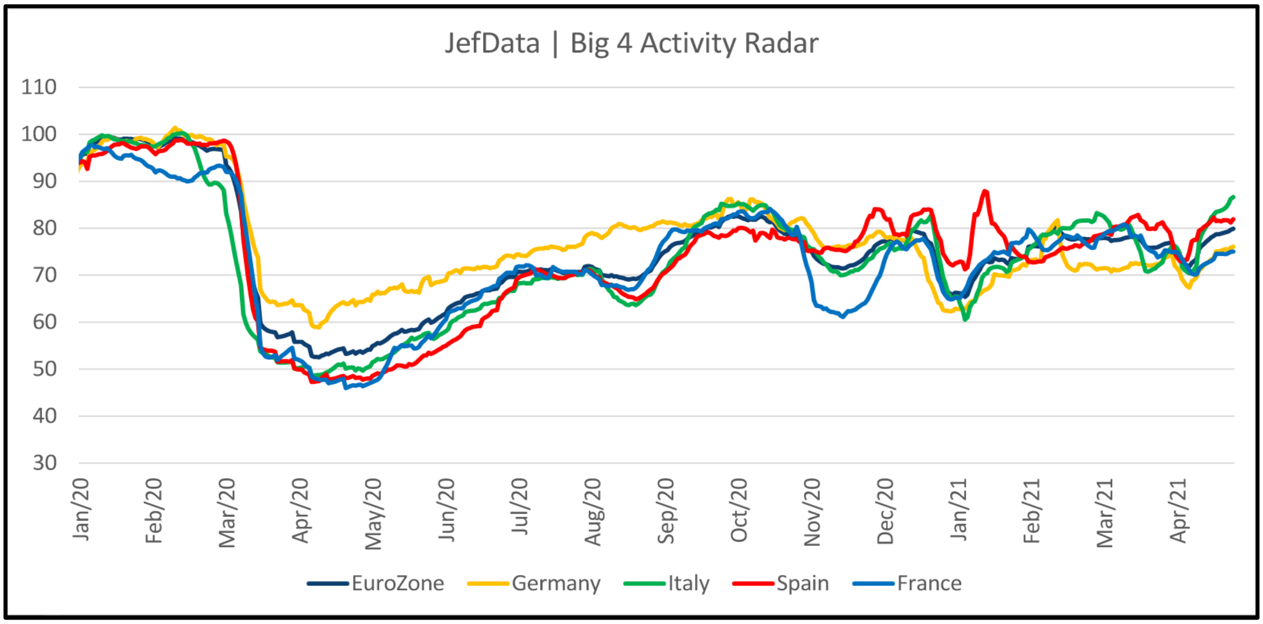
November 2020, surged in January and February, while growth regained some ground in March, as rates took a breather.

The residual impact of the pandemic and associated lockdowns will continue to delay economic expansion in some markets until later in the year. The United States appears to be the country with both the most expansive fiscal and monetary policies, promoting a circumstance of pent-up demand, supply constraints, product pricing power, and leadership moving towards "herd immunity" with higher vaccination rates. The United Kingdom has vaccination rates similar to the United States, and they will likely see the benefits of a reopening prior to their European neighbors. Unfortunately, there remains a major trade relationship between the island and the continent that could weigh on the United Kingdom's full recovery. We expect that Europe will start to loosen restrictions – thereby reviving economic activity – during the summer with momentum building during the second half of 2021. Mutations of the virus remain a risk, but at this point, the vaccinations appear to be effective against all major strains.



Source: Our World in Data, Jefferies International Ltd.

Though some uncertainty still exists, we should continue to move towards the recovery with ample stimulus remaining in the system. The recovery will be incongruous and some estimates for real GDP growth reflect the timing of the re-opening. We believe consensus estimates for continental Europe likely need to emphasize more of the recovery spilling into the third quarter as restrictions on activity remain very high. Cases remain elevated, and economic activity monitors have failed to break levels of ~80% of pre-pandemic activity. The United Kingdom appears to be poised for a greater jump in the second quarter, as their progress on vaccination should lead to further lifting of restrictions. The persistency of these restrictions, supply chain disruptions, and personal savings rates should extend some of the benefits expected in 2021 into 2022.



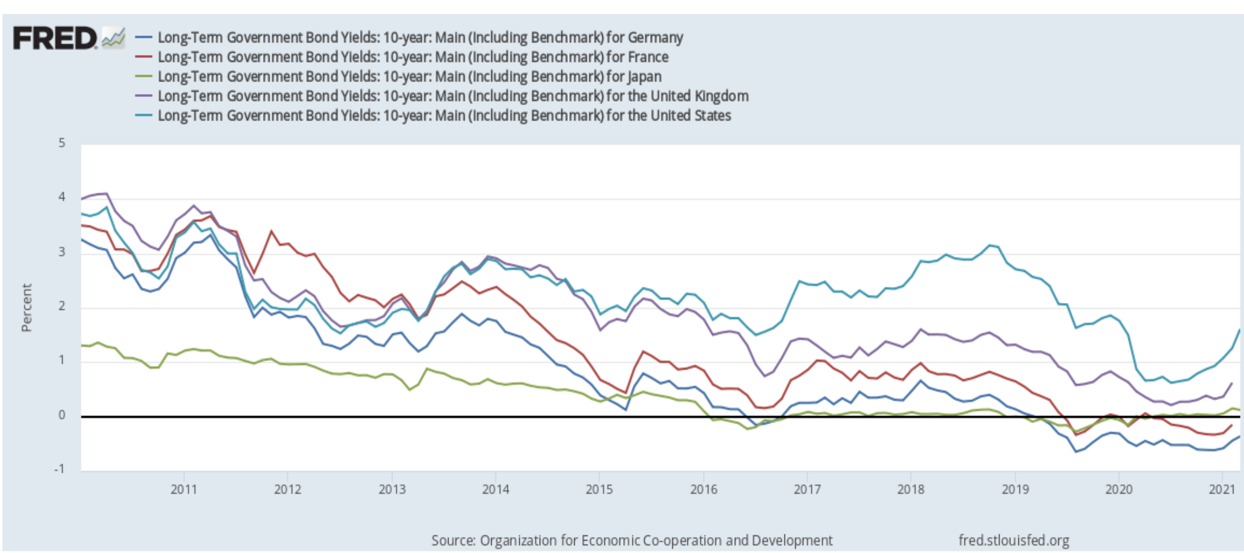
Source: Jefferies International Ltd.

Consensus Estimates for Real GDP Growth (QoQ% SAAR)

	Q2 20	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	Q4 21	2020	2021
United States	-9.0%	-2.8%	-2.4%	0.2%	12.2%	6.4%	6.6%	-3.5%	6.3%
United Kingdom	-21.4%	-8.5%	-7.3%	-6.6%	20.6%	6.1%	6.5%	-10.1%	5.5%
Germany	-11.3%	-4.0%	-3.6%	-3.2%	9.5%	3.4%	4.1%	-4.9%	3.3%
France	-18.6%	-3.7%	-4.9%	1.0%	17.7%	1.5%	4.0%	-8.1%	5.5%
Spain	-21.6%	-8.6%	-8.9%	-4.5%	18.0%	4.0%	6.0%	-10.8%	5.8%
Italy	-18.2%	-5.2%	-6.6%	-1.7%	14.8%	1.1%	3.9%	-8.9%	4.3%
Japan	-29.3%	22.8%	11.7%	-3.9%	4.7%	4.0%	2.3%	-4.9%	2.9%

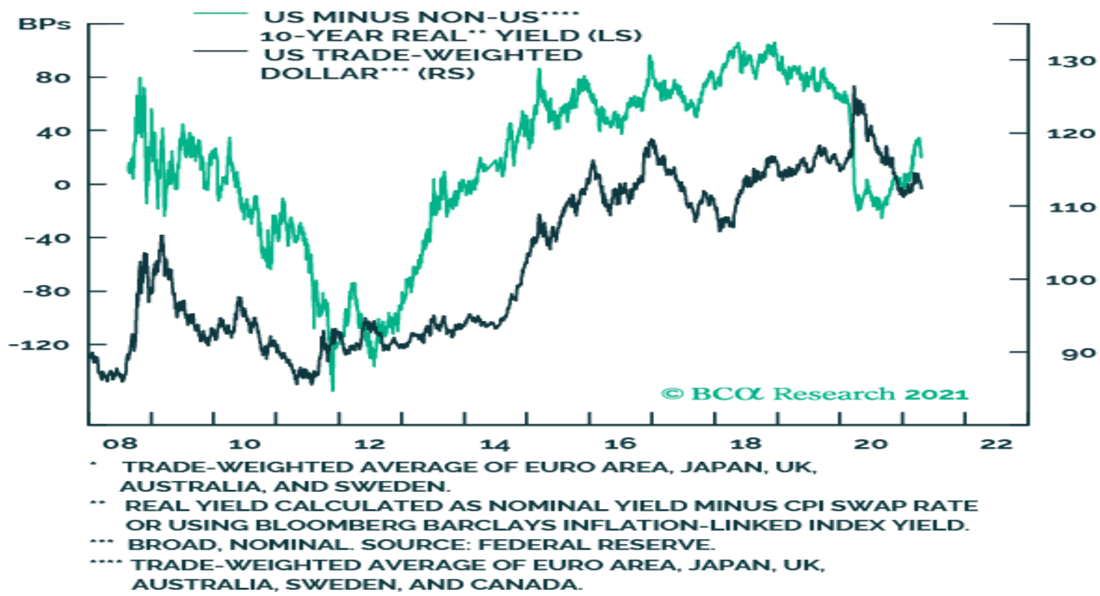
Source: Bloomberg LP

As the global economy moves towards resumption in economic output growth, we anticipate inflation expectations and interest rates to continue to trend higher. While policymakers will continue to hold the short end of the yield curve down, the longer end will be harder for central bankers to manage. As we exhibited in our prior quarter's review, 10-year sovereign rates had continued to remain cyclically low throughout most of 2020. The United States saw the initial increases in rates as the prospects for economic growth on extraordinary stimulus measures led many developed markets. Recently, we have seen longer duration rates starting to increase in other developed markets.



Source: Federal Reserve Banks of St. Louis

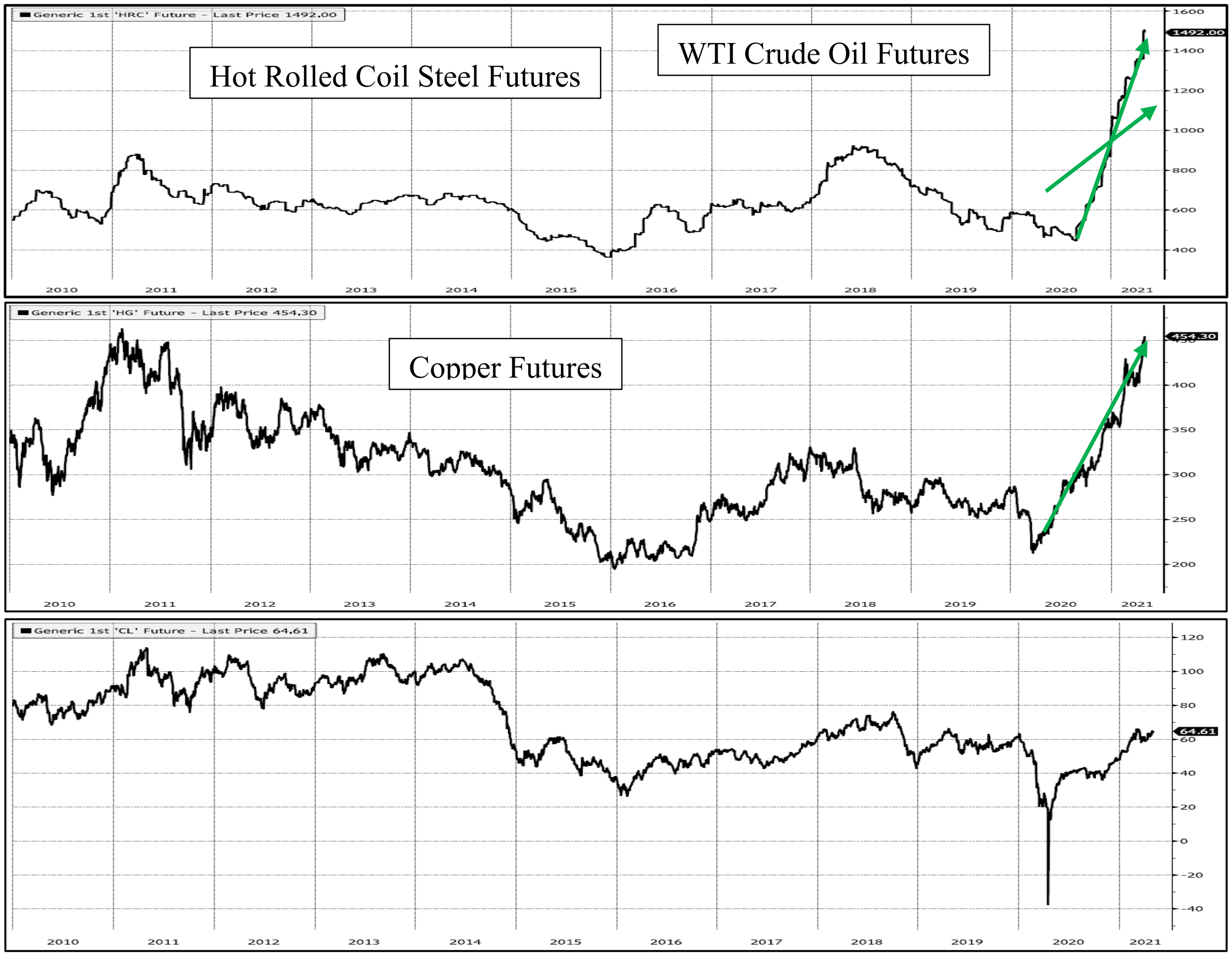
The move by the 10-year U.S. Treasury did widen the rate differential on the longer end of the yield curve, providing some respite for USD during the first quarter after the weakness experienced during the second half of 2020. As other markets have moved closer to better economic prospects, the rate differential has again narrowed slightly. This narrowing spread provided additional weakness in USD during April. We expect longer duration rates to generally trend higher as the year progresses, but the interplay between rate differentials will play an important role in the call for a weaker USD. If these rate differentials hold at these levels and the U.S. rates don't surge ahead, then we would expect to see further weakness in the USD and strength in the Euro and Pound.



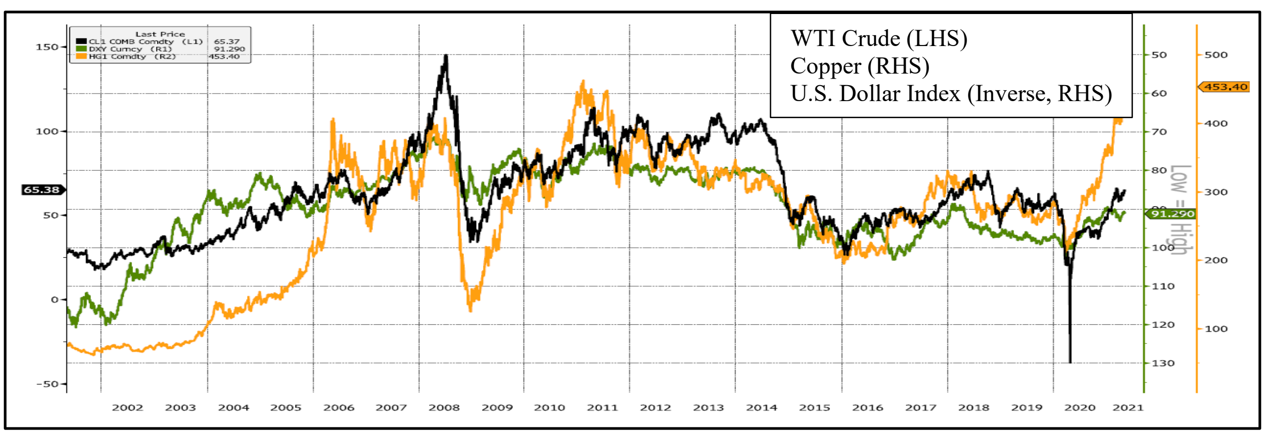
Source: BCA Research Inc.

Central bankers will continue to anchor the short end of the curve, but we expect the outlook for output growth and inflation will shape the yield curve. Currently, bankers view a spike in inflation as transitory, but numbers may surprise on the upside over the next few quarters. Price dislocations have appeared in many sectors as supply chain disruptions have driven up prices ahead of broader economic strength. As strong demand persists and inventories refill, pricing power will remain on the producers' side even as supply chains normalize. At this point, there is little visibility into whether or not these inflationary pressures will abate in 2022. Regardless, economic data should allow for rates in Europe – and to a lesser degree Japan – to move upwards as the current year unfolds, reflecting a more pro-cyclical global economy.

Commodity prices are a gauge of global demand and – typically – inversely correlated to the USD. "Dr. Copper" is less than 2% from the record prices set in 2011, during the latter part of the commodities "super" cycle, which reflected a reflation trade and cyclical expansion after the financial crisis. Prices for this commodity have doubled since lows set last March, as both structural and cyclical factors are at play. Futures prices for crude oil have increased nearly threefold since last March, which excludes the distortions in April. These price movements historically reflect cyclical recovery, tighter supply demand, and dollar weakness. These are just two of many commodities setting new cycle highs and should foreshadow further rotation of capital into cyclical assets.



Source: Bloomberg LP



Source: Bloomberg LP

The outlook for recovery and expansion continues to strengthen as we move closer to a "normalization" after the pandemic. Aggressive interest rate and monetary policies, combined with deficit spending, have set up conditions for a rebound in economic activity, consumer spending, and capital investment. The initial interest rate move in the U.S. provided a positive bump in the USD during the first quarter, but as we move towards a more global re-opening later in the year, the rates in other markets have started to move, as well. Inflation, as measured by the consumer price index or measured by core commodities, reflect the existing and – particularly, in the case of oil – expected global demand relative to available capacity. Historically, the confluence of these events has been supportive of capital flows to markets outside of the United States that are more dependent upon export. The British Pound and Euro are both also trading below their purchase price parity against the U.S. Dollar. We would expect a continuation of a rotation towards cyclical markets as we move through the reopening of the United States and towards the reopening of Europe, which we expect later in the year.

Mason D. King, CFA
March 4, 2021

IMPORTANT INFORMATION