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Market Update

Ahead of the Game

Investment markets often react in anticipation of an event rather than in reaction to it. Such has been the case throughout the recovery phase of market growth since the depths of last spring. The expectation that a way beyond covid would be identified drove the initial recovery through the summer months of 2020 and then once the vaccination breakthroughs were announced, confidence in economic reopening developed, driving share prices further higher. This was despite the UK and many other regions battling a brutal winter wave of covid. The rally continued through much of the spring and yet, once we actually got the start of the protracted reopening programme, market confidence ran out of steam. Since May this year the FTSE 100 has largely been in a holding pattern, with few gains over this period and this is despite the significant progress made in the level of economic activity occurring. The fact that stock markets are forward looking should come as little surprise, as of course, an investment decision should be based upon the expectation of future returns. This therefore means that it is worth considering what future investment markets are now expecting, given the sideways movements being experienced. To answer this question, it is worth considering two factors: inflation and the delta coronavirus variant.

Inflation on the Rise

With the economic reopening we are now experiencing, the opportunity to spend has returned. Alongside this *opportunity*, there is also the *ability* to spend, given the high levels of saving that have been built up over the past 18 months (as incomes have been supported by furlough, while spending has reduced). Also add into this mix continued stimulatory policy positions from central banks and governments and there is the recipe for surging demand. With the supply side still facing pandemic related difficulties, the prices paid for goods and services are increasing and inflation is on the rise. This has been occurring since the spring across much of the developed world. The US is the furthest ahead on this curve, with CPI (a commons measure on inflation) at 5.4% and while the UK is relatively sluggish at 2.5%, this is still ahead of the 2% target level and, as minutes from the Bank of England's latest meeting show, is expected to increase significantly over the coming months. The Monetary Policy Committee now expects UK CPI to peak at 4% later this year.

Watch Your Footing

With the path to higher inflation becoming apparent, stock markets have lost their shine. Investors are increasingly worried that central bankers will be forced to raise interest rates sooner rather than later and will therefore remove the punchbowl just as the party is getting going. Such a situation means that even though the economy is likely to continue to be in fine form over the short to medium term there is growing concern over whether US Federal Reserve Chair, Jerome Powell, and his peers, act appropriately in slowing inflation sufficiently so as to avoid overheating, while also managing to avoid excessively slowing the economy. At this stage, this question remains open and as such so is one of the two main factors which are preventing further stock market gains, for now.

Controlling Delta

The second factor is that of the continued global spread of covid and how this is increasingly caused by the delta variant. Encouragingly, case numbers are now falling in the UK despite the greater liberty that came with July 19th's 'Freedom Day'. The falling case numbers can be attributed in part to the ending of Euro 2020 and its contribution to the case load with football fans spreading the disease in large celebratory groups. But the falling virus transmission can also be attributed to the continued success of the UK's vaccination programme, with large portions of the adult population now fully vaccinated. Not all the world is as advanced in their vaccination drives as the UK, however. While they got off to a slow start European vaccination rates are now at reasonable levels, and thankfully they are potentially seeing a turning point in their latest covid wave. The US, however, looks set for continued increase in cases, as the delta variant is still taking over and, despite a fast start to their vaccine rollout, is seeing numbers stall as there appears to be significant population groups who are refusing the vaccine.

Showing the Way

It is the expectation of this increasingly difficult situation in the US that appears to be an important factor in recent lacklustre investor sentiment. As the UK is (so far) showing, high vaccination uptake is the route to avoid high levels of hospitalisation and deaths and perhaps the US is on a course to learn this lesson the hard way. Nonetheless, should this scenario occur, while the health cost could well be high, it appears now that the economic cost should not be extreme. With the US amongst the most hesitant nations to impose lockdowns and restrict economic activity throughout the pandemic, now that a vaccination is on offer to most Americans, it seems highly unlikely that significant restrictions will be imposed again.

One to Watch, One to Discount

As such, while the rise of the delta variant will raise questions over the US economy, in our opinion, the answers are unlikely to be particularly worrying for investment markets. Yes, the impact of inflation and the subsequent moves in interest rates look set to have a significant influence on the direction of the global economy and markets, but it appears likely the recent hesitance in markets related to the delta variant will fade.

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