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Portfolio Review — *May 2021*

Once again economic growth, government bond yields and central bank rhetoric have been the key drivers of markets over the last month, as indeed they have been for most of the year; a factor that is unlikely to change in the foreseeable future. Economic data was very strong over the month but market reaction has been more muted given the already strong start to the year.

As many economies around the world continue to reopen, fears about rising inflation seem stuck at the forefront of investors' minds. There are a number of potential inflation "drivers". The pandemic-driven disruption to numerous supply chains, commodity prices continuing to rise, and evidence of labour shortages, particularly in the reopening hospitality sector, could all lead to rising prices.

In the short term, therefore, inflationary forces are starting to build and when added to the base effects of falling prices this time last year, it is unsurprising that we are starting to see inflation coming in at close to or above central bank targets. In the US, consumer prices increased 0.8% in April and headline inflation rose to 4.2% compared with a year earlier, the biggest upside surprise since 1982.

It was a similar picture in the UK where prices rose 1.5% compared to a year earlier with utility, clothing and fuel prices making the greatest contributions to the gains. As we move through the year, higher relative energy prices and a strengthening economy will likely see the figure rise above the Bank of England's 2% target in the second half.

Whether or not inflation is transitory is one of the biggest questions for investors right now. While central banks have been keen to stress that they are willing to tolerate higher inflation in the short term, understanding how they will react to possible further upside surprises on economic growth will be key. There is the potential for plenty of volatility, driven by inflation expectations, but the Federal Reserve's steadfastness that recent inflation spike is indeed transitory has helped to calm markets for now.

The strong economic growth, rapidly rising commodity prices and inflation expectations mentioned above did put pressure on equities in the first two weeks, however they staged a rally from mid-May onwards as central banks downplayed the sustainability of the pick-up in inflation with plenty of dovish comments. Coupled with ongoing vaccine rollouts and fiscal stimulus measures, developed market equities posted gains for the month, although the strength of sterling meant these numbers became largely negative for UK investors. For example, the MSCI World Index rose 1.4% in US dollar terms but was down 1.2% when translated back to sterling.

In an almost complete reversal of April's stock market performance where the US led the gains, markets in May reasserted themselves to the trend of Value stocks outperforming Growth stocks year-to-date, whilst the US trailed other developed markets.

UK equities rose over the month with a number of domestically focused sectors performing well as confidence grew around the re-opening of the economy. Both the FTSE All Share and FTSE 100 returned 1.1%, taking their year-to-date returns above 10%. The pick-up in inflation expectations drove domestically focused banks and life insurance companies to outperform the broader market. In contrast, large internationally diversified financials were negatively impacted by both sterling strength and a weak US dollar.

The unlocking of the UK economy continued in May, with greater social mixing allowed, indoor hospitality reopening and some foreign travel now permitted. Whilst there is a question mark over the removal of social distancing laws on June 21, in general the outlook for UK consumers and businesses looks strong resulting in various upgrades to GDP predictions – the Bank of England now forecasts the UK economy to grow 7.5% for the year as a whole.

In the US, while equity markets rose in local currency terms thanks to improving economic momentum and the reopening of many industries, for sterling investors these were the weakest performing indices with the S&P 500 down 1.9% and tech-heavy Nasdaq down 3.7%. The strongest performing sectors were those closely tied to economic growth such as energy and materials while consumer discretionaries lagged, particularly impacted by the shortage of semiconductors in areas such as auto production.

European equities returned 1.8% in May, outperforming all other developed markets. The continued progress of the vaccine rollout and loosening of lockdown restrictions resulted in a greater economic and business outlook for the rest of the year. In addition, with over half of company revenues being generated overseas, European corporates stand to benefit from the wider global economic recovery. Once again economically sensitive sectors fared well while healthcare, information technology and utilities lagged.

Elsewhere, Japanese stocks gained but returns were negative for UK investors. Leading indicators pointed to a sharp decline in activity this year as vaccination rates remain disappointingly low, with less than 5% of the population having received a first dose at the time of writing, and the country struggling to contain new waves without implementing new restrictions. However, the export sector looks set to be a bright spot as global growth continues to recover.

Away from equities, government bond yields were little changed in May allowing fixed income indices to consolidate having sold off since the start of the year. The benchmark US 10-year Treasury yield ended the month just three basis points lower at 1.59% and the UK 10-year gilt fell 5 basis points to 0.8%, having both risen significantly year-to-date. Inflation-linked bonds performed well as did investment grade credit and high yield bonds, both of which outperformed government bonds.

Portfolio Review

Taking into account the mixed market backdrop, and in particular the currency implications, the majority of Beckford James portfolios delivered positive returns during May, with only the higher risk Growth portfolios (8, 9 and 10) and the Ethical portfolio delivering marginally negative returns.

The best performing was the Income portfolio, up 1.6% for the month and comfortably outperforming its benchmark return by 60 basis points. This was closely followed by the Balanced Income & Growth portfolio which returned 1.1% and was 25 basis points ahead of its benchmark. It is a similar picture for year-to-date figures for these portfolios, up 9.7% and 6.7% respectively, which are again both ahead of their respective benchmark returns.

The key driver of this outperformance is their exposure to value-orientated investment funds, most notably UK equity income funds which have an inherent bias towards the more cyclical areas of the market. The strongest performers during May were the Unicorn UK Income Fund (up 3.0%), closely followed by JO Hambro UK Equity Income, Man GLG Income and Chelverton UK Income which all returned between 2-3%.

Turning to the Growth portfolios, the best performance was achieved by the lowest risk portfolio, Growth 3, which returned +0.5% and then followed in ascending risk order down to Growth 10 which fell 0.1%. The lower risk profiles Growth 3-6 were exactly in line with their benchmark returns, with only the highest risk profiles slightly underperforming their benchmarks by around 20-30 basis points.

This underperformance of the higher risk profiles versus lower risk profiles can be explained by their higher degree of exposure to overseas equity markets, such as the US and Japan, which as highlighted above were weak over the course of the month. In addition, the bias towards growth-orientated investment funds, which served the portfolios very well over the course of the recovery phase in 2020, have so far lagged the value styled investment funds over the past few months.

There were some strong performances from the Vanguard UK Inflation-Linked Gilt Index Fund, which rose 2.9% as inflation fears rose, as well as some good returns for the HSBC European and FTSE All Share Index trackers. Unsurprisingly, the weakest fund in the portfolios was the Baillie Gifford Japanese Smaller Companies fund which fell 5.4%.

The Beckford James Ethical portfolio was the weakest performing portfolio, and its equity exposure coupled with a growth bias were the main factors behind performance this month. The best performing fund was the UK Ethical Income fund, closely followed by the EdenTree Responsible and Sustainable European Equity, reflecting positive returns for both UK and European markets.