TALARIA

CERTAINTY EMPOWERS YOU

# Monthly market commentary - August 2021

Equity markets continued to move higher through August as abating concerns about inflation drove renewed outperformance of growth equities. Additionally, concerns about rising COVID-19 cases only weighed on a small part of the market, specifically those value stocks most exposed to re-opening. However, despite all this strength, we think the outlook for equity markets is becoming a lot less clear, pointing to the fine balance between the 'bull' and 'bear' arguments.

Those more optimistic can point to several supportive factors. For starters, swelling household savings suggests there is a tremendous amount of pent-up demand. Consumer sentiment should additionally benefit from a wealth effect induced by rising asset prices. The Federal Reserve has also done a good job at distinguishing between the path of its tapering timeline and the outlook for interest rates, which, their messaging suggests, are set to remain lower for the foreseeable future. Add to this the prospects of trillions of dollars in US government spending and it is relatively easy to construct an argument for why corporate earnings and sentiment should remain well supported from here.

On the flip side, those with a more cautious outlook point to the fact that equity market valuations have now reached very high levels thus making indices vulnerable to a sudden change in sentiment. Higher starting valuations also increase the reliance on EPS momentum to drive overall prices higher. On this front there are a few headwinds to contend with.

Supply chain constraints due to COVID-19 continue to hold back earnings growth with rising 'Delta' cases likely to exacerbate this. Furthermore, while inflation has already started dragging on company margins, it is also beginning to weigh on sentiment. For example, the significant jump in inflation has meant that real wages are now at 40-year lows! Low real wages will also likely weigh on corporate profits as employees will ultimately demand higher nominal wages. Record US house price inflation has also seen buyer sentiment fall to record lows and has reduced the pool of potential buyers to pre-GFC levels. To top it all off, corporate taxes are set to rise in coming years, reversing some of the tailwinds witnessed over the past decade. This was noteworthy in Bunzl's recent result, where management flagged a ~300bps increase to FY22's tax rate should the Biden administration's tax plans be fully implemented. Clearly, all these considerations make it a particularly tricky time in the market.

Growth's outperformance as a factor was again evident at both the geographic and sector level. US large cap indices performed very strongly with the NASDAQ up 4% and S&P500 up 2.9% compared to 1.9% for the S&P 600 Small Cap Index. Performance in Europe was more muted with the German DAX up 1.9%, UK FTSE up 1.2% and French CAC up 1%. Asian markets fared a lot better, reversing some of the weakness over the previous three months. The Nikkei 225 finished up 3% in August with the China's Shanghai Composite also up 4.3%.

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At a sector level, Info Tech and Telcos were the key standouts, both up almost 4%. Financials and Utilities also performed strongly, up 3.4% and 3%, respectively. Materials and Energy were the only sectors negative for the month, down 0.9% and 1.8%, driven by uncertainty around China's near-term growth prospects.

Our holding in global reinsurance firm, Swiss Re Group was one of the biggest contributors to performance. Swiss Re provides a range of reinsurance and other insurance-based risk transfer services with a dominant ~15% of the global market. We are attracted to reinsurance businesses given that they are relatively immune to the economic cycle and the fact that earnings should benefit from higher interest rates on longer dated bonds. We are also attracted specifically to Swiss Re given its pricing discipline with insurance pricing based on delivering a minimum 10% return on equity. In short, we think Swiss Re is a high quality, conservatively run business with an attractive valuation (~1x P/BV) and a high dividend yield of >7%, thus making it a rarity in the current market environment.

French oil major, TotalEnergies was also a positive contributor to performance in August. TotalEnergies owns a collection of attractive oil and gas E&P assets and extensive interests in downstream refining, marketing, and distribution capabilities. It also owns a growing portfolio of renewable energy assets. While the bulk of earnings remain sensitive to oil dynamics, we think TotalEnergies is an attractive equity even in the absence of higher oil prices. This reflects the combination of very strong yield support (~7% dividend yield) and our view that current dividend levels are sustainable courtesy of a strong balance sheet, solid cash flows and its positioning on the cost curve. We also see the potential for a re-rating opportunity on the back of more ESG improvements at the firm. Despite being an 'oil company', TotalEnergies is making considerable progress in differentiating itself and continues to lead other oil majors on ESG matters. For example, the bulk of incremental expansion capex is now going towards renewables and management have flagged that all future bond issuances will have green covenants attached.