July 2021
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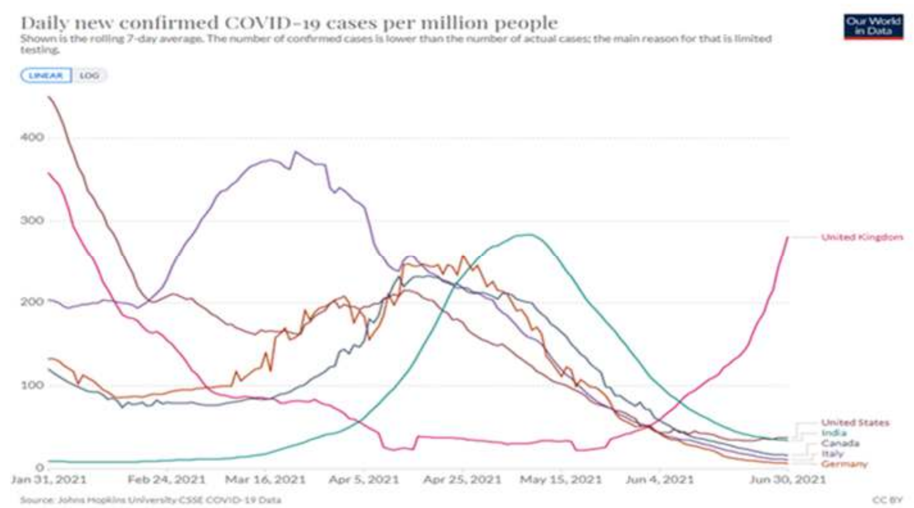
HOTTINGER GROUP

GLOBAL INSIGHT

Overview

- In our Macro View, we look at the expanding economic activity since economies have started to re-open.
- Global Covid cases are at their lowest rate in 2021 but the spread of the Delta variant remains a concern as the political emphasis moves to living with the virus.
- In our Investment Outlook, we assess activity in the second quarter and the position that financial markets find themselves.
- This gentle drift higher masks a number of significant changes beneath the surface of global markets, however, as investors adjust to a recovering global economy and the associated policy shifts.
- While the path toward a more inflationary world is likely to be a volatile one we believe very strongly that taking an active and opportunistic approach toward building robust, well-diversified portfolios is the most effective way to protect and grow the assets of our clients over the longer term.
- In our guest article, Toby Hayes, Portfolio Manager, Trium Capital, defines a structural return and describes how they can add diversification in a multi-asset portfolio.
- Cross correlations of traditional asset classes have been rising ominously.
- There is no one ‘event’, neither pandemic, global depression nor Federal reserve policy pivot that hurts structural returns at the same time. Their ability to diversify is fundamental, not just statistical.



Inside this issue

Economic Highlights

- UK GDP Growth in April was 2.3% - the fastest since July 2020.
- UK inflation also jumped to 1.5% in April, up from 0.7% in March.
- In May, US headline and core Consumer Price Index inflation jumped from 2.6% y/y and 1.6% y/y in March to 5% and 3.8% respectively.
- The Eurozone composite Purchasing Managers Index covering both manufacturing and services registered 59.5 in June, up from 57.1 in May.

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Based upon information available up to and including
16th July 2021

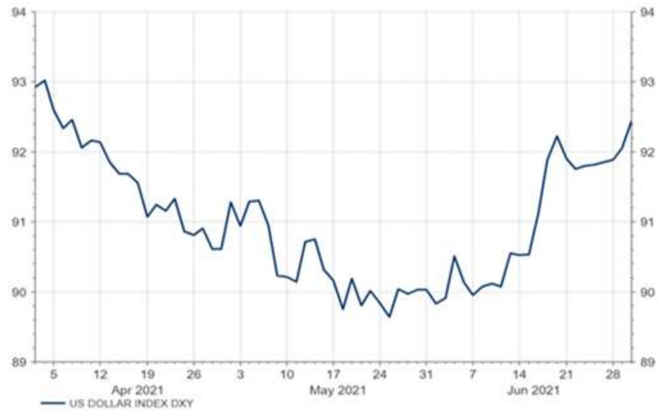
Key Issues in Charts

US Core Consumer Price Inflation Year-on-Year vs February 2020

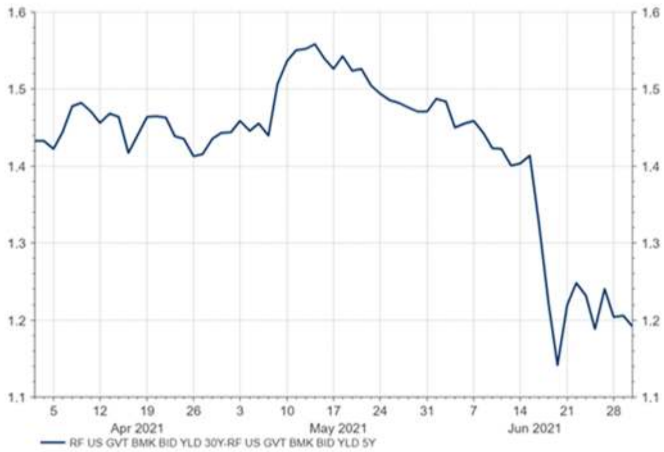
- A leading headline of the quarter has been the strength of core and headline inflation.
- This chart compares the actual level of US Core CPI with the level as at February 2020, pre-pandemic.
- We believe the spike in inflation to be a result of the imbalances in the removal of Covid-19 restrictions rather than persistent .
- This means that many of these pricing pressures will ease during the second half of the year in our view.

Trade-weighted US Dollar Index

- The Dollar lost its strength after the start of the pandemic as stimulus was injected into the US. But has gained in 2021 due to vaccine roll-out success and economic recovery.
- The trade-weighted dollar was created by the Fed to measure the currencies competitiveness versus its trading partners.
- As inflation fears were stoked by pricing pressure the US competitiveness was questioned but as the view, led by the US Treasury market, moved to transitory from persistent the currency has strengthened once more.



5-30 Yr US Treasury Curve Flattening



- The chart represents the difference between the US 5Yr Treasury yield and the 30yr yield.
- The narrowing of the spread in June demonstrates a flattening of the overall curve, with less of a 5-30yr yield differential.
- This may indicate that investors expect inflation to prove transitory and fall in the long term leading to comparatively lower long-term rates.
- Conversely if investors believe that the higher-than-expected US inflation rates will lead to the Fed tightening rates sooner than expected, then the yield curve may flatten on rising short-term rates.
- More recently, lower 30yr yields have been linked to investing in growth stocks as the economy is allowed to run "hot" for longer.

Macro View

While the global economy continues to open and manufacturing remains strong despite bottlenecks in the supply chain, the growing number of cases of the Delta variant of Covid-19 once more threatens economic activity. The experience in the UK, where the Delta variant is now responsible for 90% of all new cases, suggests that a successful vaccine roll-out has prevented the volume of cases from being reflected in hospital admissions and fatalities[i]. However, in developed and developing countries, where vaccination programmes have been slower or uneven, the spread of new cases has become a bigger concern. The recent speeches from UK Prime Minister, Boris Johnson, are an example of a sea change in government policies from protecting life at all costs to learning to live with the virus, supporting businesses and populations in getting back to normal[ii].

Sea change in government policies from protecting life at all costs to learning to live with the virus.

UK

Monthly UK GDP figures would suggest that many companies anticipated the recovery in consumption and had started hiring before the restrictions started to lift[iii]. The Office for National Statistics estimated that GDP Growth in April was 2.3% - the fastest since July 2020 – with the service sector growing 3.4%[iv]. UK unemployment also fell for the three months to April to 4.7%, or approximately 1.6 million people[v], as non-essential shops and hospitality venues were allowed to re-open. Of the 4.7 million workers on furlough, 1.1 million were in accommodation and food sectors and a further 938,000 were in retail[vi]. As the scheme begins to wind down from the beginning of July, many fragile businesses that have only just returned to operation may find the next couple of months very important. The Bank of England estimates that the unemployment rate may move back up to 5.5% towards the end of the year as the furlough scheme winds up in October[iv].

Monthly UK GDP figures would suggest that many companies anticipated the recovery in consumption and had started hiring before the restrictions started to lift.

UK inflation also jumped to 1.5% in April, up from 0.7% in March, a reflection of the re-opening boom and intensifying price pressures, and the Bank of England's Monetary Policy Committee left policy unchanged at its June meeting. However, there is a difference of opinion between outgoing Chief Economist Andy Haldane and Governor Andrew Bailey as to the risks attached to the higher-than-expected jump in inflation so far this year. The last minutes suggest that the current jump in inflation is tied to irregularities in the reopening of economies and labour shortages. The continuing fiscal support offered by governments has made employment in low paid sectors less attractive, meaning that this may prove to be the peak in near term inflation pressures as support begins to wind down[vii] .

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Meanwhile, IHS Market interim Purchasing Managers Index (PMI) was 61.7 in June following May's record high of 62.9 – any reading above 50 notifies of an expansion[viii]. The PMI data showed a rapid growth in new orders and very strong job creation in response to the rising demand. The latest GDP forecast for 2021 from Deloitte expects stronger than projected annualized growth of 7.5% in the UK following steady progress in easing restrictions, an efficient vaccine roll-out as well as an improving global outlook.

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Barclays is forecasting second quarter GDP to surpass the pre-Covid fourth quarter 2019 level by 1.8%.

United States

The steady growth in vaccinations has helped the US economy to maintain its momentum, with 44% of the population fully vaccinated by mid-June. Another round of federal transfers in late March and early April saw consumer spending on goods continue, but an acceleration in services spending looks to be underway as the economy re-opens. Barclays is forecasting second quarter GDP to surpass the pre-Covid fourth quarter 2019 level by 1.8%. Although this may prove to be the peak in growth we believe accumulated savings should keep activity strong[ii].

The sluggishness in labour market activity has surprised many and although 14.8m jobs have been recovered there is still a shortfall of 7.6m from the pandemic.

The sluggishness in labour market activity has surprised many and although 14.8m jobs have been recovered there is still a shortfall of 7.6m from the pandemic[iii]. The continuing state aid has been blamed for the slow return of lower paid service sector personnel, leading to wage pressures in certain sectors as the economy re-opens. Other supply bottlenecks have seen inventory levels fall, backlogs grow, and slower delivery times, leading to a jump in both headline and core inflation during the quarter. In May, headline and core Consumer Price Index inflation jumped from 2.6% y/y and 1.6% y/y in March to 5% and 3.8% respectively.

The prepared comments following the Federal Open Market Committee's June meeting proved more hawkish than the markets had been expecting, with formal acknowledgment that inflation may prove less transitory than anticipated. The introduction of average inflation targeting had led to the expectation that inflation may be allowed to run hot for a period but the outlook for policy rates has shifted quicker than we expected. Chair Powell also acknowledged the impact of unemployment benefits on employment, which has brought forward market expectations for the start of the tapering of quantitative easing – the beginnings of policy tightening.

Joint debt issuance is a major step forward for the European Union in our opinion.

Europe

The European economy is now in better shape than when the Next-Generation recovery package was agreed last year and now that all 27 member states have approved the "Own Resources Decision"[ix]. The EU has successfully raised EUR 35 billion related to the fund via the issuance of two ten-year bonds. It is planning to raise a total of EUR 80 billion throughout 2021 and even more through shorter dated bills. Joint debt issuance is a major step forward for the European Union in our opinion, but it is unlikely to offset the fiscal support during the pandemic that is set to be phased out over the next twelve months. By mid-July, the EU is expected to disburse EUR 50 billion in pre-financing to the twelve member states with approved recovery plans positively contributing to GDP growth.

Supply side disruptions are also affecting production in the EU with many manufacturing firms citing shortage of equipment as the main factor in limiting production. June's manufacturing output and new orders releases are both below March peaks and we feel the export figures reflect the slowing momentum in China and the US. HICP Inflation is also decelerating despite strong June activity to 1.9% y/y from 2% y/y in May. The basket of prices that make up the HICP figure has changed in composition which may have affected the calculation, but there is still slack in the labour market and wage growth remains weak.

Industrial production, construction and retail sales are all back to pre-crisis levels and the pace of vaccinations has increased significantly, which is good news in the face of the surging Delta variant. The Eurozone composite Purchasing Managers Index covering both manufacturing and services registered 59.5 in June, up from 57.1 in May, suggesting a strong rebound in the second quarter for Europe's main economies. The number of employed continues to rise with the unemployment rate falling for the third consecutive month in May to 7.3% from a peak of 7.7% last September, although still above the pre-pandemic 6.6%. As the holiday sector is allowed to re-open over the summer the surge in consumer spending should drive the recovery through the third quarter, leading Barclays to raise their growth forecast for the Euro area to 4.6% y/y this year[ii].

The Eurozone composite Purchasing Managers Index covering both manufacturing and services registered 59.5 in June, up from 57.1 in May.

Japan

Rising virus cases and the slow vaccine roll-out has increased talk of a possible double dip recession in Japan. The decision to push ahead with the Olympics without foreign attendance has also added to the state of emergency being extended throughout the quarter, and supply shortages particularly in the semi-conductor automotive industry has severely curtailed production. Absolute Strategy Research has lowered its 2021 average annual growth forecast to 2.25%[x]. However, vaccinations are set to pick up with Prime Minister Suga aiming to vaccinate the elderly, which make up approximately 30% of the population, by the end of July. This should provide a base for activity to pick up in the second half of the year. With inflation expected to remain sluggish, pressure to spend more on the recovery could feature in lower house elections in September.

Absolute Strategy Research has lowered its 2021 average annual growth forecast for Japan to 2.25%.

Emerging Markets

Absolute Strategy Research believes that one of the key risks to global growth comes from the slowdown in China where growth momentum looks like it peaked in the fourth quarter of 2020. The consumption boom has been disappointing as the pandemic seems to have affected spending habits which have been further impacted by slowing household income growth, particularly amongst lower income groups[ii]. A recent speech by President Xi linked to the 100th anniversary of the Chinese Communist Party was surprisingly antagonistic, particularly towards Taiwanese independence, and will have done little to ease tensions with the west. The continued boom in exports has underpinned the industrial sector, although we feel the strength in the property sector may prompt an early move in policy rates.

The consumption boom in China has been disappointing as the pandemic seems to have affected spending habits which have been further impacted by slowing household income growth.

The rise in Covid-19 cases during the second quarter has dealt a blow to parts of Asia causing growth downgrades for full year 2021 particularly in the Philippines, Thailand, and Malaysia - although Korea and Taiwan have fared better buoyed by booming global semi-conductor demand. Inflationary concerns have grown on the supply side, not least since the region is a net importer of energy and commodities although like elsewhere, we believe these pressures will prove transitory.

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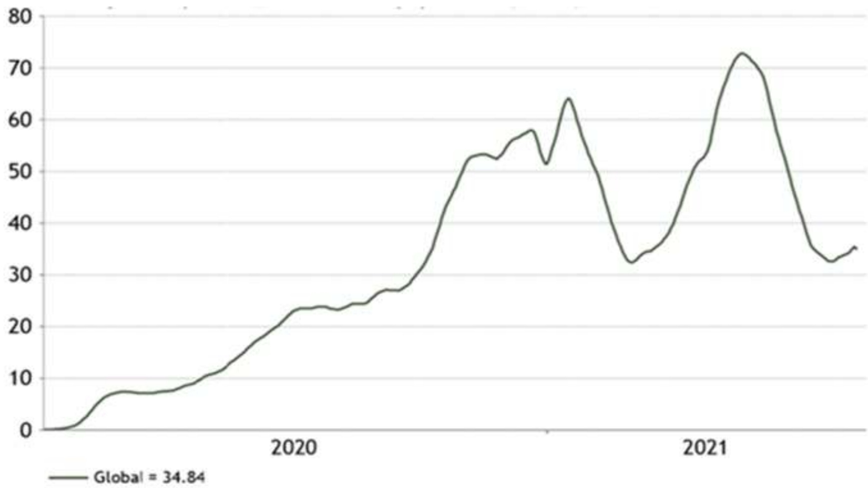
As economies are encouraged to re-open, we expect to see consumption move from mainly goods to include service sectors, supported further by the accumulation of excess savings during the pandemic.

In Latin America inflation is also a major concern with many central banks already hiking rates where economic activity has been better than expected. The second quarter has continued the strength seen in the first, albeit from a deep contraction in 2020, with the region benefitting from rising commodity prices. GDP remains significantly below pre-Covid-19 levels and we feel political uncertainties continue to influence economic and investor decision-making.

Conclusion

As economies are encouraged to re-open, we expect to see consumption move from mainly goods to include service sectors, supported further by the accumulation of excess savings during the pandemic. The boom in manufacturing led by China and the US has begun to slow, leading central bankers to maintain the belief that the jump in inflation will prove transitory and dissipate over the course of the second half of the year.

Weekly cases per 100,000 heads of population (1WMA)



Source: *Refinitiv Datastream, ASR Ltd*

Global Covid cases are at their lowest rate in 2021 but the spread of the Delta variant remains a concern as the political emphasis moves to living with the virus.

Global Covid cases are at their lowest rate in 2021[xi] but the spread of the Delta variant remains a concern as the political emphasis moves to living with the virus, meaning that the situation will only become clearer as fiscal support is phased out.

[i] Barclays - Global Synthesis – Little Fires Everywhere – July 2, 2021

[ii] FT.com – Johnson to end almost all Covid restrictions in England on July 19 – July 5, 2021

[iii] Barclays – Economic Outlook – June 24, 2021

[iv] https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpmonthlyestimateuk/april2021

[v] https://www.theguardian.com/business/2021/jun/15/uk-unemployment-rate-falls-staff-jobs-covid-restrictions

[vi] https://www.statista.com/statistics/941233/monthly-gdp-growth-uk/

[vi] https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2021/june-2021

[vii] https://ihsmarkit.com/products/pmi.html

[ix] Absolute Strategy Research – Next-Generation EU arrives – June 15, 2021

[x] Absolute strategy Research – The end of the upgrade cycle – June 1, 2021

[xi] Absolute Strategy research – ASR Investment Committee Briefing – July 1, 2021

Investment Outlook

Q2 saw global equities continue their ascent with the US market regaining its leadership. This gentle drift higher masks a number of significant changes beneath the surface of global markets, however, as investors adjust to a recovering global economy and the associated policy shifts.

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Having started our previous outlook piece with a discussion around the rise in government bond yields it seems only fair to begin this one with a discussion around their subsequent (and rapid) decline during the second quarter. 10yr US Treasury Bonds today offer investors an annualised yield of just 1.3% versus the 1.67% available on April 1st.

Whilst this does not appear to be a huge move in absolute terms (0.37%) it is significant in the context of an already low starting point for bond yields. To us this illustrates the market's fundamental belief in the transience of current inflation. At their meeting in mid-June, the US Federal Open Market Committee lowered the market's belief that they would allow inflation to exceed its target. The FOMC left the statement on economic conditions essentially unchanged whilst allowing the median estimate for the 2023 Federal Funds rate to rise from implying zero rate hikes to implying two full 25bp rate hikes.

The decline in bond yields illustrates to us the markets fundamental belief in the transience of current inflation.

The result of this adjustment has been a sharp reversal in any-and-all positions related to expectations of higher inflation. Bond yields have fallen, interest rate curves have flattened, the technology sector has resumed its outperformance and the US Dollar has strengthened in recent weeks. The chart below highlights the movement in short term inflation expectations (*dark blue*) as being the primary driver of bond yields (*light grey*) over the past year, while longer term measures (*light blue*) remain more stable.

Bond yields have fallen, interest rate curves have flattened, the technology sector has resumed its outperformance and the US Dollar has strengthened in recent weeks.

Air Pocket

Bond Yields and Inflation Swaps

Source: *Barclays Live.*

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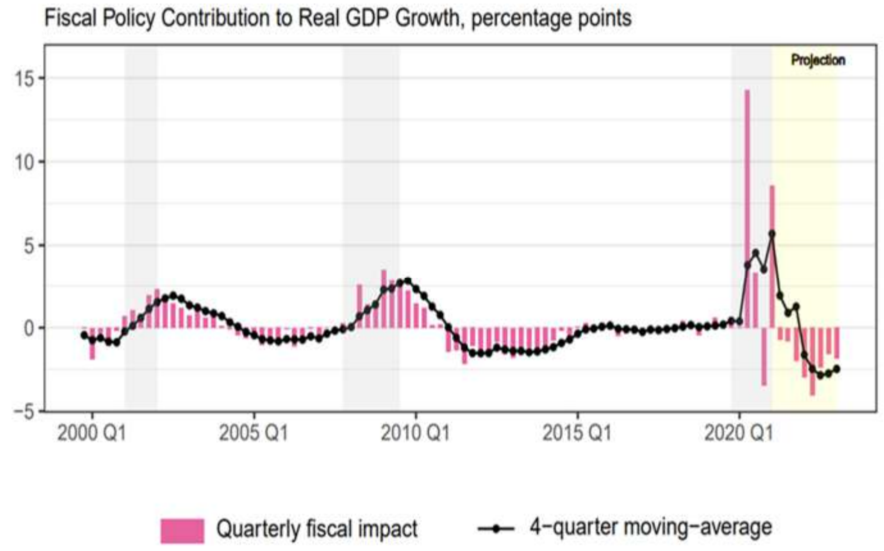
Whilst we maintain our view that risks to inflation are skewed higher over the medium to longer term there are a number of issues that could drive inflation outcomes lower than widely anticipated over the balance of Q3 & 4 (with the exception of this month's data where base effects are likely to peak);

Firstly, the Hutchins Center on Fiscal & Monetary Policy at Brookings (a Washington DC based think-tank) produce an excellent measure of expected policy impacts in their 'Fiscal Impact Measure', which currently points to a significant reduction in aggregate demand as last year's more extreme stimulus measures begin to roll-off or expire.

Fiscal 'Drag' to persist through 2022



Source: *Hutchins Centre on Fiscal & Monetary Policy at the Brookings Institute*

This 'fiscal drag' is likely to persist beyond 2022 (peaking in Q2) and in our view represents the next key challenge for policy makers.

This 'fiscal drag' is likely to persist beyond 2022 (peaking in Q2) and in our view represents the next key challenge for policy makers. One caveat here, however, is that the Hutchins forecast does not include the impact of any additional legislation brought forward by congress over the remainder of 2021 (more on this below).

in the very near term we appear to be beyond the peak of accelerating prices seen in categories such as new & used cars, airfares, food away from home and vehicle insurance.

Secondly, in the very near term we appear to be beyond the peak of accelerating prices seen in categories such as new & used cars, airfares, food away from home and vehicle insurance. These areas have provided the greatest contribution to this year's rise in headline inflation and, at least at the margin, will likely begin to detract from headline numbers moving forward. Add to this the fact that most major commodity curves also imply lower prices over the months ahead and we start to more clearly understand recent moves in both bond yields and inflation pricing.

Lastly, while there are very clear signs of wage growth in those specific sectors most affected by the pandemic, these pressures have yet to manifest more broadly in the employment market. The Atlanta Fed's wage growth tracker chart below shows hourly earnings continuing to trend lower on an overall basis. Job openings have also rapidly accelerated which, when combined with the expiry of unemployment benefits in September, should feed through to higher employment numbers in the coming months and alleviate those more immediate pressures on global supply chains.

Wages will continue to be a key area of focus for those wishing to keep ahead of shifting trends in inflation and one we will be monitoring closely.

While there are very clear signs of wage growth in those specific sectors most affected by the pandemic these pressures have yet to manifest more broadly in the employment market.

US Wage Growth Tracker (3 month average of median wage growth, hourly data)

Source: *Federal Reserve Bank of Atlanta*

If we are correct about the path of forthcoming data it feels likely that the US Federal Reserve will be given sufficient 'cover' from weaker inflation numbers to drive the engineering of an even more dovish and domestically-orientated policy outlook.

Path vs Destination

If we are correct about the path of forthcoming data, it feels likely that the US Federal Reserve (alongside other Developed Market Central Banks) will be given sufficient 'cover' from weaker inflation numbers to drive the engineering of an even more dovish and domestically-orientated policy outlook, particularly with respect to labor markets and fiscal expenditure.

The past three decades have seen a surge in the world's available labor supply owing to the integration of Chinese and Eastern European workers and production into global supply chains, a trend that looks set to at least reduce if not completely reverse as the pandemic laid bare the fragilities of relying on external sources of supply. Recent remarks from President Biden during a College speech provide the clearest evidence we can find of a country looking increasingly inward and reorienting priorities toward domestic growth;

The three decade surge in the world's available labor supply looks set to at least reduce if not completely reverse as the pandemic laid bare the fragilities of relying on external sources of supply.

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President Biden, Cuyahoga Community College, Cleveland, Ohio, May 27th 2021

"If we invest, we can create millions of jobs rebuilding the foundation of a strong, fair, resilient, competitive economy, and save hundreds of thousands of lives.

And 100 percent of our investment is going to be guided by one principle: Make it in America. Make it in America.

If I can hold that for just a second, there is a law that was passed in the '30s — doesn't violate any trade principle — saying that whatever money — that whatever program that taxpayers are paying for, you can spend it all on American contractors. No one's ever done it — though, I promise you, I signed an executive order. If in fact we're building the new deck of an aircraft carrier — well, guess what? — I get, as President, to make — let contracts for over $600 billion a year.

I promise you, there'll be no contract let to a foreign company or any of the product down the line. Right now, what can happen is you can hire an American company and they can sublet to — and they can — their downstream product can all be foreign. All you got to do is get that particular agency to say, "You got an exception. We can't find that job here in America."

Well, guess what? They're going to find the job here in America, I promise you, or they're not going to get the contracts. These jobs will be good jobs — American jobs that deliver good wages and dignity. "

Source: *Remarks by President Biden on the Economy / The White House*

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Market Opportunities

Throughout the course of the quarter we had been reviewing our fixed income holdings and the recent acceleration in the decline of yields led us to further reduce our exposure to investment grade corporate bonds. The level of additional yield provided by these securities no longer appears to offer sufficient reward to compensate investors for the risk of default and/or the potential for higher interest rates and inflation moving forward.

One area of global fixed income markets where we do see an attractive opportunity, however, is in Emerging Market Sovereign Bonds (specifically local currency). The developing world has responded far more quickly to the threat of inflation than elsewhere, with a number of Central Banks including Brazil, Mexico, Russia, Hungary & the Czech Republic having already raised domestic interest rates in a bid to temper inflationary pressures. This leaves many bonds offering significant current income yields alongside positive real (after-inflation) yields, characteristics which have long since left us here in the Developed World.

One area of global fixed income markets we do see an attractive opportunity, however, is in Emerging Market Sovereign Bonds (specifically local currency).

The level of yield available on these securities, particularly when viewed in the context of their underlying policy rates, provides investors with a healthy buffer of protection against any further rate hikes whilst delivering attractive real returns in a world which remains starved of income.

Emerging Market Bond Yields: Attractive vs Policy Rates

Source: *Absolute Strategy Research*

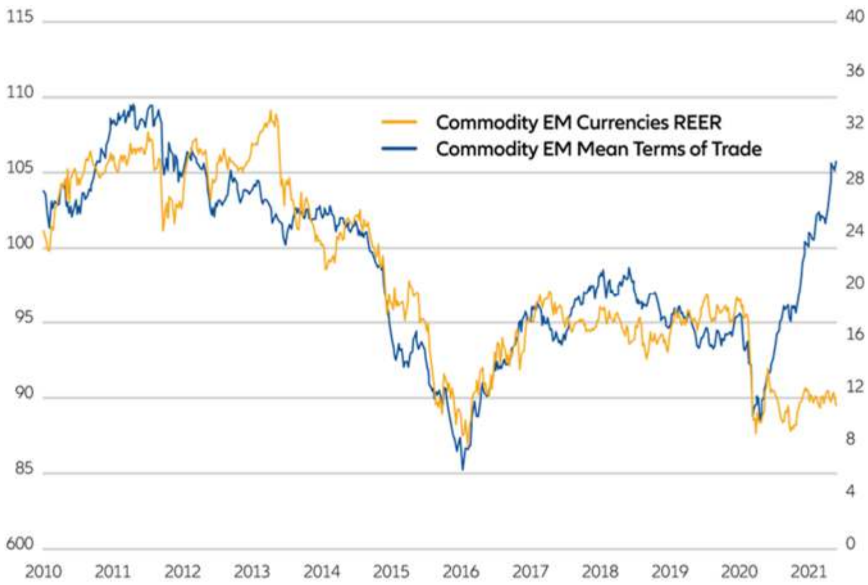
The level of yield available on these securities, particularly when viewed in the context of their underlying policy rates, provides investors with a healthy buffer of protection against any further rate hikes whilst delivering attractive real returns in a world which remains starved of income.

The opportunity is further amplified when considering the currency in which these bonds are denominated. The recent rally in commodity prices has left the value of exported goods relative to imported goods at its highest level since 2012 (for a basket of 9 commodity exporters), however their currencies have yet to reflect these moves (chart below).

Whilst we accept that the price of some of these commodities may well have peaked for now, there could still be a degree of catch up over the months and years ahead.

The recent rally in commodity prices has left the value of exported goods relative to imported goods at its highest level since 2012, however their currencies have yet to reflect these moves.

Emerging Market FX is yet to catch up



Source: *Allianz Global Investors*

Whilst we accept that the price of some of these commodities may well have peaked for now, there could still be a degree of catch up over the months and years ahead.

Valuations in the UK have now fallen below those of many emerging markets whilst providing investors with far higher standards of corporate governance, dividend income and access to a truly diverse global revenue base.

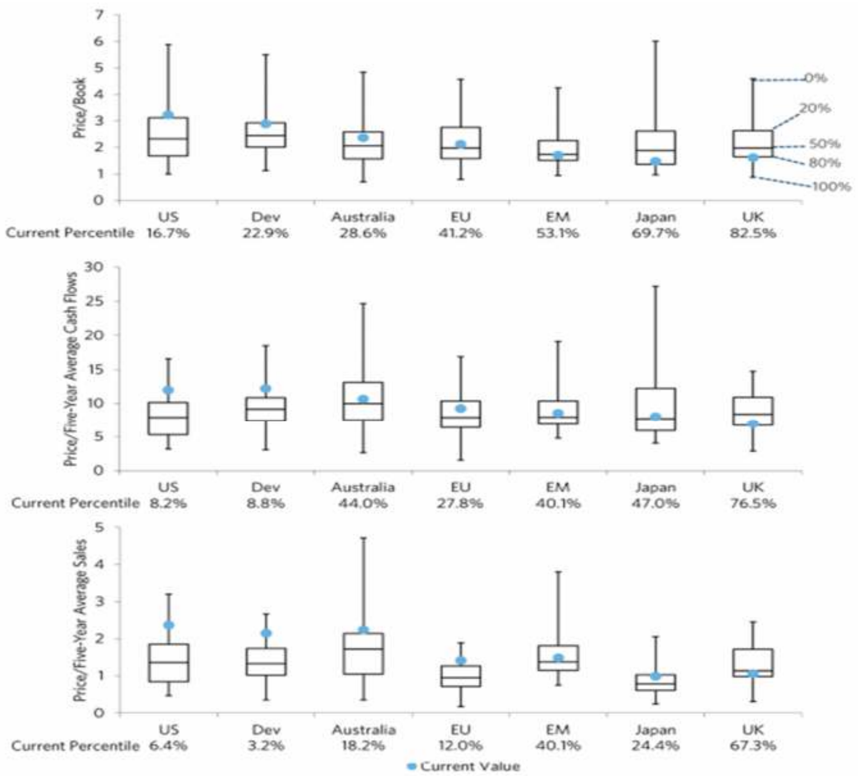
Given the forthcoming removal of constraints on mobility the scale of the opportunity in the UK gives us genuine cause for optimism.

In summary we prefer exposure to UK & European equities versus other parts of the world at present and continue to maintain a low exposure to corporate and government bonds.

In equity markets we continue to identify opportunities in UK listed stocks, a vision clearly shared by overseas private equity investors whose activity in the UK market has reached a record high over the first half of 2021 (the recent bid for Morrisons Supermarket being the clearest example of this trend).

Valuations in the UK have now fallen below those of many emerging markets whilst providing investors with far higher standards of corporate governance, dividend income and access to a truly diverse global revenue base. Many of the names directly related to the economic reopening have also suffered particularly poorly over recent weeks as new Covid-variants continue to threaten the recovery. Given the forthcoming removal of constraints on mobility the scale of the opportunity in the UK gives us genuine cause for optimism.

Valuations Relative to History for Major Equity Markets



Note: Valuations are based on year-end price-to-book ratio, price-to-five-year average cash-flow ratio, and price-to-five-year average sales ratio relative to historical levels. Historical period for the United States is 1962–2020; for the developed markets, United Kingdom, Japan, and Australia is 1982–2020; and for the EM markets is 1994–2020. The box plot shows the minimum and maximum values over the historical period as well as the first and fifth quintiles and the median.

Source: *Research Affiliates*

In summary we prefer exposure to UK & European equities versus other parts of the world at present and continue to maintain a low exposure to corporate and government bonds. Our allocation to alternative strategies is growing and we are in the early stages of due diligence with a number of exciting new funds in the space.

"Out with the new, in with the old" - Structural Returns in a Balanced Portfolio

By Toby Hayes, *Portfolio Manager at* ***Trium Capital***

In 1923, a then little-known economist, John Maynard Keynes was analysing commodity futures markets, when he stumbled on a peculiar feature of futures pricing. He noticed that the costs of commodity storage which are often very high, were baked into futures pricing. He observed that speculators invested in commodity futures would not only receive the commodity return but would also be paid the storage costs on top. What's more, he designed a simple strategy to isolate the storage costs to be paid out as a unique return. Little did Keynes know, but he had stumbled on the first structural return, a return source embedded within a traditional asset class that is independent of the wider macro risks that drive the market.

In 1923, John Maynard Keynes stumbled on the first structural return.

Structural returns are clearly not new, but before we dive into the hows and whys, it is worth framing some constructs of portfolio management. Even Keynes did not quite understand the importance of what he had discovered, and it took some 85 years before the concept of structural returns would become embedded in financial lexicon.

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For most of Keynes' life, all the return on one's portfolio was considered to be alpha, or more specifically stock selection 'skill'. No one had yet formally described that maybe stock prices ebb and flow with the market until Harry Markovitz in the 1950s posited that a portfolio's return was mainly due to the market return (beta) and only partly stock selection skill. It was not until the 1970s that two academics, Fama and French, identified that the market return could be further decomposed into styles, such as Growth or Value stocks which can have very different return profiles. While style investing is now ubiquitous across the equity world, it is only relatively recently that the same styles, found embedded within the equity market, are also prevalent in bonds, commodities, and FX. And last, but not least, over the last ten years it has become apparent that there is a small component of one's portfolio return that is neither market driven, style driven or a function of selection skill. This is now what we know to be a structural return.

It has become apparent that there is a small a component of one's portfolio return that is neither market driven, style driven or a function of selection skill. This is now what we know to be a structural return.

Structural returns are not only unique but are quite idiosyncratic, which makes them hard to define as one homogenous group, but you know one when you see one. Their defining characteristic is that their return profile is independent of the traditional risk factors (Fed policy, macroeconomics, pandemic response, earnings etc.), and instead, is driven by often quite esoteric factors (i.e. weather, taxation policy, regulation, seasonality, index rebalancing, congestion, credit rating slippage) - factors that are specific and unique to the market in question.

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To illustrate, let's go back to commodities and consider a variant of the Keynes conundrum. The chart below shows a generic Commodity ETF tracker versus the physical commodity price index. It's quite obvious that something other than fees is dragging the passive tracker down versus the physical commodity market. As it happens, there are two structural returns working (in this case) against the tracker. One of these is the 'congestion effect', a structural phenomenon that is now ubiquitous across any market which has been touched by the rise of the passive investor.

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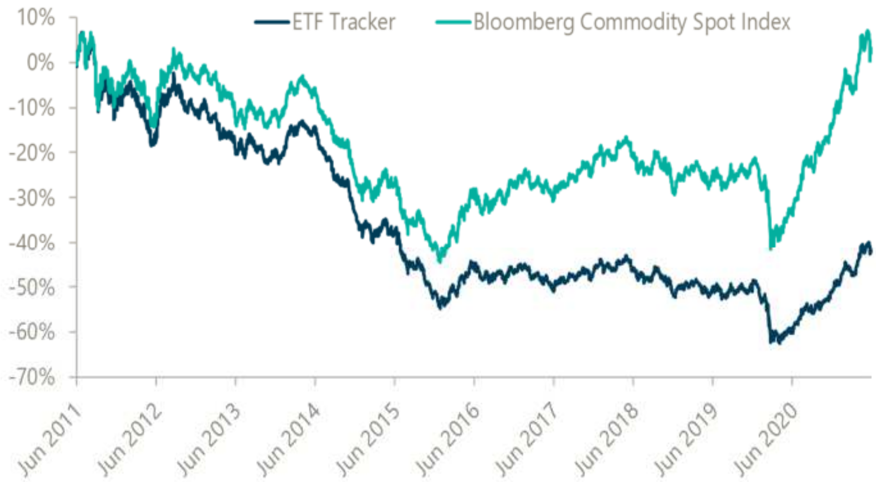
Commodity ETF Tracker vs. Physical Commodity Price Index



Source: *Bloomberg. Data as at 23/06/2021.*

This wall of money causes price distortions leading to structural underperformance of the ETF tracker.

To see how passive investors have created a structural return, lets dig into the mechanics of this commodity example. Most investors (either passive or active) typically invest via the futures market to avoid physical storage costs. However, these investors have to periodically roll their position, buying the near-term future and then selling it just before it expires to buy the next one out. This 'rolling' on the commodity curve maintains the constant exposure (beta) to the commodity market. However, all passive money has to follow the same index tracking roll schedule and as such, on the same day every month, $150bn dollars tries to squeeze in and out of the same contracts at the same time. This wall of money causes price distortions which every passive investor has to swallow (as they are price insensitive), leading to structural underperformance of the ETF tracker.

Congestion and similar crowding phenomena can be seen wherever passive money goes. Indeed, any market where large non-price sensitive agents operate, structural anomalies arise which can be monetised.

It is at this point that the structural investor comes in. Index roll schedules are published well in advance, and it is easy to see that one can preposition for the passive money flows, profiting from the price squeeze. By buying and selling the same contracts just before the index wall of money hits, the congestion 'fee' paid by the passive investor becomes a very persistent return stream for the structural investor.

However, this effect does not stop in commodities. Congestion and similar crowding phenomena can be seen wherever passive money goes. Indeed, any market where large non- price sensitive agents operate, structural anomalies arise which can be monetised.

For instance, the most recent example is that of the frenetic online retail investors, desperate to trade the latest tech meme stock. Their herding behaviour has created predictable and monetisable rebalancing flows from levered tech

ETFs, desperate to keep up with speculative flows on the way up and the way down. And yet, at the other end of the spectrum, we have the Federal Reserve, perhaps the largest price insensitive agent of all time, which has depressed long term volatility in US interest rates to such an extent, that interest rate hedging is now a positive carry trade – i.e. you get paid to take out insurance. While such distortions clearly make little fundamental sense, the structural investor is agnostic, indifferent to market views, seeking only to profit from the anomaly while avoiding the market risk.

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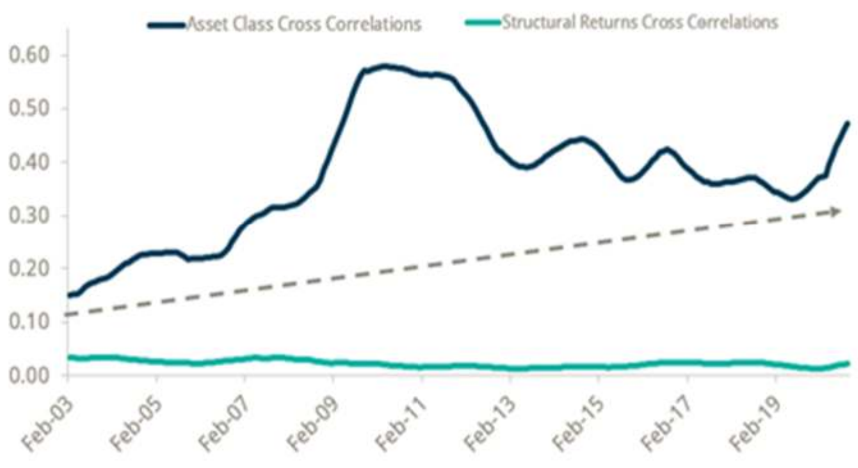
While a picture has been painted on the sources of structural returns, what of their risks? Structural returns monetise market anomalies, without taking broad market risk. As such, the principal risk to the structural investor is that the anomalies dissipate, leaving only residual crumbs for the investor. Fortunately, forecasting of when and where a structural return may come or go is not necessary. The structural investor seeks only to identify the return and be proactive to move through different return sources as they come and go. What's more, if a particular return source were to fade, the risk of this occurrence is particular to each anomaly and unrelated to the wider universe. And herein lies the most important aspect of structural returns that make their inclusion indispensable in a traditional balanced portfolio: correlation and the art of diversification.

How confident can one be that bonds will protect the portfolio if confidence in central banks falters?

Uncorrelated returns are probably the dirtiest words in finance, not because it is something to be avoided (far from it), but because its misuse (or rather abuse) periodically leaves investors nursing portfolio losses after every market crash. Statistical correlation is simply not a good metric to assess how a portfolio will fare in a stressed environment; correlations are neither stable nor accurate. Given asset classes have been pushed to stratospheric valuations by central bank intervention, how confident can one be that bonds will protect the portfolio if confidence in central banks falters? How does the traditional balanced portfolio behave in an inflationary environment? These are existential portfolio management questions, that are too great a magnitude to be left to the vagaries of a historical correlation statistic. And this is where structural returns come in.

How does the traditional balanced portfolio behave in an inflationary environment?

Correlations—Traditional Asset Class vs Structural Returns



Source: *Trium Capital LLP. Data as at 30/09/2020.*

Cross correlations of traditional asset classes have been rising ominously.

There is no one ‘event’, neither pandemic, global depression nor Federal reserve policy pivot that hurts structural returns at the same time. Their ability to diversify is fundamental, not just statistical.

The chart above shows that cross correlations (for what their worth) of traditional asset classes have been rising ominously (N.B Federal Reserve), yet correlations of structural premia have remained near zero. However, the diversification goes deeper. There is no one ‘event’, neither pandemic, global depression nor Federal reserve policy pivot that hurts structural returns at the same time. Their ability to diversify is fundamental, not just statistical. And in this regard, they are unique in finance and have earned an essential place within a balanced portfolio.

John Maynard Keynes may not have appreciated the significance of the first structural return, and it would take some 85 years before an investment process would focus on this space. Yet we now find ourselves with markets that have never been so exuberant and yet so fragile and interconnected at the same time. However, cometh the hour, cometh the man. Structural returns cut a different path and provide the allocator the opportunity to invest away from macro, away from central banks and their endless market interventions. In many ways, structural returns are the only true alternative return.

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