Strong corporate earnings in developed markets offset the threat of the spread of the Delta variant in economies that are reopening. Policy makers in the US, Europe and Japan continued with stimulus measures while some smaller countries announced a winding back of support. Bond markets largely ignored the continued higher prints in inflation numbers. Equity markets set record highs across the month but finished July just off highs. Corporate reporting season will be the focus of the Australian market this month. Overall, the outlook remains solid as economies reopen, vaccines roll out, and corporate earnings recover, albeit at a slightly slower pace expected than recent months. We have maintained our elevated risk weights as markets are likely to continue grind higher.

Policy Watch: The policy language of central banks is slowly shifting. Increasingly, more and more voting members of monetary policy committees are signalling an intention to slow quantitative easing and bring forward the normalisation of cash rates. In speeches, central bank governors right across the world have been at pains to reassure markets that policy reversal will be slow, careful and not derail fragile recoveries. New Zealand's Reserve Bank (RBNZ) is among the first to start normalisation announcing an end to quantitative easing in July and a hike in the cash rate fully priced by the market for November 2021 at the latest. Tax policy was front and centre when the OECD met in Venice and agreed a new framework for the taxation of the digital economy for developed nations.

Politics Update: Most countries continue to battle with the balance between supporting the economy through the recovery phase and rising debt levels. However, the major political risk remains the deteriorating relationship between China and the West. This was further exacerbated by Chinese authorities announcing a crackdown on US listed Chinese companies which resulted in significant share price reactions. In addition, investors in China were negatively surprised by a wave of regulatory actions though July impacting online education, real estate and internet-based companies (covering music, food delivery and news).

Vaccine Update: Outbreaks of the Delta variant has plunged further lockdowns across Australia just as many of the developed world economies open up and live with the consequences. Australia is now developing a program for re-opening the economy and living with the virus. Federal cabinet has agreed that vaccination rates at 70 per cent are a requirement to move to 'Phase B' which would remove some restrictions for those fully vaccinated. While the vaccination rate would need to be at least 80 per cent to move to 'Phase C' where vaccinated residents will have no domestic restrictions and can travel overseas.

Inflation Watch: Central bankers have convinced the market that elevated price pressures are temporary and will moderate over the next few months. Inflation measures remain elevated but there has been some easing of pockets of price pressures.

Risk Budget: Volatility measures continue to bounce around at relatively benign levels. Option skew has eased somewhat, and our bear market checklist continues to point to a more moderate risk environment. With central banks likely to taper, and inflation numbers likely to surprise on the higher side, we expect some increase in volatility in coming months. Historically equity markets tend to struggle in the latter months of Northern Hemisphere summer, however, we have maintained our overweight level of risk (albeit still well short of our aggressive equity positions during the first half of the year).

Call to Action: While we are looking for decent pullbacks to add to risk and are assessing the recent Asian markets weakness as a potential buying opportunity, we have not yet added to our allocations to that region. Profit taking or risk off events in developed markets should be well supported with plenty of liquidity on the sidelines.

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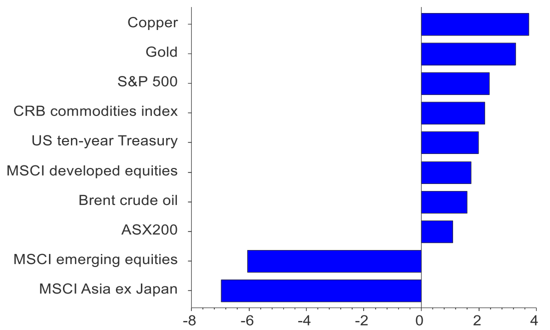
July Review

Copper and gold rebounded after a softer month in June. Emerging markets, and Asia in particular, had a very poor month, after the Chinese Government announced a crackdown on many of its leading internet companies.

Equity markets ground out gains as corporate earnings largely met elevated expectations. Companies have taken some very hard decisions on cost bases during the pandemic and efficiency gains are showing up in much improved bottom lines. Bond markets performed strongly as yields surprisingly fell across the curve.

Chart 1: July Asset Class Performance
Percentage Change (total return in local currency)

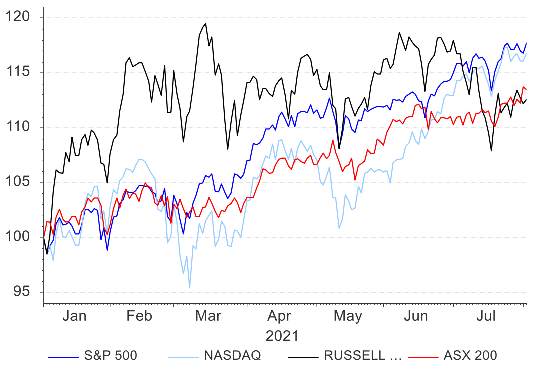


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The S&P500 index rose 2.3 per cent in July to be up a little over 17 per cent for the calendar year. Healthcare, utilities, and real estate drove the market higher, while energy stocks had a weak month. The NASDAQ composite rose 1.2 per cent in July to be up 14.3 per cent for 2021.

Small companies had a soft month on the back of investor concerns about rising Delta numbers. The Russell 2000 fell 3.7 per cent for the month, with the calendar gain moderating to under 13 per cent. European equity markets enjoyed good gains, with Germany rising 3.2 per cent and the French market putting on 1.6 per cent. The UK market, which has lagged the recovery in continental Europe, rose a modest 1 per cent.

Chart 2: US and Australian Equity Markets YTD Relative Performance (100 = 1 Jan 2021)



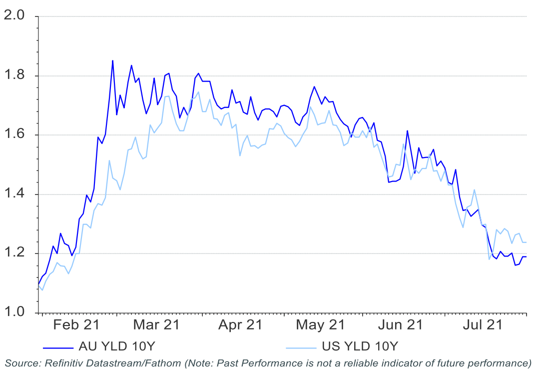
Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The ASX200 rose 1.1% in July and closed just below a record high. Materials (+7.2%) and consumer durables (+7.4%) were incredibly strong but were largely offset by diversified financials (-1.4%), media (-4.5%) and IT services (-6.9%). The market is up just over 12 per cent in 2021 with the strongest returns coming from financials, materials and consumer cyclicals.

The Fed held a two-day meeting in July and left policy unchanged – the cash rate was maintained at 0.25% and bond purchases of $80 billion per month were reaffirmed. In testimony to a U.S. House of Representatives Committee, Powell said he is confident recent price hikes are associated with the country's post-pandemic reopening and will fade, and that the Fed should stay focused on getting as many people back to work as possible.

US Government ten-year bond yields surprised markets and moved significantly lower over the course of the month. Yields tested key technical support levels before rising slightly to close the month around 24 basis points lower at 1.23%. This was against the broad market expectations that bond yields would continue to rise towards 2 per cent in response to rising inflationary pressures and the reopening of the economy.

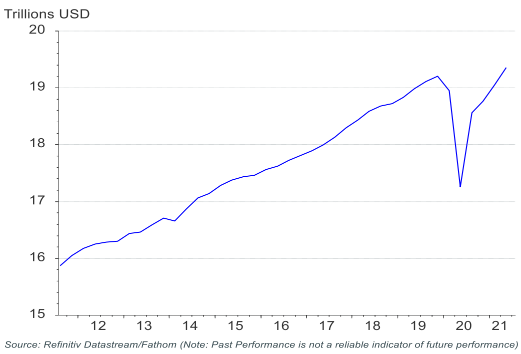
Chart 3: 10 Year Bond Yields (%)



US GDP rose 1.6% qoq or 6.5% p.a. last quarter, while missing expectations of 8.4%, underlying data such as consumption and business investment grew strongly. Inventories were a drag on growth, reflecting continued supply chain disruptions.

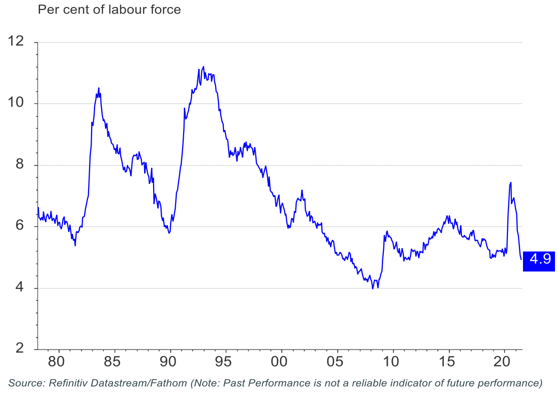
The level of GDP is now 0.8% higher than it was at its peak in the fourth quarter of 2019, marking the shortest recession and fastest recovery in US history.

Chart 5: US Real GDP



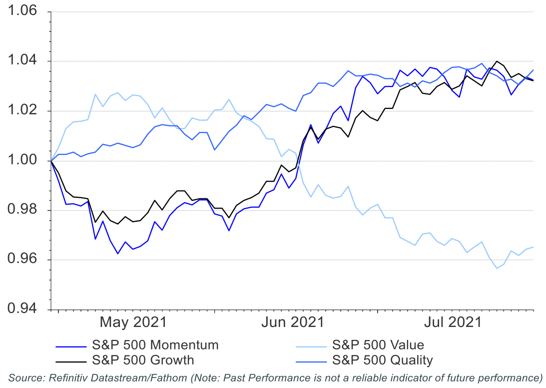
The Australian economy continues to perform well, despite the lingering lockdown in Sydney and the recent lockdowns in other states. The CPI release in July showed that prices increased by 3.8 per cent and the labour force numbers continued to show a resilient labour market. Lockdowns are likely to soften economic data over coming months, making it difficult to interpret the true strength of the underlying economy.

Chart 4: Australia Unemployment Rate (%)



Value had been the dominant factor for a handful of months starting in last quarter of 2020 as bond yields rose on the back of economic reopening. However, with bond yields falling, growth has once again become the dominant factor style. Momentum and quality were broadly neutral in July.

Chart 5: S&P500 Equity Factor Relative Performance (3 months)



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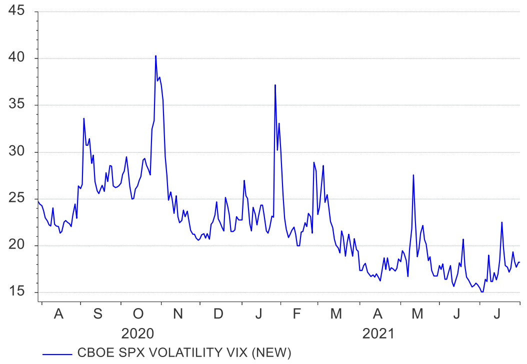
Risk

The CBOE VIX index — a measure of investors' expectations for future volatility — continues to bound around at relatively benign levels. An earlier spike in the cost of put protection has eased, signalling investors have become a little more relaxed about the outlook for equities in the next few months – which has been further supported by the very solid earnings season in the US.

Chart 6: S&P 500 Volatility Index (VIX)

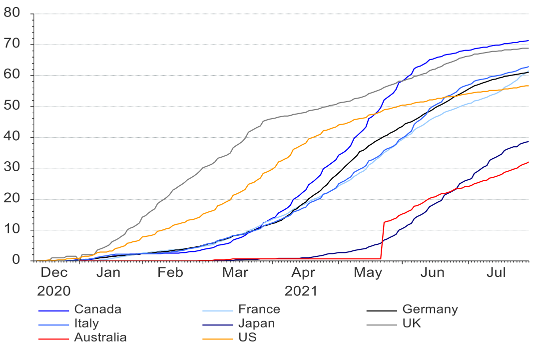


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Outlook

Vaccination rates continue to climb across the world, as economies open back up. Some of these countries, which have experienced significant outbreaks over the past 18 months, have large sections of the population with some antibodies from previous exposures which should assist reduce infection rates.

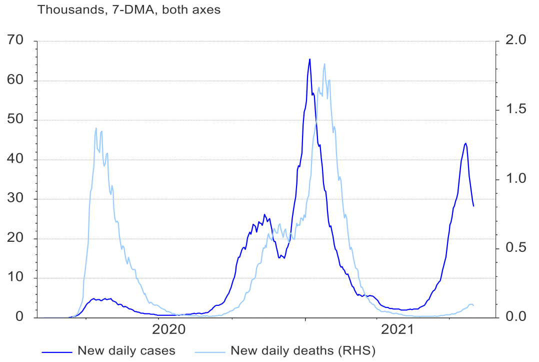
Chart 7: Vaccine Rollout (% of population with at least one dose)



*When data are unavailable Refinitiv repeats previous data point *ıance is not a reliable indicator of future performance)*

The UK Freedom Day on 19 July has signalled a new phase in the pandemic recovery. With a majority of the adult population vaccinated, the UK is being seen as an experiment of sorts for other countries striving towards herd immunity. Case numbers continue to rise in the UK, but the hospitalisation and death rates are a fraction of what was seen at the height of the pandemic.

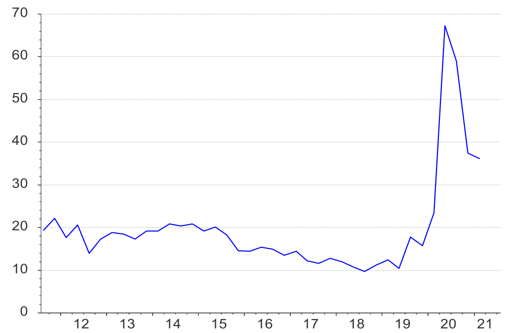
Chart 8: UK new COVID-19 cases and deaths



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The extended Sydney lockdown, combined with other intermittent lock downs in other States, is undermining the confidence in the Australian recovery. Vaccination rates remain well below global peers with vaccine hesitancy impacting the uptake rates in Australia. National Cabinet has reached agreement on a phased program out of the pandemic – having set vaccination targets of 70% for Phase B and 80% for Phase C. Increasing liberties and reduced likelihood of lockdowns and border closures will result when these levels are achieved.

Chart 9: Australian Net Savings (AUD Billions)



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

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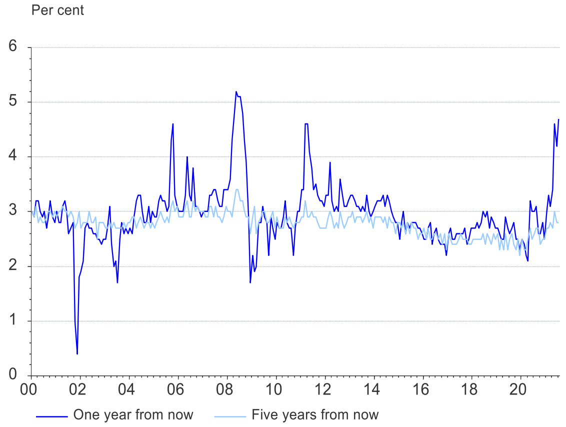
Since the commencement of the pandemic, government support and an inability to spend has added more than $140 billion to household savings, the equivalent to about 10 per cent of annual household income. Once the economy does fully reopen, this pent-up savings is likely to provide a significant boost to consumption levels.

The question over whether price increases are transitory or more persistent will probably not be answered for several months. However, while short term expectations about inflation have risen in the US, longer term expectations have remained below 3 per cent and have softened in the most recent surveys.

Chart 10: US Uni. Of Michigan Inflation Expectations



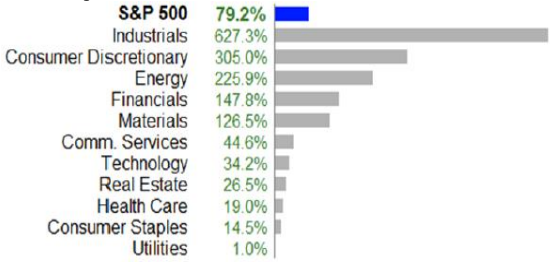
Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

To date, 59% of the companies in the S&P 500 have reported results for Q2 2021 with 88% of these companies reporting actual EPS above estimates.

This is above the five-year average of 75%, as corporates recover from the Covid-19 pandemic and cycle lower numbers from last year. If the trend continues, this period will mark the highest year-over-year earnings growth rate reported by the index since Q4 2009.

While we remain confident that corporate earnings should be strong, with such lofty expectations already built into the market, there may be grounds for anticipating some disappointment should companies not deliver or provide outlook commentary that disappoints the market.

Chart 11: Q2 2021 S&P 500 Blended Earnings Growth Rate



Source: Refinitiv, Past performance and performance forecasts are not reliable indicators of future results.

We have maintained an overweight exposure to risk assets and feel reasonably positive on the outlook for the remainder of 2021. We are reviewing the pull back in Asian stocks as an opportunity to add to exposure to this growing region.

While the path of inflation and the expected change to the Federal Reserve's quantitative program is likely to create more volatility, the reopening of economies and continued improvements in corporate earnings are likely see markets grind higher over the course of 2021.

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