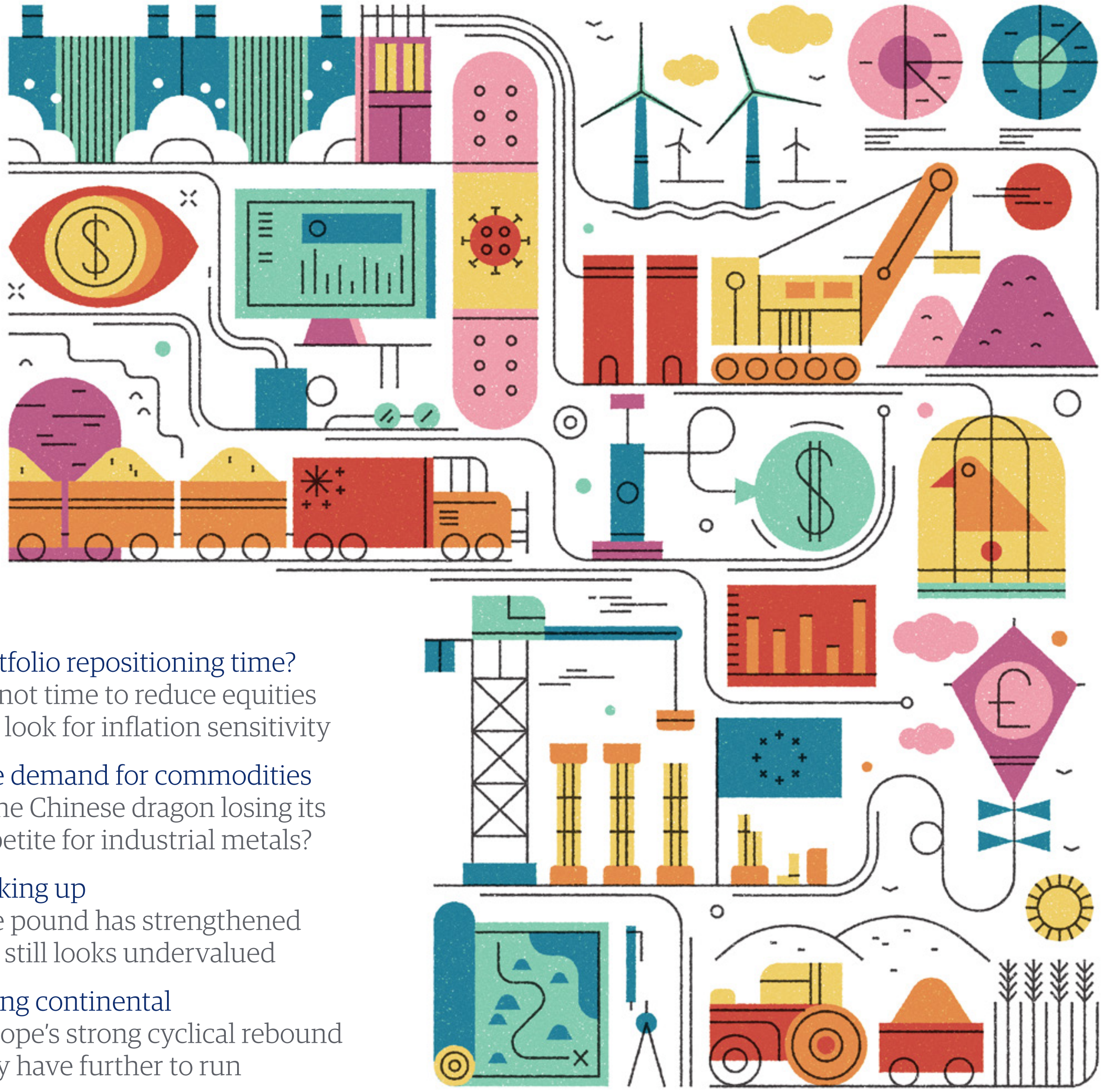
Investment*Insights*

Issue 29 – Third quarter 2021

Inflation fixation

Although the recent spike in prices is likely to be temporary, investors may need to adjust to a world where inflation is higher than before the pandemic



Rathbones
Look forward

Foreword

Investor optimism spread over the second quarter as economies around the world continued to reopen and many aspects of our lives returned to normal. Successful vaccination programmes and stimulus measures across the developed world improved the global outlook.

During the period, government bond markets stabilised as investors gained confidence that policymakers won't have to renege on pledges to keep the monetary stimulus flowing. And corporate bond spreads (the extra yield offered over government bonds for taking on the additional risk of default) fell, signalling investor confidence that recent rises in inflation will not hinder the economic recovery.

It is on the topic of inflation that we begin this issue. Though May's inflation-induced spike in market volatility had subsided by June, uncertainty remains: will it be a fleeting inflation spike or are there more profound underlying causes that could make it a lasting trend?

We take an in-depth look at the shift towards value stocks on page 5, expanding on our observation last summer that it made sense to shift towards good-quality, cyclical companies. These types of businesses are well managed with sound financials and stand to benefit from the upturn in the economic cycle.

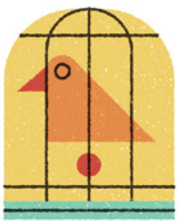
China remains by far the dominant demand driver for industrial metals, but is it losing its appetite? On page 6 we examine the resurgent growth in the post-COVID world and why talk of the next 'supercycle' for industrial commodities may be overblown.

Our next article looks at the pound and its recent rise following a sluggish few years. Brexit and the pandemic sent sterling's exchange rate down against the currencies of our major trading partners. But as businesses reopen following a successful vaccination programme, this has attracted foreign investors, helping to buoy the pound.

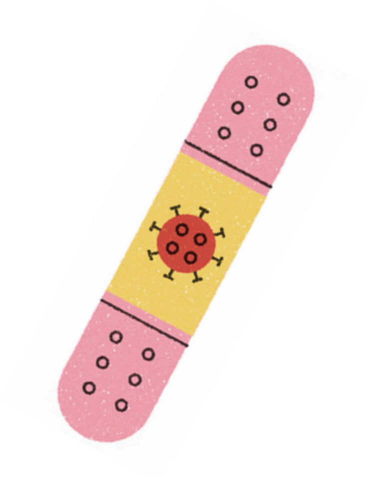
You can read about this year's resurgence of European stocks on page 8, as investors rush to price in their catch-up potential. And in our final article we examine how, without good governance, the best intentions on social and environmental policies are doomed to failure. In other words, G is the glue in ESG.

I hope you and your family remain healthy and safe. We hope to be able to open offices more in the coming months, which should allow more opportunity to meet up. In the meantime, we will continue monitoring how the investment environment is evolving as the world reopens and we start to see what the 'new normal' looks like. Please visit rathbones.com to find out more about our latest views.

Julian



Runaway prices are unlikely but the outlook is uncertain



Indicators of a strong post-COVID recovery keep coming out of the US and other major developed economies, but upside data surprises have brought with them concerns of persistent high inflation. Though May's inflation-induced spike in market volatility had subsided by June, uncertainty remains: will it be a fleeting inflation spike or are there more profound underlying causes that could make it a lasting trend?

For the most part, this inflation fixation is focused on the US. This makes sense because the US accounts for the largest share of global demand, the dollar is the predominant global funding currency and inflation is as much a global phenomenon as a domestic one in today's world. Perhaps most importantly, global bond markets can often move in tandem, and changes in US Treasuries are felt in government bond markets all over the world.

Clearly inflation risks have increased. Core US CPI inflation, which excludes volatile elements such as food and energy prices, was 3% in April and 3.8% in May – a rate not seen since 1992. We continue to believe the current period of high inflation is likely to be transitory. The main reason for the spikes is that prices were abnormally low a year ago, and there have been dislocations in spending, employment, production and logistics. (You can read more of the detail in our March *Investment Update.*)

After that, we think there are too many heavy, long-term phenomena that will keep inflation subdued, as they have for many years now. The structural trends of automation and digitisation, producing more with less, are likely to continue. Meanwhile, the world is even more indebted than it was before the pandemic and there are a lot of people who've been thrown out of work by the pandemic – limiting any increases in spending and wages.

However, by transitory we don't mean that inflation will be back on target by the end of the year (simple maths shows that this is impossible without a deflationary shock), but rather we see it peaking in the next month or two, before falling back towards the US Federal Reserve's (Fed's) targeted average of 2% throughout 2022. Indeed, we think it's likely that inflation over the next two years will average above 2%, in stark contrast to the below 2% average of the last decade. This is a profound change that all investors should consider. We highlight some of the implications it has for bond and equity markets in our next article on page 5.

The outlook is uncertain

The degree of uncertainty around the inflation outlook is also larger than anything investors have had to face for the best part of a decade. Do we fully understand the consequences of the unprecedented degree of money creation during the pandemic? No we don't, and that uncertainty, over the next 18 months, is skewed to more rather than less inflation relative to the base case that we set out above.

So why are we sticking to our view of transitory inflation, beyond the reasons set out above (and in more detail in our March update)? Half of the month-on-month increase in the latest inflation figures for May was due to a small number of COVID-affected sectors, such as household construction materials and furnishings (note lumber prices have recently fallen by about a third and this should presage an easing of pressure here), recreational goods, and used

The world is even more indebted than it was before the pandemic and there are a lot of people who've been thrown out of work by the pandemic – limiting any increases in spending and wages.

Figure 1: US household savings

The US savings rate in April was still an enormous 15% despite a seismic shift in social restrictions as lockdown measures became more relaxed.

Source: Refinitiv, Rathbones.

Past performance is not a reliable indicator of future performance.

vehicles (inflation in the latter may have now peaked if auction prices continue to serve as a lead indicator).

COVID-benefited sectors make up a much larger share of the CPI basket than COVID-recovery sectors (such as air fares, clothing and hotels), and the passing of inflation in the former to inflation in the latter will therefore act to decelerate overall CPI inflation. Some of the more economically sensitive components of the CPI that are undistorted by COVID, such as rents, have stayed calm.

Some more specific inflation risks have heightened over the last quarter. For example, banks have surprised by easing lending standards to both firms and households. Depressed service-sector inflation in countries that have been relatively free from COVID restrictions, such as Taiwan, have suddenly shot up from their persistently depressed levels, suggesting that consumer behaviour may be more tied to vaccinations.

Some risks have increased

At the same time, some inflation risks have decreased. The US savings rate in April was still an enormous 15% despite a seismic shift in social restrictions (figure 1 on page 3); retail sales fell in May and innovative, high-frequency data suggest that the mountain of savings amassed from the stimulus cheques and lockdowns are still largely unspent.

This is no surprise – there is a much stronger case for excess savings fuelling asset price inflation rather than consumer price inflation. The risk to inflation from further fiscal stimulus has also been reduced for 2021 as Senate rules make it impossible for the Democrats to pass another budget without any Republican votes this fiscal year. Stimulus-induced inflation remains a risk for 2022, however.

Finally, for inflation to run hot perpetually, wage inflation must accelerate, but several indicators we've looked at suggest this is unlikely, and in fact our favoured gauge has been decelerating recently. We do expect evidence of skills shortages to push wage inflation higher over the remainder of the year, but not to a de-stabilising degree (figure 2).

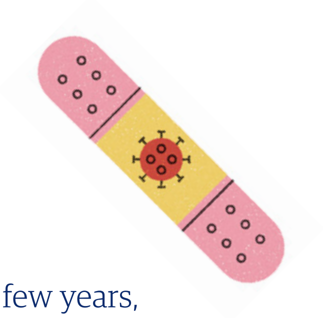
Some inflation risks should continue to be ignored. Commodity prices dictate the difference between core and headline rates of inflation, but have no relationship whatsoever with core inflation. During the enormous commodity bull market of the 2000s surveys of company input costs such as the ISM prices paid sub-index got to levels just as high as today and there was no runaway inflation. For more on why we think speculation about soaring demand and rising prices for industrial commodities may be overblown, see our article *The demand for commodities* on page 6.

Expectations are important

Over the past few years, economists and central bankers have expressed increasing humility about their ability to understand the inflation-forming process. But most agree that inflation expectations are central to it. The Fed monitors many different gauges, with different look-ahead horizons, drawn from different samples of the population, and relating to different measures of inflation.

The common trend (in technical terms, the first principal component) has not broken out above the normal range of the past 25 years. Moreover, unlike in the 1970s to early 1990s, rising prices seem to be destroying demand rather than boosting it by encouraging consumers to buy something today before it rises in price tomorrow. Just look at the University of Michigan consumer surveys asking if it's a good time to buy a house, furniture or a car – they're all down significantly.

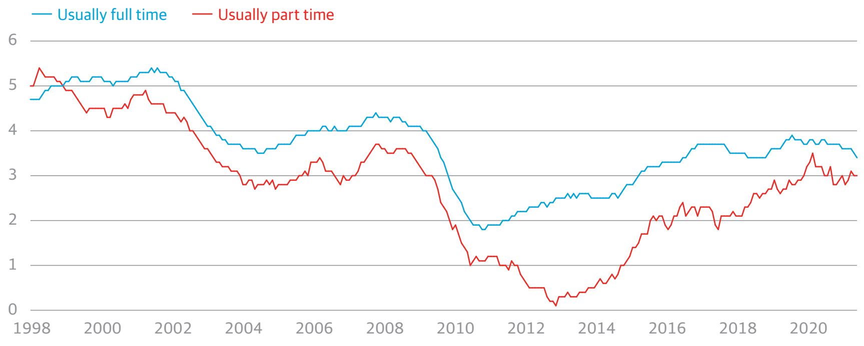
As we explain in the next article on investment implications, the real concern for equity investors is rising real (inflation adjusted) rates, so investors will be focusing a lot on Fed policy and looking for any signs of a premature tightening of its easy money stance. As long as the markets don't get spooked, the Fed may be content to continue letting inflation overshoot and not put its foot on the brakes for the time being.



Over the past few years, economists and central bankers have expressed increasing humility about their ability to understand the inflation-forming process. But most agree that inflation expectations are central to it.

Figure 2: Atlanta Fed Wage Growth Tracker

Skills shortages may push wage inflation higher over the rest of 2021 but it's unlikely to be a persistent inflationary pressure over the longer term.



Source: Refinitiv, Rathbones.

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It's not time to reduce equities but look for inflation sensitivity

As we said in our lead article on pages 3 and 4, we expect inflation to start to fade in the second half of the year, allowing central bankers to keep their foot on the accelerator with loose monetary policy. But even with our view that inflation will settle into a higher range than where it was pre-COVID, equity investors can take further comfort from our historical analysis showing that profits have rarely failed to keep pace with inflation.

In the higher-inflation times of the 1970s and 1980s, and even in the beleaguered UK, companies still managed to deliver profit growth in real (inflation-adjusted) terms (figure 3). But while earnings tend to be able to cope with inflation, it's valuations that can suffer if real rates rise, increasing the discount applied to expected future earnings. This is not our base case. Furthermore, our analysis shows valuations have already built in a buffer against an increase of about half a percentage point in real rates.

Have cyclicals had their day in the sun?

In anticipation of a strong post-COVID rebound, we noted last summer that it made sense to shift towards good-quality, cyclical companies. These types of businesses are well managed with sound financials and stand to benefit from the upturn in the economic cycle.

Leading economic indicator (LEIs) are now near all-time highs. We believe they are likely to stay elevated due to the nascent boom in capital spending, inventory rebuilding and the ongoing resumption of activity in the service sector as economies open up more fully.

However, there is a risk that these elevated LEIs could start to roll over. While we don't see this as the most likely scenario, if it were to happen it could mean a change of leadership away from cyclicals, which are now looking very expensive after an unprecedentedly strong run.

As LEIs have risen, so-called value shares (with cheaper valuations) have also outperformed more expensive growth companies whose earnings tend to be strong across economic cycles, such as big tech. However, value and cyclicality can decouple. Stocks that tend to do well in periods of rising inflation or bond yields have also outperformed this year, but we think there is more scope for this to continue.

A record-breaking run

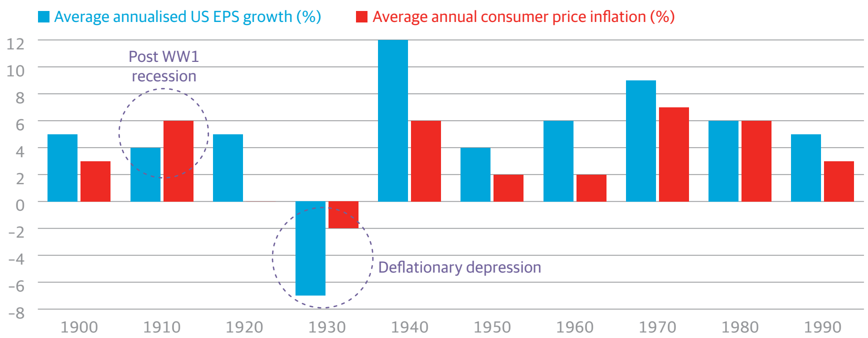
These stocks are more likely to be found in those sectors with a higher representation in value indices, particularly financials and energy — which Europe has a lot of (see article on page 8). Indeed, the record-breaking run of cyclical shares versus defensives has already started to peter out in the last two months, while value still has a very long way to go before it regains ground on the broader market.

Early on in the recovery from the pandemic we didn't think it was the right time to shift towards value. So what's changed? Risks to a post-COVID reopening have dissipated, while risks from rising real yields and inflation have risen substantially. The fact that we are exiting a decade of inflation averaging below 2% and entering a phase of above target inflation (which we think is likely to last until the end of 2022) is a profound change that equity investors need to note. We think value stocks that tend to do well in periods of rising inflation and bond yields could continue to outperform over the next year. But in the longer term we still see a lot of structural headwinds limiting the upside for financials and energy stocks.

Early on in the recovery from the pandemic we didn't think it was the right time to shift towards value. So what's changed?

Figure 3: Keeping up

Earnings have rarely failed to outpace inflation, even in the 1970s.



Source: www.econ.yale.edu/-shiller/data.htm, Refinitiv, Rathbones.

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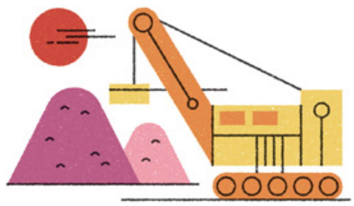
Is the Chinese dragon losing its appetite for industrial metals?



Resurgent growth in the post-COVID world has rekindled talk of the next 'supercycle' for industrial commodities. But beneath the headlines, the reality is that this demand is likely to pale in comparison with the driver of the original supercycle.

For many years the fortunes of the FTSE mining sector have been linked to developments in China. Rapid growth in demand for commodities like iron ore and copper in the late 2000s led to what became known as the first mining supercycle. That was followed by a downturn from 2011–15 as slowing demand from China combined with overexpansion of mining production.

In recent years commodity prices have rallied back towards previous highs and the FTSE mining sector has regained much of its lost ground. But some caution is required – demand from China is unlikely to repeat the growth of the 2000s and we don't see a new driver of supercycle-style demand emerging.

China remains by far the dominant demand driver for most metals – accounting for over 60% of global iron ore and over 50% of global copper demand. What happens in China far outweighs what happens in the US and Europe. For example, the infrastructure stimulus plans of the new Biden administration are expected to increase US steel demand by 3–5% from approximately 100 million tonnes per annum (mtpa) to 103–105mtpa. This pales into insignificance compared to Chinese steel demand of 1,000mtpa.

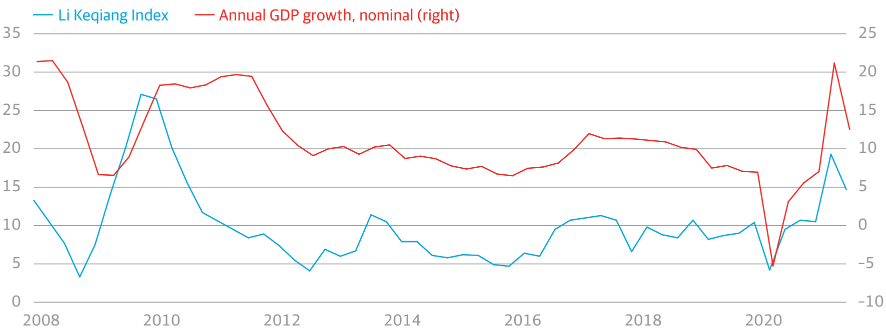
We can monitor Chinese demand by looking at a few key economic indicators, like its GDP growth together with the widely followed Li Keqiang index (figure 4), built by the Chinese Premier in the mid-2000s. Mistrusting official GDP figures, Li Keqiang's index was based on real-world metrics like railway cargo volumes and electricity consumption, to get a better measure of industrial demand. Note how the Li Keqiang index shows industrial demand conditions through 2013 to 2015 were weaker for longer than the global recessions of 2009 and 2020. It was this period of slower growth which caused the mining downturn. Following a spike in 2020 as the economy started reopening, demand may now be slowing. The primary tool used by the Chinese government to manage the economy is the supply of credit. Figure 5 shows the 'credit impulse' – the percentage change in the amount of credit supplied compared to the previous year.

The longer period of slowing credit supply from 2011 to 2015 corresponded with the previous mining downturn. After a burst of credit growth in response to COVID, the credit impulse has turned negative again as China's policymakers attempt to cool down the economy. Shorter term demand growth for metals looks to have peaked.

In the longer term, Chinese demand for metals may also face a structural headwind that has not been seen before – China's newfound desire to combat global warming. Its economy is resource intensive and inefficient, accounting for over a quarter of global CO2 emissions. China's recently announced plans to reach net zero emissions by 2060 will involve a large transition that will use far fewer resources. This could be a very different world from the commodities supercycle of the 2000s.

Figure 4: A better measure

The Li Keqiang Index is based on real-world metrics like railway cargo volumes and electricity consumption, to get a more accurate measure of industrial demand.

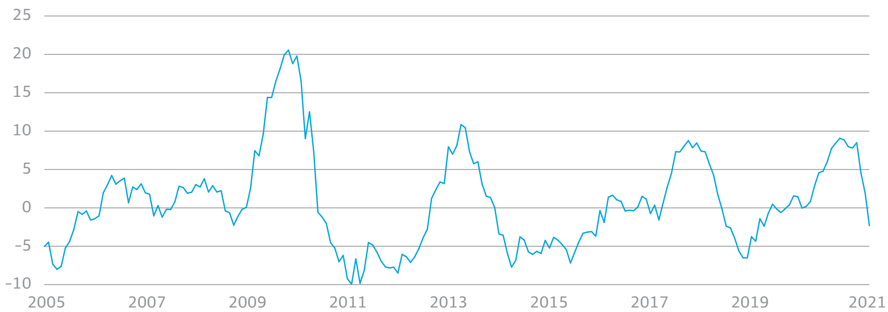


Source:Refinitiv Rathbones.

Past performance is not a reliable indicator of future performance.

Figure 5: The credit impulse

This chart shows the percentage change in the amount of credit supplied in China's economy compared to the previous year.



Source:Refinitiv Rathbones.

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The pound has strengthened but still looks undervalued

After a good few years in the doldrums, sterling has perked up just in time for the borders opening up and letting us go on holiday. It's probably no coincidence – as COVID-19 has been beaten back, both here and abroad, the world has started to reopen and become more hopeful about the future. Brexit and then the pandemic hammered the pound, sending the exchange rate egregiously low against the currencies of our major trading partners.

The pound is what we call a 'cyclical' currency. It tends to rise when global economic growth is improving and investors' spirits are high. It then falls when clouds darken the horizon and traders' moods.

Sterling was once a mighty reserve currency that priced global trade and offered the safest harbour for frightened investors. No more, unfortunately – that mantle has passed to the dollar and to a lesser extent the euro. So as most of the world emerges from the pandemic, allowing businesses to reopen and rehire and households to spend, it has no doubt buoyed the pound considerably, and attracted foreign investors to UK assets.

Gaining in strength

Against a basket of major currencies, the pound has strengthened 6% since the end of September. Most of that was driven by an almost 10% increase in value compared with the dollar, which makes up a large part of the currency basket because of its importance to trade. The pound/euro exchange rate rose 6%, while sterling was up a whopping 14% against the yen, which is seen as a safe-haven currency.

Despite these significant gains, the pound is still extremely undervalued according to simple frameworks like purchasing power parity, very complex ones like the IMF's external balance framework, or our preferred proprietary framework (figure 6). Our framework compares British prices, productivity and savings with those abroad, giving a 'fair value' exchange rate to compare with today's price. It suggests that the pound should trade at just under $1.80 and just over €1.40. That compares with $1.40 and €1.17 at the time of writing.

However, a purely quantitative framework is only ever a starting point. Making some assumptions about what Brexit is likely to do to the economic relationships on which our 'fair value' rests, we think $1.45 to $1.55 and €1.20 to €1.30 are more realistic targets.

It's all bonkers

We cannot stress enough that currency markets are bonkers. They are extremely volatile and impossible to predict at all accurately over short periods of time. However, we've found that large divergences from 'fair value' have historically been eradicated after three to five years.

So our work is helpful information for long-term investors because currency movements can have sizable impacts on overseas investment returns. When sterling rises, foreign assets are worth less when you convert them back. When the pound falls, it boosts the value of overseas investments.

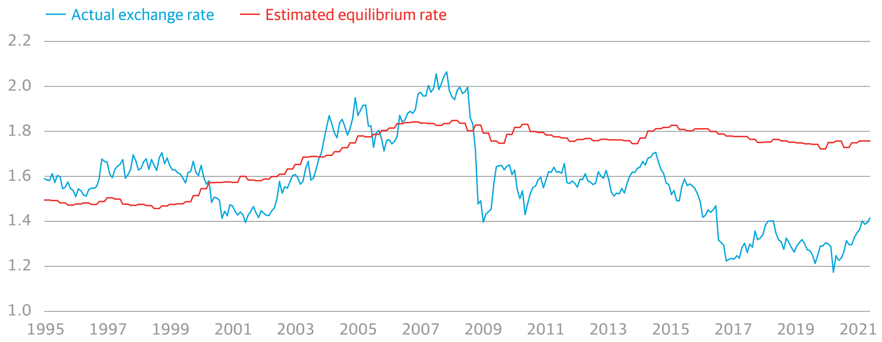
Political risk lurks on the horizon as well. The UK and EU are still squabbling over how to operate the Irish border, an inevitability given the fudge that was baked into the Brexit deal. More directly relevant for our valuation framework, there has been little progress on negotiations that will determine the UK's outsized service sector's access to the EU marketplace. A loss of access may require a cheaper pound to facilitate a reallocation of resources to the less competitive manufacturing sector.

Meanwhile, the Scottish leadership is angling for anther tilt at independence. This is probably the foremost political risk in currency traders' minds. Yet, the effect of Scottish secession is counterintuitive. According to Capital Economics it would reduce the UK's budget deficit from 2% to 1.5% of GDP, which would be a positive for the pound.

This comes about because Scotland accounts for about 9% of UK public spending, but it contributes roughly 8% to the union's tax take. Still, sometimes the turmoil of change is enough to overwhelm expected benefits.

Figure 6: Feeling undervalued

Our currency model suggests the pound is undervalued compared to most other major currencies, including the US dollar.



Source: Refinitiv, Rathbones.

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Europe's strong cyclical rebound may have further to run

For much of last year, Europe's stockmarket trailed the US significantly. It suffered from the usual structural headwinds as well as sluggishness in the global race to rebound from the pandemic. Yet European stocks have bounced back sharply in 2021 as investors have rushed to price in their catch-up potential. Earnings momentum has been particularly strong in part because the region has a high weighting of cyclical businesses that tend to be geared into economic recovery.

With Europe's immunisation drive taking off in earnest from late April, the European Central Bank has upgraded its outlook, with recovery gathering pace later this year on the back of pent-up consumer demand and an easing in supply bottlenecks.

While its economic data has been warming up nicely, Europe appears less troubled by the concerns about overheating that are complicating the US recovery story. In particular, the region seems at less risk of the wage inflation that could weigh on profit margins in the US (see figure 7 and our lead article on page 3 for more on what's driving inflation). So Europe's policymakers should be more able to keep the stimulus pumps primed.

Nearing the peak?

However, with global leading economic indicators (LEIs) near all-time highs, some are questioning whether the global recovery that has been supporting Europe's exporters could start to lose momentum. A range of factors (a nascent capital spending boom, inventory rebuilding and the ongoing resumption of service sector activity) suggest to us that LEIs can stay elevated. But some cyclicals have already notched up very large gains and now look expensive. This argues for more nuanced cyclical exposure going forward.

Still, Europe's cyclical stocks continue to look attractively valued versus their US counterparts – in particular, the region's banks and energy stocks, which our analysis suggests have tended to do well when global bond yields and inflationary risks are rising. Over the longer term, however, these sectors do have some ongoing issues.

Europe's banks have underperformed US peers significantly over the past five years owing to sluggish economic growth and loan demand. More recently, negative interest rates have put pressure on their profits by squeezing the margins between the interest rates they pay depositors and charge for lending. Investors continue to be concerned about the inherent stresses in the European banking system, in particular the possibility of banking failures that remain the problem of individual governments that lack an independent monetary policy to deal with them.

Progress on a European banking union has remained slow, and in the meantime European banks are accumulating increasing amounts of sovereign debt to help finance COVID relief spending. This leaves them vulnerable in the event of any renewed financial stress in Europe's periphery.

Meanwhile, the European energy sector faces the challenge of transitioning to a zero-carbon business model by 2050, while needing to generate attractive returns for shareholders. Its US equivalents appear under less pressure so far – from either the government or investors – to accelerate their transition to 'green' energy.

Europe has many world-class companies across a variety of sectors – healthcare, consumer staples and industrials to name a few. Industrials in particular have potential cyclical upside as well as exposure to attractive thematic growth areas such as automation and energy efficiency. Europe also has a number of interesting and unique plays on renewable energy and climate change mitigation, which should enjoy structural growth as the world continues to place more emphasis on achieving the Paris 2050 goals for reducing emissions.

Europe has many world-class companies across a variety of sectors – healthcare, consumer staples and industrials to name a few.

Figure 7: Labour shortages are a US phenomenon

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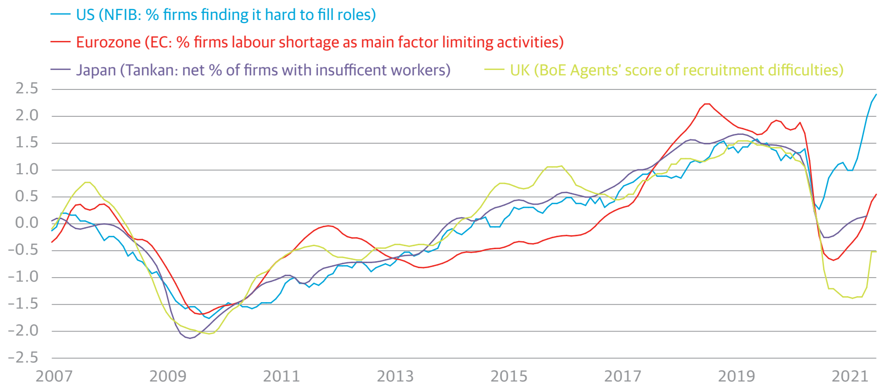

Source: Refinitiv, Rathbones.

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Without good governance ESG falls apart

Responsible investing and capitalism itself are doomed to fail without good corporate governance – the G in ESG. It may not be a term that sets pulses racing but its role in capitalism is vital (figure 8). It's the foundation on which responsible investment thrives or fails.

When new environmental, social and governance (ESG) analysts join our team at Rathbones, we send them a 700-page textbook. Dog-eared copies are passed down from senior to junior, with pages worn thin by constant reference and reading. Analysts can't do their job without the 5th edition of Corporate Governance by Monks and Minow – an unlikely candidate for centre stage.

At its heart, good governance solves a crucial issue. It's what social scientists call an agency problem – how do you get someone to act in your best interests when they are controlling an asset you own? That's what happens when you invest. You put your capital in the hands of company management, over whom you have influence but no control, and whose interests may differ from yours.

To put it another way, imagine I give you a crisp £20 note, ask you to buy me lunch and say you can keep the change. What's stopping you from getting the cheapest deal possible from the discount aisle and pocketing the difference? Our interests aren't aligned. To align them, we must have an ongoing relationship and there needs to be accountability. In other words, aligning our interests is costly and time consuming, but necessary.

Zoom out and apply that at the company and investor level – how do we begin to solve these problems and ensure that companies invest for the long term, aligning their short-term goals with our long-term objectives as investors? In short, corporate governance. It's the hidden glue that holds the modern social contract together.

The problem is that you don't know you need it until it fails. It's also the oil in the engine that keeps the machine running smoothly. Neglect it and you'll soon find yourself standing on the hard shoulder next to steaming wreckage.

Volkswagen's emissions testing scandal is an important example of a company failing to protect the environment. Around 11 million cars were fitted with 'defeat devices' between 2009 and 2015, causing untold harm through dangerous levels of undetected air pollution. The company's arcane governance structure was programmed to turn a blind eye, with no incentive to discover the truth or to investigate it.

Large supervisory boards prevent detailed scrutiny, with non-independent directors the norm. Alexander Juschus, director at IVOX, the German proxy adviser, commented: "There have been warnings about VW's corporate governance for years, but they didn't take it to heart and now you see the result."

Checks and balances

Putting the right checks and balances in place is a vital part of good governance and enables better decision making. When the Gulf of Mexico was rocked by the Deepwater Horizon explosion in 2010, with a massive oil leak devastating thousands of livelihoods, much of the talk was technical. How had this or that bit of safety equipment failed? What hadn't been maintained?

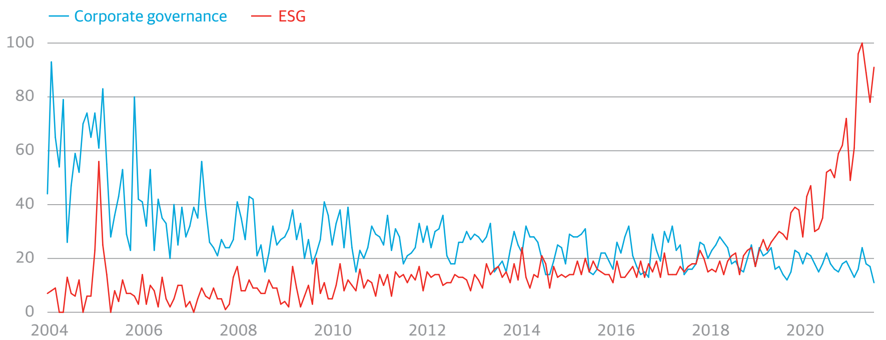
However, the root cause was human, and the failures were on the governance side. The National Commission investigating the disaster concluded there was a "culture of complacency" that never subjected key design and operational decisions to risk assessments as they were costly and timely.

This is not to say that good governance is a magic bullet – a vaccine against corporate ESG failure. A myriad of factors can combine to produce a serious ESG controversy. But this much is clear – it doesn't matter how well thought through your safety plan is if the corporate culture is weak and pay arrangements encourage behaviours which diverge from those mandated in well-meaning ESG policies.

We feel strongly that responsible investing means taking great care to investigate governance and culture as well as social and environmental policies. Are the right people with the fewest conflicts of interest given the best information? Do pay arrangements encourage all valuable long-term wealth preservation behaviours and not just short-term financial metrics? Our team learns this and more from day one at the feet of Monks and Minow. We'll keep checking the oil because we all need the car to keep running.

Figure 8: Google search trends

People search for ESG far more frequently than they do for governance, which wasn't always the case.



Source: Google, Rathbones.

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Financial markets

With inflation spiking and its future path uncertain, stock markets bounced around as investors pondered whether the Fed would be able to stick to its pledge not to tighten its easy money stance for the foreseeable future. Stock indices reached record highs towards the end of the period in the US and multi-year highs in Europe as investors became more comfortable that central banks will tolerate higher inflation, and that it wouldn't get out of control.

Since the end of last year there has been a general shift away from tech and media stocks, which profited greatly from the stay-at-home economy, towards cyclical companies such as banks, airlines and industrial firms that should benefit from reopening.

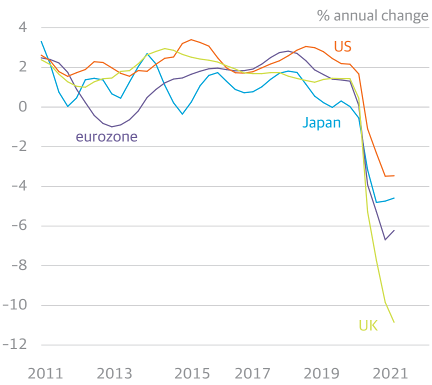
Cryptocurrency bitcoin suffered a bout of extreme volatility, at one point shaving off more than half of its value after peaking at over $60,000 in April. Among the catalysts for the drop were Tesla's CEO Elon Musk reversing a decision to accept the digital currency as payment for its cars and news that China was clamping down on bitcoin miners.

Bond markets settle down

Elsewhere, government bond markets also stabilised as investors gained confidence that policymakers won't have to renege on pledges to keep the monetary stimulus flowing. Meanwhile, corporate bond spreads (the extra yield offered over government bonds) have fallen, which signals investor confidence that recent rises in inflation will not hinder the economic recovery.

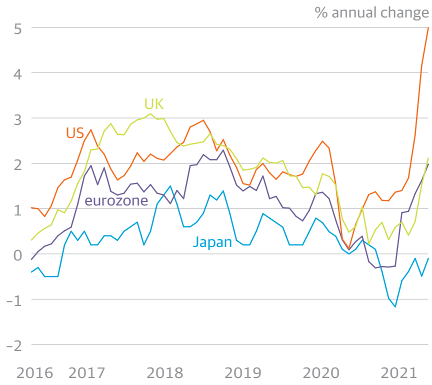
Demand for commodities has increased, at one point pushing prices of iron ore and copper to record highs, in part because China's factories are sucking up supplies. Lumber prices had also spiked amid a US housing boom, but these and metals prices had fallen sharply by quarter end, helping ease inflation worries. However, Brent crude oil prices remained near their two-year highs above $70.

GDP growth



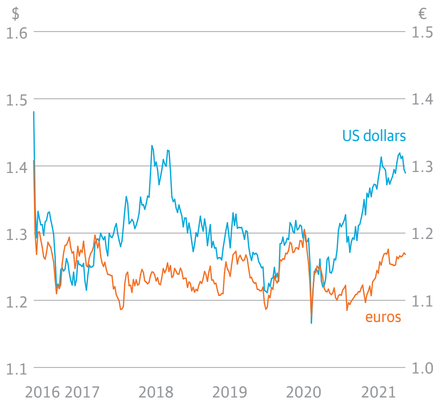
Source: Factset and Rathbones.

Inflation



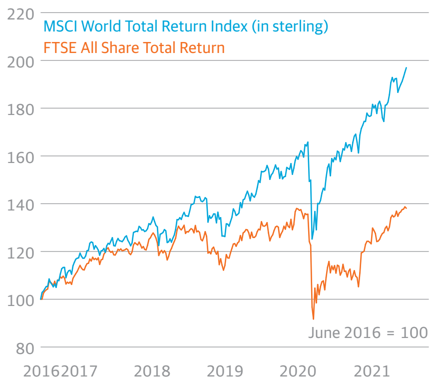
Source: Factset and Rathbones.

Sterling



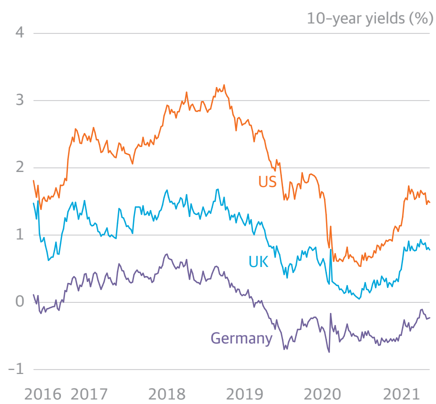
Source: Factset and Rathbones.

Equities



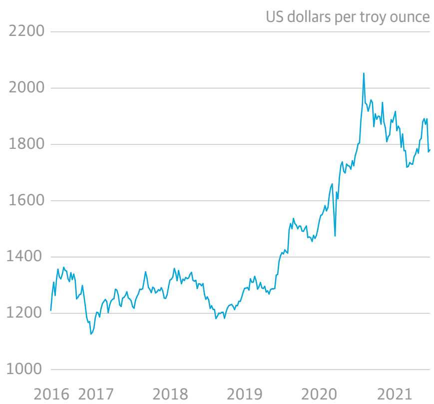
Source: Factset and Rathbones.

Government bonds



Source: Factset and Rathbones.

Gold



Source: Factset and Rathbones.

Past performance is not a reliable indicator of future performance.

Important information

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