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BILBoard April/ May 2021 – Brighter light, shorter tunnel



FR NL DE

The implicit message in April's better-than-expected macro data was that an economic rebound is well underway – more so in some regions than others. The upturn is supported by accommodative fiscal and monetary stimulus, while the hastening of the vaccine rollout (over 1 billion doses have been administered globally) is shortening the tunnel between the present and a bright, post-pandemic future.

But as they say, "there's no show without Punch" and inflation is attempting to steal the show. Supply chain bottlenecks, a global chip shortage, pent-up demand and rising commodity prices are converging to present a convincing case for higher inflation. However, we believe price pressures will be temporary and that they will not provoke premature monetary tightening. The communiqué of major central banks and inflation break-evens suggest that policymakers and

markets share this conclusion.

Then comes the question of interest rates. Earlier in the year, led by the US rate market - the biggest in the world and a foundation for global asset prices - bonds went into decline, as the prospect of higher inflation drove investors to flush them out of their portfolios. Consequently, the yield on the US 10-year tore above 1.7%. Since then, central banks appear to have quelled fears, insisting that they will not pull the rug from under the markets until the recovery is confirmed as sustainable. From here on out, we believe that the potential for further steepening on the US curve is limited and see the 10-year yield gradually moving higher – the key word being *gradually*.

This scenario – a gentle rise in rates, in tandem with brightening eco data – is consistent with a pro-risk stance. As such, we are overweight equities and credits while being underweight core government bonds and duration.

EQUITIES

Equities are still moving up while exhibiting relatively low volatility, supported by positive earnings revisions, liquidity and optimism around the reopening. A modest rise in interest rates, as is our base case, should not derail the general uptrend, but it means that **sector and style** decisions will be crucial determinants of returns.

Regionally speaking, we continue to favour the **US** and **China**. These regions can be considered MVPs in ushering in a broader global recovery. In the US, consumers are joining corporates as growth drivers (retail sales rose 9.8% in March), and President Biden is going "all guns blazing" when it comes to fiscal stimulus. To help fund this, the Democrats propose corporate tax hikes and increased capital gains tax for high-net worth individuals (from 20% to 39.6%). The US economy, in our view, should be able to more-than-adequately absorb the scale of the proposed tax increases and markets did not react strongly to the announcements. Republican resistance could spell a watering-down of the proposed measures. It is also worth mentioning that, if passed, much of the money will be redistributed into the economy, for example amongst lower income households, boosting their spending power, which is a positive for the macro outlook and ultimately corporates.

Style-wise, we have a **Value tilt in our US exposure**, where macro momentum is more robust. Sector-wise, we prefer **cyclicals** that can benefit from a strengthening economy and infrastructure spending (i.e. **Materials** and **Industrials**). According to Moody's, globally households have amassed a \$5.4tn stockpile of extra savings (more than 6% of GDP), with \$2tn of this attributable to US households (largely due to voluntary precautionary savings and because many businesses were shut or restricted). The **Consumer Discretionary** sector is expected to receive a boost after the reopening allows this money to percolate back into the economy. We also like **Utilities**, selecting names that will benefit from the energy transition

(including Biden's commitment to half 2005 levels of US net greenhouse gas emissions by 2030).

China is an economic trailblazer, having expanded 18.3% (annualized) in the first quarter. After the recent sell-off, valuations are relatively cheap compared to global peers and onshore equity markets are supported by strong foreign inflows and rejuvenating IPO activity.

Europe's growth story has been held back by delays in the vaccine rollout and the fact all EU member states have yet to approve the EUR 750 billion recovery fund, leaving the ECB to do the heavy-lifting until at least July at the very earliest. The good news is that the German constitutional court finally gave the green light for Germany's ratification. Consumer sentiment is still fragile, which is unsurprising given labour market dynamics and Covid-19 restrictions. While Europe is traditionally a Value play that benefits from rising rates and a steepening curve, we are reluctant to switch to an overweight with the outlook still studded with uncertainty.

Emerging Markets outside of China are still in the grip of the pandemic, especially India, while central banks (Russia, Brazil, Turkey...) have begun hiking rates in the face of higher inflation. We are therefore underweight emerging market equities.

FIXED INCOME

The rise in yields momentarily paused, but ultimately we think they will continue their gradual move higher as the economic recovery ensues. As such, we are underweight govies and duration.

In an environment where central banks are expected to continue to provide support, where the macro picture is improving and where investors seem to be looking beyond the pandemic, investment grade corporate bonds should continue to perform. Strong demand for new bonds, slower issuance and high inflows create a favourable balance and credit spreads have shown very little volatility. Limiting duration risk, while stepping down in credit quality is still what works best.

For investors who can stomach additional risk, the **high yield bond** space is the go-to destination. Investor flows, ample liquidity and government stimulus programs are supportive (as well as rising oil prices if we focus on the US market). Rating migration trends continue to improve, approaching 2 in the US and Europe, meaning that the number of upgrades is twice that of downgrades.

The environment remains supportive for **emerging market debt**, so long as US real rates remain negative and yields rise at a gradual pace. Within our EMD exposure, we prefer Hard Currency corporates which have a better risk-adjusted profile. Corporates are more resilient against a rise in real yields vs. government related entities.

CURRENCIES AND COMMODITIES

Our long-term outlook for the **US dollar** remains negative: In the absence of hawkish signals from the Fed and facing the twin deficit, we believe the greenback will be under pressure, even if virus flare-ups, geopolitical risks and prolonged lockdowns in Europe could provide some temporary tailwinds.

We are neutral on **gold**, which holds a place in our portfolios as a diversifier. However, if prices were to test the upper resistance level (\$1825), we would consider taking some chips off the table. We are also neutral on **oil**. Prices are subject to opposing forces – on the upside a weaker dollar, OPEC supply constraints and the fact that demand is edging higher (especially as airlines take to the skies again): On the downside, extended lockdowns and Iran's intentions to resume production.

CONCLUSION

As with almost every economic upturn, the current recovery is not perfectly synchronized and disparities between nations are quite clear. However, as investors, we can focus on the opportunities, rather than placing too much focus on the blemishes of this boom. For now, we are well-positioned for the upwards leg of the cycle in regions where macro indicators are flashing green. As mentioned previously, style and sector decisions will be critical for investment returns. These largely hinge on movements in rates markets and as such, this is an area that must be monitored diligently.

	23/04/2021	DEFENSIVE		LOW		MEDIUM		HIGH	
		Stance	Change	Stance	Change	Stance	Change	Stance	Change
Global Allocation	Equities		=		=>		=		
	Bonds								=
Equities	USA		-		-		4		>
	Europe				\Rightarrow		\Rightarrow		=
	Japan						=>		
	China		=				=		
	Emerging Markets Ex-China		→		→		=>		₹
Bonds	Government Bonds - Developed								=
	Emerging Market Debt				=>		\Rightarrow		
	Corporate - Investment Grade				4		=>		=
	Corporate - High Yield						\Rightarrow		=
	Total Return				=>		=		-
Commodities	Oil				→		4		→
	Gold		=		=>		\Rightarrow		

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