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BILBoard July 2021 – A pause in reflation

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Since our last Asset Allocation Committee, the key event was the June FOMC, at which the Federal Reserve's communication was decidedly less dovish. Its refreshed dot-plot suggested two rate hikes in 2023 (up from zero) and showed that 7 out of 18 members already expect one in 2021. Given the Fed's preferred normalisation sequence, this could imply tapering in Q1 2022.

This change of tone caught markets off-guard and we saw a strong repositioning across all asset classes. With the idea that the Fed – contrary to the narrative of the last few months – will not actually allow the US economy to run "too hot for too long", yields at the long end of the curve tumbled as bond traders unwound their reflationary curve steepening bets. Cyclical and value stocks tied to reopening and reflation themes suffered as growth stocks rebounded.

However, we do not see any change in the fundamental picture and deem the moves as a temporary overreaction. While the prospect of long-term yields shooting up sharply has declined, we still see them drifting up in the US and the rest of the world, in tandem with accelerating growth. For yields to change direction and start moving downwards in a sustained manner, the macro picture would have to change drastically; for example, as a result of a new virus variant, which is not our base case.

Regarding inflation, we believe it could still push higher (especially as rising home rental rates in the US seep into the CPI figure), but believe it will ultimately settle within central banks' comfort zones – potentially at higher levels than in the last cycle when price pressures were notoriously sticky.

In our investment strategy, we remain positioned for a cyclical upturn, believing that while the reflation trade has faced a setback, it is still intact.

Equities

Supported by growth and stimulus, equities are still our preferred asset class. Some investors are concerned that talk of tapering could derail stocks, but we believe that the market can digest slow and measured adjustments to monetary policy, which, in the end, are necessary to keep overheating fears in check. As we have noted previously, the next leg of the cycle will be about rotation, not direction, meaning that investment returns will largely be dictated by style and sector decisions.

Sector-wise, we like reflation beneficiaries such as financials, who could see plumper net interest margins as long yields grind up, while central banks keep the short end of the curve anchored for now. Dividends and buybacks should also lend support to the sector, while in June the Federal Reserve announced that all 23 banks that took the 2021 stress test passed, with the industry "well above" required capital levels in a hypothetical economic downturn. We also like cyclicals such as consumer discretionary and materials, which are well positioned to benefit from the reopening theme and pent-up demand. At our most recent committee, we upgraded energy from neutral to overweight. Energy is a key beneficiary of the reopening theme (especially as travel resumes), earnings revisions are strong and the sector is supported by higher oil prices, which render more fields profitable. At the same time, we downgraded utilities, a sector that has broadly underperformed, even if we still like the structural long-term potential of green renewables.

At this stage of the cycle, we continue to believe that the value style will prevail, despite coming under pressure as of late.

Regionally, we are overweight the US, China and Europe, seeing strong growth momentum in each, especially Europe where the reopening is just getting started. Given that the Fed is drawing closer to tapering, our short-term outlook for the US dollar is less bearish and we have removed the currency hedging on our US equity overweight.

Fixed Income

The reflationary environment makes us broadly reluctant on fixed income. Expecting higher rates down the road, managing duration will be key. On credits, spread compression leaves us mid-cycle with end-cycle valuations.

We are most active in the investment grade space (both developed and emerging), which still offers some opportunity for excess return, though this will be generated by being highly selective. The sector continues to be supported by central bank buying, economic momentum and strong demand. Given that the Fed is further ahead in contemplating tapering, we have a preference for European Corporates versus the US equivalent.

Further down the quality curve, select pockets of the high-yield bond market in developed regions are still attractive. Inflows are strong as are ratings trends, on both sides of the Atlantic. For the same reasons as with IG, we now give preference to European high-yield corporates. In the US, senior secured loans (SSL) may be preferable to HY, as they carry less duration risk and a lower exposure to rising rates. SSLs are less interesting in Europe where coupons are calculated using the EURIBOR rate as a base (which is still negative).

As the recovery unfolds, Government bond yields are destined to rise, compelling us to carry an underweight on duration and European govies, and virtually no exposure to US Treasuries.

Conclusion

On the back of the vaccine rollout, and winged by expansive fiscal and monetary policies, the global economy expanded more rapidly than expected in the first half of the year. We expect the positive momentum to continue through 2021 and believe that the fundamentals underpinning the reflation trade remain intact. Given the speed of the recovery, investors must be prepared for shifts in cyclical positioning across regions and should brace themselves for potentially higher volatility than we have witnessed recently. While bull market pullbacks are unavoidable, they should not be considered as a reason to stay on the sidelines.

Just as the reflation trade has paused temporarily, we will pause our BILBoard publication for in August, resuming in September. In the meantime, our extensive Midyear Outlook should provide ample reading material. We wish you happy and safe summer holidays.

	22/06/2021	DEFENSIVE		LOW		MEDIUM		HIGH	
		Stance	Change	Stance	Change	Stance	Change	Stance	Change
Global Allocation	Equities	🟡	➡	🟢	➡	🟢	➡	🟢	➡
	Bonds	🟡	➡	🔴	➡	🔴	➡	🔴	➡
	Cash & cash equivalents	🟡	➡	🟡	➡	🟡	➡	🟡	➡
Currencies	EUR	🟡	➡	🟢	⬇	🟢	⬇	🟢	⬇
	USD	🟡	➡	🔴	⬆	🔴	⬆	🔴	⬆
	Other	🟡	➡	🟢	➡	🟢	➡	🟢	➡
Equities	USA	🟡	➡	🟢	➡	🟢	➡	🟢	➡
	Europe	🟡	➡	🟢	➡	🟢	➡	🟢	➡
	Japan	🟡	➡	🟡	➡	🟡	➡	🟡	➡
	China	🟡	➡	🟢	➡	🟢	➡	🟢	➡
	Emerging Markets Ex-China	🟡	➡	🔴	➡	🔴	➡	🔴	➡
Bonds	Government Bonds - Developed	🔴	➡	🔴	➡	🔴	➡	🔴	➡
	Emerging Market Debt	🔴	➡	🔴	➡	🔴	➡	🟢	➡
	Corporate - Investment Grade	🟢	➡	🟢	➡	🟢	➡	🔴	➡
	Corporate - High Yield	🟢	➡	🟢	➡	🟢	➡	🟢	➡
	Total Return	🟢	➡	🟢	➡	🟢	➡	🟡	➡
Commodities	Gold	🟡	➡	🔴	➡	🔴	➡	🔴	➡

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