Perspectives

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IN SHORT

- Despite good news, markets are taking a breather, but we expect the reflation trade to take hold again
- The rotation into cyclicals should gather steam again as fiscal plans become more concrete
- We maintain our constructive outlook, but we keep an eye on sentiment given crowded positioning

Taking a breather

This year started where 2020 ended, with markets rallying. However, despite the good news that came over the holidays and in early January, we appear to have entered a period of consolidation. In our view, markets are only "taking a breather" as investors digest recent news and process what is already priced in. Indeed, Brexit is done, the US agreed on another USD900 billion in fiscal stimulus and the Democrats won both Georgia run-off races, giving President Biden a razor-thin majority in the Senate to enact further fiscal measures. So what gives?

From a full-year, 2021 perspective, not much has changed. The underlying fundamental supports for markets are still here. Monetary policy will remain ultra-accommodative, including in the US. Indeed, we expect Mr Powell to highlight that tapering of the Federal Reserve's QE program is not on the cards. Elsewhere, support is only likely to increase, though the People's Bank of China could reduce support as the Chinese growth engines roars again. With the Democrats' mini-sweep, fiscal support is set to expand further under the Biden administration. While we do not believe Biden will manage the USD1.9 trillion he suggested, but USD1 trillion is coming. And a second fiscal package is set to be unveiled later this year. Earnings are expected to rebound throughout 2021, even though the first quarter might still be difficult, for Europe in particular. Finally, and most importantly, the vaccine rollout is ongoing. It has been a slow start, but distribution should accelerate and expectations are for broad swaths of the population to be inoculated by the summer.

Still, a number of obstacles we anticipated, including logistical hurdles with the vaccines, are unfolding. While these are not surprising, they are delaying the prospects of getting back to normal and leading to a pause in the reopening trade. In addition, Biden's American Rescue Plan is likely to be shrink and take time before it is approved. As such, it appears that much of the good news is already priced in and markets are pausing before the reflation trade takes hold again.

In this context, we remain constructive on risk assets even if we could see some range-trading in the very short term. We still expect equities to advance and believe the rotation towards cyclicals will gain steam again in the coming weeks. Still, we keep an eye on sentiment and positioning in a very consensus view. We are more cautious on sovereign debt, although we believe that yields will only rise gradually. Indeed, we expect the Fed to act to cap yields if needed. We maintain a preference for credit for the carry and still see opportunities in HY and in EM debt, where there is more remaining potential for spread compression.

Asset class details

Equities

Despite a possible period of consolidation, we continue to believe that equity markets will resume their rally in the coming weeks. Indeed, the underlying fundamental supports of fiscal support, ultra-accommodative monetary policy, vaccines and rebounding earnings all remain.

For now though, we could see a pause in the cyclical rotation, as markets process slower vaccine rollouts and a slow approval to Biden's American Rescue Plan before it regains strength.

We choose to focus on the medium term and still favour the reopening trade and more cyclical sectors that have plenty of room to play catch-up. We believe that vaccine rollouts will pick up and the renewed US fiscal impetus will reignite this view. We expect the recent strong performance of Japan to continue and we maintain our preference for emerging Asian equities. We believe that commodities should continue to rebound with strong Chinese growth and expect the developed Pacific region to benefit.

Nonetheless, with positioning crowded and valuations rich, we keep an eye on sentiment to avoid falling into complacency. But given still elevated cash levels and the above-mentioned underlying supports, we expect any potential correction to be mild.

Fixed Income

After US yields burst through 1% on reflation expectations, they have retreated from the recent peak as risk appetites takes a breather, but are likely to gradually move higher again.

The divergence in spreads between the US and Europe is only likely to increase over the coming months as the fiscal impetus will come from the US and the rise in inflation expectations as well. As such, US Treasury yields have more upside potential than German Bunds, especially with a weak European growth backdrop. Still, European sovereign yields are likely to rise in sympathy, to some extent.

In this context, we look to reduce duration even though we expect yields to remain capped by central bank actions.

Overall, we maintain our preference for credit over sovereigns. Spreads have tightened sharply already but potential remains in HY, though we remain selective due to lingering default risk. We continue to see opportunities in hard currency emerging market corporate debt, where the carry is attractive and there is further room for spread compression. This should also allow some absorption of higher Treasury yields.

Currencies

The recent retreat in risk appetite has benefited the dollar, but we expect it to return to weakness as investor sentiment rebounds again. That said, we believe that USD weakness is likely to be more muted going forward as much of the move is likely behind us already. In addition, it is likely to materialise more against EM currencies than against the major currencies that have their own challenges. Indeed, with stronger growth, more fiscal support and higher yields, USD should find some support.

Commodities

Oil prices should benefit from the reopening trade as it gather steam again and demand picks up as we start to get back to normal. However, abundant supply is likely to limit appreciation potential at some point. We expect demand for gold to continue given low real yields, medium-term inflation expectations and central bank QE programs, even if it has paused for now.

Alternatives

We continue to see a place for alternatives in portfolios, as we look for de-correlating and diversifying strategies to complement traditional asset classes. We believe that real assets can also help provide income in a lower for longer world.

Asset Classes	Negative	Neutral	Positive
Equities			●
Fixed Income		●	
Equities			
US		●	
Europe			●
Japan			●
Asia ex Japan		○	●
Emerging Markets			●
Asia			●
Latam		●	
Europe		●	
Fixed Income			
Sovereign US		●	○
Sovereign EUR		●	
IG US			●
IG EUR			●
HY US		●	
HY EUR		●	
EM Hard Ccy			●
EM Local Ccy			●
Commodities			
Oil		●	
Gold		●	
Base Metals		●	

● Current month ○ Previous month (no dot means no change)

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