

Perspectives

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IN SHORT

- The improving economic outlook and reopening prospects have reignited the reflation trade
- Bond yields have jumped but equity markets are holding up, with the rotation into cyclicals accelerating
- We maintain our constructive outlook and would look to “buy the dip” in case of a correction

Yields take off

After a short breather at the end of January, the reflation trade is back. Bond yields have jumped, with 10-year Treasury yields rising 33 basis points and 10-year German Bunds climbing 22 basis points since the beginning of February. The steepening of the yield curve has also, as anticipated, reignited the rotation into cyclicals. Investors now face two big questions: How high can yields rise? At which level does it impact equity markets?

In our view, bond yields are unlikely to continue to move in a straight line up. Indeed, much of the move is predicated on the Federal Reserve reacting sooner than expected to higher inflation. However, we do not believe inflation will be lastingly high and we are convinced the Fed will look through any rise in inflation over the coming months, seeing it as ‘transitory’, and maintain its current policy stance throughout 2021. As such, yields will eventually be capped, even if they can overshoot in the short term, especially as base effects from the 2020 lockdowns lead to big headline CPI numbers in the months ahead.

With a lot of the move in yields due to the improving growth outlook and reopening prospects, risk appetite is holding up. In addition, the pace and scale of the move in yields is more important than the absolute level, suggesting that as long as the move is gradual, risk assets should be able to absorb them. As such, with Fed guidance fixed, the move should pause.

For now, equity markets are showing a rotation within and not out of the asset class. That said, an overshoot in yields could lead to a short-term correction in markets, but we do not expect it to lead to a protracted sell-off. Indeed, the fundamental underlying supports of the equity market rally are still present and are even being reinforced. The vaccination effort is picking up speed, suggesting the prospects of reopening are nearing. Fiscal support is set to increase further with President Biden’s American Rescue Plan. Monetary support is not going anywhere and the earnings outlook for this year and next continues to improve. As such, we remain constructive and believe that financials, energy, and materials will continue to benefit. More value-oriented regions such as Europe and Japan should also do well, as should Pacific ex-Japan with its higher exposure to commodity markets and Chinese growth.

Conversely, we look to further reduce duration in case yields overshoot and continue to prefer credit risk. With tight spreads already and longer durations, we turn more cautious on IG and see more potential in HY, though on a selective basis as default risk has not vanished. While emerging markets tend to suffer in a rising rates environment, we believe there is room for further spread compression in EM and, as a result, potential for EM hard currency corporate debt to absorb some of the rates move.

Asset class details

Equities

The underlying fundamental supports for equity markets are only being reinforced and we maintain our constructive outlook. The next round of US fiscal measures is set to arrive in March, the vaccination effort continues to gather steam, 2021 and 2022 earnings expectations are being revised up and the Fed will remain ultra-accommodative for a long time.

As a result, the reflation trade is back and the rotation into cyclicals is accelerating, with still plenty of room for catch up. In addition, while the quick pace of the move in yields could lead to a short correction if it continues, we would view it as an opportunity to buy the dip. Indeed, despite bullish sentiment and rich valuations, we not concerned of bubbles bursting for now.

We therefore continue to favour cyclical sectors such as financials, energy, and materials. European and Japanese stocks should benefit from risk on sentiment and the more value tilted construction of their indices. Commodities should continue to rebound with strong Chinese growth and reopening expectations, and we expect the developed Pacific region to benefit in particular. We also believe emerging Asia will continue to do well, supported by better management of the pandemic and reopening prospects.

Fixed Income

The move higher in yields accelerated in February, with the US 10-year yields close to 1.40% and 10-year German Bunds above -0.30%. Indeed, while we would have expected European yields to rise less than their US counterparts, the 'sympathy move' has been almost as strong across the Old Continent.

That said, we do not expect the Fed to tighten monetary policy sooner than anticipated and believe Mr. Powell will continue to reiterate his commitment to full employment, looking at any rise in inflation over the coming months as 'transitory'. As such, we believe yields will eventually be capped, even if they can still overshoot in the short term.

With this in mind, we look to reduce duration further and continue to prefer taking credit risk. The longer duration of IG indices and the very tight spreads suggest less room to absorb higher rates than in HY, though we remain selective given 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

With the return of the reflation trade, the dollar retreated from recent peaks, but the weakness has not been on the scale of 2020. Indeed, while risk appetite should weigh on USD, better growth, earnings, and carry should limit the weakness going forward, suggesting more range-trading than outright weakness going forward. Moreover, it could materialise more against EM currencies than major currencies, which face their own challenges.

Commodities

Oil prices should benefit from the reopening trade as it gathers 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 improve with the reopening of EM economies, low real yields, and medium-term inflation expectations, even if it has paused for now.

Alternatives

Alternatives continue to provide diversification and re-correlation in portfolios, a welcome complement to traditional asset classes. We believe that real assets can also help provide income in a lower for longer world.

Perspectives

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)

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