March 2, 2021

BILBoard February / March – A Smooth Landing?

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Let's rewind to August 2020. Astronauts on the first commercial spacecraft mission, operated by Elon Musk's SpaceX, returned to Earth successfully, splashing into the Gulf of Mexico after spending two months on the International Space Station. For the rest of us, "staycations" were largely on the cards, with travel still restricted. Global Covid cases had surpassed 20 million and Russia had approved its Sputnik V vaccination, becoming the first country to grant regulatory approval for a jab against the coronavirus. The major central bank collective was running with "whatever it takes" monetary policies, their asset purchase programmes taking "cheap borrowing" to a whole new level. A collapse in real yields had echoed through financial markets, stoking what was coined an "everything rally", causing key equity indices and gold to hit new highs.

Back to the present, risk assets have moved even higher, now accompanied by commodities (hard and soft). Investors are encouraged by the ongoing economic recovery, continued central bank largesse, more fiscal stimulus and the vaccine rollout. However, promising growth prospects have left investors anxious that the stars are aligned for higher inflation; US 2-year breakeven rates (a gauge of the market's inflation expectations) recently hit a decade high of

2.6% and yield curves have been steepening around the globe. Investors are cognisant that because longer-term yields determine borrowing rates (mortgages, business credit lines, corporate debt, etc.), if they were to rise too high too quickly, it could be detrimental to the economic recovery, eventually compelling central banks to tighten policy earlier than expected (the market is already starting to price in Fed rate hikes with lift-off in summer 2023). Real yields have also picked up, stoking fears that the "everything rally" could come back down to earth with a bump.

At BIL, this is not our base case. Until now, the rise in nominal yields is largely the result of rising inflation expectations. While there is a danger that inflation expectations can ignite a self-fulfilling feedback loop, there are signs of fatigue in breakeven rates and published inflation has yet to corroborate lofty expectations. Published CPI in the US was lower than anticipated in January at 1.4%, while the relatively high reading in the Eurozone (+0.9%) can be explained by an increase in VAT and carbon prices for German consumers, as well as the timing of winter sales in Italy and France. While breakeven rates do have the potential to go higher, a lot is already priced into the market, limiting upside potential. To quantify this, at the time of the Committee, real rates — the return that bond investors can expect after discounting expected inflation — sat at -0.8% in the US. By the end of the year, a move to around -0.5% (which is still a supportive level for risky assets) is a reasonable expectation.

As such, moving forward we could expect a more orderly rise in real yields, in tandem with improving fundamentals (particularly in the US as Biden's new stimulus package enters the orbit). If our estimates are correct and the rise plays out in a controlled and steady manner, markets should not be derailed. If the opposite plays out and long-term yields defy the laws of gravity, skipping ahead of the recovery, central banks are there as a safety net. Just as ground control can alter the course of a rocket, central banks can influence the course of the bond market, whether with more hawkish communication or adjustments to their asset purchasing programmes and so on.

In light of our view, we remain overweight risk assets, preferring equities to bonds.

EQUITIES

In the equity space, we hold our regional allocation steady, giving preference to the US and China where macro momentum is the strongest. Europe is hampered by delays in the vaccine rollout and prolonged movement restrictions. Given that we are now riding the upwards leg of the growth cycle, we added more cyclicality to portfolios via our sector preferences. To elaborate, we brought Energy up to a neutral weighting (as a sector benefitting from the economic reopening and rising oil prices), while downgrading defensive sectors such as Consumer Staples and Healthcare. This leaves us with an overweight in the following cyclical sectors: Consumer Discretionary (earnings revision trends are strong while consumer confidence surveys, e-commerce data and corporate commentary suggest consumer demand is resuming at a faster pace than expected), Materials (rising commodity prices are translating into strong earnings growth) and Industrials (a play on rising PMIs and a key beneficiary of large-scale fiscal stimulus). We balance this out with an overweight in Utilities - a defensive sector with promising prospects given the energy transition and the amount of fiscal stimulus being poured into the "greening" of the economy.

FIXED INCOME

In the fixed income world, we are naturally reluctant on sovereign bonds and duration, given that yields are on an upward trend (prices move inversely to yields). We believe that the bulk of the rise in inflation breakeven rates is behind us, so we see the risk/reward dynamics on inflation-linked bonds as less compelling and have downgraded our view on TIPS to neutral. From a regional perspective, yield differentials between the US and Europe are expected to continue to widen and we closed our Treasury positions earlier in the month.

We remain positive on investment grade corporates. Spreads are showing very low volatility, indeed, the last 3 months represent one of the least volatile quarters on record. In an environment where central banks are expected to continue to be supportive, the macro picture is improving and investors are looking towards a bright post-pandemic future, IG corporates should continue to perform well and could even overshoot in terms of spread tightening.

We are cautious on the high-yield segment of the bond market. High yield indices are at or close to all-time lows from a yield perspective, breaking through the 4% barrier in the US and the 3% barrier in Europe. Assets at the lower end of the quality curve could be vulnerable to rising yields as this represents increased financing costs.

In the emerging market debt space, we continue to prefer investment grade corporates over sovereigns, as their duration profile offers a better buffer against rising real yields.

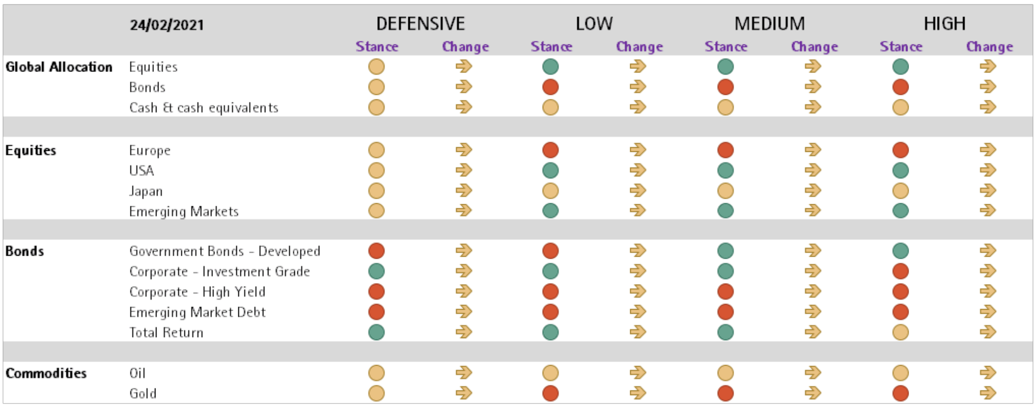
OTHER

We are neutral on oil for the time being. While travel restrictions continue to depress global demand, prices are trending upwards as the reopening and recovery theme starts to kick in. Saudi Arabia's unilateral decision to withhold an additional 1 million barrels per day in February and March adds further support.

CONCLUSION

In summary: we are riding the upwards leg of the growth cycle and so our investment strategy remains positive on risk assets, with a preference for equities over bonds. Within equities, we have implemented a cyclical tilt through our sector selection, and in our bond solar system, investment grade corporates are the Jupiter while our sovereign allocation would be more comparable to the size of Pluto. Much now depends on the ability of central banks to orchestrate a smooth rise in yields in tandem with the economic recovery. A communication misstep could indeed result in a "Houston, we have a problem" moment on markets and elevated volatility. Our portfolios are to an extent protected by being well-diversified across asset classes and regions. We have maintained our gold allocation in line with the benchmark, which has served well as a diversifier during recent bouts of market volatility.

Asset Allocation Matrix



	24/02/2021	DEFENSIVE		LOW		MEDIUM		HIGH	
		Stance	Change	Stance	Change	Stance	Change	Stance	Change
Global Allocation	Equities	🟡	⇨	🟢	⇨	🟢	⇨	🟢	⇨
	Bonds	🟡	⇨	🔴	⇨	🔴	⇨	🔴	⇨
	Cash & cash equivalents	🟡	⇨	🟡	⇨	🟡	⇨	🟡	⇨
Equities	Europe	🟡	⇨	🔴	⇨	🔴	⇨	🔴	⇨
	USA	🟡	⇨	🟢	⇨	🟢	⇨	🟢	⇨
	Japan	🟡	⇨	🟡	⇨	🟡	⇨	🟡	⇨
	Emerging Markets	🟡	⇨	🟢	⇨	🟢	⇨	🟢	⇨
Bonds	Government Bonds - Developed	🔴	⇨	🔴	⇨	🟢	⇨	🟢	⇨
	Corporate - Investment Grade	🟢	⇨	🟢	⇨	🟢	⇨	🔴	⇨
	Corporate - High Yield	🔴	⇨	🔴	⇨	🔴	⇨	🔴	⇨
	Emerging Market Debt	🔴	⇨	🔴	⇨	🔴	⇨	🔴	⇨
	Total Return	🟢	⇨	🟢	⇨	🟢	⇨	🟡	⇨
Commodities	Oil	🟡	⇨	🟡	⇨	🟡	⇨	🟡	⇨
	Gold	🟡	⇨	🔴	⇨	🔴	⇨	🔴	⇨

Stance: Indicates whether we are positive, neutral or reluctant on the asset class Change: Indicates the change in our exposure since the previous month's asset allocation committee

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