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BILBoard June 2021 – The R&R Trade

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R&R would normally stand for rest and recuperation. However, the economy has already had its downtime and the R&R theme driving markets is quite the opposite: reopening and reflation. Accelerating vaccination campaigns mean a growing number of countries are following in the footsteps of the US and China, and staging an economic ***reopening*** *– particularly in Europe. At the same time, central banks remain supportive and a bombardment of fiscal policy measures is forthcoming. All this is fanning a* ***reflation trade*** *in markets; one that seeks to capitalise on* *higher growth and inflation expectations.*

As is reflected in the OECD's recent decision to upgrade its 2021 global growth projection to 5.8% (which would represent the fastest growth since 1973), the macro outlook continues to brighten and we expect strong momentum through the second half of the year – should there be no surprises on the epidemiological front. On top of the vaccine rollout and accommodative monetary policy, the upturn is amplified by government stimulus programmes. In the US, President Biden has put another USD 1.7 trillion infrastructure spending plan on the table, while in Europe, after months of delay, all 27 member states have finally ratified the legal instrument that underpins the EUR 750 billion recovery fund.

Against a backdrop of strong growth and rising commodity prices, the elephant in the room is inflation: US CPI hit 4.2% in April, while Euro Area inflation rose 2% in May. This has led to fear that central banks could tighten monetary policy sooner rather than later, to prevent overheating, thereby cutting off economic expansion.

However, key central bankers – Jerome Powell and Christine Lagarde included – have iterated and reiterated their belief that the inflationary spike will be transitory, making them reluctant to adjust policy. As of now, market-based inflation expectations imply that investors buy into this theory and indeed it makes sense if you consider base effects, bottlenecks and the fact that pent-up demand is being met with limited supply. Moreover, the factors that have anchored inflation in recent decades (globalisation, digitalisation, Amazonisation and others), have not abated.

As such, while we do expect inflation to rise further from here, we do not think it will spiral out of control, nor do we believe that central banks will tighten policy in an abrupt way that would derail markets. In light of this, our strategy is overweight equities versus bonds, while being calibrated to take advantage of the R&R trade (which reflects positive economic growth, rising but controlled inflation and a gradual rise in yields).

EQUITIES

We have come to the end of a very positive Q1 earnings season and analyst revisions (relative and absolute) are moving in the right direction in all regions. Nonetheless, markets have traded rangebound with inflation fears tempering gains. From here, while we do believe equities could have further upside – in line with improving macro dynamics – investment returns will largely be dictated by style and sector decisions. In such environments, we have historically seen a rotation from growth and defensive plays to value and cyclicals.

For the past few months, we have carried a value tilt within our US equity exposure; this has been beneficial in light of rising Treasury yields, which have spelled trouble for growth and technology stocks. This month, we rebalanced our regional exposure, bringing our European allocation to overweight. In doing so, we essentially doubled down on our value play, given that Europe has a high concentration of value stocks that typically benefit from rising inflation and interest rate expectations. Additionally, Europe has a lot of catch-up to play given that it is only just beginning to experience its own reopening boom. Further talks about stimulus packages in European countries (e.g. Germany) could be a positive driver, as well as the disbursement of the pan-EU recovery fund in the second half of the year.

To fund this trade, we reduced our US equity exposure (though we remain overweight). We also remain overweight on China, which is an unambiguous global growth driver. The medium-term correction in Chinese equities has levelled off and we are seeing the beginnings of a rebound. The market is supported by strong inflows, while valuations are compelling relative to global peers. Observing that Chinese authorities have made little use of monetary stimulus, especially compared with the West, investors in China will not have to sniff out when tapering might start.

In terms of sectors, we brought industrials down to neutral, while increasing financials to overweight. We have not yet seen a material impact from inflationary pressures on margins but expect this will become more apparent in Q2 earnings results. Moving forward, industrials may lack the pricing power needed to pass on rising costs to consumers, resulting in some margin pressure. Financials, on the other hand, are a key beneficiary of higher inflation and rate expectations. We continue to like cyclicals such as consumer discretionary and materials, which are well-positioned to benefit from the reopening theme and pent-up demand. We are keeping our overweight on utilities, hand-picking stocks that will play a role in the energy transition that governments are pursuing with billions of dollars, euros and yuan.

FIXED INCOME

On the whole, the reflationary environment makes us reluctant about fixed income. Where we do have exposure, we prefer investment grade corporates (in both developed and emerging economies) as well as developed market high-yield bonds. Just as the reopening has signalled a return to tourism in the real world, in search of sunshine, reflation has signalled a return to tourism in the bond world: that is, investors venturing out of their comfort zone in the IG space, into high-yield, in search of yield. These inflows are supportive of the segment, alongside positive rating trends: it is worth noting that in the US HY space, rating upgrades outnumber downgrades by the largest amount seen in a decade (2.04x).

COMMODITIES

On the back of recent price momentum, we felt that it was an opportune moment to take profit on gold. The price of gold recently reached a four-month high topping USD 1,900, erasing yearly losses. We remain more cautious in the medium term with the potential for tapering talk to start popping up more frequently in Q3. We remain neutral on oil. While the reopening narrative and the resumption of travel could push up prices, there is also the prospect of an

Iran-US nuclear deal, which could see a flood of supply.

CONCLUSION

As the global economy keeps soldiering on, with steady ammo in the form of fiscal stimulus and accommodative monetary policy, our portfolios are geared towards taking advantage of the R&R trade. This entails an equity overweight, focusing on reopening beneficiaries and typical reflation winners.

	27/05/2021	DEFENSIVE		LOW		MEDIUM		HIGH	
		Stance	Change	Stance	Change	Stance	Change	Stance	Change
Global Allocation	Equities	🟡	⇨	🟢	⇨	🟢	⇨	🟢	⇨
	Bonds	🟡	⇨	🔴	⇨	🔴	⇨	🔴	⇨
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	Oil	🟡	⇨	🟡	⇨	🟡	⇨	🟡	⇨
	Gold	🟡	⇨	🔴	⇨	🔴	⇨	🔴	⇨

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