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Weekly Market Flash

Will the rise in yields challenge equity returns?

February 21, 2021

Equity markets unexpectedly started a correction this week, with some of the recent top performing sectors leading the way down, including US tech and ESG related themes. The most likely trigger for the weakness was the spike in volatility in fixed income, with yields rising and the curve steepening. Overall, we remain constructive on equity markets, in particular the Italian equity market, since we continue to believe that a long window of recovery in valuations has been opened.

Highlights

▪ US tech stocks, innovation related companies, Italian equities and ESG themes posted losses between 3% and 10% during the middle of the week. European stocks managed to end the week higher.

▪ We saw some profit-taking activity on the Italian equities market, after Mario Draghi received the official mandate as Italy's Prime Minister.

▪ The US labor market once again showed signs of weakness with a much higher than consensus initial jobless claims number (861k versus 773k expected).

▪ Pipeline systems operator Enbridge printed the first ever non-financial SOFR-linked floating rate transaction. Enbridge's order book was nearly seven times, which is massive for a floating rate deal, for a final spread of SOFR + 40 bps.

"Our overall view is that equity markets will be able to manage a situation of the 10-year US Treasury yield remaining in the 1.20-1.40% region, and only gradually rising."

Markets & Macro | Will the rise in yields challenge equity returns?

Bond market volatility spreads to other asset classes.

Equity markets unexpectedly started a correction this week, with some of the recent top performing sectors leading the way down. US tech, innovation related names, Italian equities and ESG themes posted losses between 3% and 10% during the middle of the week. US tech stocks, innovation related companies, Italian equities and ESG themes posted losses between 3% and 10% during the middle of the week. However, it isn't a coincidence that the weakness in the Italian market started the same day that Draghi obtained the trust vote from the Senate. We thus remain constructive on equity markets in general, and toward the Italian market specifically, since we continue to believe that a long window of recovery in valuations has been opened.

Our view: The most likely trigger for the weakness was the spike in volatility in fixed income markets, with yields rising and the curve steepening. Our overall view is that equity markets will be able to manage a situation of the 10-year US Treasury yield remaining in the 1.20-1.40% region, and only gradually rising. While some further sector rotation is likely, with financials and value sectors benefiting and technology/growth likely to suffer, the overall direction of the market should be upward. However, a sudden move to the 1.50-1.70% range in the 10-year yield would put pressure on equities, potentially triggering a more dangerous correction of around 10% in aggregate indices.

We addressed the risk of this happening, however we believe that such a scenario remains unlikely due to the amount of liquidity in the system – especially with the US Federal Reserve (Fed) and other major central banks remaining accommodative. The ongoing benign medium-term inflation outlook should also contribute to calming such fears in the coming months.

It is also not surprising to see yields rise. Economic activity has weathered the winter lockdown well, while the examples of Israel and the UK are showing the world the road toward social and economic normalization. In the US, a huge USD1.9 trillion (9% of GDP) fiscal plan seems to be on the way, with quick impact measures such as $1,400 cheques to Americans. This week's publication of a shockingly strong retail sales report (up 5% month-on-month) showed how quick US consumers have been to spend their available income ($600 cheques were part of Trump's last fiscal package). US Treasury Secretary Janet Yellen also reinforced the message of the need for strong and immediate stimulus this week. It appears that the only relevant variable to her is the labor market, which once again showed signs of weakness this week with a much higher than consensus initial jobless claims number (861k versus 773k expected). When asked about the risk of cheques being used to invest in the equity market instead of being spent on real goods, she dismissed the argument saying that "the risk to do too little is higher than doing too much". Meanwhile, commodity prices are also rising, suggesting a robust cyclical recovery and inflating production costs for companies (as seen from this week's PPI number doubling economists' expectations at 2% year-on-year).

Looking at the question on whether the rise in yields should challenge equity returns, we have initially observed that, for the time being, the rise in nominal rates is largely explained by the rise in inflation expectations (Figure 1 highlights this with the rise in the 10-year breakeven inflation rate). Real rates are still close to the very low (and negative) levels where central banks' financial repression has pushed them. A situation in which current and expected inflation is much higher than nominal interest rates means financial conditions are very expansive, and therefore investors should hold real assets, not debt, which depreciates in real terms. And central banks have made clear that they intend to maintain such a situation at the moment.

The impression is that real rates will remain low unless exuberant growth forces them higher, which may well be the case – but this is not bad for equities. To this point, next week's testimony to the Senate from Fed Chair Jay Powell becomes particularly relevant to quell fears of a rise in real yields, guided by a change in direction in monetary policy. We are confident that this will not happen, since it would constitute a policy mistake at a time when economies are still impacted by the virus and its variants continue to pose a threat to normalization.

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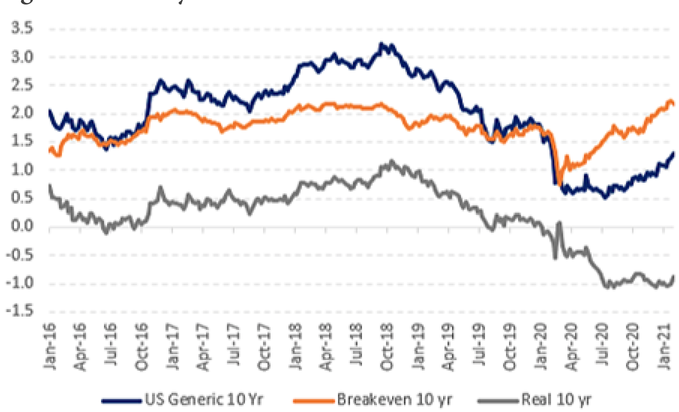
Figure 1: US 10-year Yield versus Breakeven



Source: Bloomberg, as at February 19, 2021.

While the bond market's volatility has indeed extended to other assets, we believe that the post-Covid world, with extreme monetary and fiscal activism, should be able to bear higher structural volatility levels in financial assets.

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Another channel through which higher rates could harm equities is via the "discount factor". Yet, only a move toward 2% in the 10-year yield should seriously decrease valuations, and only in the tech space, since value and financial sectors are not highly sensitive to higher rates (while the opposite applies to financials). Yet, we recognize that the direction in rates is clear, and the 40 basis points (bps) increase in yields year-to-date is a new dynamic that investors are not used to – and one that has to be monitored.

Longer term, the question about the direction of inflation remains open and we're still far from convinced that a structural spike in inflation is looming. The upcoming US fiscal stimulus is undoubtedly large, but it needs to be measured against the size of the collapse in economic activity in the past year. With the broader measures of unemployment slack much higher than before the pandemic, wage inflation – the most relevant factor driving inflation – seems far away.

Equities | Will the reflation trade play a bigger role?

European stocks lead in mixed week.

“ e believe 202 will be a stock-picking year, with reflation trade plays taking up a bigger weighting in the portfolio than in previous years.”

An increase in the 10-year US Treasury yield this week weighed on technology stocks and boosted financials’ share prices. European stocks were also impacted by this move – as well as by concerns about inflation – but the market managed to end the week higher. Meanwhile, Chinese stocks resumed trading following the Lunar New Year holiday with mixed results. Trading volumes continued to fall back from the record levels seen in January.

Figure 2: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	31,494.32	0.16%	5.22%	3.17%
S&P 500	3,906.71	-0.68%	5.29%	4.22%
Nasdaq	13,874.46	-1.54%	6.22%	7.75%
Euro Stoxx 50	3,713.46	0.50%	6.79%	4.82%
FTSE 100	6,624.02	0.71%	3.57%	2.76%
CAC 40	5,773.55	1.23%	6.93%	4.15%
DAX	13,993.23	-0.40%	4.17%	2.00%
FTSE MIB	23,136.31	-1.17%	7.25%	4.45%
Nikkei 225	30,017.92	1.69%	8.51%	9.38%
Hang Seng	30,644.73	1.56%	8.35%	12.54%
CSI 300	5,778.84	-0.50%	7.98%	10.89%

Source: Bloomberg, as at February 19, 2021. Performance figures in indices' local currencies.

Our view: We believe 2021 will be a stock-picking year, with reflation trade plays taking up a bigger weighting in the portfolio than in previous years. We also continue to advocate the barbell approach to our equity portfolios.

Chart of the week

“...we saw some profit-taking activity on the Italian equities market, after Mario Draghi received the official mandate as Italy’s Prime Minister. The pullback stopped at 22800 – the 76.4% Fibo’s retracement.”

This week, we saw some profit-taking activity on the Italian equities market, after Mario Draghi received the official mandate as Italy’s Prime Minister. The pullback stopped at 22800 – the 76.4% Fibo’s retracement. Likewise, the close above this support would suggest an extension of the bull trend to test new highs. We used this correction to increase our exposure to our long Italian equities trade.

Figure 3:

Source: Bloomberg, as at February 19, 2021.

Fixed Income & Credit | Bond investors welcome the rise in yields

Demand for floating rate notes strengthen.

"Floating rate bonds are indeed a way of diversifying issuer funding sources, but are for the moment of no use for the fixed income investor..."

Government bonds continued their sell off this week as investors started to price in the impact of the expected stimulus plan in the US. For now, rising yields are thus associated with an improving economy, which supports corporate fundamentals. However, the movement in the underlying benchmark yields has fully eroded the narrowing spread, and investment grade corporate bond returns are negative for this year.

In this broadly improving economic outlook, it is not a coincidence that demand for bonds with floating rates has started to resurface. Pipeline systems operator Enbridge (BBB+/Baa2) printed the first ever non-financial SOFR-linked floating rate transaction – which is the latest signal that the debt capital markets are preparing for life after Libor. Enbridge's order book was nearly seven times, which is massive for a floating rate deal, for a final spread of SOFR +40 bps.

Our view: Floating rate bonds are indeed a way of diversifying issuer funding sources, but are for the moment of no use for the fixed income investor, who may be fed up of buying bonds with seemingly ridiculous coupons. Our view is that a rise in yields for many fixed income players is more than welcome, and that insurance companies, pension managers, and foreign investors are waiting on the sidelines for a stabilization in US rates.

Week Ahead | Key events to watch for

- **In the week ahead, Fed Chairman Powell's testimony to Congress will be of importance**. This is also tied to the publication of the Fed's monetary policy report, which should provide substantial guidance on how the Fed views the path of monetary policy in the medium term.
- **In terms of data there are GDP revisions**, consumer confidence and the Fed's favored measure of inflation, the core PCE deflator. In Europe, the German Ifo business climate indicator will be published.
- **The earnings season is coming to an end,** with 64 S&P 500 companies reporting.

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