NOVUM
CAPITAL PARTNERS

Weekly Market Flash

Will yields retrace in the short term?

March 21, 2021

A rare divergence between emerging markets (EM) and developed markets (DM) central banks' monetary policy occurred this week – Brazil, Turkey and Russia hiked rates, surprising investors with both the moves and their magnitude. In a broad sense, the EM policy cycle seems to have turned. In fact, it is surprising that EM monetary policy makers are proving to be much more sensitive to inflation risks than their DM counter parts.

Highlights

- The rise in 10-year yields accelerated again after the FOMC showed little concern about the recent surge in long-term yields.
- The Fed and Bank of England meetings had dovish outcomes, with the Fed leaving unchanged expectations for its first rate hike. The Fed also raised its forecast for real GDP growth this year to 6.5% versus a prior forecast of 4.2%.
- The slow vaccine rollout in Europe and renewed lockdowns in the face of a third Covid wave in Germany and France drove oil prices and energy stocks lower this week.
- In the US primary market, bonds maturing in less than three years have reached 13% of all US investment grade issuance through March 15, more than double what it was at the same point in 2020.

Markets & Macro | Will yields retrace in the short term?

"...the fact that the Fed took away the facility despite their intention to fix the rule suggests that it was the FOMC's intention to restore the capital ratio limits anyway."

Fed demotes inflation as biggest concern.

With rates hiked in Brazil, Turkey and Russia this week, it is surprising that EM policy makers are proving much more sensitive to inflation risks than their DM counter parts (although it has to be noted that Erdogan removed Turkey's central bank governor two days after the move, replacing him with an advocate of lower rates).

Meanwhile in DM, the Federal Reserve (Fed) and Bank of England meetings had dovish outcomes, with the Fed adjusting notably higher its economic forecasts – but leaving unchanged expectations for its first rate hike. The Fed also made very clear, through its projections and through Powell's words, that any tightening of its stance, including tapering, needs a strong improvement in data and not just that of expectations – and that inflation has to significantly rise above target, for a considerable period of time, before raising rates.

Our view: Two days after its meeting, the Fed announced that it would not extend the exemption of Treasuries from the Supplemental Leverage Ratio (SLR), which expires on March 31. This exemption made it easier for banks to accumulate Treasuries and free up capital to facilitate lending, and the decision to not extend this exemption means banks may be forced to reduce their positions in these assets to some extent (at a time when the market is weak), and will likely see available capital contract.

It is also worth noting that the Fed added that it will gather comments to make adjustments to the SLR ruling, which will perhaps allow for amendments if the effects are excessive. However, the fact that the Fed took away the facility despite their intention to fix the rule suggests that it was the Federal Open Market Committee's (FOMC) intention to restore the capital ratio limits anyway.

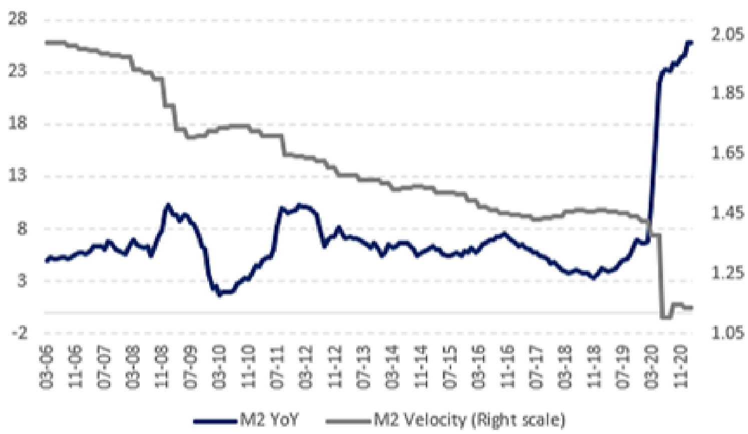
The rates markets reacted accordingly to such statements: since this is clearly a recipe for stronger inflation, the short end of the curve saw rates fall, discounting a more patient Fed, while the long end of the curve remained weak, pricing in a higher inflation risk premium. But the other overriding theme at this stage is the acceleration in growth, linked to the reopening and the explosion of fiscal stimulus currently sweeping the US economy. In fact, the Fed raised its forecast for real GDP growth this year to 6.5% versus a prior forecast of 4.2%, while the projection for the unemployment rate was revised down to 4.5% at the end of 2021 from 5.0% previously. PCE inflation forecast was raised from 1.8% to 2.4%. The key topic for investors remains around inflation, and in fact, the Fed expects the inflation spike to be a temporary phenomenon, declining to 2.0% in 2022 due to a slowing economy.

"While it is certainly impossible for anyone to correctly forecast inflation in such a complex (post-Covid) environment, it is apparent that the Fed has demoted inflation as its biggest concern..."

While it is certainly impossible for anyone to correctly forecast inflation in such a complex (post-Covid) environment, it is apparent that the Fed has demoted inflation as its biggest concern and pushed the economy – and specifically the labor market recovery – to the top of its priority list. In our opinion, letting M2 growth rise to 25%, and holding rates at basically zero, in spite of an economic recovery, is proof of this.

A point can be made here. During the last decade, monetary policy operated without a consistent, targeted, demand-side fiscal impulse, with two clear unintended consequences: inflation didn't rise as the velocity of money imploded, while asset prices boomed, thus exacerbating the already rising inequalities.

Figure 1: M2 Year-on-Year versus M2 Velocity



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

"Short term, we think the move in yields has reached extreme levels and an interruption or a retracement is likely..."

Having apparently learned from that experience and highly concerned by the stretched K-shaped recovery induced by the pandemic, the US administration has decided to implement an impressive fiscal push to the economy, thus contributing to the upward move in long-dated yields. Short term, we think the move in yields has reached extreme levels and an interruption or a retracement is likely, with a likely consequential pause in the equity sector rotation from tech to value. For the moment, Powell has done nothing to alleviate rates concerns. Meanwhile, longer term, it is not difficult to envisage the market forcing the Fed to implement even more aggressive versions of such policies, such as yield curve control, which widened the wealth gap in the first place.

In our view, the reason why the current episode is scaring investors is the fact that the M2 measure of the money supply has never grown as fast as it has in the past year. Combining this with the income supportive policies implemented by the government, an inflationary environment could easily be created.

Equities | Will defensive sectors return to the top?

Taking profit on value, cutting exposure to growth in China.

Equity investors maintained their focus on bond yields, which are now close to pre-pandemic levels. The slow vaccine rollout in Europe and renewed lockdowns in the face of a third Covid wave in Germany and France drove oil prices and energy stocks lower this week. Bank shares were supported by rising yields throughout the week, but lost ground on Friday on the Fed's decision not to extend banks' exemption from holding lower capital reserves. The large cap Shanghai Shenzhen CSI 300 Index slipped for the fifth consecutive week in response to negative headlines from the US-China meeting in Alaska.

Figure 2: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	32,627.97	-0.45%	5.62%	7.12%
S&P 500	3,913.10	-0.74%	2.78%	4.54%
Nasdaq	13,215.24	-0.77%	0.22%	2.70%
Euro Stoxx 50	3,837.02	0.12%	5.59%	8.39%
FTSE 100	6,708.71	-0.69%	3.97%	4.79%
CAC 40	5,997.96	-0.80%	5.17%	8.20%
DAX	14,621.00	0.82%	6.05%	6.58%
FTSE MIB	24,199.42	0.36%	5.91%	9.25%
Nikkei 225	29,792.05	0.25%	2.85%	8.60%
Hang Seng	28,990.94	0.88%	0.35%	6.80%
CSI 300	5,007.09	-2.71%	-6.18%	-3.92%

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

Our view: While most global equity benchmarks are hovering near their all time highs, a sense of unease prevails among equity investors. Stage 1 of the equity market recovery was induced by massive central bank liquidity in March 2020. Long duration equities, mainly technology stocks, were the first to react to this stimulus, given their high sensitivity to low interest rates. In mid-August, the tech rally peaked with Big Tech (Apple, Alphabet, Microsoft, Facebook and Amazon) representing 25% of the S&P 500 index. This coincided with Treasury yields reversing their downward trend as the bond market began to price higher inflation from massive fiscal stimulus unwitnessed before.

Stage 2 of the equity market recovery was more broad-based, led by cyclicals, energy and financials. With yields approaching pre-Covid levels, and having witnessed a broad-based equity recovery in both growth and value styles, we see the market entering a new stage of uncertainty regarding the path of inflation. The "transient inflation" effect is well understood by the market. What is unclear is the path that inflation will take post the "transient" period, with two major fiscal stimulus packages working their way through the US economy – and potentially an infrastructure package toward the end of the year.

"With yields approaching pre-Covid levels, and having witnessed a broad-based equity recovery in both growth and value styles, we see the market entering a new stage of uncertainty regarding the path of inflation."

We noted earlier that while the Fed tried to reassure markets of a continued dovish stance, three EM central banks surprised markets with unexpected or larger-than-forecasted rate hikes. We add that this year, so far, there have been nine rate hikes around the world – compared with five cuts. The new stage of the market is likely to usher the return of the leadership mantle to defensive sectors e.g. consumer staples, as investors seek refuge from bond yield gyrations. Yield stabilization is likely to require Fed action, as bond vigilantes test the Fed's limits. Going forward, we expect the market to start pricing in two new risks: higher taxation and stricter regulation (on multiple fronts including Big Tech antitrust, carbon emissions and crypto).

We continue to advocate a defensive path by increasing theme and stock diversification. During the week we took profit on part of the value stocks and cut some exposure to growth in China. We look to deploy the cash raised into stocks with high earnings visibility and attractive valuations post the recent correction.

Fixed Income & Credit | Short-term bond issuance more than doubles

IG and HY spreads remain stable.

The rise in 10-year yields accelerated again after the FOMC showed little concern about the recent surge in long-term yields. In the US primary market, this has forced some US companies to avoid long maturities. As a result, bonds maturing in less than three years have reached 13% of all US investment grade issuance through March 15, more than double what it was at the same point in 2020.

Our view: The continued upward trend in rates, coupled with last week's large ETF outflows, restarted the fears of a connection between flows and return. For the moment, however, spreads on investment grade and

"The continued upward trend in rates, coupled with last week's large ETF outflows, restarted the fears of a connection between flows and return."

high yield bonds have remained stable without suffering too much from the rise in rates.

With regard to central banks, and to add new arguments to the yield curve control debate, the Bank of Japan decided to widen the tolerance band around zero on 10-year yields from +/-0.20% (previously implied, although never declared) to +/-0.25%.

Elsewhere, in the CHF primary market, Russian Railways, the state-owned vertically integrated company managing infrastructure and operating freight and passenger train services, issued a Ba2-rated green perpetual bond, callable in 2027 for a yield of 3.10%. Given the usual lack of yield in this market, and the very much sought after green label, demand has been very strong.

Chart of the week

The weekly chart of the US 10-year Treasury bond shows that the RSI is currently at an extreme. The last time we saw such extreme levels was in 1994 – and the sell off had a stop for six months before rising 55 basis points more. Today, the RSI indicator is signaling that the move upward has potentially gone too far. If this is the case, the equity sector rotation can take a temporary breather.

"...the RSI indicator is signaling that the move upward has potentially gone too far. If this is the case, the equity sector rotation can take a temporary breather."

Figure 3: US 10-year Treasury

Source: Bloomberg, as at March 19, 2021.

Week Ahead | Key events to watch for

- **In Europe, PMIs will provide insight** into how much the extended lockdowns have limited activity, particularly in the services sectors.
- **The UK economic calendar is packed with reports on the labor market**, inflation, PMIs and retail spending.
- **In the US, only second-tier data,** with durable goods orders, personal income and spending reports will be released.

Vittorio Treichler
Chief Investment Officer

Flavio Testi
Senior Fixed Income Portfolio Manager

Daniele Seca
FX and Derivatives Portfolio Manager

Karim Khalil
Senior Equity Portfolio Manager