# Little inflation and booming markets

- **Markets were supported by lack of inflationary pressures and unabated stimulus**
- **Powell wants a labour market that "is sustained for an extended period"**
- **We maintain a pro-cyclical stance although behavioural factors have turned into a headwind**

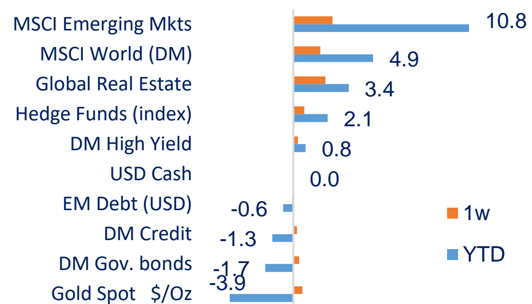
Stocks closed at new all-time highs both in the United States and in the emerging markets, with the former seeing well more than 1% gains and the latter north of 2% for the week. The 10-day winning streak in global equities was driven by positive corporate news, improving virus trends and high expectations for US stimulus plans. The reflation trade gained steam, anchored by the conviction that robust growth will support the rally in risk assets, including commodities. Brent crude closed 5% higher in the five days through Friday and US 10-year Treasury yields ended the week at 1.208%, a level last reached almost a year ago.

Mr Powell underscored the need for more fiscal stimulus and continued monetary support until full employment is reached. He said that we are still "very far" from a complete recovery and that it could take "many years". His lack of concerns about inflationary pressures was born out by the CPI January release, with core CPI basically unchanged for the second straight month.

Easy money alongside lack of inflation make for an ideal backdrop for the current rally to continue, although we acknowledge that positioning and investor sentiment are no longer on our side. We maintain a pro-cyclical stance with an equity overweight in both DM and EM and would be seeing setbacks as buying opportunities.

The week was marked by two high-profile figures, Donald Trump, fully acquitted of the charge of inciting the Capital Hill insurrection, and Mario Draghi, being sworn in as new Prime Minister in Italy. The spotlight will be on 'Supermario 2', and his ability to lead the country out of the woods.

ASSET CLASSES USD % TOTAL RETURN, YTD 2020, LAST WEEK

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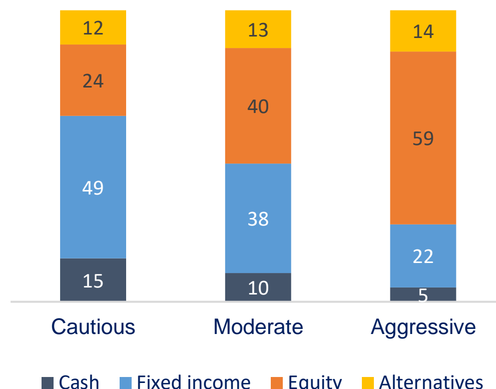
## Cross-asset Update

The talk about inflation has recently become more relevant and worth debating, given that US market-implied inflation measures have just touched levels last seen in 2014, at 2.2%, and long-dated Treasury yields have been rising since November last year and consolidating well above 1%. Bill Dudley, ex Federal Reserve Bank of New York president and FOMC chairman, in his Bloomberg column recently posted a piece titled ‘Four More Reasons To Worry About U.S. Inflation’, which was preceded by an article on the same topic, ‘Five Reasons To Worry About Faster U.S. Inflation’. Although investors see inflation and rising yields as a threat to the current equity bull market, the norm is actually that equities and yields tend to rise together. When real growth is strong, stocks tend to perform and government bonds to suffer as investors discount rising price pressures, hence higher bond yields. This is what has happened since late last year, when the prospects for more fiscal stimulus increased alongside hopes for a quicker solution to the pandemic with successful vaccines. If the outlook improves, as it is happening, then there should be no reason to be concerned about yields pushing higher. The CIO view remains constructive as well as our equity strategy. Of course, too much of a good thing could be a bad thing, the unintended consequences of excessive stimulus cannot be gauged accurately and an inflation scare is always possible. This could be for instance fueled by the chunk of supply wiped away by the pandemic, especially in the services sector, combined with increased transfers to households and the subsequent pent-up demand for services as the recovery takes hold.

In general, we hold the view that there is ample room for equities to absorb a rise in interest rates. Equities may be expensive in absolute terms, but remain pretty cheap versus bonds, as measured by the wide gap between the earnings yield, now at about 4.5% for the S&P 500, and the bond yield, slightly below 1.2% for the US 10-year Treasury note. Should the latter rise even towards 2%, this would imply that the earnings yield gap would be moving towards the middle of its historical band, hence equities would still be fairly valued, rather than expensive versus bonds. We would be hard put to see yields rise that much, considering that inflationary pressures are still cyclical and not structural. There should be a mechanical rise in inflation towards the middle of the year, due to base effects and the rise in crude prices. Yet, it should not be sustainable, considering the extreme slack in the system due to the pandemic. For the same reason a very fast rise in yields, usually a common cause of inflation scares, is unlikely to be sticky.

Irrespective of the shorter-term views about possible rising price pressures, the longer term tendency is most likely towards a reflationary tilt, as after all the joint efforts of monetary and fiscal policy are directed that way. Equity investors should take notice and actively manage the duration of their holdings. In the case of equities that would mean being constructive on cyclical stocks and EM equities.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

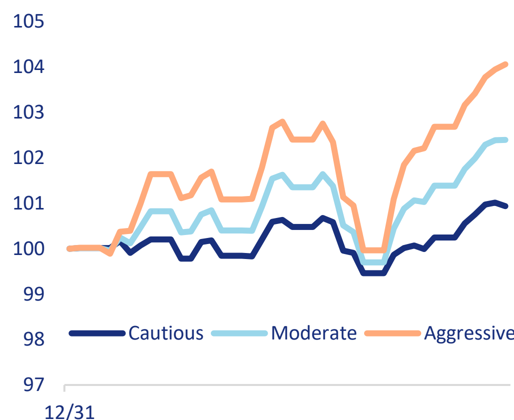



TAA – RELATIVE POSITIONING – MODERATE PROFILE

| | UW | N | OW |
|---|---|---|---|
| Cash | | = | |
| DM Gov. | <<<<< | | |
| EM Debt | | | > |
| DM Credit | | | > |
| DM H. Yield | | | > |
| DM Equity | | | >> |
| EM Equity | | | > |
| Gold | | | > |
| Real Estate | | = | |
| Hedge Funds | <<< | | |

UW/N/OW:Underweight/Neutral/Overweight

TAA – 2021 INDICATIVE PERFORMANCE




Source: Bloomberg. CIO Office calculation based on TAA applied to market indices, net total return in USD.

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## Fixed Income Update

The 10-year Treasury yield has officially crossed our 2021 year-end estimates, and we suspect this might not be the first time it would happen in the year. The 30-year yields touched 2% for the first time since Feb 2020. Most of the Developed Market benchmark bond yields have moved up in tandem with peripheral Euro area sovereigns remaining an exception. The US Treasury yield curve steepening took place despite softening macro data, including the jobs data, as markets overlook this temporary weakness and price in the future inflation expectations.

Spreads of all the sub-sectors benchmark indices of the fixed income asset class tightened, further stretching the already high valuations. The spread tightening mitigated the results of the yield uptick to some extent, and all the credit indices posted positive returns last week except Emerging Market, which was slightly negative with -0.04% returns.

The default rate has been benign this year, with YTD default rates at nine, the lowest number in the last three years. High issuance from the High Yield investors has helped the sub-sector to keep the default rates flat. The media and entertainment, and retail and restaurant sectors currently lead the default tally with three each, reflecting a larger number of issuers with higher leverage and lower ratings. Although down from March peaks, the media and entertainment, retail and restaurants, and consumer product sectors hold a high number of 'CCC' and below rated issuers. According to S&P, historical default rates for companies with those ratings from 1981 through first-quarter 2020 are 11x higher than those rated in the 'B' category.

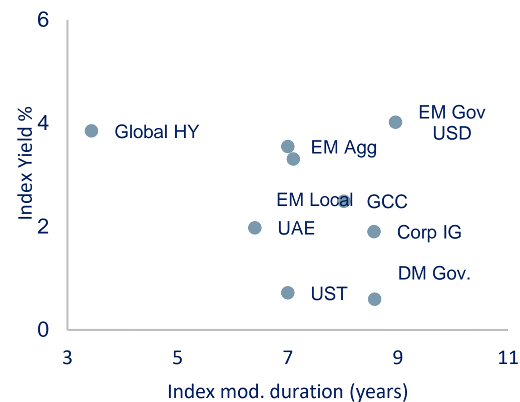
Weekly Fund Flows into the Fixed Income asset class slowed down as fund inflows into equity markets increased to 58bn last week. Looking back at the previous four weeks, long-duration funds have lost c.$1bn while short-duration funds have seen inflows of $9.4bn vindicating our stance preferring to go short duration during these curve steepening times. EM Debt continued to draw investors' attention with significant weekly inflows of c.$3bn equally distributed between hard and local currency funds.

The emerging Market primary issuance scene softened due to the shortened workweek on account of the Chinese New Year. GCC markets saw Qatar's first AT1 perpetual bond issuance as Ahli Bank issued a PNC5 bond at a 4% coupon. We may see other banks from Qatar and the KSA follow suit for AT1 issuance to bolster their capital reserves and take advantage of the low rates environment. From the UAE, DIB is expected to issue AT1 Sukuk to refinance the upcoming obligations of the perpetual issued by Noor, which has the first call date on 1st June this year. All the UAE banks have called their outstanding AT1 perpetual without resetting coupons, and we believe this trend would continue in the current year.

FIXED INCOME KEY CONVICTIONS

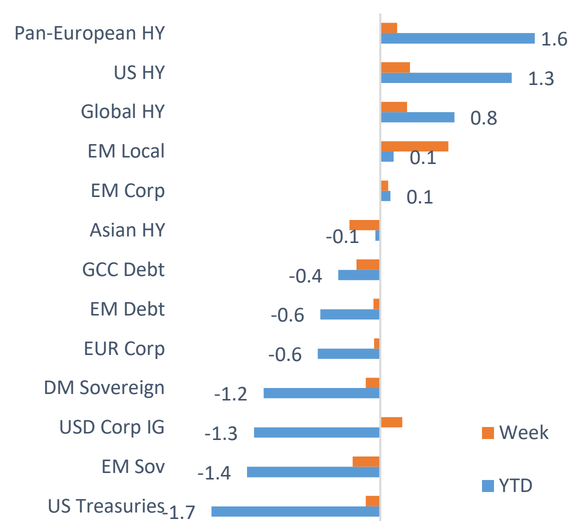
| DEVELOPED MARKETS |
|---|
| UW DM Government |
| OW Credit (Cau. & Mod.) |
| OW High Yield |
| **EMERGING MARKETS** |
| OW Asia |
| OW IG Sovereigns |
| OW Latin America |

FIXED INCOME VALUATIONS




Source: Bloomberg, indices modified duration and YTW

FIXED INCOME SUB ASSET CLASS RETURNS (YTD, LAST WEEK)




Source: Bloomberg

**Equity Update**

6 weeks into 2021 and it's been a bit of rock and roll in terms of asset price moves, with the Russell 2000 +16%, EM Asia equities +12% and 10 year bond yields +30bp. Also, impacting markets have been GameStop's Reddit run, Tesla's investment into Bitcoin adding to a rally in the cryptocurrency, strong IPO issuance and record inflows. Global equities made new records up 1.8% last week, with emerging market equities continuing this year's outperformance. Our overweight equities and EM bias is holding ground, so far. China equities gained +4.2% and India +2.5%. Positive earning beats in the US, Europe and japan continue, a vaccine rollout building hope and high expectations for US stimulus plans. Janet Yellen, US Treasury secretary, is supportive of fiscal stimulus saying "go big". The reflation trade gathered momentum with strong growth expected following the opening up of businesses and demand rebound, however inflation in the US remains muted. Higher oil led to strong gains from the energy sector, along with financials benefiting from higher yields.

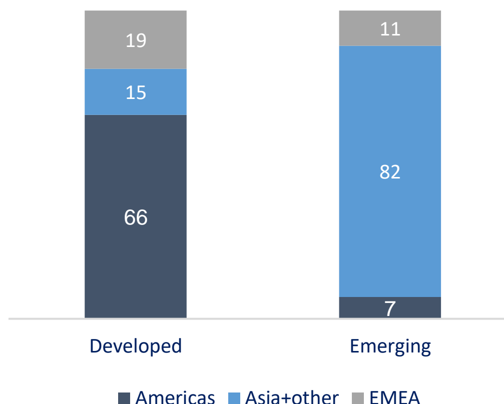
We began the year agnostic between regions within the EM and DM allocations, however we think the strong stimulus measures in the US warrant continued gains and we have shifted to an Overweight US and UK positioning balanced by a matching underweight in Europe and Japan. The UK has among the strongest vaccine rollouts, hence we think it is well positioned for a rebound. We have also moved to an EM Asia overweight within the EM allocation, with a relative underweight in LATAM and EMEA.

Stocks closed at new all-time highs in the US with the S&P 500 and the Nasdaq Composite gaining 1.3% and 1.7% respectively. Boosting performance were the record $58bn inflows into global stock funds last week, with the US and technology funds receiving the majority of stock inflows. The S&P 500 is up nearly 6% so far this month, driven by "continued pledges from the Fed to keep monetary policy loose during the recovery". Q4 earnings, 75% of S&P 500 constituents have reported EPS growth of 4.36% and Sales growth of 3.21%; of those reporting approximately 80% of them have beaten estimates by 15.1% on average.

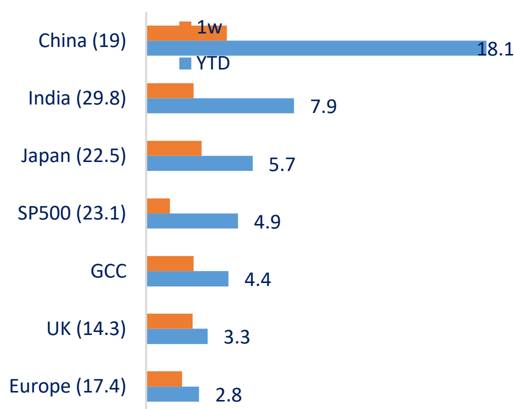
UAE markets have recorded strong year-to-date gains and the KSA has caught up with a strong week, supported by higher oil prices. An impressive vaccine roll out in the UAE with 50% of the population vaccinated supports economic recovery. Telecom companies remain the best performers and are taking advantage of their strong subscriber base with Etisalat adding to its food delivery services on its Smiles app. The UAE focus on innovation is extending across space with spacecraft Hope entering Mars planetary orbit.

India has managed to reduce virus cases, on its way to likely achieving herd immunity. However risks are not over with UK, South Africa and Brazil's new variants. Vaccines are already being modified to tackle these variants, though there will be a lead and lag effect. India equity markets were supported by $1.3bn in FII inflows last week and COVID containment with the growth recovery continuing to attract capital. The RBI is watching benchmark bond yields to prevent a premature rise: positive for equity markets.

EQUITY RECOMMENDED REGIONAL POSITIONING

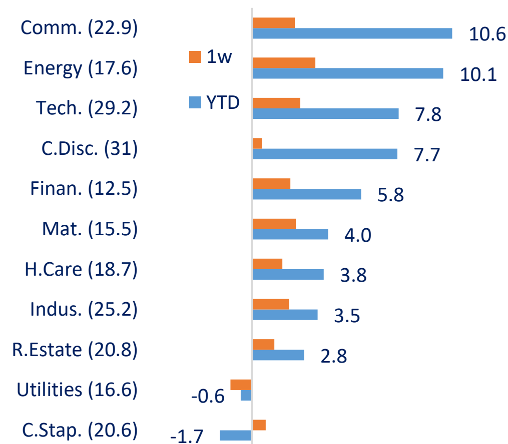



MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE




Source: Bloomberg consensus. MSCI Indices unless specified.

GLOBAL SECTOR PERFORMANCE (TR, US$) AND 2021PE




Source: Bloomberg consensus. MSCI All Country World sectors US$.

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