Here comes the red

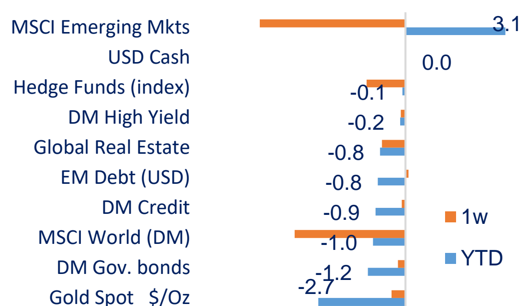
- **Global stocks had their worst week since October as retail traders attacked hedge funds' short positions**
- **The near-term is unpredictable but fundamentals support a constructive medium-term outlook**
- **Volatility should not come as a surprise - we keep our positioning unchanged.**

For some time now, our second largest underweight after the (overpriced) government bonds from developed countries is: hedge funds. We simply prefer directional positions, as we see markets being too unstable for them to thrive. Last week brought an unexpected confirmation. Retail traders, coordinating on various internet forums, provoked a historical squeeze in hedge funds by massively buying their most shorted names. As risk limits were quickly breached, alternative managers had no choice but to close their shorts, bringing additional profits to their attackers, and to sell their long positions in front of it, weighing on their prices. A perfect manoeuver, with a perfect timing as hedge funds don't have any P&L buffer for the year yet to absorb the performance impact.

The de-risking was considerable. As a result, last week was the worst since October for global stocks, down between -3 and -5%, and cash was the only asset class to avoid negative returns. This also happened in a time of concern: on the virus front, cases are still rising and the logistics of vaccine are complicated, and on the response front, the US fiscal stimulus will take time.

The fundamental data paints a different medium term outlook. Q4 corporate results so far show a strong earnings beat: in both US and Europe, numbers were around 20% better than expected. This is still the beginning, but close to 80% of the companies which have reported beat the consensus, which is extremely encouraging. The latest economic data were not that bad as well, the Fed confirmed being a long way from tapering even if inflation picks up, and the health situation should dramatically improve in Q2. We remain invested and simply stomach the volatility. Stay safe.

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



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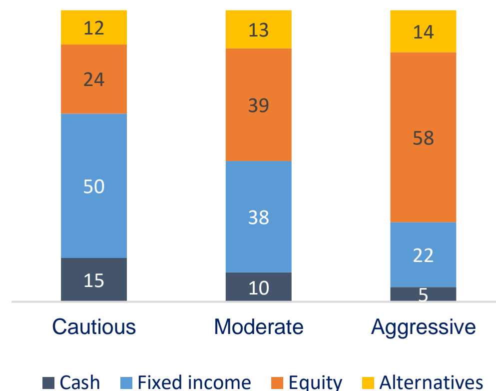
Cross-asset Update

The phenomenon of retail investors wreaking havoc on financial markets by bidding up microcaps with weak fundamentals, and forcing hedge funds out of short positions, runs deeper than the circumstances would suggest. In the end, it is not so much about decentralised finance and a relevant bunch of speculators lifting equity prices up in the sky, as a matter of financial instability that emanates from the easy money made available by central banks. The constructive macroeconomic backdrop and the abundant liquidity both work in the direction not only of raising inflation as per the Federal Reserve's plan, but also of fostering risk-taking and driving financial excesses. In this sense, what is happening today is reminiscent of the ebullience markets experienced in the late 1990s, when emerging day traders loved the heightened pre-dotcom-bubble volatility. To be clear, although quite a high number of markets carry extreme valuations, both price momentum and leverage so far to do not seem to be pointing in the direction of full-blown bubbles. Yet, this is of little comfort, as unabated Quantitative Easing and fiscal stimulus, one Biden package expected by Q1-end followed in a few months by a proposal for infrastructure expenditure, can only further boost financial assets and dramatically increase the odds of one more financial melt-up.

Jerome Powell, at the post-FOMC press conference, downplayed the link between asset values and low interest rates, saying that that relationship is "not as tight as people think", since different factors can be at work at the same time. This is surprising, considering the glaring gap which opened after the pandemic between the economy and markets simply because of the Federal Reserve's direct interventions on many fronts. Investment houses have built models tying carefully crafted financial condition indices to equity multiples and, indeed, strategists have been using liquidity as a leading indicator of macroeconomic conditions for quite a while, with a rise in the former portending improvements in the latter. An ex hedge-fund manager turned Bloomberg columnist smartly remarked that last Wednesday more than 1.9% of the Russell 3000 companies rallied at least 10%, a day when the S&P 500 dropped more than 2.5%. Is this a statistical quirk or something telling of financial dislocation? Going back to 1995, similar occurrences happened only during the Internet bubble, the Great Financial Crisis, the Corona panic and Wednesday.

Powell also said that market exuberance can be best addressed via macro prudential policies, tools aimed at preventing disruptive events in the financial system by addressing its overall vulnerabilities. Many an investor is looking forward to a solid macro prudential framework, and the well-respected twice Fed chair Paul Volcker who passed away in 1989 would most likely not be frowning upon that either. A few years ago he wrote on Bloomberg: "Ironically the "easy money", striving for "a little inflation" as means of forestalling deflation, could, in the end, be what brings it about". It won't be very long before we know whether the Bernanke-Yellen-Powell legacy will be in the same league as the Volcker one.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

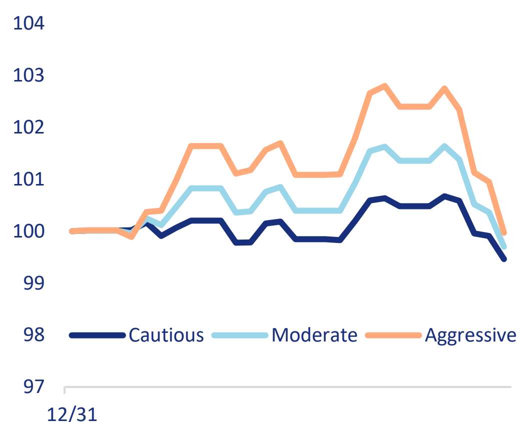


TAA – RELATIVE POSITIONING – MODERATE PROFILE

	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

Fed words remain the key this year to soothe investors' frayed nerves about rising yields and their effect on the Fixed Income returns. The first FOMC meeting did precisely that. While the rates decision was a foregone conclusion, market participants were carefully looking at the press briefing and the post-brief QnA session. Chairman Powell reconfirmed the Fed's commitment to the asset purchase program and broad-based policy support. We focus on four key takeaways from Powell's address on Wednesday. Firstly, he categorically mentioned that any discussions on asset-purchase at this stage are premature. Secondly, he noted that the Fed had learnt its lesson from the 2013 taper tantrum episode, and the learnings will be applied during communication when the time is appropriate. Next, Powell mentioned clearly that the Fed would look through any transitory uptick in inflation due to either base effects or transient causes. Lastly, full and inclusive employment remains a crucial take-off criterion for the central bank. All these factors make us quite comfortable with our risk-on positioning, and any dip shortly will be an opportunity to add risk. We also believe the rates take-off is some years away, and so is tapering of the current Asset purchase of $120 Bn. In the coming months, we will continue to monitor the bytes from the central bank to elicit any indications about modification in policy support.

The US 10-year Treasury yields hardly moved despite the turbulence in the equity markets. The yields ended up three bps higher last week. Major global fixed income index spreads mostly moved sideways, and yield curve movements drove the sub-asset class returns, with all the indices slightly in the red. But last week reinforces our view that the beta of the credit market to equity markets has decreased meaningfully. As long as policy support remains, the fixed income markets would be less volatile.

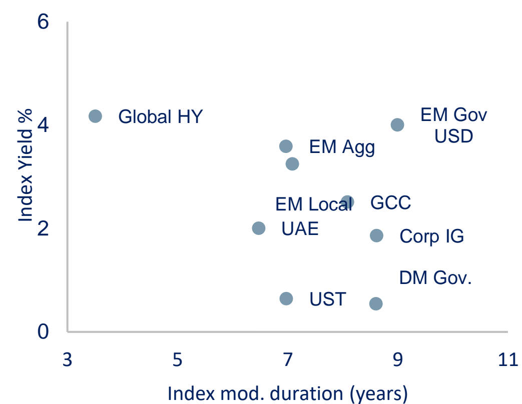
According to bond radar data, the Emerging Market issuers notched up the highest ever monthly issuance selling c. $120 Bn in Jan 2021. Chinese issuers accounted for 25% of the total sales. The Kingdom of Saudi Arabia was the largest individual issuer with a $5 Bn dual-tranche issuance last week. US High Yield issuers also notched the third busiest month ever on record issuing $48.7 Bn worth bonds. The trend should remain firm in the first quarter, with issuers front-loading this year's issuance as fear about higher yields in Q2 remains valid.

Fixed Income Fund flows were Net positive $15.7 Bn last week. Investors yanked capital from the High Yield focused funds for the first time this year. Even Government bond funds did not fare any better, losing $1.6 Bn. Long-duration funds continued their underperformance vs. short-duration funds. Emerging Markets funds attracted $36 Bn with flows tilted towards Hard currency funds, which garnered two-third of the flows. The fund flows reinforce our positioning, and we remain confident of our asset allocation to generate optimal risk-adjusted returns for the asset class.

FIXED INCOME KEY CONVICTIONS

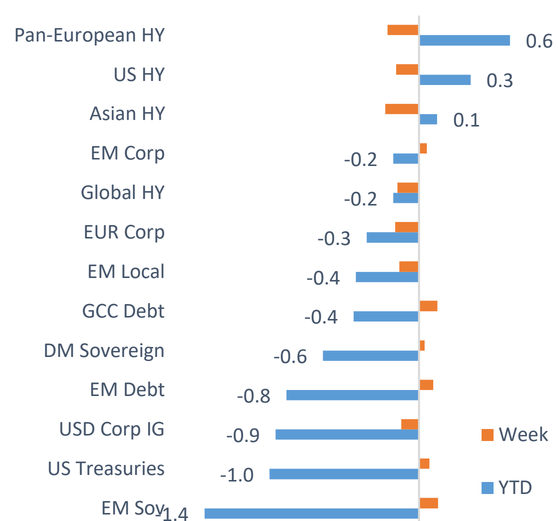
DEVELOPED MARKETS
UW DM Government
OW Credit (Cau. & Mod.)
OW High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

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



Source: Bloomberg

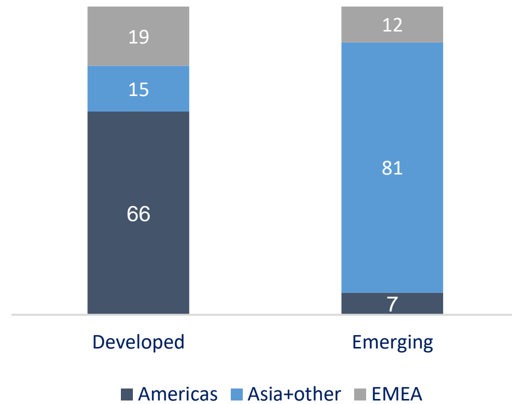
Equity Update

The week was driven by interesting retail investor activity, virus related lockdowns hampering economic activity, vaccine rollout and encouraging earnings from not only tech but consumer and industrial companies. A volatile week for global equities which ended up 3.5% lower, ending January down half a percent. Emerging market equities lost 4.5% on the week led by Asia, however still positive for the month retaining a 3% gain. Developed Market equities were down 3.4% for the week and are in negative territory for the month by a percent. US equities lost 3% on the week. Higher volatility with the Vix Index touching 38 was unsettling, however we would focus on the underlying market dynamics and ignore the noise. We retain a positive view on the global economic and corporate profit recovery. Demand is returning and the surge in US consumer activity should spill over to Asian capital expenditure. On the sector level energy, financials and materials fell last week, reversing the cyclical rally. UAE markets are doing better than global markets: the UAE indices have c. 10% gains this year. UAE reforms on the capital markets and opening up of citizenship to talented individuals are further positives.

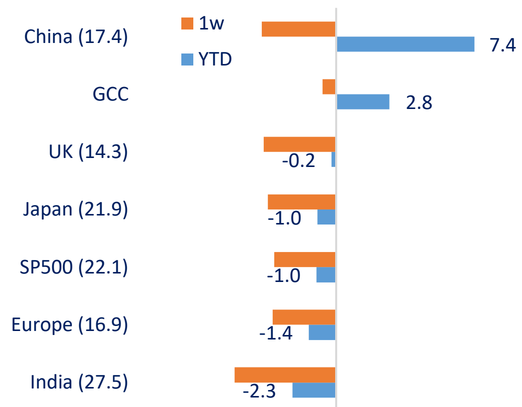
Centre stage for US markets were retail investors, swayed by social media posts and online message boards such as Reddit, targeting stocks shorted by hedge funds. GameStop, gained meteorically in the last 2 weeks with retail buying squeezing out the short sellers. Other stocks which rose on short seller squeeze included Blackberry, AMC Entertainment with a spill over to Asian markets. Is this a change in investment leadership away from institutional and large asset managers which sway markets with their large sizes? The power of retail cannot be ignored with social media influencers and industry captains such as Elon Musk's tweets adding to retail frenzy. However, to avoid being caught at the wrong end, the time tested and fundamental approach of looking at a company business model and valuation/ growth metrics will be more rewarding, produce consistent gains and be less risky. Another trend is the rise of Special Purpose Acquisition Companies "SPACS" which set a new monthly record.

Global companies are estimated to have lost 15% in profits in 2020 yet global equities gained 18% as investors looked through to 2021 for a profit rebound. This year earnings growth estimates of 20 to 30 % looks possible with encouraging Q4 2020 results. Tech companies posted strong quarterly revenue and earnings growth with Apple crossing $ 100 bn in revenue and Facebook seeing a pick-up in online advertising. Microsoft saw an increase in cloud services revenue. Semiconductor companies results have evidenced a strong demand cycle in place. Encouraging guidance from the industrials Caterpillar and Honeywell for a 2021 profit rebound. European results support a pick-up in demand with luxury company LVMH posting a good quarter and UBS wealth management business growing significantly. 7 vaccines are now approved and in use. Early vaccine success can be attributed to two key factors: supply and distribution. Friday's J&J trial results were slightly less positive than expected but it is easier to administer. Moderna and Novavax stocks have been outperformers on better efficacy results.

EQUITY RECOMMENDED REGIONAL POSITIONING

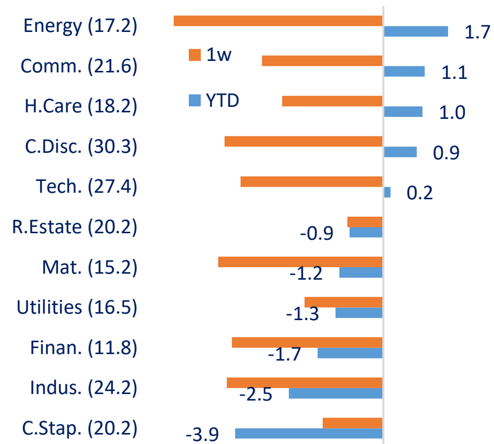


MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE



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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