Are markets ready for the rebound?

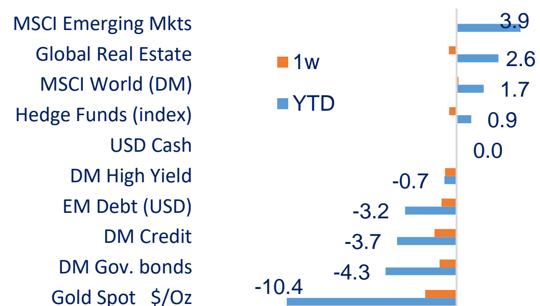
- **Global PMIs and a spectacular US job reports indicate a stronger than expected activity**
- **Interest rates and inflation expectations take note, sending shockwaves across markets**
- **We see the spike as transitory but acknowledge the risk of sustained volatility**

Bad fundamental news are not what markets dislike the most: uncertainty is. The very same news which triggered last year's Q4 rally, when market participants were overall very defensively positioned, shook markets last week with a significant rise in volatility.

The widely expected bounce in activity is apparently starting earlier than many expected. Control over the virus is improving, and signs of strength abound on the economy. PMI numbers were overall positive, with activity closing the Q4 gap, this time led by developed regions. The US job report was upbeat with twice more job creations than forecast, and China's trade numbers were buoyant. Better growth prospects come with rising inflation, especially in energy and food, which gave a boost to the current relatively disorderly rise in interest rates, creating turbulences across all markets. The US 10-year Treasury yield closed at 1.57%, pressuring the fixed income sphere. Over the course of the week, equities were flat but volatile: up at the beginning of the week, down in the middle, and up again on Friday, sought after by dip buyers. Below the surface, the rotation continued with energy and financials replacing technology and healthcare as leaders. Oil prices ended the week on a firm note: the OPEC+ decided to keep output steady through April, and Saudi Arabia rolled over their discretionary 1mn barrels a day cut.

Volatility should not come as a surprise this year. Our stance is to stomach it and to stick on the fundamental picture. We see the rise in yields and inflation as logical but transitory, and think that the current levels of interest rates can be absorbed by equity multiples. The Fed is right to be patient, and we think we should be as well. Our positioning is unchanged, and our asset allocation committee is this Tuesday. Stay safe.

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



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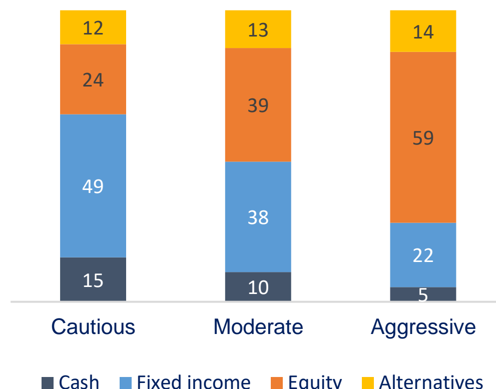
Cross-asset Update

The current year started with strong hopes that the reflationary backdrop engineered by central banks and governments would be constructive for risk assets, and much less favorable for high-quality bonds. Yet, amidst a spiking-rate scare global equities have given up most of their year-to-date gains and the US dollar is on the offensive against expectations. The implicit and not-so-innocent assumption embedded in that plain-sailing scenario was that bond yield volatility would be well-behaved and allow for a gentle Treasury bear market, while at the same time leave the case for the relative cheapness of risk assets versus government bonds unchallenged. We continue to hold the view that bond yields won't undermine the conditions for the bull market to continue, although it remains likely that the tension between rising yields and elevated stock valuations could be resolved with a temporary equity setback. The main pillar underlying the constructive outlook is the combination of strong growth, plentiful liquidity and lack of persistent inflationary pressures, which we think mark this recovery. And should yields overshoot, we doubt the Fed would tolerate that.

In the end, how high yields will reach will depend on the Federal Reserve's reaction function. Fed officials are minded to raise rates only when inflation has been for long enough above the target level, that is 2%, to gain conviction that price pressures have taken hold. Of course, long-dated Treasury yields rising too soon and too fast would be jeopardizing the chance for higher inflation further down the road. So, why didn't Powell last week sound more explicit warnings, threatening to take specific action against rates marching higher? Simply because what has happened so far in the government bond camp is not extraordinary in a post-recessionary scenario, that is 10-year yields up 100bp, bang in line with historical averages. Powell's now famous quote that he is 'not even thinking about thinking about raising rates' is conceptually not dissimilar to Draghi's 'whatever it takes' in relation to rescuing the euro. The Fed chair is equally determined to pull all the stops to generate inflation, especially considering that he is acting in concert with Janet Yellen, who recently advised Congress to "go big" on stimulus. Should yields rise further and in a disorderly way, Fed officials would be reminding markets once more that a "whatever it takes" approach is in place and that tools are available for the Fed to control yields. Should moral suasion not be enough, yield control would become inevitable, but as an instrument of last resort, putting lots of Fed credibility at stake.

If real yields are capped, investors should not think twice about buying gold between $1,600 and 1,700/oz. Gold has now reached oversold levels as per our Gold Risk Appetite Indicator, that historically have coincided with buying opportunities. It will not be a walk in the park for the yellow metal to put in a bottom amidst the strongest growth resurgence since the Great Financial Crisis. But with Mr. Powell eventually leaning against spiking real yields, investors are more likely than not to be rewarded.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

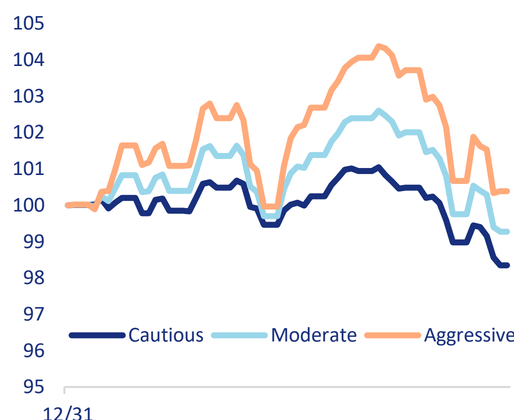


TAA – RELATIVE POSITIONING – MODERATE PROFILE

	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.

Fixed Income Update

Some investors compare the current tantrums in the US 10-year yields to a 10-year old child's demands. Chairman Powell acted like a strict parent last week, unwilling to bend down to the market players' whims. His comments make sense given the macro backdrop and still fragile growth. The FED has a dual mandate and, for the time being, focuses on employment where we can see a lot of slack. Even though the unemployment numbers dropped, the underemployed statistics still remain north of 11% in the US, and FED is clear that inflation upticks are not sustainable without low unemployment. We agree with Powell's views and believe it is better to keep some dry powder for a real crisis than to spend them to boost asset prices. The yields fell in line, and the 10-year failed to break the crucial 1%, and 30-year yields stayed below 2.40% despite the disappointment from the Chairman's remarks. We believe that a major part of current yield volatility is behind us, and if 10-year yields go near 2%, we would certainly be buyers of US Govt Debt at those levels and change our current stance from underweight to overweight the Govt bonds sub-sector.

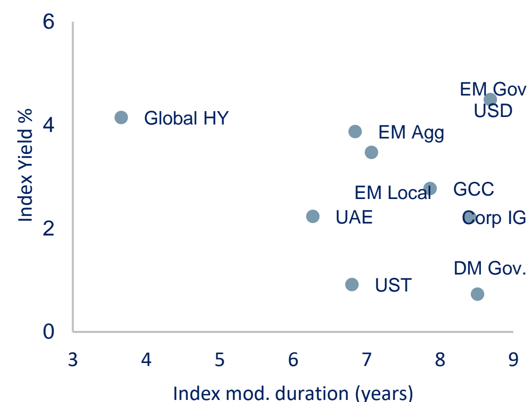
The broader indices continued their weakness last week, with High Yield and Emerging Market Debt suffering to a lesser extent than Treasuries and Investment Grade Credit which lost more than 1% last week. We have seen spreads across subsectors inch up last week but don't think it is the start of a trend. Our view for the year remains that spreads grind lower from these levels in High Yield and Emerging Market Debt. However, we are cognizant that Emerging Markets remain at higher risk to the yield increases compared to High Yield partly due to the higher duration of EM sovereigns. Within Emerging Markets, LatAm continues to lag other regions due to the longer duration. Still, we believe with high beta to commodities; the current correction presents an attractive opportunity to invest in the region.

Mena region sovereigns' curves continued to be weak last week with bear flattening where the near-term yields increased more than the long-end in the IG space. On the contrary, in the High yield space, Oman outperformed both Egypt and Bahrain, bolstered by the latest news about multi-lateral syndication of a $2.2 Bn loan. Banks from the UAE, Kuwait, and the KSA participated along with international names. This showcases continued to GCC support to the country and improved investor comfort. Oman sovereign curve aggressively bull-flattened, with the 30-year moving down by 15 bps. On Thursday, the Govt of Sharjah issued $1.25 Bn bonds spread across 12 and 30-year bonds with a skew towards the 12-year. We like the current spreads on the 12-year bond, which are trading slightly below par, and advise clients to take positions, and the adventurous players can opt for leverage to further boost their returns from the bond.

FIXED INCOME KEY CONVICTIONS

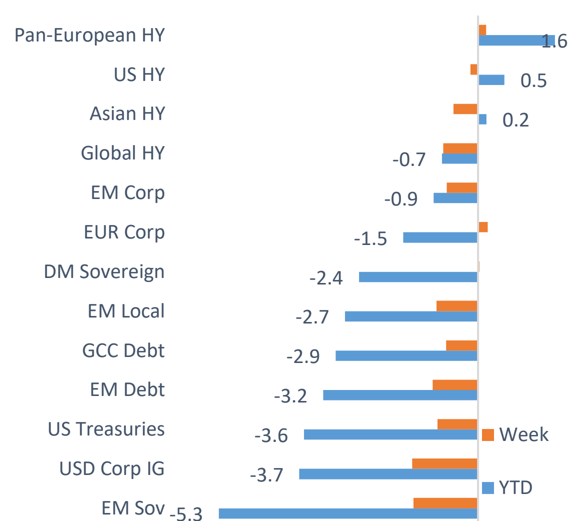
DEVELOPED MARKETS
UW DM Government
OW Credit (Cau. & Mod.)
OW High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

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



Source: Bloomberg

Equity Update

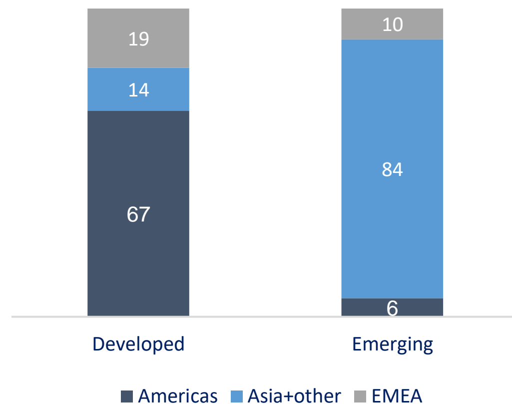
It was another volatile week for global equities, which surprisingly ended flat, with rising bond yields creating inflation concerns and high growth sectors with higher valuations i.e. technology and consumer continuing to sell off. Sectors that would benefit from an economic recovery are outperforming i.e. banking and energy stocks. Whilst the Nasdaq Index fell 2% last week, the S&P 500 +0.8% fared better as financials (higher yields), energy (on higher oil prices) and the materials sector (higher input costs and demand as manufacturing picks up) gained. Asian markets ended the week with Japan and India up and China down. Sovereign bonds sold off across the Eurozone but the EuroStoxx 600 was up a percent as it has a low weight to tech and the commodity heavy UK FTSE was up over 2.5%. The UAE saw both Dubai and Abu Dhabi Indices higher with banking continuing gains (we are overweight) and real estate rallying post Emaar Properties announcement of the planned merger of Emaar Malls.

With the $ 1.9 bn stimulus plan in the US approved, concerns have arisen that the large fiscal spending will boost not only economic growth but also consumer prices and inflation could go up and worries that the Fed could start to boost interest rates in the next two years. Fed officials have reiterated that the rise in yields reflects optimism about economic prospects and plan to keep monetary policy loose to support the economy for the foreseeable future. The US Dollar was stronger, adding to the impact on the US technology sector which has 60% revenue from overseas and EM equities which see lower inflows when the Dollar rises.

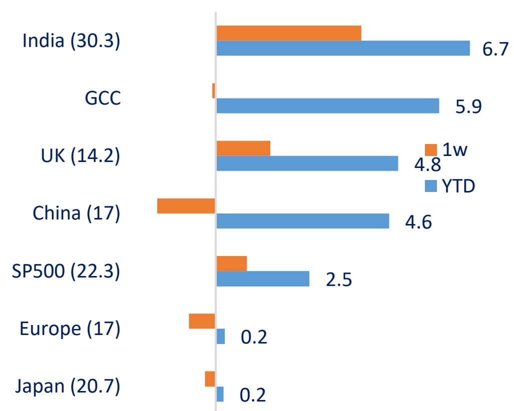
EV stocks which were 2020 darlings have given back part of last year's astronomical gains and some are reaching attractive entry levels. ESG with a focus on clean energy and EVs is a compelling investment theme for us this year, however whilst the pure EV focused companies have been in the spotlight we think the incumbent auto leaders in Europe who are ramping up their EV models are more stable and their EV production will match Tesla's in 2021 itself.

We remain overweight both the US and EM Asia. Consumers are saving more globally and there is plenty of cash on the side-lines thanks to lower spending during COVID lockdowns and government largesse. As per Bloomberg Economics the world's larger economies have $2.9 tn in extra savings. We think the current yield tantrum is probably transient as growth and recovery in the world's two largest economies is evident. China is targeting economic growth of over 6% this year. The US is seeing job growth, retail sales up and robust manufacturing numbers. The stimulus bill could push GDP above pre pandemic levels. The Fed's Beige Book revealed the U.S. economy grew modestly at the start of the year, but leisure and hospitality were challenged by Covid-19 restrictions. Business travel in the decade prior to 2020 grew 5.1% p.a., however from April to December last year it fell by 80% in Europe and North America and 50% in Asia and the MEA. It may not ever reach earlier levels as the efficacy of video conferencing is well established. However, staycations are now the order of the day and domestic leisure air travel has picked up sharply globally.

EQUITY RECOMMENDED REGIONAL POSITIONING

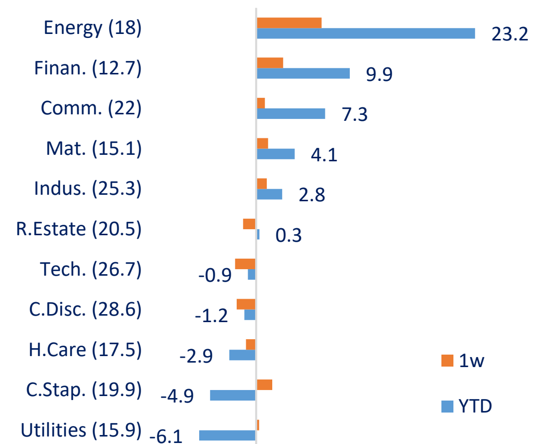


MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE



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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