Getting ready for a booming economy in Q2

- **The first quarter is about to end with mixed, divergent market returns**
- **In Q2, a resilient manufacturing activity should be joined by a consumption rebound**
- **Inflation and delayed vaccine rollouts are temporary and probably priced-in by markets**

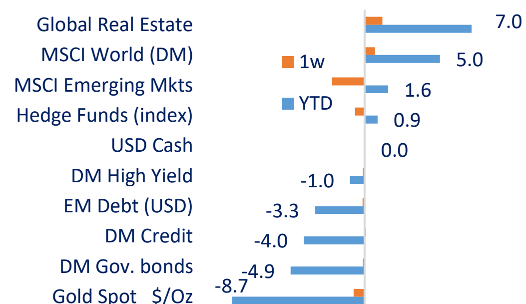
A 400m-long container ship ran aground and blocked the Canal Suez last week. As about 12% of global trade passes through the canal, the issue is serious, and a massive queue of more than 300 ships is waiting for the route to be re-opened. We can't help pointing out the analogy with global consumption: a massive pent-up demand is waiting for better control over the pandemic to be unlocked. Cases are rising again in some European countries as well as in Brazil and India, but the examples of the UAE, Israel, the US and the UK show that vaccines are effective in containing the virus.

It's a matter of time. The canal should be unstuck in the coming days, and with an acceleration in vaccine rollouts, the global weakness is consumption should reverse in Q2. By contrast, industrial activity is already showing evidence of a sharp upturn. Asian exports readings and business surveys were unambiguously upbeat, with an unexpected leadership from the Euro area where the leading components of the March manufacturing flash PMIs were the best in 20 years.

The scenario for the second quarter should be a boom in global growth, firing on all cylinders. It won't happen without questions as inflation overshoot should start to materialize. We are firm believers that it will only be temporary and won't require counter measures from Central Banks. However, all market participants are not in this camp which should support volatility. We tend to think that most of the short-term rise in inflation is already priced-in by interest rates, while the boost in earnings may be underestimated.

The week ahead will bring many economic data, including PMIs and the US job report, and will see an important OPEC+ meeting on Thursday. Stay safe.

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



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Cross-asset Update

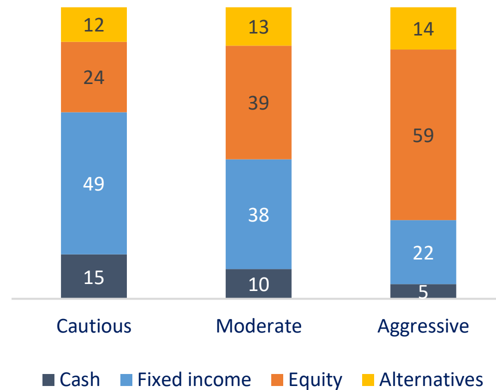
Investors must still be concerned about rising yields, as pointed out by the diverging performance between the Dow Jones Industrial Average, with a more cyclical bias and close to record levels, and the Nasdaq Composite, more sensitive to the direction of rates and well off all-time highs. With growth expected to boom in Q2 and Q3 as money from stimulus checks is put to good use, this angst seems only set to rise in the shorter term to increase the tension between the valuations of risk assets and surging yields in global Treasuries, now including a bit more of a risk premium accounting for Fed action. Sequential growth in the United States is projected to be in the very high-single digits in the next two quarters and Europe itself, in spite of prolonged lockdowns, is showing resilience, according to the latest Purchasing Manager Index release.

We continue to hold the view that investors should not mechanically extrapolate recent trends in yields. If it is true that this time most of the rise in rates is due to stronger growth, rather than fears of Fed tightening as in 2013, it is also true that economic growth rates are seen to be relatively strong throughout 2021 to moderate next year as stimulus effects fade. Hence, it should not be a matter of whether yields will peak, but rather of whether they will stay strong once they have peaked. Views about the year-end target value of the yield on the 10-year Treasury note are quite divided, ranging from a consensus clustering more or less at 2%, to as low as 1% or even lower, depending on how bearish one gets as a function of the slack estimated to be still in the economy in spite of large stimulus efforts. There is more agreement on the fact that levels much above 2% seem untenable, given that there is a limit to how steep the yield curve could go or how high inflation breakevens could reach in the current environment.

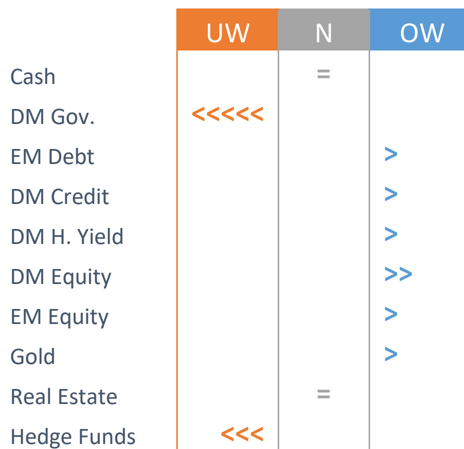
For a country considered to be the utmost expression of capitalism, in the United States we are starting to witness occurrences running quite at odds with that notion. Not only is there now a tighter-than-ever dependence of Wall Street on stimulus, but Main Street as well is being affected by the ebb and flow of easy money. American Personal Income and Spending were negative for the month of February, due to fading stimulus effects. Likewise, the short-to-be-expected consumption boom is predicated on past relief measures. President Biden himself seems to be bent on reshaping consumption patterns across the country, with a soon-to-be-announced infrastructure package which should also address income inequality.

Seismic shifts in the American economy driven by ultra-accommodative monetary and fiscal policies could eventually foster new market regimes more favourable for real assets like commodities, than financial ones like bonds and equities. It is still very early days to assess how markets will indeed be impacted, but the direction of travel seems to be already quite clear.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING



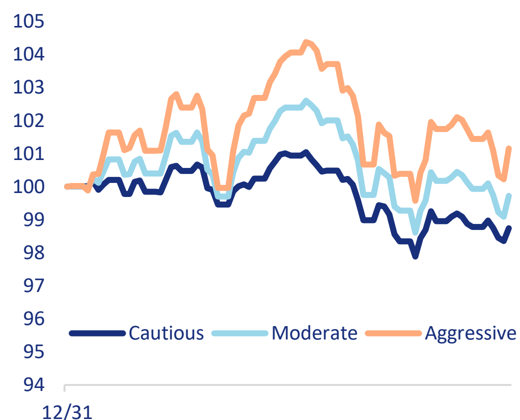
TAA – RELATIVE POSITIONING – MODERATE PROFILE



	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

The rates market has stabilized, but whether it is a lull before the storm or the post devastation calm, that's the question we need to ponder over. Our view is that the Treasury yields could move up from these levels, and we subscribe to the majority view that 10-year yields over 2% are unsustainable for long periods. The treasury yield curve bull-flattened last week as front-end rates stayed anchored and the long-end yields moved down by c.5 bps.

The outlook for this week for the treasury yields remains volatile as quarter-end rebalancings kick-in. Since bonds have underperformed Equities, Treasuries should see significant inflows. This demand should mitigate the pressure on the asset-class from the expiry of pandemic era SLR exclusions on 31st March. The banks would need to sell the Treasury holdings to reduce their capital requirements post-March.

Most of the sub-sectors that we track traded in a tight range with hardly any movement in the OAS spreads. Developed Market Sovereign bonds had a good week except for Friday when the European benchmark yields increased slightly. Most of the long-duration assets performed well as compared to the short-duration ones due to the yield movement. Asia HY was a notable loser on the back of the profit warning and rating downgrade of Yuzhou Group.

This year's global default tally touched 24 last week. While the pan-European HY index remains the best-performing asset class on YTD returns, European defaults are elevated, now making up nearly one-third of the total global default tally. With seven defaults so far, the region's first-quarter default tally has reached an all-time high. However, the financing conditions remain largely accommodative throughout the region as the number of quarterly defaults has slowed considerably since 2020. 12-month trailing HY default rate remains at 5.4%.

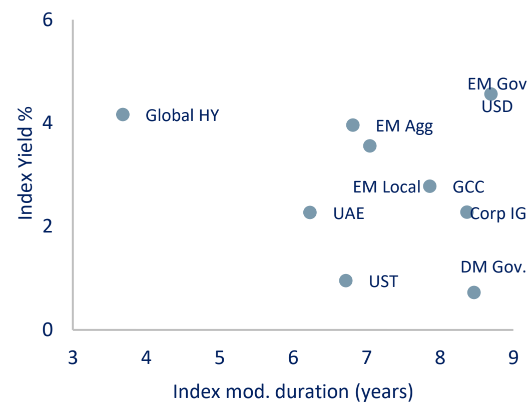
Fixed Income Fund flows remained steady for a second week in a row, with inflows at $8.6 Bn. Investors continue to avoid long-duration bonds, which saw only modest $18 Mn net inflows. Short duration funds, on the contrary, received more than 65% of the total inflows. Emerging Market Debt weekly flows were back above the $1 Bn mark we had seen in Jan and Feb.

GCC Fixed Income outperformed the broader EM Debt with long-end IG debt stabilizing and spreads on HY sovereigns compressing by 3-5 bps on the short end while long-end yields remained flat. There is a flood of Sukuk issuance. Boubyan issued an AT1 perpetual Sukuk which saw books covered by 2.4x, and the pricing at 3.95% was c.20 bps wider than the NBK perpetual. The UK also issued its second GBP Sukuk last week. The Republic of Maldives and Arabian Centre have announced mandates for Sukuk issuance as well.

FIXED INCOME KEY CONVICTIONS

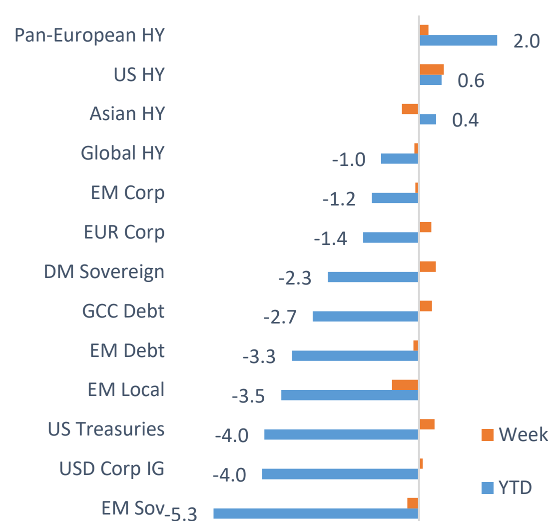
DEVELOPED MARKETS
UW DM Government
OW Credit (Cau. & Mod.)
OW High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

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



Source: Bloomberg

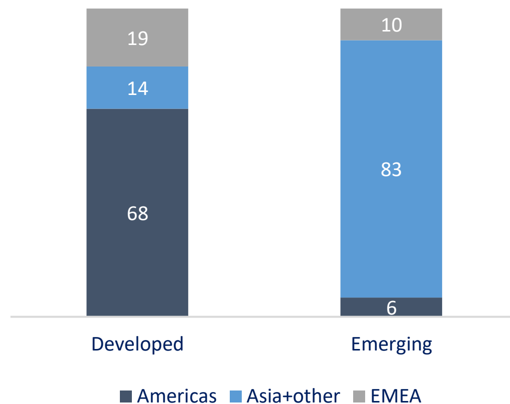
Equity Update

The MSCI ACWI Index managed to close up for the week, supported by US markets whilst EM fell with the heavy weight EM constituent China dragging the index down. China equities are now negative for the year. The China tech sector has seen a double whammy with the global stalling of the tech rally as well as increased regulatory scrutiny. Also last Fridays $19 bn fire sale probably from a distressed hedge fund or family office had several China blue chips in its cross fire. Leading global sectoral returns ytd is the energy sector and leading regional returns is the GCC. Oil prices fell at the beginning of the week on concerns around economic recovery specially in the Eurozone area which is seeing a shortfall of vaccines and increasing cases but oil gained later in the week due to the disruption of oil supplies with the Suez canal blockage. GCC equities had a down week as even the supply disruption did not take Brent back to the previous week's $70/ bbl. Globally markets have struggled for direction recently. There are conflicting signals with the U.S. economy primed for a spell of rapid growth against concerns about rising bond yields and a jump in coronavirus cases that threatens to stalemate European economies. Also, a strengthening dollar, increasing rivalry between the China and the US and the prospect of a rise in inflation are contributing to the current volatility. Whilst our OW DM and US strategy is working our OW EM should see traction once Q1 results demonstrate strong corporate earning growth.

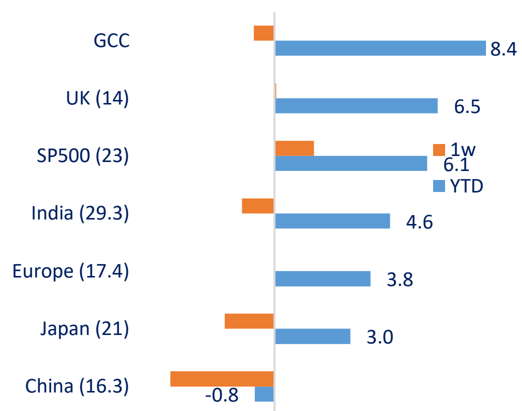
Cyclically-natured sectors found support and growth stocks, as Treasuries were relatively calm. Whilst the S&P 500 gained 1.5% last week the Nasdaq fell 0.6% but is still in positive territory at +2% ytd. Optimism of a robust economic recovery in 2021 as COVID-19 vaccine rollouts gain momentum while fiscal and monetary policy support remains vigorous. Higher yields have posed a particular problem to technology companies, as the higher rate of discount lowers the present value of the high growth sector. The month of March to date has seen all global sectors up with utilities the best performer and tech at the bottom but still positive. On global sector gains in 2021, energy leads at +25%, with all other sectors positive except consumer staples which in spite of a strong March is the only global sector marginally in the red.

Bank shares continue to outperform. The Fed on Thursday said temporary limits on dividend payments and share buybacks will end for most banks after June 30. The difference since the financial crisis of 2008 is the relatively stronger balance sheets. Bank of America estimates that large banks could return as much as 10% of their market cap in buybacks and dividends between Q4 2021 and 3Q 2022. Tech leaders in the US faced remote questioning paradoxically on the Cisco Webex platform. This does not prevent takeover talk and Microsoft is in advanced talks to acquire messaging platform Discord for an estd. $10 bn. On social media news Facebook has removed almost 16 bn fake accounts since 2018, double the world population.

EQUITY RECOMMENDED REGIONAL POSITIONING

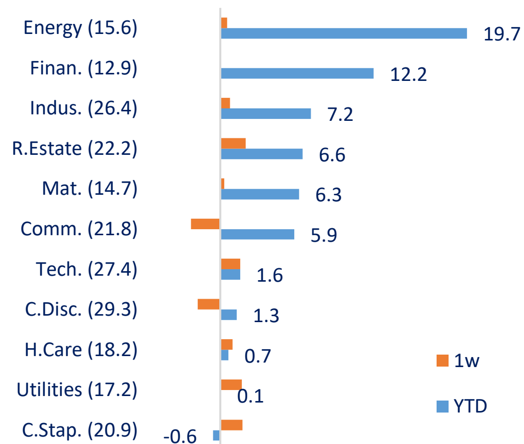


MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE



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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