EDMOND DE ROTHSCHILD

LETTER FROM THE CIO AM

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

MARCH 2021

HIGHER LONG BOND YIELDS WILL DENT BUT NOT SHATTER THE UPWARD TREND

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► At the recent FOMC, the Fed maintained its ultra-expansionary monetary policy even though Congress had just approved a massive stimulus plan which triggered a sharp upward revision in the Fed's growth forecasts. However, only a minority of committee members are for tightening in 2023 so the coast looks clear. And the Fed is still not saying anything about the sort of conditions that would lead to tapering. This means liquidity will continue to expand for at least another few months despite a significant bounce in growth.

THE US BOND MARKET IS UNDER PRESSURE

The Fed has rapidly shifted from trying to exert some control over the long end of the yield curve to releasing its grip. As a result, US long bond yields have been quickly returning to normal; the yield on 10-year US Treasuries has jumped by 80bp since the beginning of 2021. The big question is whether such a big move will destabilise markets. After all, current valuations make indices look slightly fragile. For the time being, however, we have essentially seen sector and factor rotation with cyclicals and value plays enjoying strong bounces.

In any case, a few things suggest US bond markets could now calm down. First, the ECB and Australia's central bank have shown their determination to keep long bond yields at current levels by increasing their bond buying. This will widen the spread between the rest of the world and the US, effectively enhancing the appeal of US bonds and thereby easing pressure on Treasury yields. Second, today's yields in the US show that investors already expect 3 to 4 hikes by the end of 2023. And yet if the Fed's scenario turns out to be right, there is no policy committee majority for even a single rate hike. In other words, bond markets are anticipating moves that are simply not backed up by Fed statements.

Even so, we cannot rule out a further rise in US long bond yields if only because fixed income markets tend to overshoot. And with the reopening of

KEY FIGURE

2,3 %

US 10-year inflation expectations linked to inflation-indexed bonds. They are already half-way between its mean (1.94%) and its 2.71% historic high.

the US economy beginning to take shape, we could also see erratic inflation data over the short term due to a supply-and-demand lag for certain goods and services.

THE ENVIRONMENT IS STILL PROMISING

We have not changed our overweight equity stance. As we explained above, further rises in long bond yields in the US are not a done deal, especially at the sort of rapid pace we have seen recently. A more gradual rise would be much more easily accepted by investors. And in any case, a market correction would not automatically follow even if rates were to continue rising. We have in the past seen equity market selling off when investors started to factor in Fed rate hikes - there is no chance of that happening this year - or when long term inflation expectations started to look excessive, i.e. over 2.5% for 10-year inflation break-evens; at 2.3% currently, that is still some way off. Consequently, this increase in long bond yields does not strike us as coming with the usual triggers likely to impact all asset classes. However, volatility could still return. The S&P500 is currently highly biased towards long-duration growth stocks so it is naturally more sensitive to rising long-bond yields.

That is why we have been reducing US equity exposure in favour of UK stocks. The UK market's discount has widened since the Brexit referendum and the fact that it is geared toward value stocks makes it less interest-rate sensitive. In addition, the vaccination campaign has been a success and the country has essentially turned the Brexit page.

KEY POINTS

We are overweight equities and underweight bonds

We like UK equities

We have cut US equity weightings

As for fixed income, we decided to underweight bonds in January and we are sticking with this decision. We think it too early to resume duration risk. We also consider that in portfolio construction terms, the possibility that long bond yields might continue higher means equity and bond risks add up rather than cancelling each other out.

	Our convictions for March*	Changes compared to the previous month
ASSET CLASSES		
Equities	+	→
Fixed Income	-	→
Cash	=	→
EQUITIES		
US	=	↓
Europe (ex-UK)	+	→
UK	+	↑
Japan	+	→
China	+	→
Global Emerging	+	→
Convertibles	+	→
SOVEREIGN BONDS		
US	-	→
Euro Zone	-	→
Emerging Markets	+	→
CORPORATE BONDS		
US Investment Grade	-	→
Euro Investment Grade	-	→
US High Yield	=	→
Euro High Yield	=	→

*Range of investment committee ratings on the asset class/geographical zone (from -/- to +/+). Source: Edmond de Rothschild Asset Management (France). Ratings at 22/03/2021.

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