A spike in interest rates volatility

- **Rising growth and inflation forecasts pushed global yields brutally higher last week…**
- **Triggering a sell-off across all asset-classes, especially stocks from emerging markets and gold.**
- **We see this spike in rates as temporary but as another reason to expect significant volatility ahead.**

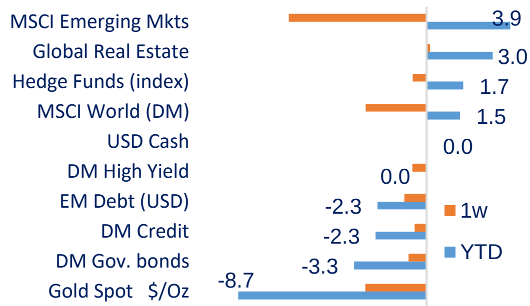
In our previous weekly publication, we highlighted the positive data supporting a brighter outlook for the economy in 2021: encouraging signs on the virus containment, resilient economic data and of course increasing commitments to fiscal stimulus. The logical consequence was a boost to growth and inflation expectations, leading to higher interest rates. It was gradually happening since the beginning of the year, but it went unexpectedly ballistic last week, with a considerable volatility in these usually quiet markets. After having gained around 50 basis points since the end of 2020 in a relatively ordered manner, the US 10-year Treasury rate saw intraday swings of 30 to 40 basis points on Thursday and Friday, reminding investors of the terrible "taper tantrum" episode of 2013.

It was a tantrum, without a taper - the Fed is nowhere near tightening their policy – but it rocked all interest rates and dollar sensitive assets, starting with stocks, losing 6% in emerging markets and 3% in developed, and Gold, down almost 3% as well.

We were not expecting such a brutal episode – markets are often quicker than we think. However the level of interest rates is not inconsistent with the current outlook. It is higher than our fair values, especially as we didn't forecast an infrastructure stimulus plan, but it doesn't change our constructive stance on risk assets. We hope for rates volatility to ultimately calm down, and keep on thinking that their rise is temporary, given the still high unemployment rate in particular, and the ability of Central Banks to act if necessary.

The short-term remains risky. Volatility should never come as a surprise this year. We stomach it so far and have kept our positioning unchanged.

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



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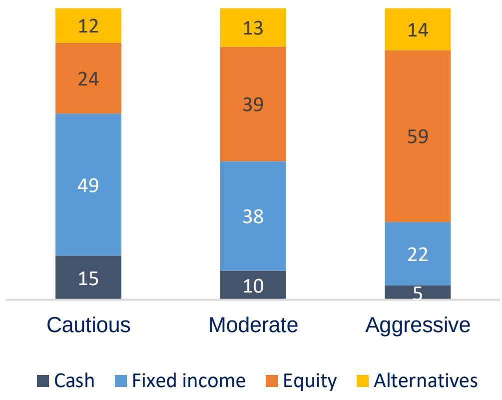
Cross-asset Update

Investors must be looking forward to getting insights about the level US Treasury yields could be stabilizing at, following the disorderly bond sell off which saw Treasury volatility surge to a 10-month high. The end of the Fed's easy money is being priced in and pulled consistently forward by markets. The latest pricing suggests that expectations are running high for the Fed to start tightening policy by Q1-end 2023, versus previous projections of a shift occurring by mid-2023. It would become irrational to think that lift-off for rates could happen even sooner, clashing with the reality of Fed declarations that rate increases won't occur until the Quantitative Easing bond program, planned to last until 2022, is wound down. And indeed, if Jay Powell is bent on letting the economy run hot before he even thinks of thinking of hiking, with full employment not in sight before 2022 followed by the need for the economy to further gather steam before Powell acts, then it is really difficult to reconcile market pricing with reality. It is equally premature to think that Fed officials, alarmed by rising real rates, could on the other hand intervene and even add to asset purchases to cap yields. That would be a risky proposition with an over-bloated size of new purchases necessary to absorb ever larger auctions, hence the more palatable option of jawboning markets rather than challenging them. In the end, yields seem to be close to peaking more likely than not. And should they resume their upward move, a much slower pace of advance is likely.

A moderation in Treasury volatility, alongside limited yield upside, would be bullish for risk assets. Our 10-year yield model is pointing to a level of 1.6% in the next three months, and with future hawkishness already fully discounted, market-implied inflation at the top of the historical range and manufacturing leading indicators possibly close to peaking, one could speculate that further upside is somewhat capped. One large risk factor, though, is posed by the infrastructure plan Joe Biden is minded to discuss once the $1.9tn stimulus package is approved by the Senate. Overall, anyway, it seems appropriate to conclude that once rate volatility subsides risk assets can continue to rally, even allowing for marginally higher yields.

Gold has been a casualty of the rout in US Treasuries and investors are likely to wonder whether the yellow metal has just embarked on a prolonged bear market, or is rather close to oversold levels, following a year-to-date drop of 8.6%. We would be supporting the latter, rather than the former scenario, with real yields being unlikely to push into positive territory anytime soon as the Fed remains committed to allowing the economy to overheat before raising rates. So, even an unlikely spike in the direction of 0% in the 10-year real rate, should not see gold drop significantly below $1,600oz, about 7% away from current levels. Yet, gold bulls should at the same time hold their horses, as a renewed bull market is not round the corner either.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

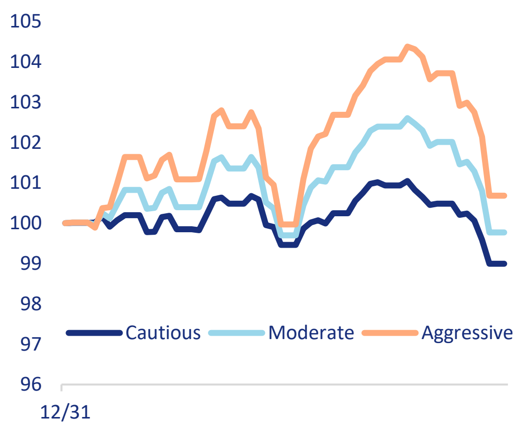


TAA – RELATIVE POSITIONING – MODERATE PROFILE

	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 Buzzwords are back. Investors must have come across words such as "Bond Vigilantes," "Delhi Belly in Treasuries," and "Taper-less Tantrum" quite frequently these days. While these phrases grab eye-balls, it is imperative to look beyond the noise and read between the lines. 10-year Treasury yields closed last week at 1.4%, well below the level of 1.61% achieved intraday last Thursday. A lot of superlatives have been expressed to describe the movement in yields last week. We saw the steepest weekly jump in 5-year Treasuries in months, 10-year Treasuries hit the highest level in a year, and a 7-year Treasury bond auction had the lowest bid coverage ratio ever on Wednesday. According to Bloomberg, traders were the most short on Treasuries post-2013 taper tantrums. The market is pricing in rate hikes in late 2022. So the real question in front of us is whether the "Powell Put" is over.

Let us analyze the hard facts before us. The real unemployment rate in the US is still far away from where the policymakers like it. Last week's CPI numbers were not scorching hot and broadly in line with expectations. While 5-year US inflation expectations have hit the highest point in almost a decade, we would do well to remember that sustainable inflation is impossible without higher employment numbers. The Fed's dot plots themselves point towards no rate hikes till 2023. All these factors conclude that markets are running ahead of the fundamental factors and pricing in a lot of froth. The US yield curve bull-flattened on Friday with 10 and 30-year yields down by c.12 bps compared to Thursday close as markets calmed down. This week a slew of Fed speakers will be on the media culminating with Powell speaking at an online event on 4th March. We expect the officials to reiterate their commitment to lower rates and look through the transitory inflation upticks.

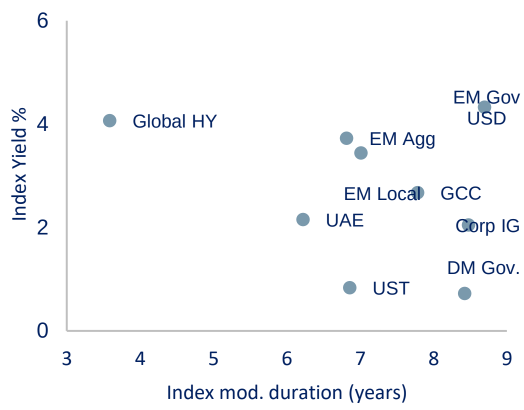
Broad fixed income indices were in the red following the uptick in the yields. The spreads traded in a tight range across various sub-sectors. High Yield and EM Debt spreads widened by +6 and +4 bps, respectively, driving the underperformance across the sectors. However, compared to the other risky assets, this was a very respectable performance by the asset classes and drives home the point of diversification and importance of Fixed Income even during this low yield era.

Primary Issuance remains strong, indicating that rising yields have not had a large effect on the funding markets even for the riskier issuers rated below Investment Grade. Junk bond issuance has crossed $85 Bn so far this year. With almost a month to go, HY issuers need to sell only c.$10 Bn more bonds to make this the most prolific first quarter ever on record. Emerging Market issuance also remains robust, with YTD sales crossing $175 Bn so far. The investor appetite for these sectors backs our investment thesis of continuing Hunt-for-Yield this year.

FIXED INCOME KEY CONVICTIONS

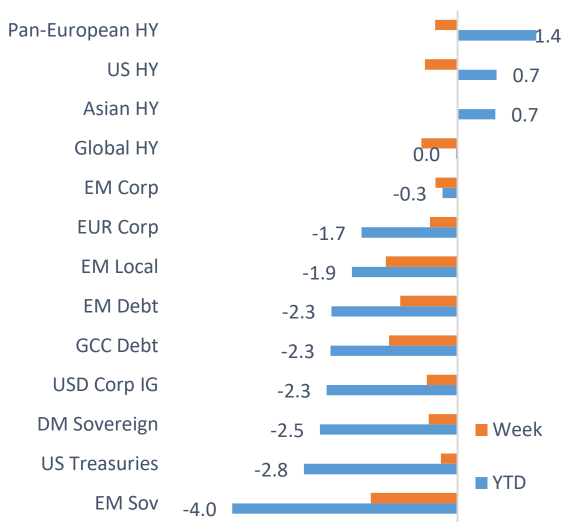
DEVELOPED MARKETS
UW DM Government
OW Credit (Cau. & Mod.)
OW High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

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



Source: Bloomberg

Equity Update

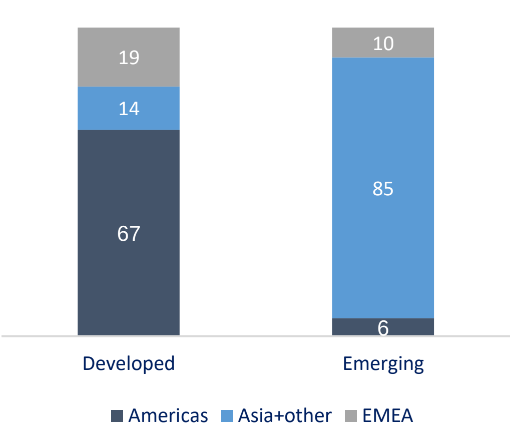
An intense week of equity volatility saw markets yo-yoing between gains and losses and global equities ending the week down -3%, with a broad based sell off, though EM equities at -6.3%, surprised with the magnitude of the move. However, it's still an upward bias as global equities in February gained 2.2%. The growth segments of the market were among the areas most impacted this month: Discretionary and Technology ended flat to slightly positive while Energy +13% and Financials +9% continue to lead. On the big tech front Alphabet and the Semiconductor stocks are holding onto on mid teen gains whilst Apple Amazon, Facebook and Tesla are down year to date, 5% on the average. EM equities which were at double digit gains for the year are now up only 3% year to date, with China down 9.6% on the week. China tech stocks have been vacillating more on regulatory than inflation and yield concerns and are up c.5% year to date. GCC equities are faring better with the Abu Dhabi Index at 11.5% year to date gains. DM equities are +1.5% year to date as the S&P 500 was down 2.4% for the week with the Nasdaq double that and European indices also negative but slightly less, as they have a smaller weight of tech.

Concerns grew that the worldwide economic recovery boosted by slowing virus numbers, vaccine distribution and President Biden's fiscal package could generate inflationary pressures with monetary policies tightening earlier than envisaged . Thursday saw the highest yields in a year at 1.51% for the 10-year U.S. Treasury However, conviction on growth and a resumption of mobility is reflected in oil up 18% for the month. All this is happening at a time when the economic picture is visibly improving. The almost approved additional fiscal aid package should lead to more spending in the U.S. and higher economic growth, bolstering corporate earnings. Fed Reserve Chair Powell says higher Treasury yields reflect optimism on the growth outlook and there are no plans to tighten policy giving lingering weakness in the labour market. In Q4 earnings, 96% of S&P 500 constituents have reported an average EPS growth of 3.4% and Sales growth of 3.1%. We don't expect EM countries to start tightening monetary policy any time soon either and remain overweight equities with a preference for EM. For now better growth can offset higher yields and inflation worries.

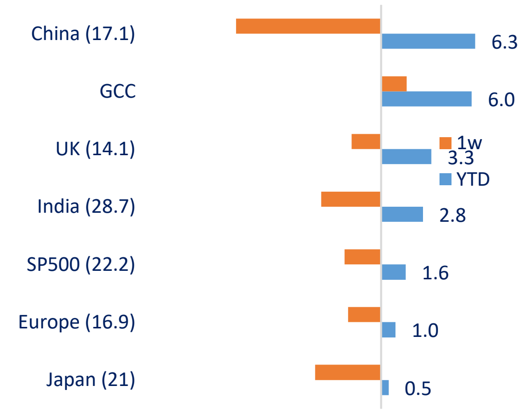
The vaccine rollout is accelerating and Johnson & Johnson's single dose coronavirus vaccine was cleared for use in the U.S., making a third shot available that could fill gaps in the immunization campaign as concern grows over an influx of virus variants. Other vaccine makers have already worked on dealing with the variants as the mRNA technology which Pfizer and Moderna employ permits quick adjustments to the vaccine.

The greater corrections in stocks are coming from more speculative retail favourites losing steam or overly hyped US IPO stocks that had delivered record outperformance or too quick cryptocurrency rallies. Focus remains on investing selectively with a continued emphasis on quality and balance sheets rather than worrying about market volatility, which could continue and is a normal feature of markets.

EQUITY RECOMMENDED REGIONAL POSITIONING

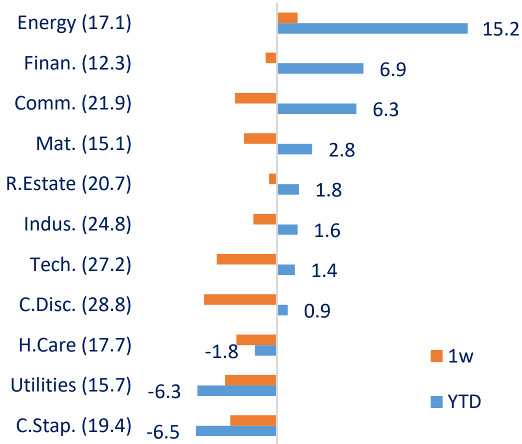


MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE



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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