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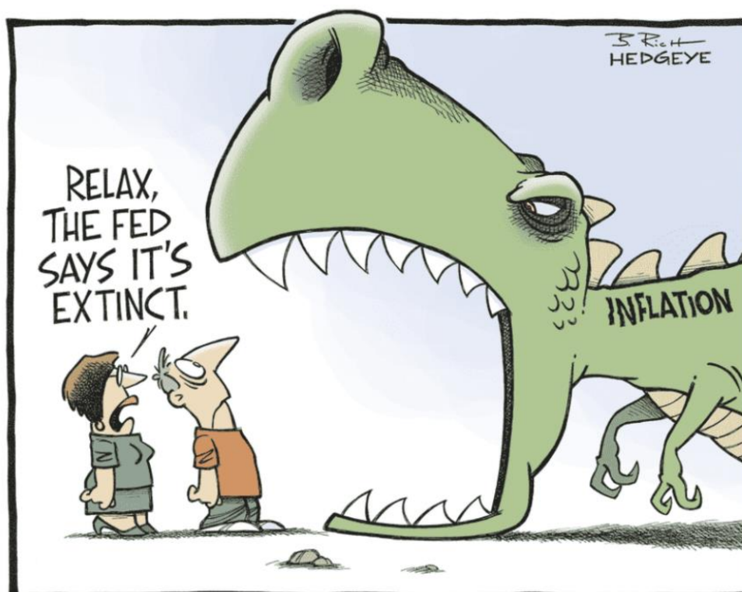


Source: Hedgeye, 18 March 2021

Tug of war – bonds vs. equities

This week marks the anniversary of the turning point of the 2020 COVID stock market crash. Investors looking at their one-year portfolio returns may well be astonished to find double-digit return figures, ranging from around 15% for lower risk strategies to close to 50% for pure global equity portfolios. Alas, don't expect a repeat over the coming months, as these exceptional annual return levels are purely due to the 'base effect'. When improvements are measured from an exceptionally low point, the percentage increase is particularly pronounced. If we measure from the beginning of 2020, returns are in the much more sustainable range of 5-15%.

Nevertheless, it is pleasing that much of what we projected to clients in our ad hoc crisis communications a year ago has materialised. The global economy remains intact, and near-term growth prospects look strong – as does the likely unprecedented demand spike – once the pandemic finally retreats.

With stock markets having already priced in a considerable amount of what recovery hopefully lies ahead, there's – somewhat paradoxically – more to be anxious about. This is a period without real historical reference, and economic data affected by the very same base effect that investors experience for their investment returns creates considerable uncertainties and nervousness that has led to renewed volatility in capital markets. Over the next few months in particular, we can expect extraordinarily high annual economic growth rates, as well as higher reported inflation numbers, almost entirely as a result of the comparison to where we stood a year ago.

Overall, markets are still making upwards progress. However, the concern over rising yields is both a risk for spoiling the expected recovery party and creating different winners and losers compared to last year. While this should not prove too much of an issue for holders of widely-diversified investment portfolios,

those investors with more concentrated exposure to particular regions, industries or investment styles are experiencing a reversal of fortunes compared to last year.

Given how much sway yield levels and inflation concerns are having over market action right now, it is worth taking a snapshot of where we are, which still starts with a look at the state of the pandemic.

Globally, the COVID infection numbers are rising again, perhaps driven by a large increase in testing, perhaps because restrictions are being lifted with schools reopening in many places, perhaps driven by the new more contagious strains, perhaps because people everywhere are getting tired of being distanced.

In the (traditionally insular) US, hospitalisations are declining sharply, and the 'positive test' numbers have stopped falling since schools went back and the testing capacity doubled. The now-passed American Rescue Plan Act is already putting money into the pockets of American consumers, which will boost consumption strongly, especially after the winter storm-induced (rather than COVID-induced) slowdown in late February-early March. Consumer service spending could prove particularly strong with, for example, tourist resort hotels completely booked out in the coming weeks and months. As we have noted, the massive bump in US activity has dominated discussions about spillover effects into global growth, which has led to a sharp rise in long-term US bond yields, which has in turn dragged up yields elsewhere. Yet current activity data elsewhere in the world is no longer improving – just like the daily figures on the pandemic.

Case numbers are rising again in Europe and, unfortunately, this appears to be down to greater transmission rather than more testing. The vaccination pace has started to increase, and there is some good news in that the vaccines also appear to be reducing the overall impacts of catching the illness, while renewed lockdowns in Italy and elsewhere appears to have brought some stabilisation. Of course, that's not a good story economically. The victory of vaccination is that lockdowns should not be necessary.

Meanwhile, Asia has also had some of its confidence shaken by what appears to be a small COVID resurgence. This is at a much lesser level than Europe, but has been enough to keep consumers from enjoying the oncoming spring.

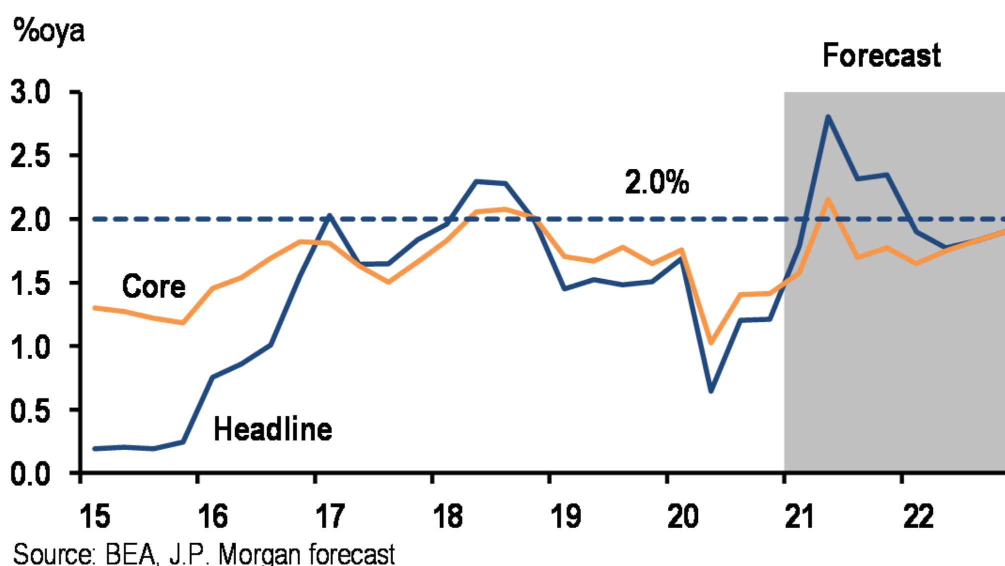
Just like with the UK and £-Sterling, the slightly lower virus impact has led to the US dollar regaining strength over the past month, against the Euro and the Yen, and against many emerging market currencies. This, in turn, has fed through to some central banks beginning to tighten policies, a year after the sharp virus-led cuts.

At the margin, global monetary policy is tightening, even if the big western blocks are unlikely to explicitly do so until 2023. We look at US Federal Reserve (Fed) policies in more details below following its meeting last Wednesday. Meanwhile, the European Central Bank (ECB) stands out as still in easing mode, after promising more quantitative easing. However, many other nations have started to move in the other direction.

China has been indicating a hawkish stance, as we have discussed in the past two weeks. Last Friday, the oil-related nations have indicated a return to normality. Russia has raised rates in a surprise move while Norway has signalled it expects to raise rates later this year. Japan is allowing a (slight) rise in long-term yields. We have also seen rate rises from Brazil, Turkey, Ukraine and Georgia.

The financial conditions tightening effect of a stronger dollar, higher US bond yields and policy tightening from the above central banks have converged to take the edge off the very same global growth expectations that have been driving yields higher since the beginning of the year.

Interestingly enough, that probably means that US ten-year Treasury yields will struggle to go much higher than the 1.75% level seen briefly last Thursday. And, given that equity markets had been driven more by bond yield movements than growth expectations recently, it suggests a period of stabilisation in the recent tug of war between growth excitement, inflation fears and bond yields.



Markets doubt the Fed doves

Interest rates are on hold for years to come, according to the latest announcement from the US Federal Reserve (Fed). After its two-day meeting, monetary policymakers resolved to keep interest rates close to zero, and signalled more of the same until at least 2024. This comes despite upgrades to the Fed's own economic forecasts, which now plot a stronger path out of the pandemic for the US economy. Due to the rapid vaccine rollout in the US, and a heavy dose of fiscal stimulus from the Biden administration, the Fed's growth forecasts have moved sharply higher to a 6.5% expansion in 2021 – the biggest since 1984 – with unemployment expected to fall to 4.5% by the end of the year.

Nevertheless, Fed chair Jay Powell is preaching caution: "No one should be complacent… At the Fed we will continue to provide the economy the support that it needs for as long as it takes". Keeping things easy in the face of vastly improved economic prospects makes for quite a change for the Fed. A recent review found that, in the past, policymakers had leant (too) heavily on the inflation targeting part of their 'dual mandate', to the detriment of US employment. More specifically, gauging slack in the economy through the unemployment rate had proven misleading in anticipating wage pressure. As has been well-publicised, the Fed has since resolved to shift its framework in response to having undershot its inflation target of 2% for

many years, by: a) applying various measures of employment (and not just unemployment) as the reference for assessing the labour market, and b) importantly inflation will be allowed to run above the target of 2% after a period of having undershot its objective. We are now in such a situation.

For observers fearing a rerun-of the 70s, it may be re-assuring that price stability is still the Fed's mandate, as well as 'moderate long-term interest rates', as defined by the Federal Reserve Act in 1977. The translation of those objectives into the economy has changed and, in fact, will be re-assessed every five years. We would also point out that financial stability – which would include debt driven asset inflation – has found its way into the current monetary policy strategy. Improvements to the growth outlook are a test of that new resolve.

Capital markets responded positively to the Fed's structurally dovish move at the time, expecting easier financial conditions and a more supportive environment for the near future. But doubts are creeping in, as improving growth expectations have led many to believe support should be withdrawn earlier than suggested. That the Fed has stuck to its guns and signalled zero interest rates for several years is therefore a good sign.

This back and forth has been most clearly visible in bond markets, where yields on longer-term US Treasury bonds have been rising for weeks, while shorter maturity yields have hardly budged. The Fed is still engaged in an indefinite bond-purchasing programme, pumping liquidity into the economy, pinning down bond yields and thereby giving the Treasury greater spending power. But unlike some other central banks, the Fed has no explicit target for longer-term interest rates, opting instead to announce the size of its purchases and allow markets to do the rest.

Policymakers do indirectly influence longer-term rates via their short-term control. That is, yields on bonds with longer maturity should reflect what the market expects the likely path of interest rates to be. Rising bond yields indicate that bond investors believe the Fed will have to raise rates sooner than it plans to. Powell and co have repeatedly stated their desire to keep conditions loose, but markets seem to not be buying it.

This is a problem for the Fed. Amid the deepest global recession on record and, despite some positivity on the horizon, the economy still needs a big helping hand to reach normality again. Keeping policy loose and liquidity abundant is therefore a must, but rising bond yields have the natural effect of sapping the available capital away, as the 'risk-free' rate of return increases – effectively leading to a tightening of financial conditions by means of market forces not central bank intervention.

Investors' doubts ultimately come from a place of optimism. They believe growth will return in strong enough force that the Fed must clamp down on runaway inflation. But paradoxically, this optimism could well get in the way of that very growth from happening, by tightening up conditions prematurely and choking off the recovery.

For the Fed, then, communicating its dovishness is key. Part of the problem stems from that, with a new policy framework now in place, markets still do not know how the Fed will react to incoming news. Indeed, policymakers themselves seem somewhat unsure of what their new 'reaction function' should be. The Fed had been planning to switch to a more employment-focused setup for some time, but ended up having to make the switch as US unemployment soared to all-time highs, and the global economy shuddered to a halt.

There are many unknowns, not just in the Fed's policy but in how the economy itself will behave. How will the catch-up recovery feed through into inflation and employment numbers? And what will the lasting effect of the substantial fiscal stimulus package be? Questions are also being asked of what the planned infrastructure package will look like, as it makes a difference whether it will be funded with higher taxes or just with debt issuance.

For the moment, the Fed's answer is that inflation will return, but will only be transitory and therefore contained, even with the added charge of fiscal stimulus. In the current environment, we should expect the recovery to be somewhat volatile, with base effects from last year making jumps look bigger and slowdowns more abrupt. In keeping rate expectations down despite stronger growth forecasts, policymakers are telling us they plan to look through this volatility, toward the longer-term picture. Similarly, the Fed's best guess on the fiscal front is that we will not see a sharp rise in employment, and that the scarring effects of the virus could persist for some time.

Markets appear more optimistic and therefore still sceptical, but clearly the Fed is doing all it can to convince otherwise. By showing off its flat 'dot plots' (see chart below), it is reaffirming its commitment to keeping financial conditions looser for longer (the dots represent each committee members' rate expectation for the future). Given the huge impact this has on bonds and the wider economy, we can only hope the Fed's steady approach can also translate into some calm in bond markets, which in turn serves as appeasement to stock markets.

Given market participants know very well that stock market valuations are a large component of financial conditions, there is a risk that they will inadvertently put the Fed to the test as they try to get to grips with its changed reaction function. In the past this has led to the paradoxical situation where improving economic news is greeted negatively by risk asset markets, and vice-versa. We expect recent market volatility to continue, but as long as the economy actually improves there is not much to suggest this will create a more lasting downdraft effect – as long as central banks stay true to their word and stick to their steady course, even when price levels pick up.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate

Global Equity Markets

Market	Fri 15:35	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6708	-0.8	-53	↗	↗
FTSE 250	21453	-0.2	-53	↗	↗
FTSE AS	3825	-0.7	-26	↗	↗
FTSE Small	6728	+0.0	+1	↗	↗
CAC	5996	-0.8	-50	↗	↗
DAX	14599	+0.7	+96	↗	↗
Dow	32704	-0.2	-75	↗	↗
S&P 500	3904	-1.0	-39	↗	↗
Nasdaq	13191	-1.0	-129	→	↗
Nikkei	29792	+0.2	+74	↗	↗
MSCI World	2802	-0.2	-5	↗	↗
CSI 300	5007	-2.7	-139	→	↗
MSCI EM	1347	-0.1	-1	→	↗

Top 5 Gainers

Company	%
BT	+7.8
Flutter Ents	+6.0
Brit-AM Tobacco	+5.6
Kingfisher	+5.6
DCC	+4.5

Top 5 Decliners

Company	%
John Wood	-11.3
Compass	-7.1
TUI	-6.9
Anglo American	-6.8
Royal Dutch Shell	-6.3

Currencies

Pair	last	%1W
USD/GBP	1.386	-0.4
GBP/EUR	0.858	+0.1
USD/EUR	1.19	-0.5
JPY/USD	108.81	+0.2
CNY/USD	6.51	-0.0
Bitcoin/$	59,058	+3.7

Commodities

Cmdty	last	%1W
Oil	63.82	-7.8
Gold	1738.1	+0.6
Silver	26.19	+1.0
Copper	409.8	-1.2
Aluminium	2216.0	+1.7
Soft Cmdties	433.6	-1.8

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.5	20.1	14.7	14.0
FTSE 250	1.7	17.8	22.8	15.3
FTSE AS	3.1	19.7	16.6	14.1
FTSE Small x Inv_Tsts	1.4	18.9	-	14.9
CAC	1.8	24.1	18.5	14.5
DAX	2.4	21.9	16.1	13.2
Dow	1.9	22.8	21.3	16.0
S&P 500	1.5	27.6	22.6	17.1
Nasdaq	0.7	34.0	32.6	22.1
Nikkei	1.4	27.7	22.2	17.4
MSCI World	1.7	25.8	21.2	16.2
CSI 300	1.7	18.2	13.7	12.4
MSCI EM	1.9	21.1	15.9	12.4

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.84	+0.01
UK 15-Yr	1.21	+0.02
US 10-Yr	1.72	+0.09
French 10-Yr	-0.05	+0.02
German 10-Yr	-0.29	+0.01
Japanese 10-Yr	0.11	-0.01

UK Mortgage Rates

Mortgage Rates	Mar	Feb
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.62	1.73
3-yr Fixed Rate	1.72	1.90
5-yr Fixed Rate	1.80	1.89
10-yr Fixed Rate	2.53	2.53
Standard Variable	3.62	3.62

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

If anybody wants to be added or removed from the distribution list, please email enquiries@cambridgeinvestments.co.uk

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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