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MARKET INSIGHT

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CITYWIRE SWITZERLAND TOP 50 INDEPENDENT ASSET MANAGERS 2021

Market Analysis

April 2021

Economic growth and interest rates leave markets caught between a rock and a hard place

These are challenging times for the world's financial markets. While economic growth clearly points to a strong international recovery over the next six to twelve months, upward pressure on the long end of the yield curve demonstrates investors' doubts as to what this recovery will mean for the normalisation of the cost of capital.

In this regard, we can surmise from the rise in long-dated bond yields in March (especially in the United States) that central banks have failed to convince market operators of the need to hold fast to accommodative monetary policies.

The game of cat and mouse that central bankers and investors have been playing since the start of the year has not prevented equities from surging over recent weeks (MSCI All Countries index), as the prospects of a strong recovery in profits remain in place for 2021 and even 2022.

However, sector and regional performances varied widely within the major stock market indices – a prime example of this was the sell-off in emerging market equities. As a matter of fact, the favourable conditions for stocks, which have been rising since the start of the year, mask specific circumstances painting more of a mixed picture.

Ongoing upward pressure on bond yields weighed heavily on the asset class, government debt in particular.

Emerging market bonds were adversely affected by news from Turkey (firing of the central bank governor) and – more importantly – the appreciation of the dollar.

Lastly, headwinds for the fixed-income market made life difficult for asset managers with tactical skills, thereby limiting the contribution we could expect these investment vehicles to make to our allocations.

Ultimately, the bond component of a diversified portfolio severely undermined our overall performance, wiping out any gains that have been generated through equity exposure in the first quarter.

In this respect, we must acknowledge that we were caught off-guard by both the speed at which bond yields increased and the ensuing appreciation of the greenback.

This prompted us to raise our year-end objective for US 10-year yields to 2%, as opposed to 1.50–1.75% previously.

In doing so, we are reaffirming our opinion that while an increase in inflation is a risk in the short term, above all owing to base effects, we are unconvinced that stronger price pressures will set in for the long term.

> "Plotting a course through the market turbulence of 2021 has proven more difficult than we were anticipating."
>
> **FRANÇOIS SAVARY,** CHIEF INVESTMENT OFFICER, PRIME PARTNERS

It is dangerous to assume that the strong growth in the second half of 2021 will continue at the same pace in 2022. We must not forget that certain business support measures, so integral to the fiscal policies implemented in 2021, will not be renewed next year.

This will feed into a gradual normalisation of the economic recovery – not a benign phenomenon given that the risk of inflation is contingent on a strong and long-lasting rebound in employment.

On that basis, we have built up a position in US Treasury bonds in the 7-to-10-year segment. This marginal adjustment does not rescind our underweight in fixed-income, as we reduced our exposure to high-quality corporate debts. Therefore, we retain our defensive bias in terms of the duration of the bond portfolio as a whole.

We mentioned that the first quarter has been difficult for emerging market debts. Our overweight exposure has therefore been counterproductive for the performance of our allocations year-to-date. Nonetheless, we think that the carry offered by these investments justifies to hold them in our portfolios.

What is more, our decision to stick to our guns reflects our doubts regarding the sustainability of the recent the US dollar strength. Although the latter prompted us to review our fluctuation margins for the EUR/USD exchange rate to 1.16–1.22 for the coming months, it did not alter our year-end target of 1.25.

An increase in the yield differential in favour of the dollar, brought about by the widening gap between the economic performances of the US and Europe since the start of the year, is shoring it up in the short term. However, Europe's shortcomings in the management of COVID-19 should gradually ease off, as the continent's vaccination programme is likely to pick up speed.

Against this backdrop, we think that greater synchronisation of economic growth in the second half of 2021 should shine a spotlight once again on the US currency's weakened fundamentals for the medium term: vast quantities of debt amassed through the fiscal stimulus programmes and the deterioration of the external balance of payments, which will prove hard to finance.

The prevailing circumstances mean that we cannot rule out additional dollar appreciation in the short term, with a possible test of 1.16–1.15, but we do not think there is reason to reconsider our bearish scenario over an horizon of six to twelve months.

On the equity front, higher bond yields continued to weigh heavily on growth stocks (long duration), although there were plenty of pitfalls along the way for "recovery stories" too. In this context, our choice to rebalance the portfolios towards greater cyclicality over the last few quarters has been borne out.

And yet we can still regret not having gone further, given the strong consolidation of the technology sector over the past two months.

However, while it is important to acknowledge that unfavourable conditions (the relative expensiveness and duration risk inherent to holding technology stocks) were enough to prompt a more cautious attitude towards the sector, we do not believe that the scenario of a lasting economic recovery, which is our base case, implies selling new economy stocks indiscriminately. As a matter of fact, the pullback we have seen in recent months is starting to yield medium-term opportunities.

Moreover, we must not forget that the rapid sector rotation seen in equity markets has also affected stocks tied to the business cycle. In other words, adopting a far greater bias in favour of cyclicals stocks has certainly not been the silver bullet in the market context prevailing since the beginning of the year.

Plotting a course through the market turbulence of 2021 has proven more difficult than we were anticipating. This was due to the rise in bond yields, which has been faster than expected. This development caused multiple disruptions: (permanent) sector rotation in equities, heightened forex volatility and even capital losses on bond positions.

In all honesty, we must acknowledge that we have struggled to plot a satisfactory course with our asset allocations in this context, especially in the period since mid-February. Does it mean that we should throw out the rule book and change tack entirely?

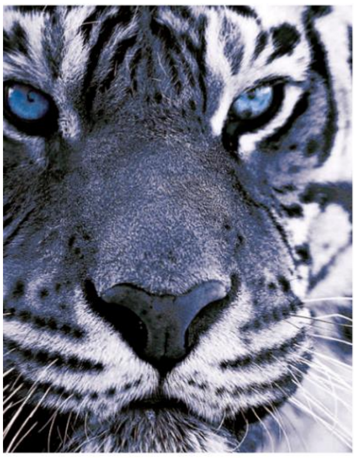
We do not think so, given that the tailwind of economic growth is likely to result in further gains for equities in the coming months as the turmoil in the bond market subsides.

We stand by our forecast that the surge in bond yields will come to a halt, given that the risk of inflation has been priced in by market operators over the past six months.

To conclude, acting tactically without losing sight of the assumptions underpinning our strategic views has proven a bit of a challenge in recent months. That said, we do not believe that we need to reconsider our expectations of a lasting global recovery in the next 18 to 24 months. This outlook supports our bias in favour of equities over bonds, as the former should eventually profit from a calmer environment for fixed-income assets.

Will the benefits of economic growth ultimately outweigh the drag of higher interest rates? We continue to bet on it.

Geneva, 31 March 2021



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