"Bond yields on a hot streak"

Investor fears raised by the "Robinhood/Reddit" episode quickly gave way to renewed optimism, which was encouraged in February by the roll-out of vaccination campaigns worldwide, fiscal and tax stimulus plans, indisputable signs of an economic recovery, and more solid-than-expected company results. Late in the month, we nonetheless witnessed a feverous surge in bond yields, something that had the markets concerned and that triggered downward pressure on equity valuations. The spike in yields is the concrete manifestation of greater inflation and growth expectations. This resulted in the worst start to a year in fixed income since 2015, with, as a corollary, portfolio rotations that continue at a sustained pace.

Market trends

Global equities gained 2.6% in February. The reflation theme triggered an outperformance by cyclicals (with energy up by 22.7% and financials by 11.5%, while utilities fell by 6.1% in the S&P 500) and by "Covid losers" vs. "Work-from-home winners" and by small caps (with the Russell 2000 up by 6.2%). Rising bond yields (US 10Y +34bps to 1.40% and US 30Y +32bps to 2.15%) triggered a correction on equity markets in the final week of February (S&P 500 -2.4%, Nasdaq -4.9%, Stoxx 600 -2.4%, and MSCI EM -6.3%). Bond prices fell on the month by 2.3% on the US 7-10Y and by 1.6% on the Global Aggregate. On the commodities markets, gold fell by 6.1% while energy (+17.8%) and industrial metals (+10.1%) rose on economic recovery expectations.

In Switzerland, the LPP pension fund indices (indices de la prévoyance professionnelle) diverged early in the year, with the LPP25+ down by 0.5% and the LPP40+ up by 0.6%.

Market performance as of 28 February 2021

STOCKS MARKETS	LEVEL 26.02.2021	CHANGE SINCE 29.01.2021	CHANGE SINCE 31.12.2020
Index			
MSCI World	2726.9	2.56%	1.54%
USA			
Dow Jones Ind	30932.4	3.43%	1.41%
S&P 500	3811.2	2.76%	1.72%
Nasdaq Comp	13192.4	1.01%	2.47%
Europe			
Euro Stoxx 50	3636.4	4.54%	2.58%
SPI (Switzerland)	13134.4	-0.44%	-1.45%
CAC 40 (France)	5703.2	5.63%	2.84%
DAX (Germany)	13786.3	2.63%	0.49%
FTSE 100 (UK)	6483.4	1.58%	0.78%
Japan + Emerging			
Nikkei 225	28966.0	4.74%	5.58%
CSI 300 (China)	5336.8	-0.28%	2.41%
MOEX Index (Russia)	3346.6	2.12%	1.77%
S&P BSE Sensex (India)	49100.0	6.22%	2.98%
Ibovespa (Brazil)	110035.2	-4.37%	-7.55%

BONDS & ALTERNATIVES MARKETS	LEVEL 26.02.2021	CHANGE SINCE 29.01.2021	CHANGE SINCE 31.12.2020
Rates			
Germany 10 y	-0.26	26 Bps	31 Bps
France 10 y	-0.011	27 Bps	33 Bps
Italy 10 y	0.761	12 Bps	22 Bps
US 10 y	1.4049	34 Bps	49 Bps
Debt			
Investment Grade US	336.47	-1.47%	-2.01%
Investment Grade Europe	263.8353	-0.77%	-0.89%
High Yield US	2354.4	0.37%	0.70%
High Yield Europe	426.1077	0.82%	1.41%
Emerging Debt	898.7	-2.56%	-3.75%
Currencies			
EUR/USD	1.21	-0.50%	-1.15%
EUR/CHF	1.10	1.49%	1.47%
USD/CHF	0.91	2.04%	2.63%
Commodities			
Crude Oil (WTI)	61.50	17.82%	26.75%
Gold	1734.04	-6.15%	-8.66%

Pandemic situation: Some 300 million vaccines have now been administered worldwide, of which at least one quarter in the United States, which is now able to vaccinate 2.0 million persons per day and which has just granted emergency approval to the Johnson & Johnson vaccine. In per capita terms, Israel, the Gulf States and the United Kingdom have set up the most effective campaigns. China is lagging behind, with just 3.5% of its population vaccinated. In Europe and Switzerland in particular, initial targets have been revised downward due to a lack of available vaccines and flawed planning. Switzerland is vaccinating just 20,000 persons per day. At that pace, it will take 20 months to administer two doses to 70% of the population. **Vaccination campaigns are in the spotlight as they are essential to ending the pandemic and boosting hopes that economies can be reopened soon.** Globally, the number of new Covid-19 cases, hospitalisations and deaths has receded significantly since the start of the year.

Economic environment: the steep rise in US retail sales in January (+5.3%) reflects well the effectiveness of US stimulus measures taken to provide direct assistance to households. Keep in mind that they have each received a USD 600 cheque and that higher jobless benefits were approved in late December 2020. **Other assistance will arrive in March after the Senate approves an estimated USD 1,900 billion stimulus plan.** Some experts are concerned about the plan's size, including Larry Summers, a former Treasury Secretary, and Olivier Blanchard, a former IMF chief economist. They feel that the plan is overly generous, given the strength of the US recovery. Manufacturing output, for example, is now back to 98% of its pre-crisis level.

And yet, consumer confidence is still lacklustre and has even receded, with the University of Michigan index, for example, slipping by 2.8 points to 76 in February. The spread of Covid-19 and restrictions on mobility continue to weigh on optimism. PMI economic activity indicators send a more mixed message, with the composite manufacturing index faring well and the composite services index still in the doldrums. We foresee a reversal of the trend as social distancing measures are lifted in the coming quarters. In China, the recovery has stalled. We will be keeping close track of trends in March and April, as recent figures were skewed by yearend festivities.

Globally, economic growth has remained strong so far this year and will continue to strengthen in the coming quarters, led by the US. The recovery is also visible in Europe, with the manufacturing PMI at 57.9, despite stricter social distancing measures and embarrassing vaccination trajectories (the services sector is still in contraction territory for the sixth month running). Mario Draghi's appointment as Italian prime minister removed some political uncertainty and sent European risk premiums down, particularly in banks. Ultimately, inflation figures are still below expectations in all developed economies, as seen in the OECD's consumer price index in late January, which came to 1.7% on an annualised basis and to -0.3% for China. That said, **we expect inflation measures to begin moving up in the second quarter** as base effects from one year earlier will be considerable, with higher commodity prices, post-Covid inventory restocking, and higher shipping costs.

Analysts have raised their forecasts for the first quarter of 2021. During the first two months of the year, analysts raised their S&P 500 earnings estimates by 5.0 %, from USD 37.61 to USD 39.50. Over the past 15 years, the opposite has usually been the case, with average downward revisions of -3% to -3.5%. This exception is due to the fact that 2021 forecasts had been cut drastically in the first half of 2020, in the midst of the pandemic. 2020 earnings were far better than expected (up by 3.2%), and we expect the upward trajectory to continue. **The acceleration in corporate earnings is the nice surprise of early 2021. We expect it to continue this year and provide support to equity prices.** Risk has shifted from the pandemic to the financial markets, and on the markets to valuation multiples, which are high and are likely to contract considerably.

The rising bond yield story. The surge in long bond yields is the main change on the markets this year. The 10-year US government bond yield rose from 0.9% at end-2020 to 1.4% by the end of February (it had sunk to 0.5% in August 2020, which was without a doubt the trough in this cycle). Yields rose first on rising inflation expectations. In recent weeks, real yields have risen, reflecting the improved outlook for growth. **All economic agents are looking closely at how fast and how long bond yields will keep rising.**

We would note first that yields are rising as central banks continue to intervene massively on the government debt market. That is why all eyes are rivetted on the US Federal Reserve in an attempt to detect the first signs of a shift in its monetary policy. Powell unambiguously **dismissed the assumption of a slowdown in pace of asset purchases and discarded risks of a sustained resurgence in inflation**. We draw from that the Fed is not concerned about current bond yields and feels no urgency to act. However, Biden's new stimulus package will take part in re-steepening the curve, as inflation figures could come under renewed upward pressure due to increased demand, constrained by a limited supply of goods and services.

We see a divergence between the Fed's forward guidance and the markets' forecasts, which have brought the first rate hike from three years from now to two. Bond vigilantes are back and will want to test how long the Fed will stand pat if bond yields keep rising. **The speed at which bond yields are normalising is a source of volatility.**

Bond yields are also rising in Europe, and that is more of a concern for the ECB, as it will want at all cost to keep from nipping the recovery in the bud. **We therefore expect the ECB to remain highly active in its asset purchases and possibly even accelerate them.** The European recovery cannot yet manage on its own without help from the central bank.

What are the impacts on financial asset prices? Despite improving fundamentals, equity valuations are still very high amidst low interest rates and the lack of alternatives. Inflation-adjusted real yields of government bonds rebounded recently from very low levels in Europe and the US. The higher discount rate is dragging down "high growth stocks", hence the recent underperformance of sectors such as information technology and consumer discretionary. As an illustration of the impact on long-duration assets, Plug Power is now 46% off its recent highs (as of this writing), Tesla by 32%, Beyond Meat by 24%, Cathie Wood's Ark Innovation fund by 25%, and the Austrian state's flagship 100-year bond by 28%.

Investment decisions

For several months now we have been steadily altering the portfolios' positioning by adding cyclicity to regions, such as emerging markets, Japan and Europe. More recently, we added to our holdings in materials, a lagging sector that is being driven by prospects for an exit from the recession. Small caps in Switzerland, the US and Europe are also present in the portfolio as they offer attractive opportunities in this recovery phase, thanks to their more industrial profile.

On the bond market, we are sticking to a good balance between high-quality credit risk and the search for higher-yielding bonds. We remain conservative on the long section of the curve, as it is likely to continue rising, albeit at a slower pace than in recent months. Credit spreads are riding the economic recovery environment.

In real assets, which fill out our portfolio construction, we have reduced our exposure to physical gold and international listed real estate, as they are both performing poorly in the current environment of rising bond yields. It is too early to bury gold, whose investment thesis is based on central banks' ongoing accommodative policies and governments' ongoing stimulus plans. Rising bond yields and the high level of premium to NAV have spoiled our appetite for listed Swiss real estate.

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