Perspectives

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IN SHORT

- The global growth outlook continues to improve, thanks to accelerating vaccination
- While the reflation stalled in recent weeks, it should ramp up again with cases rolling over and reopening prospects improving
- After a pause, we expect yields to move higher again before retreating further out as much of the good news is priced in already

Reflation trade not over

The global growth outlook continues to improve, with European vaccinations accelerating, the US economy booming and Chinese growth still roaring. Despite extended lockdowns, European data has been better than anticipated and the second half of the year should see a strong recovery fuelled by pent-up demand and the disbursements from the EU Recovery Fund. The US, which is a few months ahead of Europe in terms of reopening, continues to beat expectations, thanks to softer containment measures and massive fiscal support. With the Federal Reserve reiterating that it is too early to reduce support, growth has free reign to move higher. While Chinese growth is set to slow from its recent peak, 2021 growth is still expected about 8% for the year, which should help lift Asia. Slower vaccination across the region could see some speedbumps on the road to reopening, but the outlook is improving.

Still, inflation expectations plateaued over the month and Treasury yields retreated, stalling the reflation trade. This was also partially sparked by the spike in Indian Covid cases and a rise in cases in developed markets as well. However, with cases starting to roll over, reopening prospects should improve again, and the reflation trade should gather steam again over the coming months. As such, we look for the cyclical rotation to resume, with energy, materials, and financials advancing. We also believe that Europe and Pacific ex Japan should benefit from reopening expectations, recovering global trade and higher commodity prices.

As we wait for the next catalyst – whether higher oil prices, yields or better Covid news– we look for opportunities to add to equities. Indeed, the medium-term supports for equities remain unchanged, with vaccination, fiscal spending, accommodative central banks, and rebounding earnings all still present. Conversely, sentiment and positioning are already very bullish, and we keep an eye out to ensure investors do not fall into complacency. For now, we believe that enough concerns linger, but over-optimism is a risk.

On the fixed income side, while we believe that a lot is priced in in terms of fiscal stimulus and inflation expectations already, and yields have probably seen the bulk of the move, we believe they can move higher in the short term, before retreating again further out. As such, we favour shorter durations and remain cautious on sovereign yields. We prefer credit, though already tight spreads and longer duration suggest less potential upside from here. High yield should do better as it is less rate sensitive but remain selective. While EM often struggle during rising US yields, they are in better positions than during previous such bouts and have handled the recent move better than expected. EM hard currency corporate debt also has more room for spread tightening and therefore potential to absorb higher treasury yields.

Asset class details

Equities

With spiking cases in India and higher cases in Europe and the US, the reflation trade stalled in recent weeks. However, we believe it is set to resume as cases roll over and the vaccination effort continues to accelerate.

While we wait for the next catalyst to spark a renewed rotation towards cyclicals, we remain constructive on equity markets and continue to "buy the dip". Indeed, longer-term supports remain in place, especially with the Fed reemphasizing it is not close to reducing its support and President Biden looking to spend trillions more.

We expect cyclical sectors to outperform again, favouring financials, energy, and materials. European and Japanese stocks should also benefit from the more value tilted construction of their indices. Commodities should continue to rebound with strong Chinese growth and reopening expectations, and we expect the developed Pacific region to benefit in particular.

We keep an eye on sentiment and positioning to ensure it does not become too aggressive and complacent, as a lot of good news is already priced in. indeed, while the Q1 earnings season has been very strong so far, stocks have not reacted as much, suggesting expectations for earnings to beat even lofty estimates.

Fixed Income

Yields retreated from their recent peaks over the month of April, but they are likely to move higher again in the short term, as Covid cases roll over, vaccination accelerates in Europe, and the reopening trade gathers steam again.

However, while they can move somewhat higher in the coming months, we believe the bulk of the move is likely behind us as much of the inflation and spending expectations are now priced in. moreover, Biden's infrastructure plans, while large in scale, are set over 10 years, suggesting less impact on growth and inflation expectations for 2022.

Still, we favour shorter durations and remain prudent on sovereign debt, both US and European.

The longer duration of IG indices and the very tight spreads suggest less room to absorb higher rates than in HY, though we remain selective given lingering default risk.

We continue to see opportunities in hard currency emerging market corporate debt, where the carry is attractive and there is further room for spread compression. This should also allow some absorption of higher Treasury yields, as seen in the better-than-expected performance of the segment in recent months.

Currencies

After staging a rebound at the start of the year, the dollar retreated with US yields and has settled into something of a trading range with major currencies. As the reopening trade picks up again, "risk on" and commodity-related currencies should benefit, but we believe that stronger growth, higher yields, and ongoing fiscal impetus should limit dollar weakness.

Commodities

With reopening prospects set to improve again, oil prices should move higher again as OPEC+ maintains supply cuts. However, the balance is fragile and overall abundant supply is likely to limit appreciation potential at some point.

We expect demand for gold to improve with the reopening of EM economies – leading to better physical demand –, low real yields, and medium-term inflation expectations, even if it has paused for now.

Alternatives

Alternatives continue to provide diversification and re-correlation in portfolios, a welcome complement to traditional asset classes. We believe that real assets can also help provide income in a lower for longer world.

Asset Classes	Negative	Neutral	Positive
Equities			●
Fixed Income		●	
Equities			
US		●	
Europe			●
Japan			●
Asia ex Japan			●
Emerging Markets		●	
Asia		●	
Latam		●	
Europe		●	
Fixed Income			
Sovereign US	●		
Sovereign EUR	●		
IG US		●	
IG EUR		●	
HY US		●	
HY EUR		●	
EM Hard Ccy		●	
EM Local Ccy		●	
Commodities			
Oil		●	
Gold		●	
Base Metals		●	

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