Perspectives

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IN SHORT

- Improving growth is lifting inflation expectations, and with them, yields
- Yields can rise further in the short term, but we do not expect spiralling inflation, so yields should eventually retreat
- A reflationary environment with still low rates should support risk assets

Taking the yield move in stride

The ongoing smooth vaccination in the US and extensive fiscal support is lifting the growth outlook and with it, inflation expectations. As a result, yields have continued their upward march. Still, we still do not expect inflation to spiral out of control – though it will move higher over the coming months – and we therefore believe yields will eventually retreat.

In the meantime, markets interpreted the Federal Reserve's lack of concern over the recent move as free reign to move higher still, so the overshoot can continue. While the Fed's inaction might appear surprising, it can be explained by the following: The long end of the curve has risen, but financial conditions remain extremely easy. Real yields have jumped, but they remain firmly in negative territory. And the labour market is improving, but full employment is still likely to take some time. As such, the Fed's current stance remains appropriate, though Mr. Powell likely still has a threshold at which he would act more forcefully to cap yields.

Elsewhere, the European Central Bank was less comfortable with the move in yields, acting to cap them with increased QE purchases. As such, the divergence between US and German yields is likely to increase further going forward, though capped European yields should eventually act as a cap on US yields as well. Beyond Treasuries, markets have taken the move in yields in stride. Credit spreads have proven resilient and managed to absorb some of the move. We remain somewhat cautious on investment grade due to longer durations and prefer high yield, though on a selective basis as default risk persist. While emerging markets tend to suffer in a rising rates environment, we believe they are in a better position than during the Global Financial Crisis and the Taper Tantrum, they have more room for spread compression and, as a result, more potential for EM hard currency corporate debt to absorb some of the rates move.

Equity markets have also held up despite the rapid move higher in yields. The rotation into cyclicals continues and could accelerate further as vaccination accelerates and more economies reopen. As such, we expect cyclical sectors such as financials, energy and materials to continue to advance. European and Japanese equities should also benefit from their value tilt. Overall, while some worry that higher yields can derail the equity market rally, we believe that the underlying supports remain. Earnings growth is set to be very strong, vaccination should accelerate further during Q2, fiscal and monetary support are ongoing, liquidity is abundant and there is plenty of cash on the sidelines. In addition, as investors have concerns, whether inflation, bubbles or valuations, the downside appears somewhat limited. As such, we believe a reflationary environment with (still) low rates should support risk appetite and we continue to "buy the dip" in case of correction.

Asset class details

Equities

The recent move higher in yields has led to an ongoing rotation from more defensive sectors into cyclicals, a move we expect to continue over the coming months. However, it has not led to flows out of equities, despite what some had feared. Indeed, with strong earnings growth expectations for this year and next, with abundant liquidity and ongoing fiscal easing and an acceleration in vaccinations, the fundamental support for risk assets is in place. We therefore look to "buy the dip" during corrections.

The reopening trade is likely to continue to benefit cyclical sectors such as financials, energy and materials. European and Japanese stocks should 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.

While sentiment indicators continue to point bullish, recent conversations indicate that investors have risks on their radars, suggesting more limited downside.

Fixed Income

Yields continued to move higher throughout most of March, as investors priced in a better growth outlook thanks to smooth vaccination and massive fiscal measures in the US, which are expected to lift inflation. However, we do not see inflation spiralling out of control and therefore expect yields to retreat later in the year. Indeed, a lot of optimism with regards to growth, inflation and fiscal stimulus is now priced into bonds. The Fed sees inflation as "transitory" as well and will maintain its current stance for some time. Moreover, with the ECB actively aiming to cap European yields, Treasury yields could see some pull as well, though divergence between the regions is set to increase in the short term.

With this in mind, we look to keep shorter durations and continue to prefer credit risk. 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.

Currencies

Higher US yields have supported the dollar, which is gathering momentum against major currencies. As mentioned in the past, we believe that higher yields will lead to flows into the US, supporting the dollar. Stronger growth boosted by massive spending is another underlying support, though risk sentiment could mitigate that. However, USD could weaken more against commodity-related currencies rather than major currencies.

Commodities

Oil prices should continue to benefit from reopening prospects, as demand is set to pick up and supply remains actively capped. 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, 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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