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Monthly Update – April 2021

As at 30 March 2021

Summary

— **Loose monetary policy and government stimulus remain the dominant and positive drivers for the global economy and financial markets**

— **However, higher long-term interest rates are increasingly in conflict with high market valuations**

— **New market paradigm: The long-standing correlation between interest rates and equity prices has changed – rising interest rates cause equity markets to fall**

— **Central banks face a communication challenge as market reactions become increasingly unpredictable**

— **Partial divergence between US and Europe in economic growth, inflation and monetary environment – Europe benefits disproportionately from global economic recovery**

— **The environment for equity and credit markets is becoming more difficult, but no general trend reversal is foreseeable yet**

— **Global pressures cause inflation rates and interest rates to rise**

Significant changes compared to the previous month

— Long-term interest rates on government bonds, which have risen worldwide since their lows last August, are forcing stock markets to downwardly adjust, making valuations more compelling. This has already partly taken place on the back of price corrections (especially in the case of the previous pandemic winners). In addition, the currently markedly rising corporate profits are also leading to a more favourable valuation of equity markets. The corporate bond markets, on the other hand, remain fairly valued.

— The positive correlation between long-term interest rates and stock market prices that has been in effect for more than 30 years is beginning to reverse. In the future, rising interest rates will therefore tend to lead to falling share prices (and vice versa). The reason for this is a change in macroeconomic risks away from deflation towards inflation. This new market paradigm could already be observed in the period from 1966 to 1997.

— Interest rate-sensitive growth and technology stocks tend to struggle more in such an environment than cyclical industrial and value stocks.

— Another striking feature of recent times has been the relatively strong rise in interest rates in the US, despite clear statements by the US Federal Reserve that inflation will remain low in the long term. Since the labour market is still suffering from major problems, the current bond-buying programme (QE) is also set to continue unchanged. Thus, a gradual decoupling of the market from ultra-loose monetary policy has begun. This also makes market timing more difficult for equities. Stock markets are behaving increasingly unpredictably.

— Divergences can be observed between monetary policy and economic growth in the US and the eurozone. The ECB is significantly increasing its QE programme, while the Fed is curbing monetary dynamics very slightly. On the one hand, Fed President Jerome Powell spoke for the first time in an interview, albeit very gingerly, about the possibility of a reduction in securities purchases (tapering). Conversely, a temporary relief in the Supplementary Leverage Ratio (SLR) has not been extended. This step corresponds to a moderate tightening of liquidity in the US banking system.

— The reason for these deviating monetary policy measures is the lower economic growth and inflation in the eurozone. The US is generally further along in the recovery cycle, especially with possible openings in the economy thanks to extensive vaccination.

— This should lead to a lower euro exchange rate against the US dollar in the short term. In the second-half of the year, however, we expect Europe's economy to catch up. This would then also eliminate the differences in monetary policy and inflation. Upward pressure on interest rates should also increase significantly by then.

Current situation and positioning

— Despite the aforementioned slight tightening of liquidity (SLR ratio and tapering discussions) by the Fed, the monetary dynamics in the US and also worldwide remain extremely expansive. This results in positive feedback loops that strengthen the economic and stock market trend. The relatively homogeneous expansion of the money supply worldwide also prevents greater undesired volatility on the foreign exchange markets. Money creation is also increasing within the private banking system. Credit impulses are turning upwards.

— Labour market dynamics in the US have now improved after a slowdown from November to January. A further decline in unemployment can be expected. A realistic target for full employment in the US is the first quarter of 2022. Currently, the employment level is still about 9 million jobs below the February 2020 level. In Europe, the labour market is also expected to improve in the second-half of the year.

— The export-driven EU industries are receiving strong impulses from abroad. Europe is benefiting particularly strongly from positive feedback from the economic recovery in the US and in Asia, especially China.

— The recent rise in long-term interest rates has not yet led to major global dampening effects. The economic momentum is stronger than the interest rate momentum. However, in the US, higher rates on 30-year mortgages are already leading to some slowdown in housing market momentum. We are watching this development closely.

— Inflation expectations are rising steadily in both the US and Europe. The M2 money supply has historically been a reliable precursor to inflation. M2 is currently rising very strongly in the US (and also globally). The proportion of the CPI index accounted for by components with prices rising above 3% p.a is now over 40%, also signalling upward price pressure. In addition, base effects are at work.

— However, global trends in economic growth, commodities, inflation, interest rates and the foreign exchange market remain moderate and controlled for the time being. The central banks currently continue to have the situation well under control. The first decoupling on the interest rate markets is already becoming apparent, but does not yet represent a real danger – although we expect that temporary accelerations of movements and sudden spikes in volatility could occur at any time.
— Nevertheless, the central banks have a number of instruments at their disposal to prevent the economy and inflation from overheating without having to raise interest rates prematurely. The first time these measures are used (e.g. reduction of securities purchases), noticeable turmoil on the financial markets is to be expected.
— The enormous infrastructure programme planned by the US government (as well as additional spending in the health care system) is clearly pro-cyclical, but is unlikely to have any significant fundamental effects on economic growth, government debt and interest rates in the short-to-medium term. The programmes and funding are spread over ten years. However, market psychology could be negatively affected in the near term.
— The general market environment is becoming more difficult, but the positive forces currently still outweigh the potential dangers. We are therefore slightly reducing risk exposure in some cases, but remain positioned in a neutral to slightly elevated range, while underweighting interest rate duration. In the medium term, the equity markets in Europe should benefit somewhat more from recovering global trade, especially given a continuing lower interest rate level compared to the US and a lower euro in the short term. This combination should compensate for the delays in vaccination campaigns in Europe.

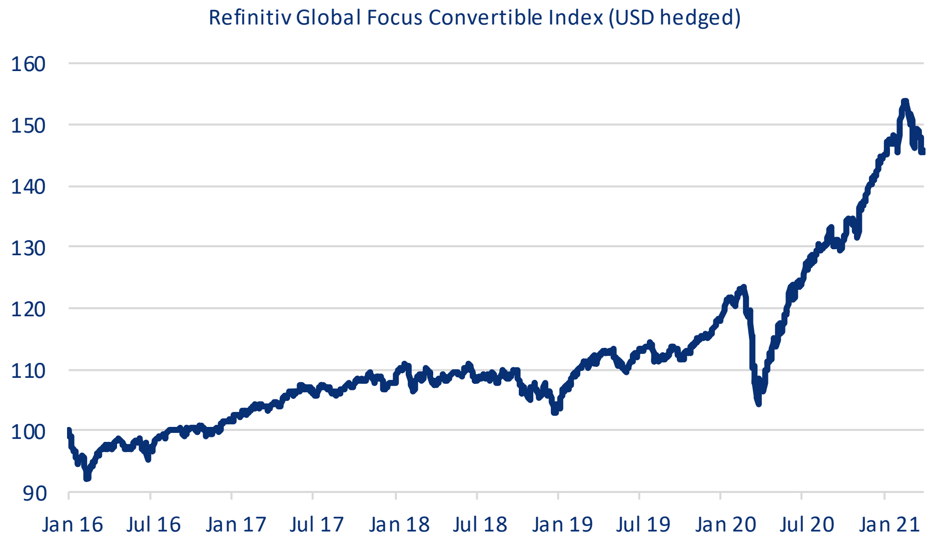
Topics “on the radar”

We see convertible bonds as a suitable instrument for optimal market timing. Due to the asymmetric participation in equity market movements (corresponding to about two-thirds in rising markets and one-third in falling markets), convertible bonds typically lose significantly less in falling equity markets, while benefiting from good participation in upswings.

The price behaviour of convertible bonds is consistent with a pro-cyclical, automatic timing strategy that quickly reduces risk in falling markets but builds risk in rising markets. Convertible bonds are also less interest rate sensitive than normal bonds with the same maturity. In addition, the convertible bond universe includes a "growth filter"; In sectors that are doing well, or are in a turnaround situation, there are many new issues. The convertible bond universe is thus continuously renewed in the most promising sectors.

The performance of global convertible bond markets over the past 12 months has more than met theoretical expectations. Convertible bonds clearly outperformed equity markets both in the pandemic-related collapse and in the subsequent upswing, and continue to offer an extremely interesting alternative to direct equity investments given the difficult market conditions we expect to encounter in the period ahead.

Chart: Global convertible bonds performed extremely strongly in the pandemic



Source Refinitiv, March 2021

Summary of *FischView* model outputs

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA
Equities	o ↓	+	+	o ↓	o ↓	o ↓
Government Bonds	-	o ↑	-			
Credit IG	o ↓	o ↓		o ↓	o ↓	o ↓
Credit HY	o ↓	o ↓		o ↓	o ↓	o ↓
Convertibles	o ↓	+	+	o ↓		

Commodities	Energy	+ ↓	Prec. Met	o ↓	Indu. Met	+ ↓

Key:

++	Strong positive
+	Positive
o	Neutral
-	Negative
--	Strong negative

Notes regarding the table: Changes from prior month are indicated with ↓ or ↑. i.e. "O ↓" means that the output has weakened from a prior value of + or ++.
The methodology for calculating model outputs, and how the various pieces fit together to form the big picture, is explained **here**.
Within government bonds, we consider the most important bonds for each region, e.g. German Bunds in Europe, and a representative group of countries for Latin America, Asia ex-Japan and CEEMEA (Central and Eastern Europe, Middle East and Africa).

Cross asset class preferences

This table combines top-down views with bottom-up analysis at the portfolio level.

	Most preferred	Least preferred
Convertible Bonds	– Reopening beneficiaries – Cyclicals	– Growth (software/ e-commerce) – Covid-19 winners
Global High Yield	– 'B' rating segment – Telecoms – Basic industry	– Retail – Leisure
Emerging Market Corporates – Defensive	– Colombia – China – United Arab Emirates	– South Korea – Qatar – Russia
Emerging Market Corporates - Opportunistic	– Africa – China	– Argentina – Oman
Global Corporates	– Investment Grade – Developed markets – TMT – 'BB' rating segment	– Emerging markets – Real estate – Basic industry – 'B' rating segment

Note: Preferred sectors/regions may differ between asset classes owing to respective performance drivers. In particular, equity exposure is the key performance driver for convertible bonds and is not relevant for corporate bonds.

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