Investment Strategy – March 2021

Data & Forecasts

Developed Markets	Growth (%)		Inflation (%)		Equities			Bonds (10 Years)			Currencies (vs CHF)		
	GDP 20	GDP 21	CPI 20	CPI 21	Actual	3 Mths	12 Mths	Actual	3 Mths	12 Mths	Actual	3 Mths	12 Mths
Switzerland	-3.3	3.2	-0.7	0.2	13'444	↗	↗	-0.27	-0.40	-0.35	-	-	-
Germany	-5.3	3.4	0.4	1.7	14'038	↗	↗	-0.31	-0.40	-0.30	-	-	-
Eurozone	-7.0	4.2	0.3	1.3	3'703	↗	↗	-	-	-	1.11	1.09	1.10
United Kingdom	-10.2	4.6	0.9	1.5	6'638	↗	↗	0.76	0.40	0.60	1.28	1.22	1.25
United States	-3.5	5.0	1.3	2.2	3'820	↗	↗	1.45	1.40	1.60	0.92	0.90	0.89
Japan	-5.2	2.7	0.0	-0.1	28'930	↗	↗	0.13	0.00	0.00	116	116	117

Emerging Markets	Growth (%)		Inflation (%)		Equities			Bonds (10 Years)			Currencies (vs USD)		
	GDP 20	GDP 21	CPI 20	CPI 21	Actual	3 Mths	12 Mths	Actual	3 Mths	12 Mths	Actual	3 Mths	12 Mths
Asia ex Japan	3.9	3.9	0.9	0.9	914	↗	↑	-	-	-	-	-	-
China	2.3	8.4	2.5	1.5	3'503	↗	↑	3.26	3.20	3.20	6.47	6.45	6.40

Review – Rising interest rates are unsettling market participants

In February, a similar pattern emerged in equity markets as in January. The month started relatively well, however markets gave back a large part of the gains in the second half of the month. The cause of the increased volatility in markets last month was not the Robinhood traders, but the rising interest rates and inflation fears of market participants.

Yields on government bonds dropped dramatically in 2020 following the global macroeconomic shock that stemmed from the Covid-19 crisis and the paralysis of the global economy. Demand for safe havens weighed on long rates while central bank action pushed short-term rates down to or below zero in most major developed countries. Yields on US and German 10-year bonds dropped 110 and 70 basis points, respectively, from the beginning of 2020 to mid-March 2020. This reflected dampened growth and inflation expectations, as uncertainty around the length of the pandemic and its impact rose.

Yields on 10-year US and German government bonds since the beginning of 2020 (Source: Bloomberg, Limmat Wealth)

As the economy healed and most assets recovered on the back of improving prospects for earnings, defaults, and activity overall, a big disconnection occurred between the pricing of risk assets and

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government bonds. Inflation expectations surged but nominal yields did not follow through and real yields (nominal yields minus inflation) dipped deep into negative territories for the first time since 2012 in the US and to unchartered territories in Europe.

Since the beginning of the year, the growth premium is starting to appear in government bond pricing. This trend will probably continue but remain constrained. In our opinion, any rise further will be capped by two factors: central bank willingness to keep long rates under control (to prevent debt financing costs from becoming too onerous) and investors' renewed interest in the asset class (as investments in government bonds in safe havens become attractive again).

The uncertainty among investors led many markets to give back the majority of their profits of the first half of the month. Equity markets around the world closed February with positive returns. The markets in Japan (+4.7%), Europe (+4.5%), the United States (+2.6%), and Germany (2.6%) appreciated, while the Swiss equity market ended the month with a small negative return (-0.4%).

Yields on ten-year government bonds worldwide increased further in February. Interest rates increased the most in the United Kingdom (+0.49% to 0.82%), the United States (+0.34% to 1.40%), and Germany (+0.26% to -0.26%). They also significantly increased in Switzerland (+0.23% to -0.19%).

Currency markets moved quite a bit last month. The Swiss Franc weakened against the US Dollar (-2.0% to CHF 0.91), as well as the Euro (-1.5% to CHF 1.10) and the British Pound (-3.5% to CHF 1.27). The Euro remained unchanged against the US Dollar (USD 1.21).

Alternative investments performed differently last month. The Gold price decreased (-6.1% to USD 1,734 per ounce), while hedge funds (+1.5%) and oil (WTI, +17.8% to USD 61.50 per barrel) appreciated. With geopolitical unrest in the Middle East, increasing demand from China and refining problems in the United States (onset of winter in Texas), three classic price drivers came together last month. The oil price has thus completely recovered from the corona-related crash in the first trimester of 2020.

Outlook – Interest rates will remain in focus

Interest rates will remain in focus (see above). Historically, rising yields have not necessarily led to losses in other, riskier asset classes. Intuitively, higher interest rates are a consequence of an improving macroeconomic context. In spite of higher financing costs, growth-driven rises in yields are a supportive environment for both equities and credit as earnings expectations improve and default risk moves lower.

Over the last 20 years, surges of 50 basis points or more in 10-year yields have been followed by above-average returns in growth-related assets. Since 2000, the average performance of the American S&P 500 Index in the six months following such a rise in yields has been positive, up 4.5% and above the 3.8% average six-month returns. In terms of frequency, over the last 20 years, only two out of seven meaningful long-term rate surges lead to negative returns: in 2002 with the bursting of the Dotcom Bubble and in 2011 during the Sovereign Debt Crisis.

It is not just the magnitude, but also the pace of the increase of the rise that matters, as well as the absolute level of rates. Empirically, neither of these two other factors impact future expected returns negatively. What does matter, however, is the path of short-term rates, controlled by central banks rather than market participants. On this front, the rhetoric of major central banks has been clear enough to provide visibility for two years ahead, and the expected yield rise will most probably take the form of a

normalization in yield curves. The question of yield curves control has been discussed by the US central bank Fed and the European central bank ECB, and is already in place in Japan. Unless there is a meaningful overshoot in realized inflation above central bank targets for a prolonged period of time, policy will remain accommodative and a lift-off in rates is off the table.

The reflation theme has gained traction over recent weeks and raises questions about the continuation of the rally in interest rates that started at the end of 2020. Yes, the long-end of yield curves are set to normalize, but the rise should remain constrained and the impact on other assets will likely be neutral to positive. There could be other risks that could temporarily materialize, mostly affecting sentiment. Arguably, the scale of the recent rally in equity markets might have been a bit excessive. Good news on the health front and fiscal stimulus have pushed 2021 earnings expectations and credit spreads into extremely optimistic territory. Room for disappointment during the Q1 earnings season has increased as a 30% profit growth is already anticipated this year for global equities, and roughly 25% in Europe.

In short, sentiment and valuations are the elements at risk now that the improvement in macro fundamentals has been discounted by the investment community. Despite these points, we are generally positive for equity markets over the next 12 months but somewhat cautious for bond markets. We favor Switzerland, the United States, and China over Europe and continue to focus on equities of high-quality companies with strong balance sheets in the healthcare, technology, and consumer goods sectors.

Market participants do not expect any further rate changes by the US central bank Fed and the European Central Bank ECB over the next 12 months. There are also no rate changes expected by the Swiss central bank SNB.

Trade disputes and geopolitical developments can lead to strong movements in currency markets. The Swiss franc serves as a safe haven in such cases.

Hedge funds continue to capitalize on the increased volatility which should provide for good opportunities over a longer period of time (in particular distressed, structured credit, and global macro funds).

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Limmat Wealth Ltd.