MARKET VIEWS

Market & Strategy Update Q2 2021

April 8, 2021 – Adrian Kirigin (kirigin.adrian@probus.ae)

PROBUS GROUP

Executive Summary

The global economic recovery has been remarkably strong and leading indicators do not suggest any imminent slowdown. Manufacturing activity has done most of the lifting so far, but the prospect of successful vaccine rollouts and further reopening are keeping hopes up that the beaten down services industry will benefit from significant pent-up demand going forward. The combination of rising growth and inflation expectations has pushed long term yields higher, leading to one of the largest drawdown in US long bond prices in decades and generating some volatility in certain segments of the equity market.

Despite the recovery, central banks are so far committing to keeping monetary policy unchanged, with the Fed suggesting that short rates could remain at current levels until 2024. The Fed has expressed a lack of concern at the rise in long term yields, but its actions may suggest otherwise, with recent bond purchases exceeding its monthly target. The ECB on the other hand has already committed to ramping up bond purchases. With yields likely going higher if the recovery persists, the Fed might be forced into action. With governments committed to keep the fiscal spigots open, central banks will be under tremendous pressure to avoid a disorderly rise in yields.

Value and cyclical companies have been significantly outperforming, while growth companies have been under pressure due to the rise in yields. Although value could still have room to catch up from a valuation standpoint, investor positioning is currently heavily tilted towards recovery plays such as commodities, emerging markets, banks or European stocks, suggesting that it may be time to switch back into more defensive plays. Moreover, sentiment readings for equities remain extremely high, as participants seem to think that nothing can go wrong now that central banks don't even react to stronger economic growth. With most equity markets looking stretched and valuations not providing a safety cushion, especially in the US, such exuberance is a red flag.

The short term growth picture will largely depend on the success of vaccine rollouts. On that front, the US seem to have a clear advantage, while Europe has yet to get its act together. Emerging markets have for the most part not secured enough supply, making them more vulnerable to potential new waves in coming months.

Executive Summary

In addition, the amount of fiscal support thrown at the US economy has tilted short term growth expectations in favour of the US, challenging the broad bearish consensus on the USD seen early this year. With positioning still neutral, this dynamic could push the USD higher in the short term, but we expect rising budget and trade deficits to re-assert themselves later this year and push the USD lower.

Global market ex-US remain far more attractively priced and the resumption of the dollar's decline would be consistent with the rest of the world outperforming. EU equity markets have looked through the renewed lockdowns and poor vaccine rollouts, making us wonder what would push prices higher in the short term. We however continue to see a lot of value in Japanese equities, where companies have rock solid balance sheet, the perspective of rising shareholder returns and where foreign investors still remain lightly positioned.

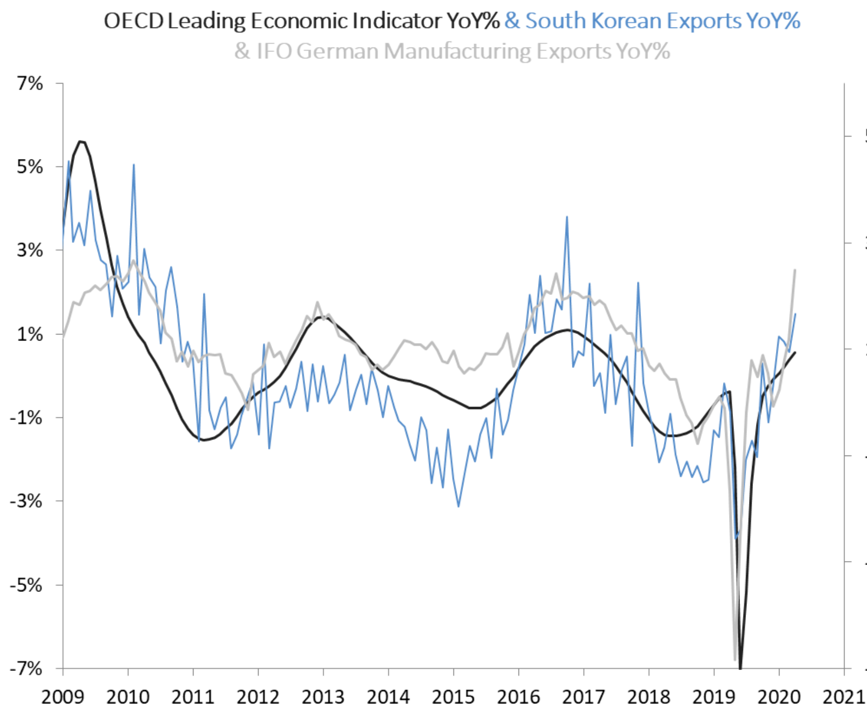
The rise in the dollar and US yields, combined with regulatory pressure on Chinese tech giants have triggered a welcome consolidation in the MSCI Emerging Market Index, which had gone through a historic rally from March 2020 lows. Fears of a 2013-style taper tantrum have led to the first outflows in months, but we do not consider this scenario as likely. The lack of vaccine and dollar revenue is a greater concern, making countries with large export industries and little reliance on tourism more attractive in our view.

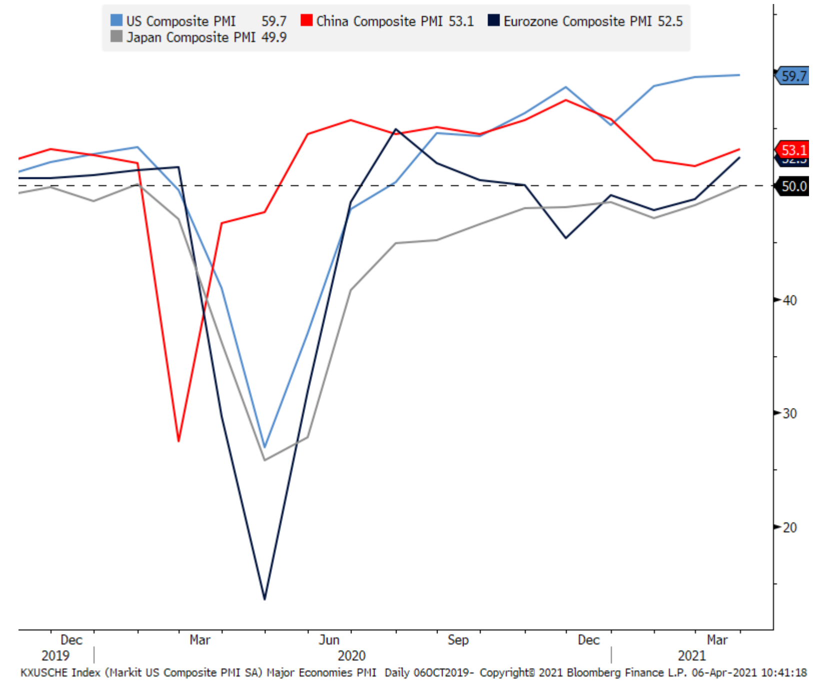
Gold has been a major casualty of the recent rise in yields, which we continue to view as temporary. With sentiment souring and outflows reaching extremes, investors may be throwing in the towel. This is setting the stage for a recovery, as the fundamental case of money debasement does not appear to be anywhere close to the end. Similarly, we remain favorable on Bitcoin, as its integration into the global financial system continues.

With Chinese credit growth rolling over, the breathless rise in commodities may be in for a pause. Oil prices appear to be consolidating, after reaching extremely overbought conditions now that OPEC is considering to progressively raise production. This could offer an opportunity to add to exposure to oil companies, which remain very attractive in our view.

Macroeconomic Context

Leading indicators still suggest growth will remain strong in the short term



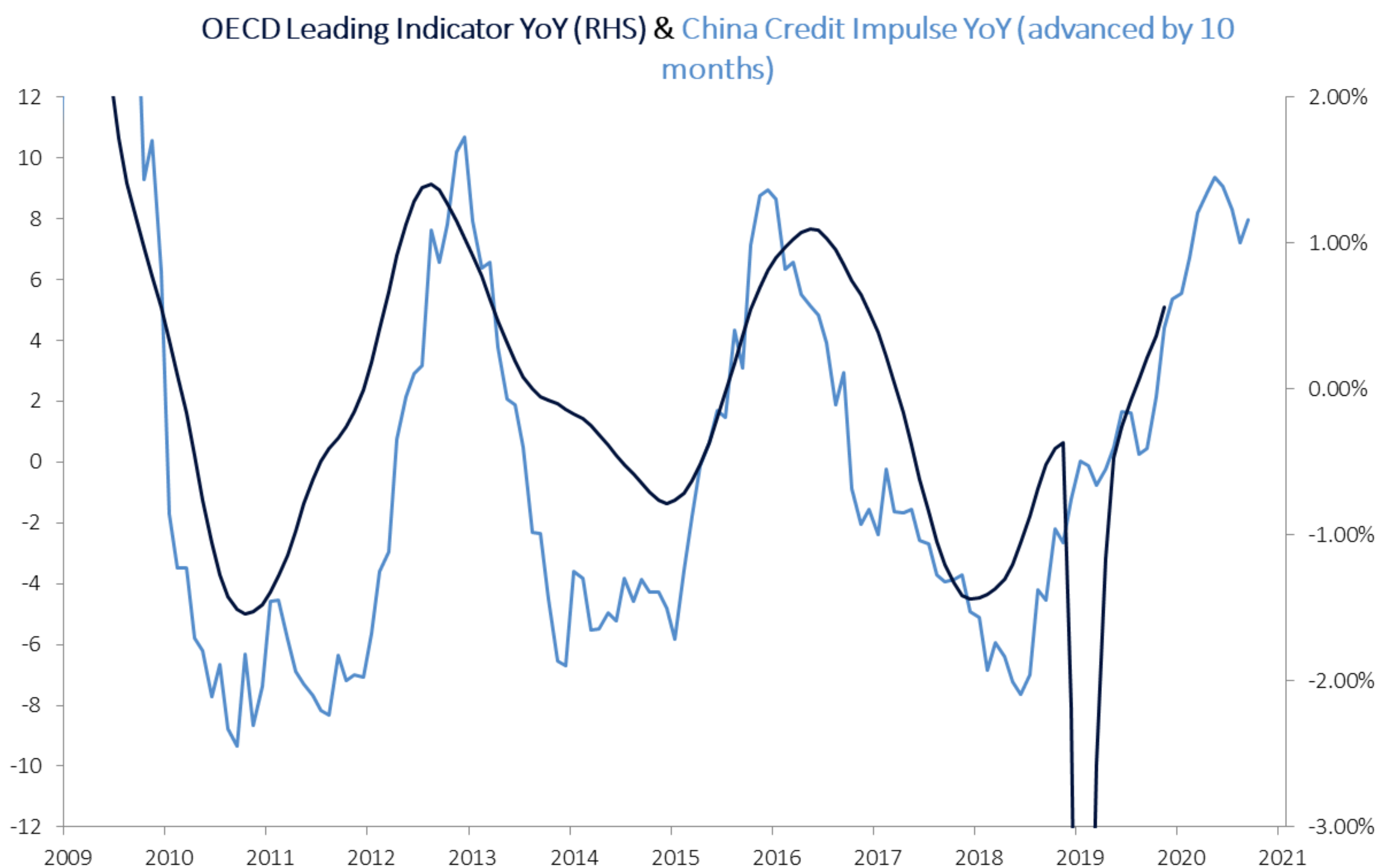


The global economic rebound has been remarkable and leading indicators such as German manufacturing and South Korean exports continue to point toward resilient growth and a recovery in corporate profits. The next few months will see large base effects kick in and growth will start slowing down later this year.

Manufacturing activity has been the main contributor to the recovery recently as economies partially reopened and inventories had to be rebuilt. However, going forward, the lagging services industry is likely to be the main contributor provided economies fully reopen, which would release pent up demand. Interestingly, while most major economies continue to see improving growth, Chinese activity (red line), although still resilient, has been underwhelming in the last few months.

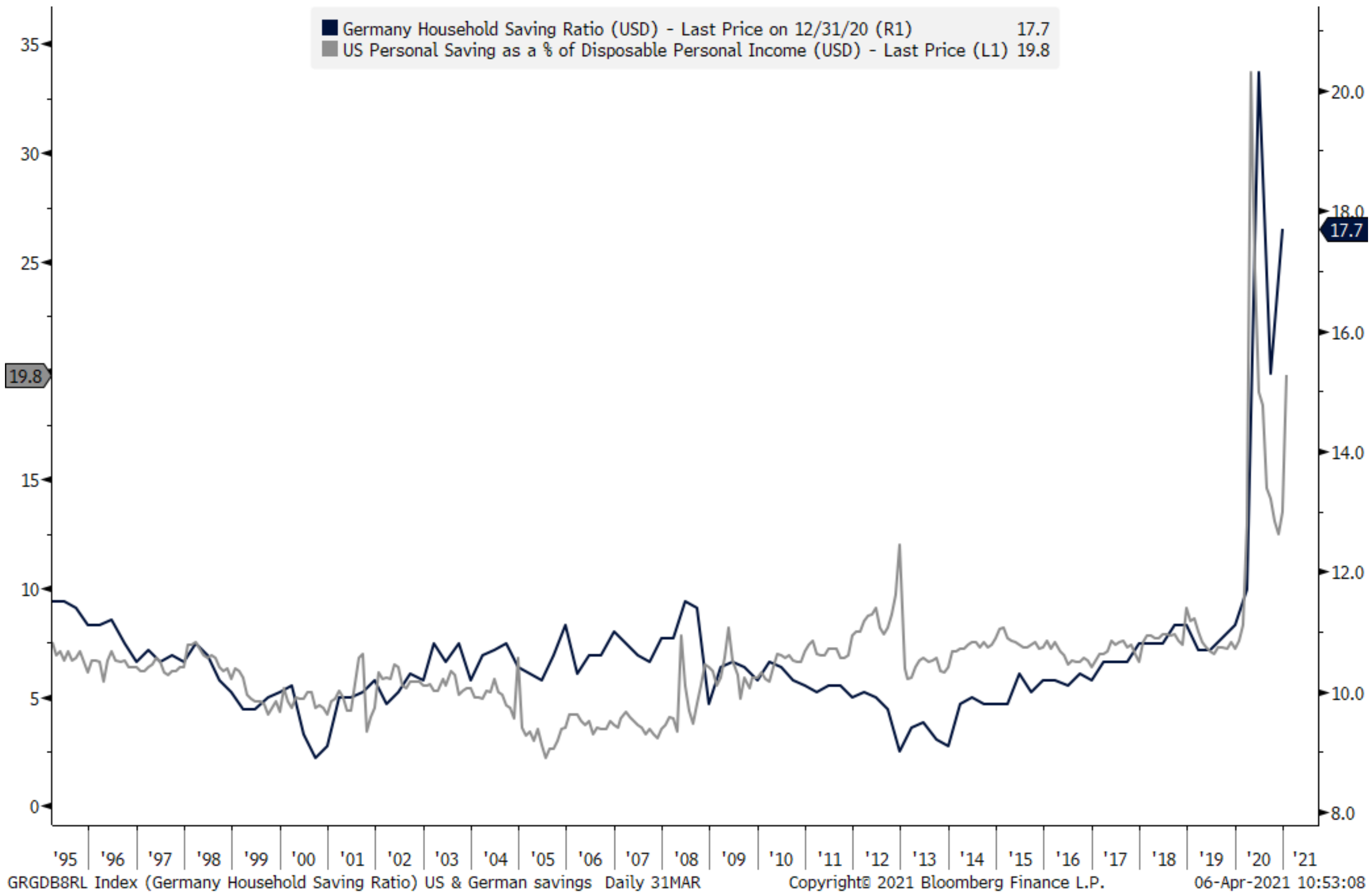
But Chinese credit growth points toward a peak in Q3

Another key leading economic indicator, the Chinese credit impulse, is rolling over and starting to flash warning signs. This suggests that growth could start to slow down toward the end of 2021. The importance of the Chinese economy cannot be overstated at the global level and its recent relative weakness should be carefully monitored.



The savings cushion is a big part of the confidence in the recovery

The market's belief in the continued strength of this recovery is also dependent on consumers spending the large savings cushion created by the combination of government support and reduced opportunities to spend. The chart below illustrates this situation, with German and US households savings ratio at record highs. A successful vaccine rollout and full economic reopening will be required for this to materialise. From this lens, developed markets are in a better position than EMs (vaccine access, more government support), while the US stands out given its successful vaccine rollout.



Inflation set to rise on base effects but will it be durable?

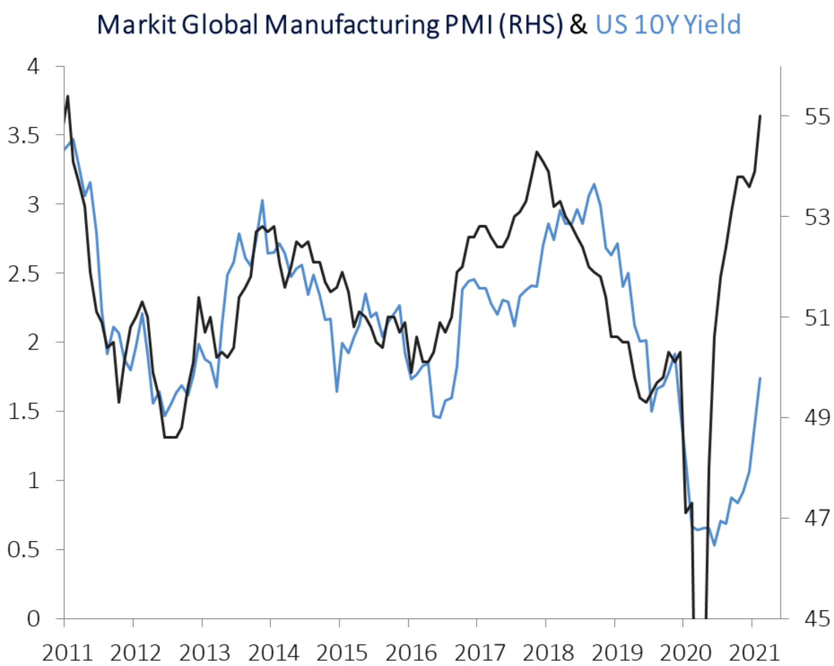
With raw materials prices rising significantly, it is no surprise that surveys point toward further increases in input costs for manufacturers (green line).

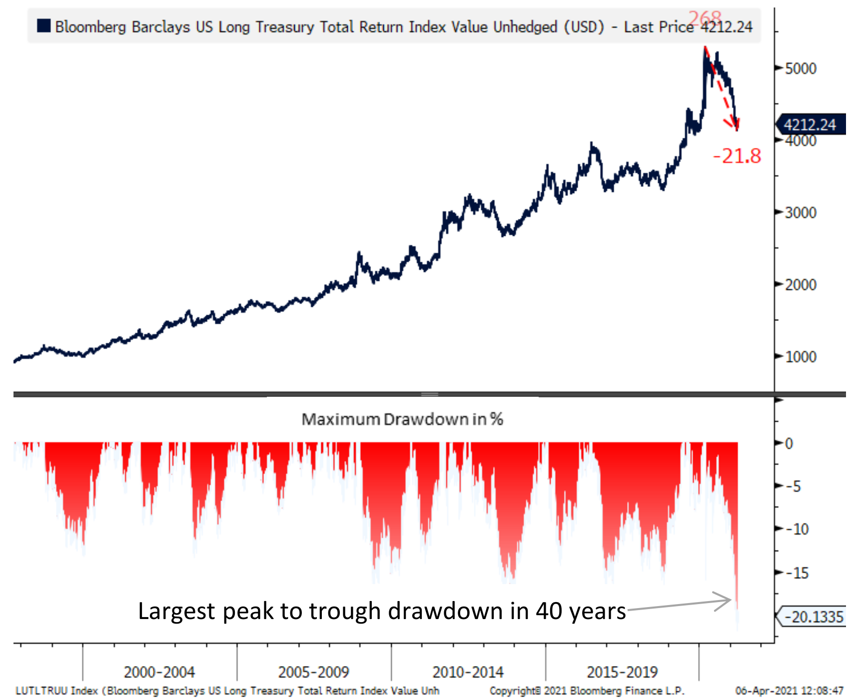
Part of the increase may end up pressuring corporate margins, but most of the bill usually ends up being paid by consumers. This is why CPI is likely to follow in the coming months, especially with base effects kicking in in April.

The market has of course already anticipated it, with US inflation expectations rising to a 7-year high of 2.55%, creating significant pressure on the bond market (see next slide).

The most important question is whether inflation will durably rise. Credit Suisse has recently argued in favour of enduring inflation given the bull market in commodities, the slow retreat of globalisation and the rise in union membership that should push wages higher. More generally, the prevalence of fiscal spending and its more direct link to the real economy (compared to monetary stimulus) could indeed mark a turning point for inflation.

Long term yields are reacting to the strong economic rebound



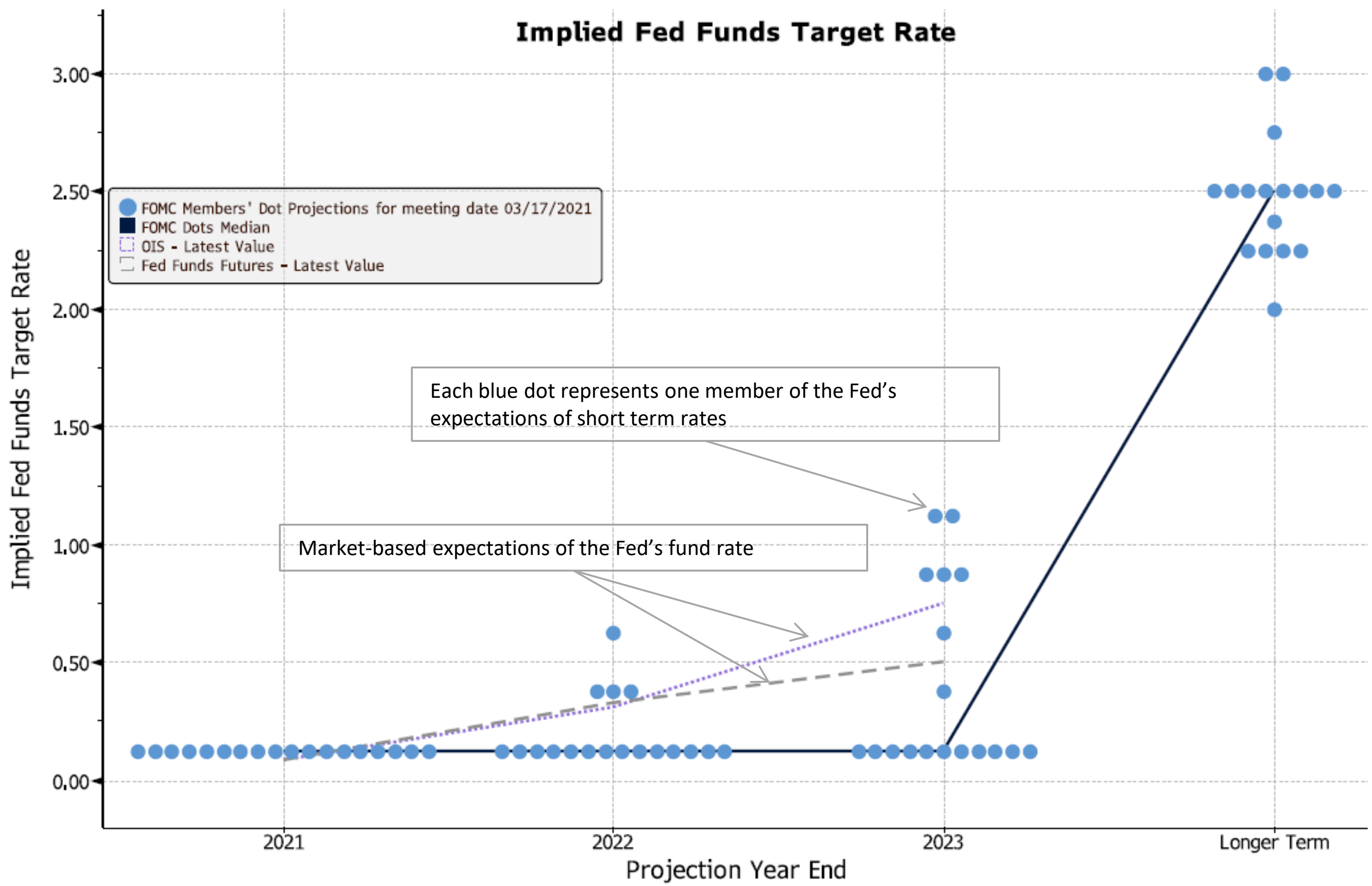


The significant economic recovery and rising inflation fears has pushed long term yields higher, with the US 10Y rising from 0.9% to 1.75% in 2021 (light blue). The level of the Global Manufacturing PMI (dark blue) suggests that long yields could still have further to go on the upside .

On the other hand, even though the rise in long term yields may have been a simple normalisation to pre-Covid levels, the resulting correction in long term bond prices has been extreme. The Bloomberg Barclays Long Treasury Index has gone through the largest pullback in 40 years (right hand chart). As the graph illustrates, previous similar instances of deeply oversold conditions have historically coincided with at least a short term high in yields (low in prices). Should yields continue their ascent, central banks will likely be forced into action; the ECB has already announced that it would ramp up purchases of bonds.

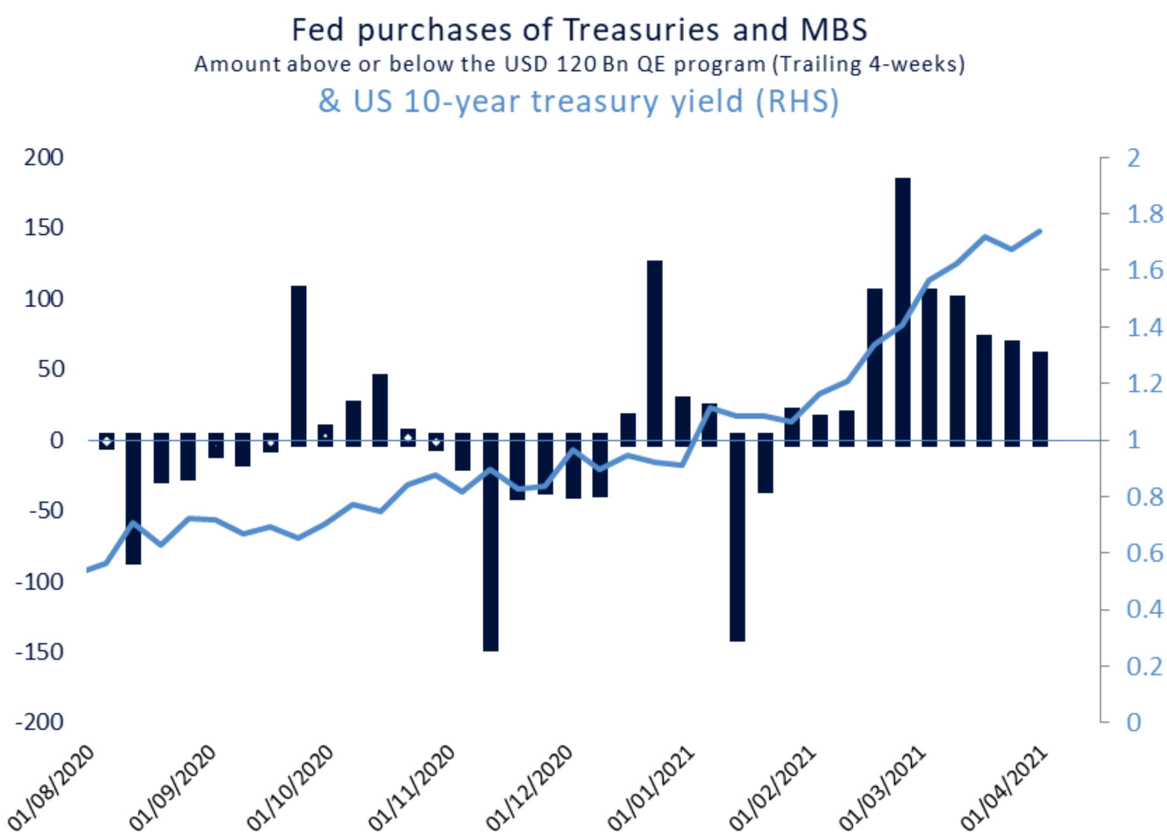
The Fed ready to stay "behind the curve"

The Fed has recently revised growth and inflation forecasts higher and yet maintained its guidance that rates will remain unchanged until the end of 2023. This solidifies the notion that the Fed is comfortable staying "behind the curve", i.e. letting the economy overheat without adjusting its policy, a big shift from historical patterns and a major tailwind behind the market's exuberance. Interestingly, Powell's speech has not managed to convince bond markets, which continue to bet that the Fed will have raised rates two to three times by the end of 2023.



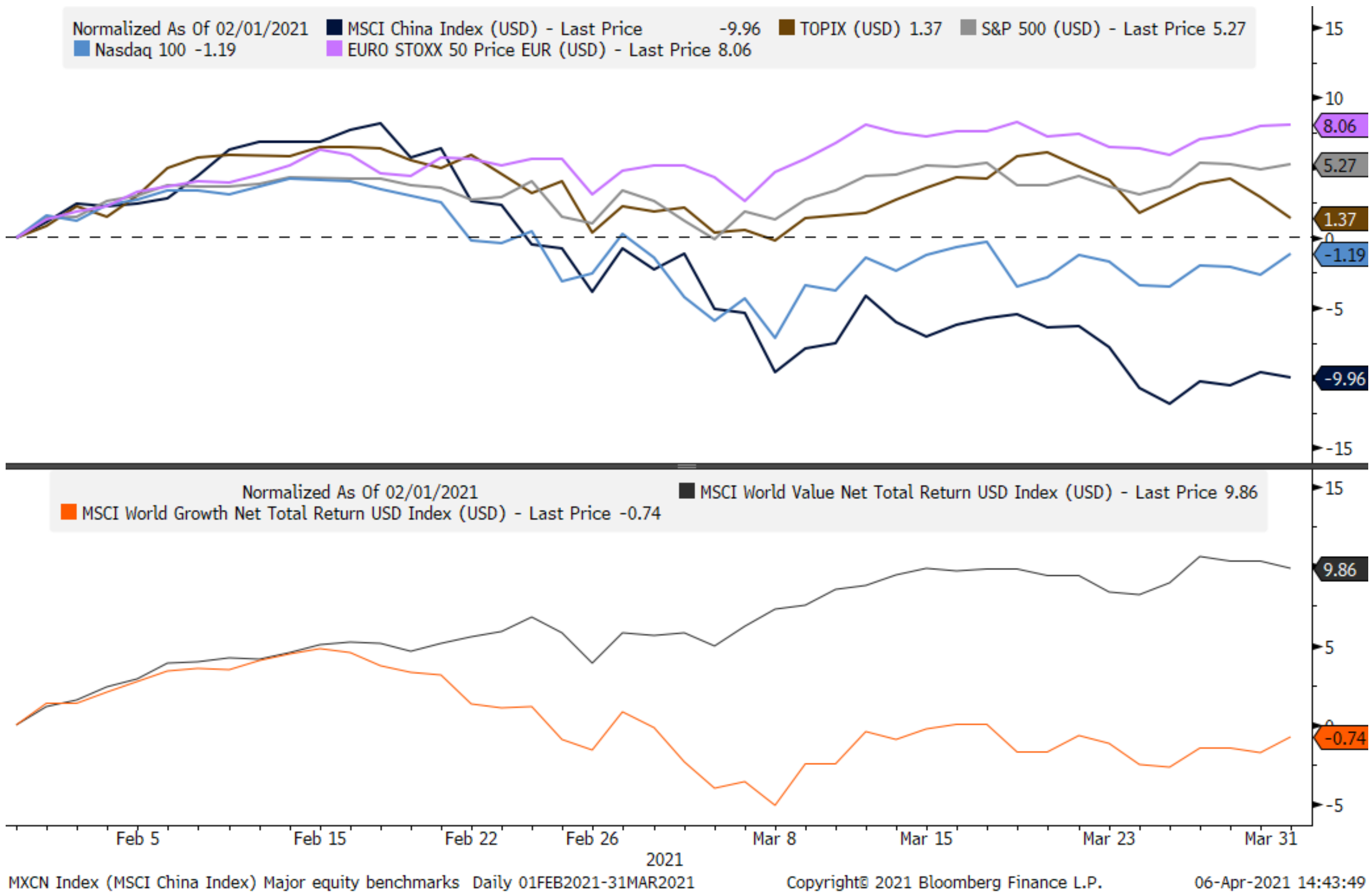
The Fed has “discretely” acted to moderate the rise in yields

The Fed may have expressed little concern at the rise in long term yields, but its actions suggest otherwise. As the graph shows, treasury purchases have been comfortably exceeding the target of USD 120bn per month recently, just as long term yields were accelerating higher. With debt levels skyrocketing (from already elevated levels) over the last year, and governments ready to keep the fiscal spigots open, central banks are going to be under tremendous pressure to avoid a disorderly rise in yields. The ECB has already announced that it would ramp up its bond purchases in the next few months, although refusing to call it “yield curve control” yet.



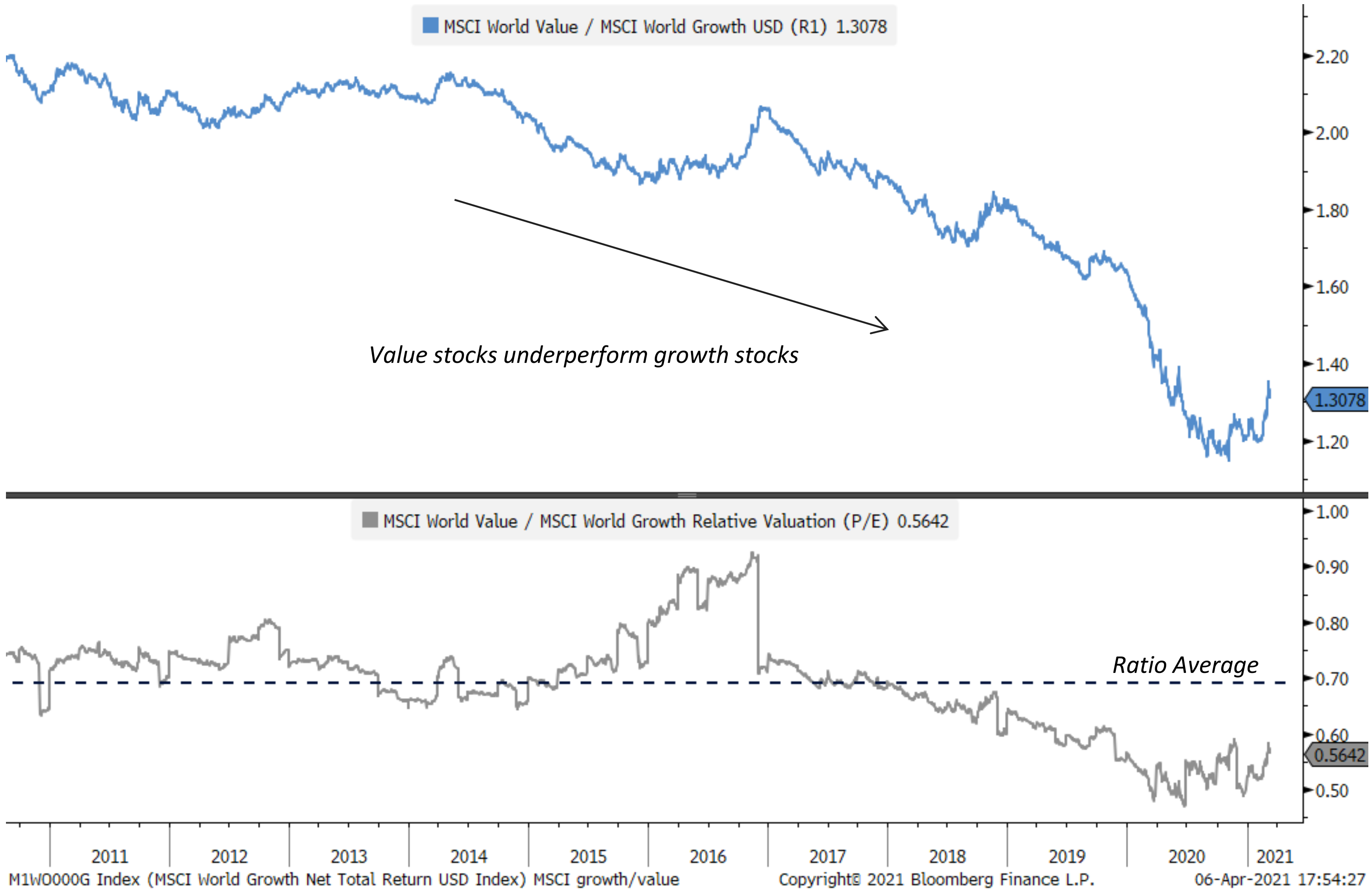
The rise in yields has favored value over growth

The rapid rise in yields has exerted pressure on the equity markets, with a higher growth bias. For example, the Nasdaq 100 was still down -1.2% as of the end of March, while the Euro Stoxx 50, with its highly cyclical bent, was up a comfortable +8%. This dynamic is well illustrated in the bottom part of the chart with the global value and growth indices. Overall, global equities have remained quite resilient to the march higher in yields.



The value trade can take a breather but it still has room to run

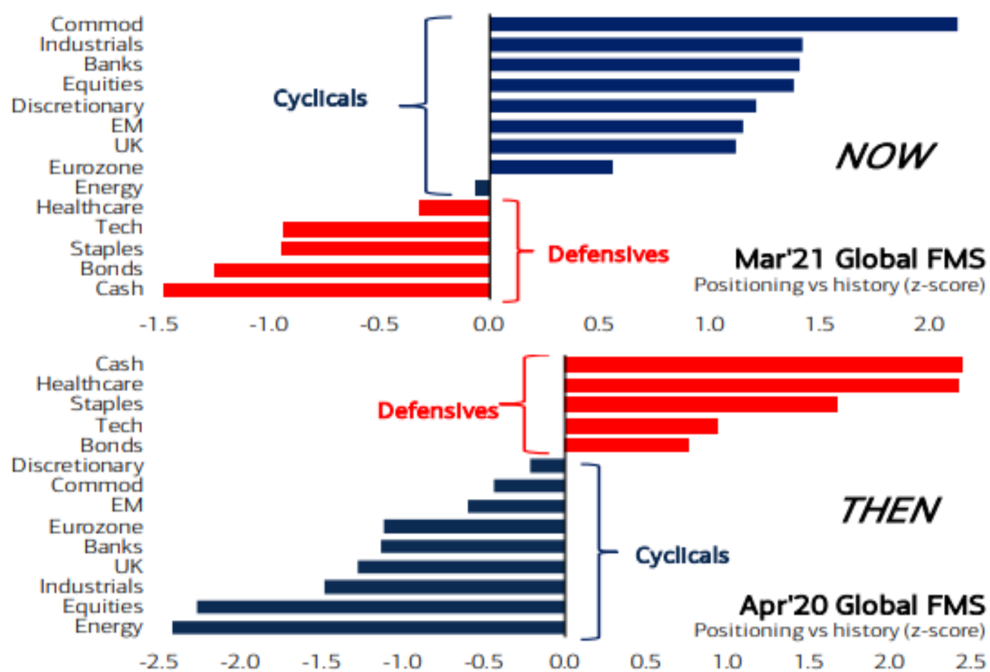
From a valuation standpoint, global value stocks still trade at a significantly greater discount to global growth stocks than the 10-year average. This suggests that recent trends are likely to have further to go. However, as the next slide shows, positioning has become very tilted toward the cyclical/value trade and with yields likely to stop rising in the short term, growth stocks could retake the lead.



Investors are very bullish and heavily betting on cyclicals

The latest Bank of America Fund Manager Survey shows that investors have continued to pile into the recovery trade. The turnaround in positioning compared to April 2020 (see below) could not be clearer, as investors are heavily positioned into equities and cyclicals in particular, confirming the various extreme sentiment readings (see next charts). Investors have the highest exposure on record to commodities, while they have scaled back their technology exposure to the lowest overweight since 2009. In addition to adding to large and highly profitable tech names, investors should look towards out of favour defensives, such as healthcare stocks and staples.

Chart 1: FMS shows cyclical consensus is "cyclical" vs "defensive" a year ago
BofA FMS positioning vs history z-scores



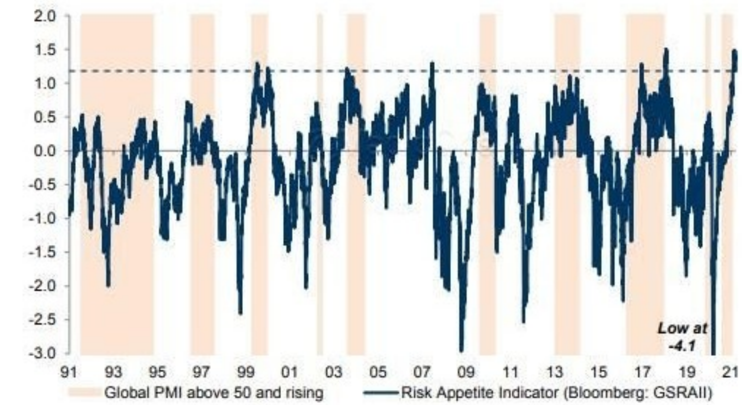
Source: BofA Global Fund Manager Survey

Exuberant sentiment as central banks are ready to overstimulate

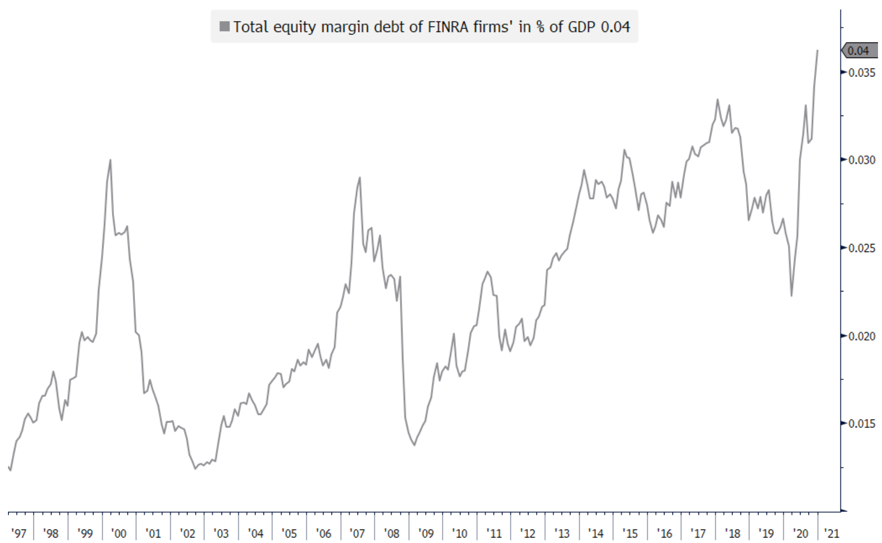
Heavy positioning and exuberant sentiment are key concerns in the current environment, especially given that valuations are not exactly cheap. Some red lights are:

- Goldman Sachs' Risk Appetite Indicator is at an extreme that has historically warranted caution;
- Margin debt has risen significantly in the last 12months, suggesting excessive speculation;
- Short interest on individual stocks is at a low last seen in 2000; this implies less liquidity during corrections (no short positions to cover!)

Exhibit 9: Our Risk Appetite Indicator has been close to all-time highs since February

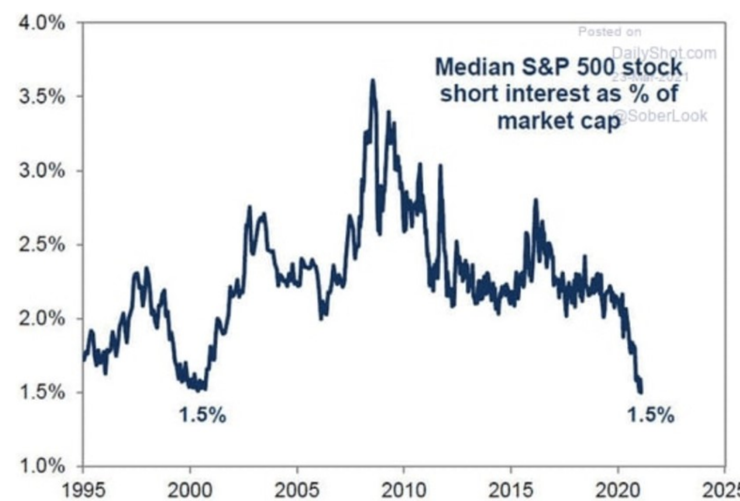


Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research @MacroOps



Source: FINRA, Bloomberg

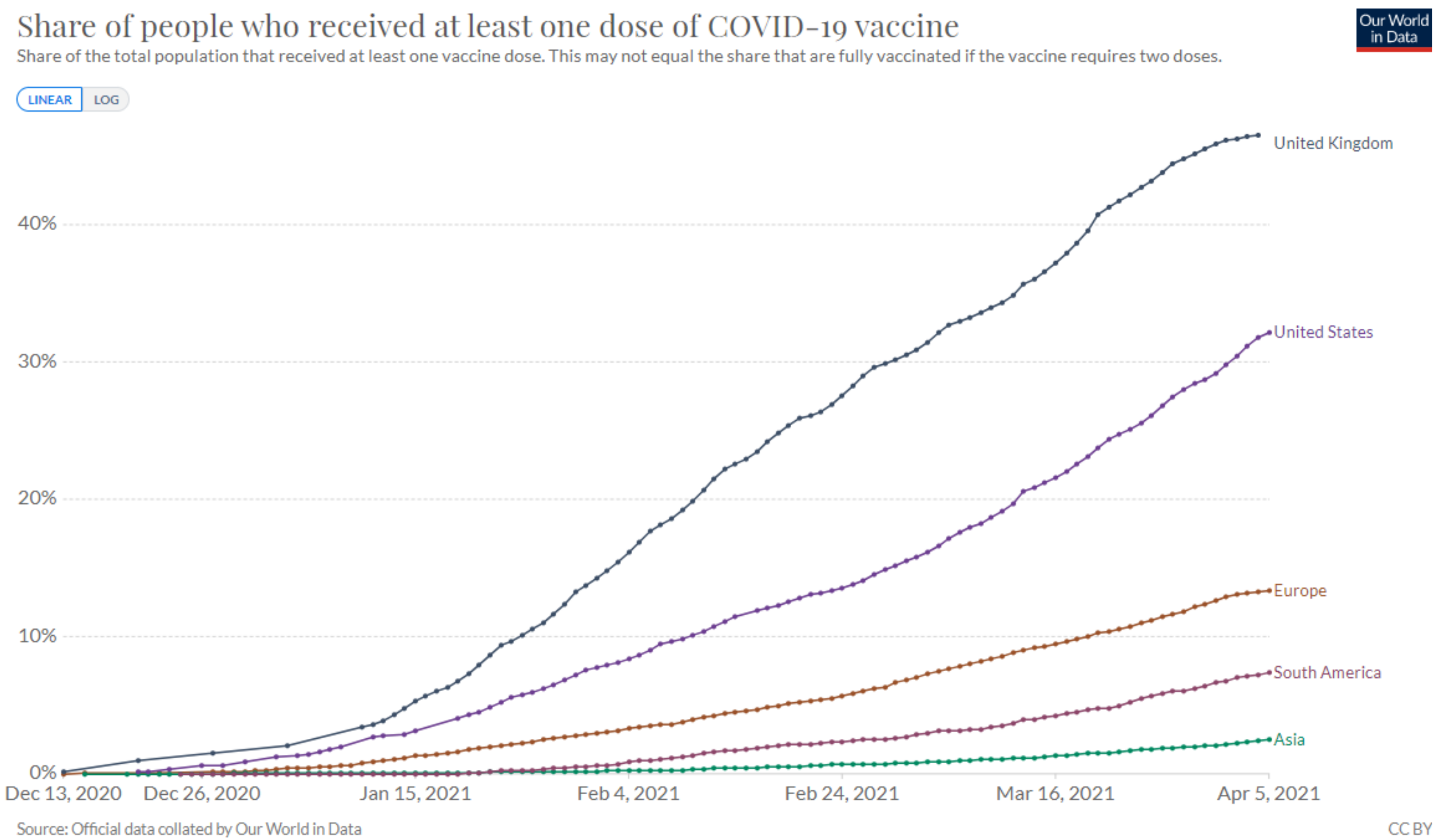
.MARGDEBT G Index (MARGDEBT) Equity margin debt Daily 01JAN1997-10FEB2021 Copyright© 2021 Bloomberg Finance L.P. 06-Apr-2021 12:53:39



Source: FactSet, Goldman Sachs Global Investment Research

Short term growth path largely dependent on vaccine rollout

The growth picture for the rest of the year seems to be largely dependent on the vaccine rollout. On that front, the US and UK are far ahead, while the situation in Europe has been disappointing, with many countries forced to extend lockdowns. Emerging markets are generally more at risk, given that many have not secured supplies and might also face distribution issues.



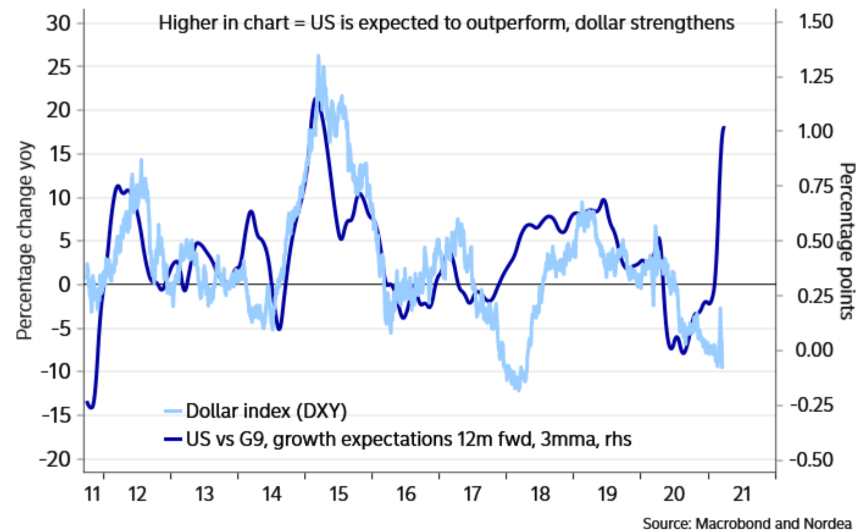
Short term growth expectations have been pushing the USD higher

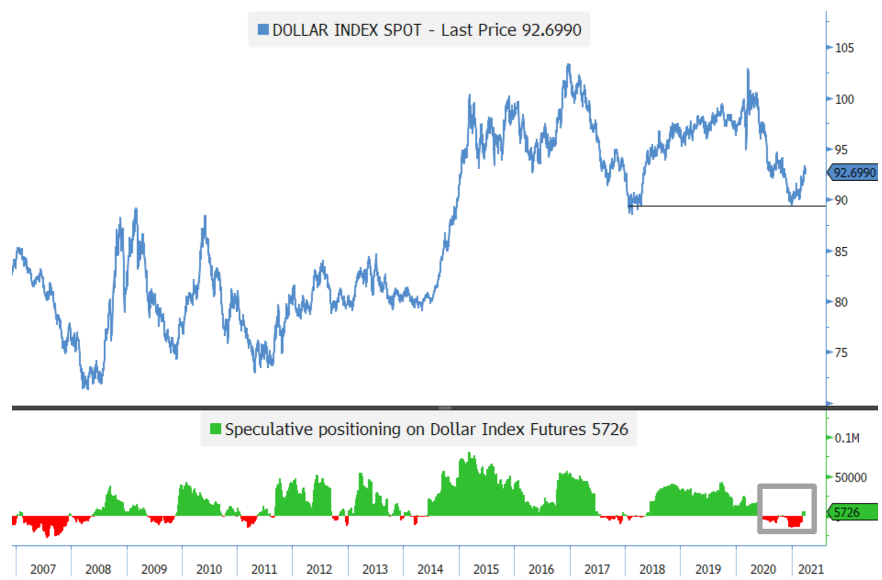
As we have pointed out and is well illustrated below by Nordea, the growth differential between the US and other major economies (dark blue) has turned in favour of the US.

This is a combination of an effective vaccine rollout and the continued large fiscal support, with almost 4 trillion USD of fiscal spending announced in 2021. This dynamic remains favourable to the dollar in the short term.

The US dollar has been rebounding for the last few weeks, forcing the broad consensus to cover their large short positions (lower part). This process could have further to go given the still neutral positioning.

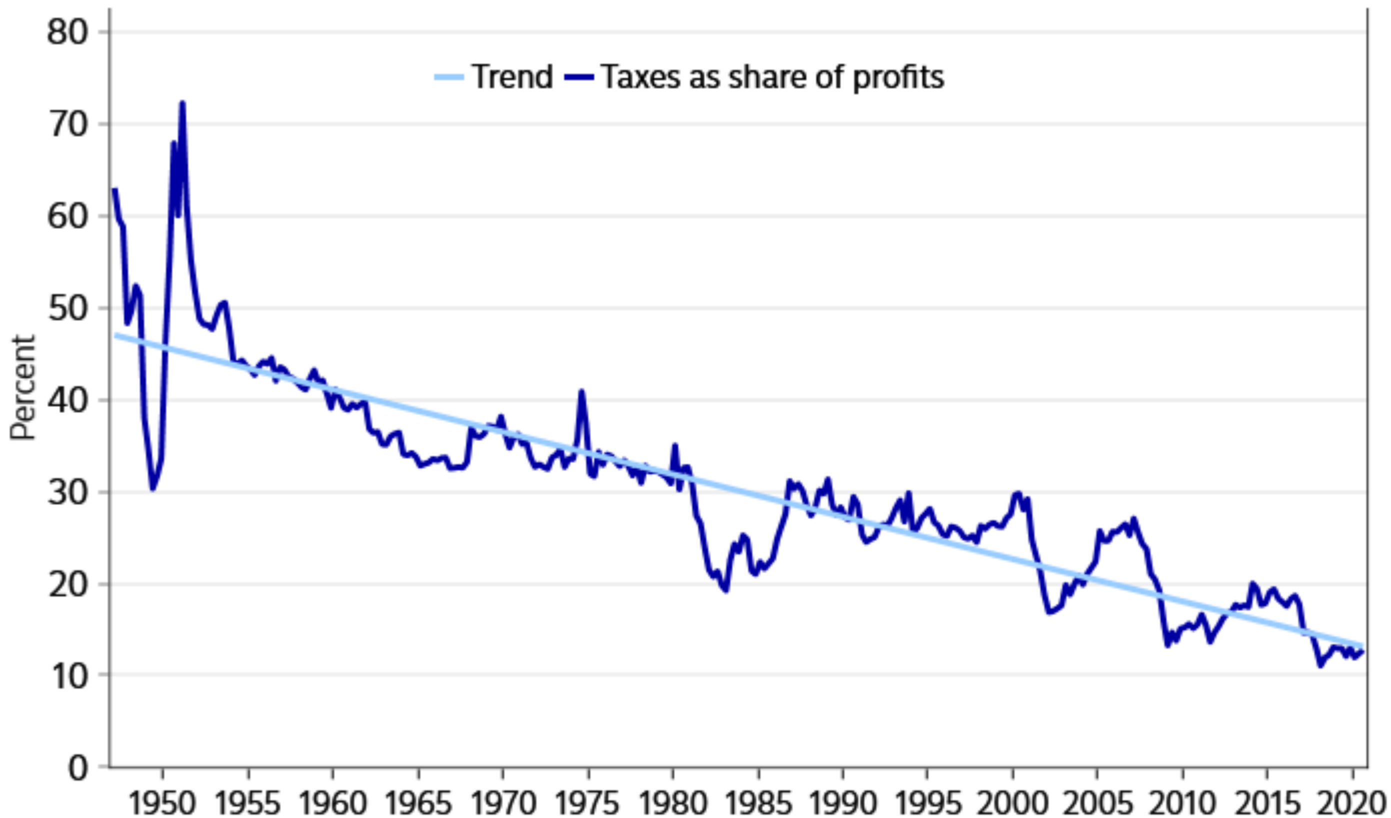
However, fundamentals remain heavily tilted against the USD over the medium term, given expanding trade and budget deficits and a resumption of its decline should be expected once positioning is adjusted.





Higher taxes to pay for the spending spree

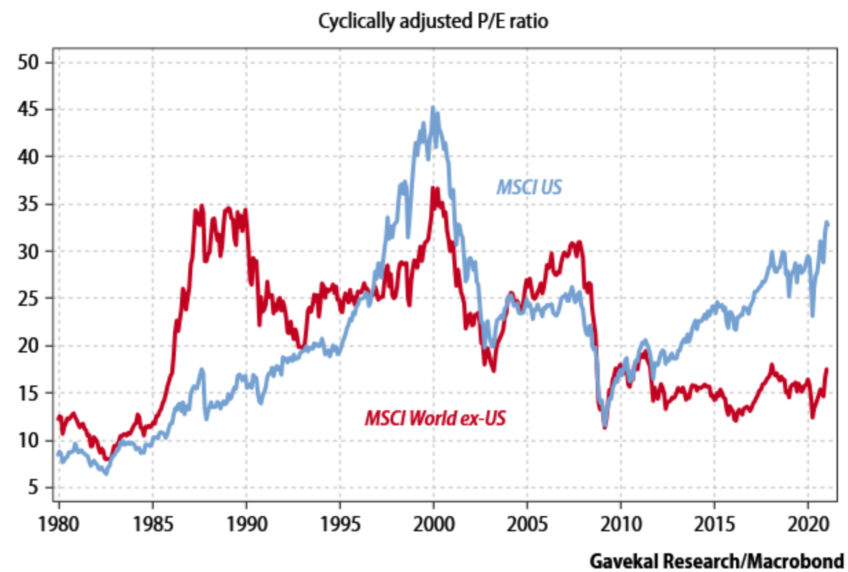
The risk of higher taxes to pay for governments' recent (and upcoming) fiscal profligacy cannot be ignored. The recent USD 2.2tn infrastructure bill of the Biden administration is proposing to raise corporate taxes from 21% to 28%, the first major tax hike since 1993. Moreover, Janet Yellen is pushing for a global minimum tax rate for corporations. Additionnally, raising taxes on wealthy individuals and corporations would help tackle the inequality issue, which has only gotten worse in the last year. Markets appear to be oblivious to this risk for the time being, even though it appears to be materialising sooner than expected in the US.



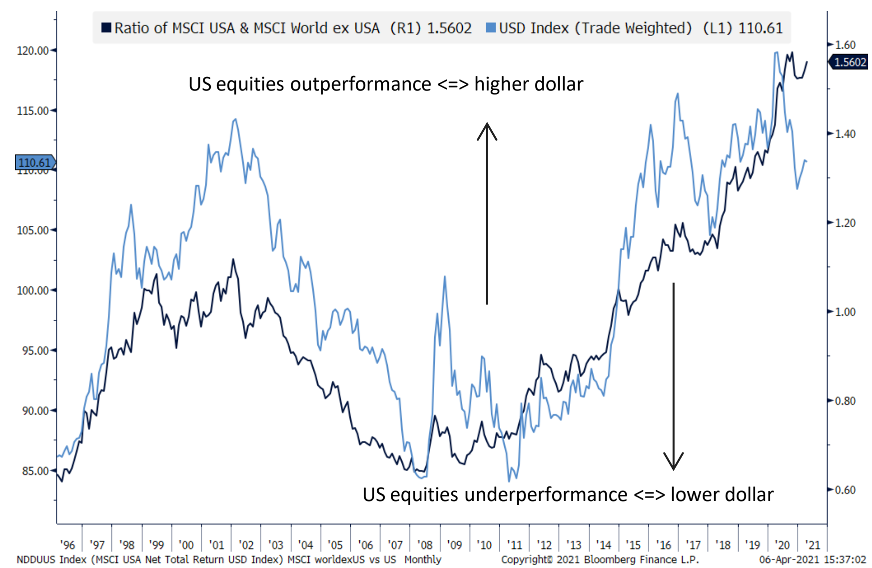
Source: Macrobond and Nordea

Global markets ex-US remain much more attractive

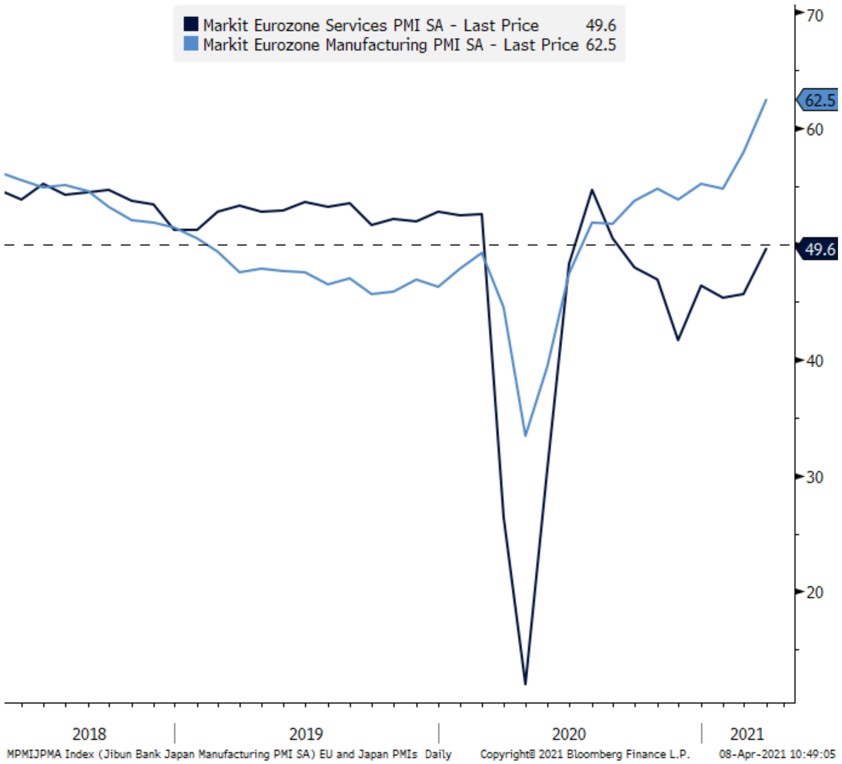
While the short term appears to be favouring the US economy and the USD, US equities are expensive and long term strategic allocation should still be tilted toward other markets, which are far more attractively priced.

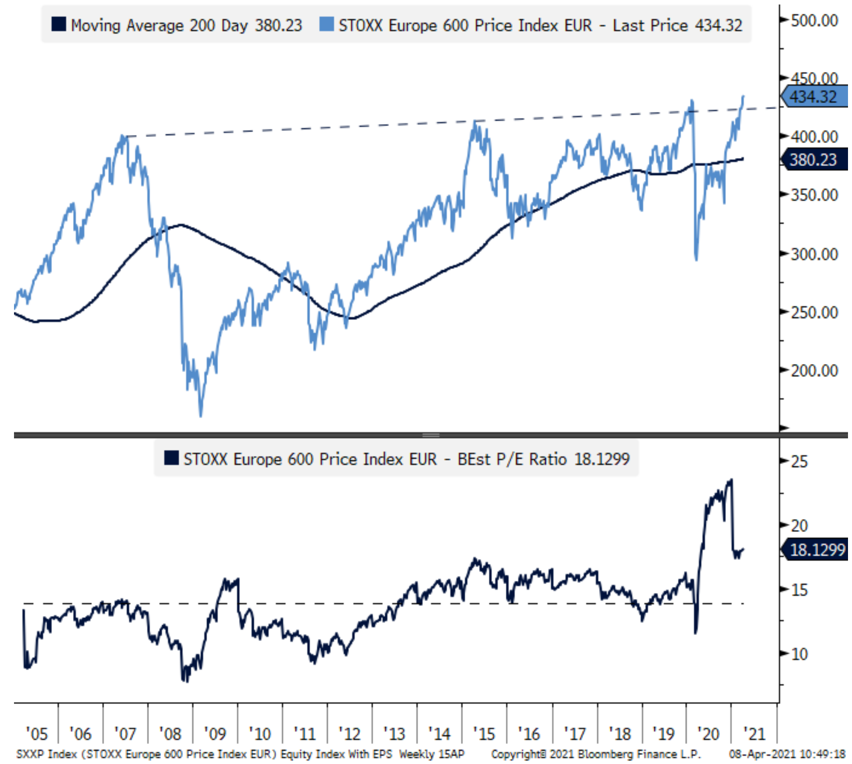


Moreover, a resumption of the decline in the USD would be consistent with the end of US market outperformance over the rest of the world.



European markets are overstretched and risks abound



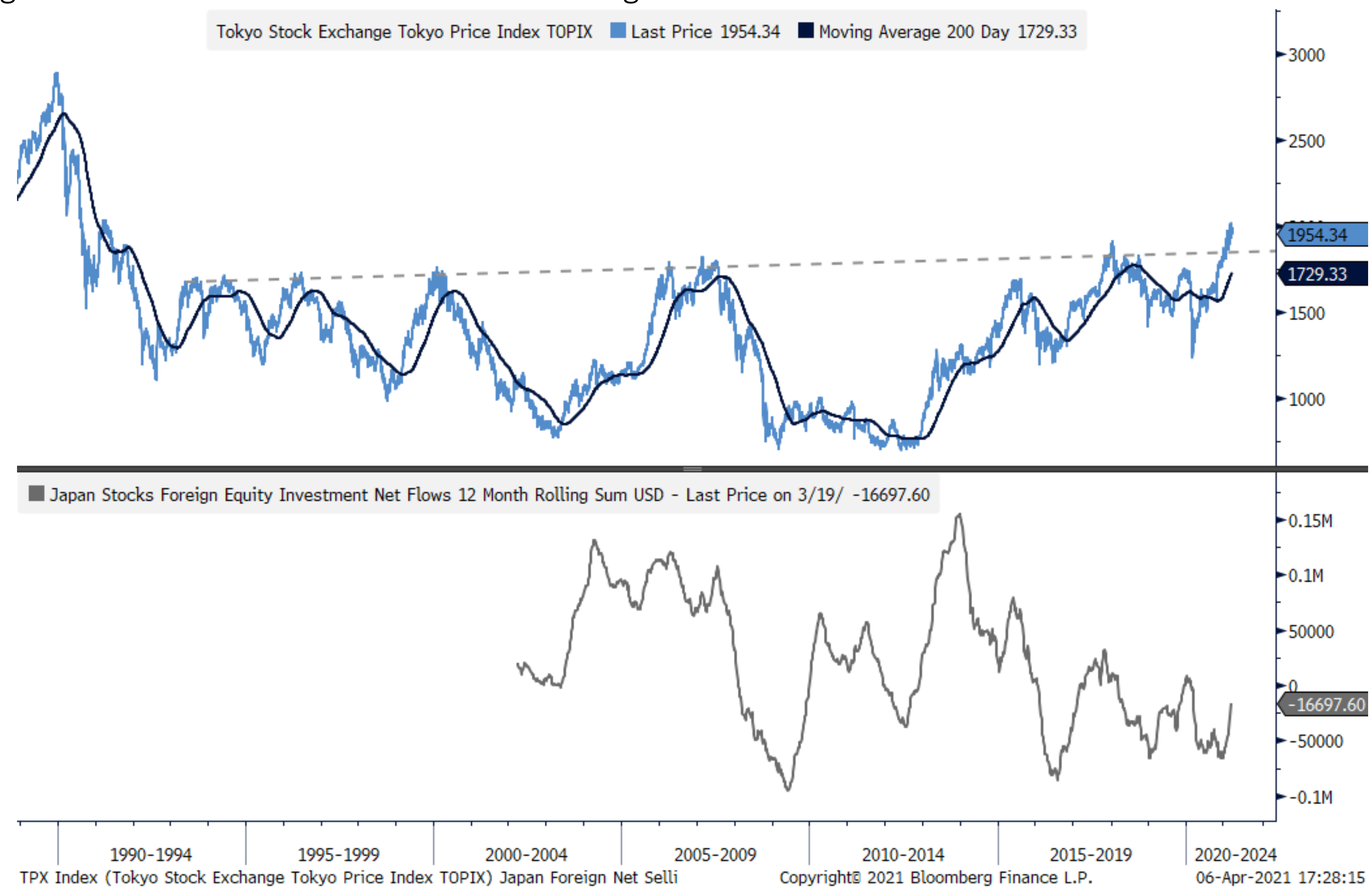


Although Europe has been able to secure enough doses for its entire population, its vaccine rollout has been particularly disappointing, with only 13% of its population vaccinated so far compared with 45% in the UK and 32% in the US. This underwhelming performance has forced many governments to prolong lockdowns, risking to slowdown the emerging recovery in the services industry (dark line, left chart).

There is hope that April and May will see a significant pick up in vaccinations, which seems to be what the equity market has been betting on, helped also by the global cyclical recovery. The pressure valve for lower EU relative growth expectations has been the currency but, given high valuations and short term risks, we fail to see what could push EU equities higher in the short term.

Japan is still one of our favorite markets

Japan remains one of our favorite developed market given its exposure to the global recovery, still reasonable valuation, rising shareholder friendliness and significant cash buffers on corporate balance sheets (55% of companies are net cash!) that are ready to be distributed through buybacks or dividends. Contrary to other markets where positioning seems to be extreme, foreign investors have only started to return to the Japanese market (lower chart) and flows remain negative over the last 12 months. The fundamental picture is confirmed by the significant breakout from a multi decade-long resistance.



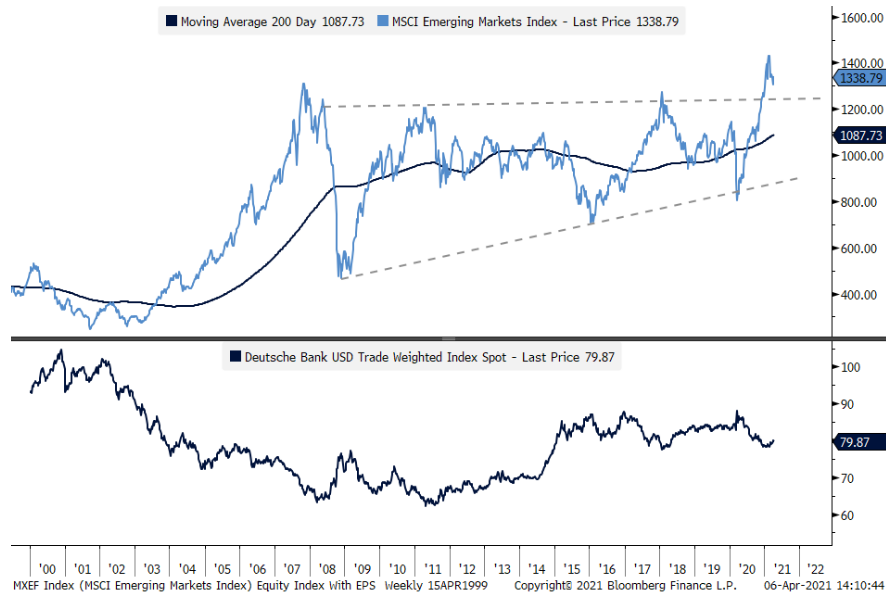
Short term consolidation for EM as yields and the USD rebound

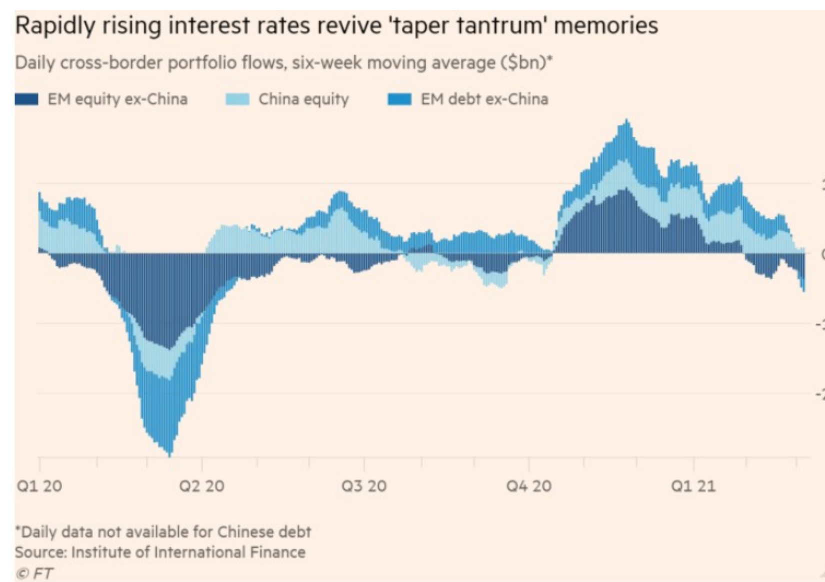
The rise in the dollar and US yields, combined with regulatory pressure on Chinese tech giants, have triggered a much needed consolidation in the MSCI Emerging Market Index, which has gone through a historic rally from the March 2020 lows.

We consider this correction as a necessary and constructive part for the EM bull market, which had become too much of a consensus call for comfort.

Fears of a 2013-style taper tantrum have led to the first outflows in months but we do not consider this scenario as likely (see next slide). The main concern is that many EMs have not secured vaccine supply and could be at the mercy of additional waves in the coming months. Countries with large export industries and little reliance on tourism remain more attractive in our view.

Therefore, further consolidation cannot be excluded in the short term, especially if the USD or US yields keep rising but we would see it as an opportunity to add to existing positions, especially if the index manages to stay above the key technical level of 1200.



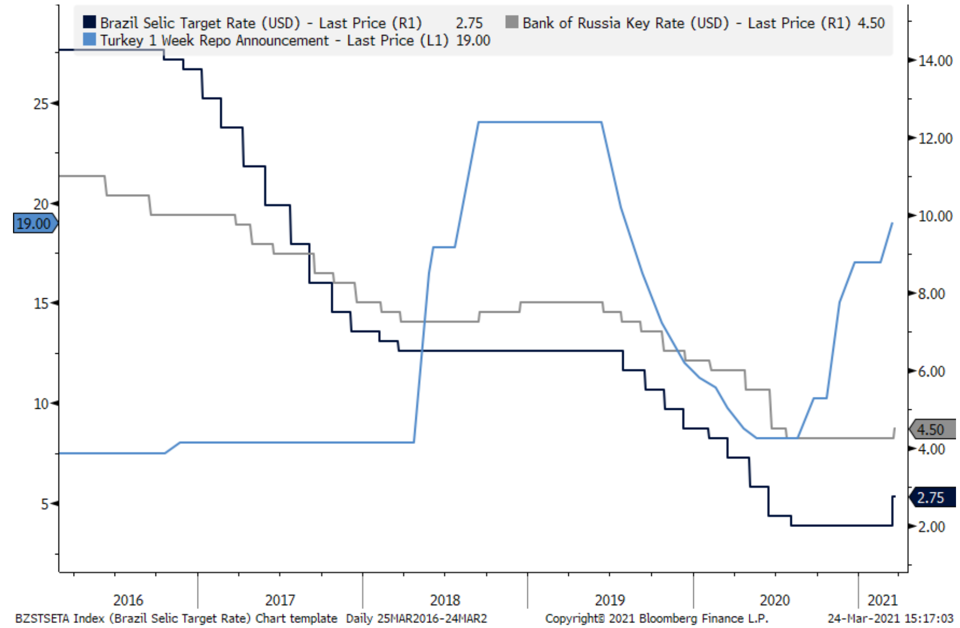


Risks of another taper tantrum appear moderate

The combination of a rebounding USD, rising yields and inflationary pressures is not exactly constructive for some emerging markets. The central banks of Brazil, Turkey and Russia raised their key interest rates, in order to fight currency weakness.

While caution is on the rise, serious contagion risks remain moderate in Asia, as many of the historical weak links appear to be in a much stronger position than in the past, thanks to higher FX reserves and improved balance of payments (e.g. India and Indonesia).

Moreover, as the table reminds us, government debt levels are still at decent levels in most emerging markets, while their bonds offer compelling yields compared to developed market equivalents. We still focus our allocation to EM debt in Asia.



	Current account latest (% of GDP)	Change in current account versus vs. mid-2013 (pp of GDP)	FX reserves over ST external debt (^)	Change versus mid-2013	Current inflation rate, %yoy	Inflation rate vs. mid-2013 (pp change)	Foreign holding of government securities(*)	Change in holding vs. mid-2013 (pp change)	Government debt as % GDP (**)
CNY	1.9	-0.4	2.5	n/a	-0.3	-3.0	9.1	n/a	66.5
INR	1.3	6.3	5.3	2.7	4.1	-5.5	2.0	0.4	89.9
IDR	-0.5	2.7	2.8	0.7	1.4	-4.0	24.8	-4.5	41.8
KRW	3.8	-1.7	2.7	0.1	0.6	-0.6	16.3	-1.8	52.2
MYR	4.4	-0.2	1.1	-0.6	-0.2	-2.0	41.2	-13.0	66.0
PHP	2.5	-2.0	9.7	4.4	4.2	1.7	n/a	n/a	52.5
SGD	17.6	1.0	0.3	0.0	0.2	-1.6	n/a	n/a	132.3
THB	5.7	8.6	4.0	1.4	-0.3	-2.6	8.5	-2.7	56.4
TWD	13.9	4.3	3.1	-0.1	-0.2	-0.8	n/a	n/a	39.1

(^) ST external debts as reported to World Bank or local statistics. (*) Foreign holding of government bonds
(**) Government debt for 2021 projected by IMF fiscal monitor (October 2020), Taiwan's debt as per Fitch 2020 forecast
Source: Bloomberg, CEIC, Macquarie Desk Strategy, March 2021

Regulatory pressure and slower credit growth

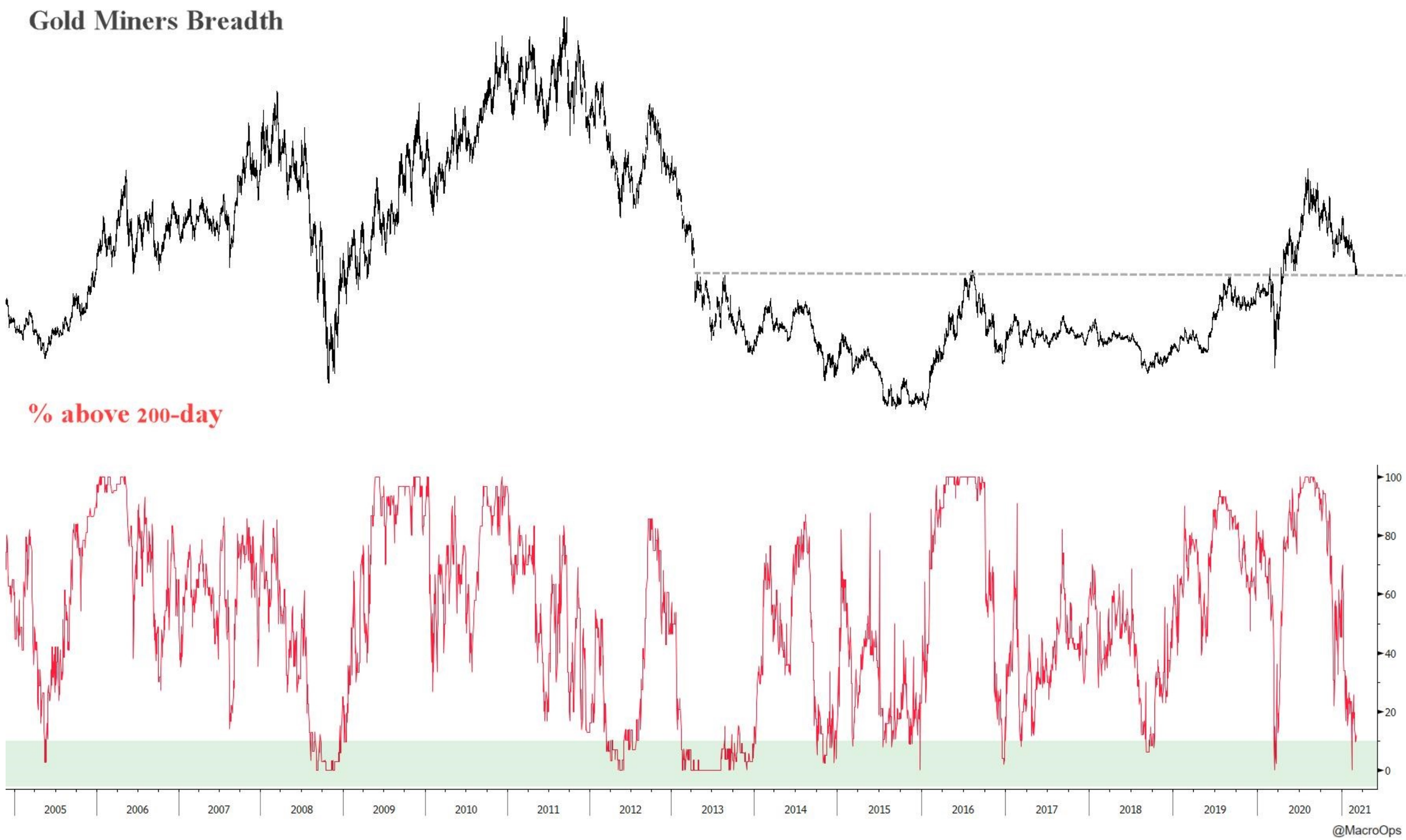
The MSCI China has gone through an -18% pullback, mostly due to the pressure exerted on its tech giants by regulatory measures and rising yields. Moreover, the government has stated that it was wary of financial bubbles and that it intended to moderate credit growth, leading to a slight tightening of financial conditions just as economic data had started to underwhelm. While the longer run remains bright for the Chinese market, which still trades at a 20% discount to global equities (dark line), we don't necessarily expect an immediate recovery to recent highs and the market is likely to test the major breakout level (grey line) of late last year.

Investors throwing in the towel on gold?

Gold has been a major casualty of the recent rise in (real) yields, which we continue to view as temporary. With speculative positioning declining over recent months and flows out of the SPDR Gold Trust (lower part) reaching extremes, it appears that investors have thrown in the towel. This is setting the stage for a recovery in the yellow metal, which has just made a double bottom around USD 1680.

Gold miners have reached extremely oversold conditions

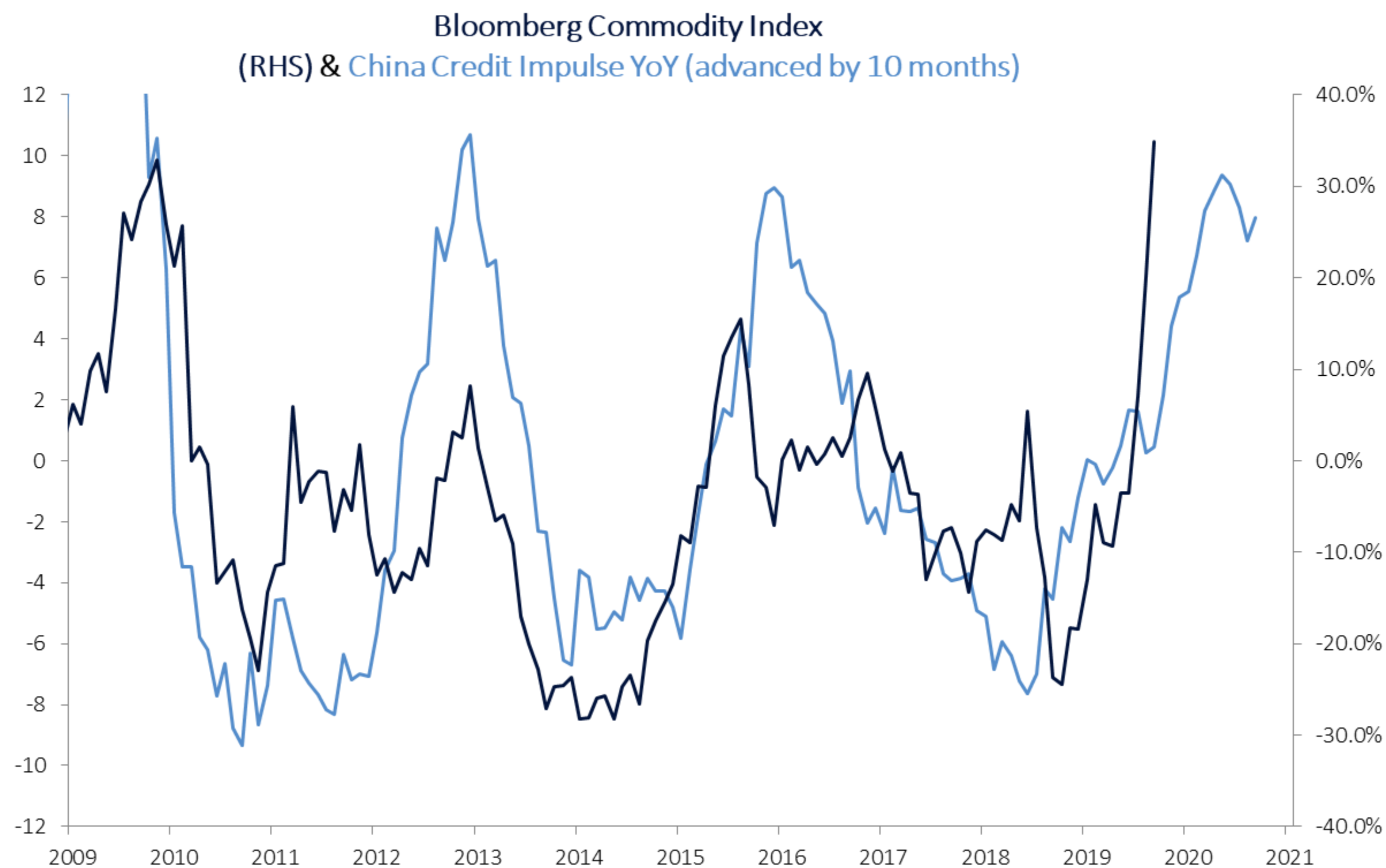
Gold miners have reached extreme oversold territory, as the percentage of companies trading above their 200-day moving average illustrates (lower part). Historically, such readings have often coincided with intermediate bottoms.



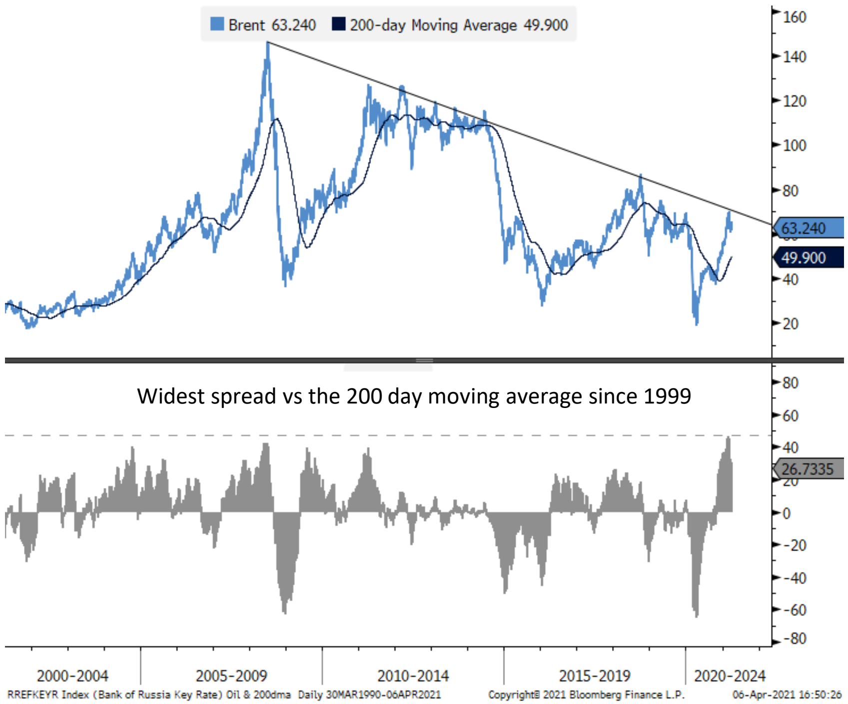
Source: MacroOps

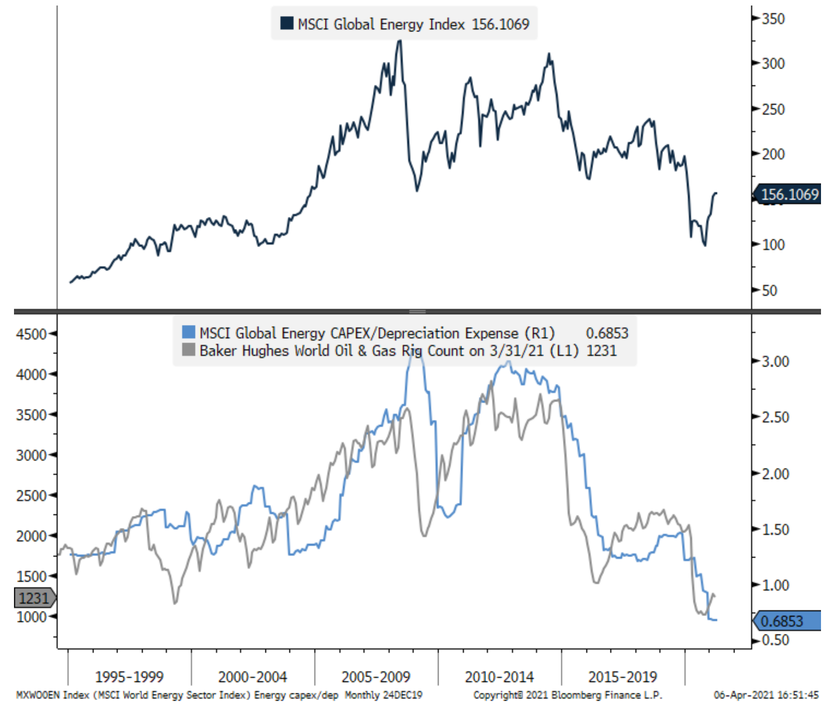
It may be risky to chase commodities here

While it may be tempting to jump in on the commodity bandwagon, the rollover in the Chinese credit impulse growth, which has a remarkable lead on global economic activity and commodity prices, suggests that this rally may be starting to run out of air soon.



Short term weakness in oil prices may offer opportunity to add to oil stocks





Oil prices have pulled back from a key resistance, after reaching their widest spread to their 200-day moving average since 1999, suggesting extremely overbought conditions. This consolidation is also consistent with OPEC announcing that it would gradually increase production again.

While the short term could indeed see some weakness, we remain constructive on oil stocks. As investors have fled the sector in recent years, valuations have overshot to the downside and capex has collapsed (right chart, light blue), which could make increasing supply difficult (particularly in the US). In fact, the supply response to the current rally has been quite modest when looking at the pick up in rig counts (grey line).

Disclaimer

This document has been prepared using sources believed to be reliable. The author and distributors of this document expressly disclaim any and all liability for inaccuracies it may contain and shall not be held liable for any damage that may result from any use of the information presented herein. The statements and opinions it incorporates were formed after careful consideration and may be subject to change without notice. Past performance is not indicative of future results. Values of an investment may fall as well as rise. This document is intended for information purposes only and should not be construed as an offer or the solicitation of an offer to buy or sell any investment products or services. The use of any information contained in this document shall be at the sole discretion and risk of the user, being directed at Professional Clients as defined under the rules and regulations of the Dubai Financial Services Authority (DFSA). Probus Middle East Limited is regulated by the DFSA.

DATA PRIVACY POLICY IMPORTANT NOTICE
PROBUS recognizes the importance of keeping the personal data of its customers and other counter-parties confidential and protecting their privacy rights. As a consequence, PROBUS has adopted a global privacy policy consistent with applicable standards. Our Data Privacy Notice can be found using the following url: https://www.probus-group.com/data-privacy-notice