

Perspectives

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IN SHORT

- Fears have shifted from inflation to growth in recent weeks
- While we may be past the peak in growth in the US and China, we expect data to hold up over the coming quarters
- We believe the cyclical trade has more room to run, as data proves solid and inflation remains higher than anticipated

Pick your scary story

These past few weeks have seen an interesting shift in investor fears, from inflation to growth, and back again – with a dose of Delta variant fear added to the mix. Indeed, growth is likely to have already peaked in the US and in China, stoking fears that a slowdown will lead to a sell-off in markets. However, although we may be past the peak it does not mean that we are late in the cycle, nor that we are set for a sharp deceleration. We expect growth to remain strong for a number of quarters ahead and believe markets will come back to this view over the coming months as data confirms underlying economic strength. Moreover, while cases are surging, hospitalisations have not risen to the same extent, especially among vaccinated individuals, suggesting that the link has been broken. In our view, hospitalisation is the factor to keep an eye on. In terms of inflation, it is likely to remain higher than previously anticipated for some time, but the degree of size, length, breadth and impact of the increase is yet unknown.

In this context, we believe that yields are too low and will drift higher as confidence in the recovery returns. Still, the rise could be limited as variant and growth concerns should keep the Federal Reserve accommodative. Overall, we remain cautious on sovereign debt and continue to prefer credit. Credit spreads have broadly remained contained and well behaved despite higher volatility in the equity market, suggesting that calm permeates. We continue to see opportunities in high yield on a selective basis, and in emerging market corporate hard currency debt, where the pick-up in yield remains attractive and spreads have more room to tighten.

Equity markets have oscillated between inflation and growth fears, which should not coexist. We tend to side with the bull case: growth will hold up, the reopening will last and the Fed will err on the side of caution and maintain its accommodative stance, even if tapering is announced sometime in the fall (to begin in 2022). That said, with less visibility for the second half of the year, we expect more volatility ahead, as fears around growth and variants persist, especially as we have already seen the peak in support from fiscal and monetary stimulus, a plateau in vaccinations in the West and the biggest part of the rebound in earnings. Still, while all of these supportive elements remain present, the downside should be limited. Moreover, with a growing 'wall of worry' for investors to surmount, complacency is becoming scarce and positioning has become less aggressive as a result.

As such, we believe the reflation trade should gather steam again and we maintain a preference for Europe, Japan, energy, and financials. Still, we look to maintain some dry powder over the summer to be able to seize opportunities for the latter part of the year, as the coming weeks could remain bumpy.

Asset class details

Equities

The rise in Covid cases due to the delta variant has raised questions about reopening prospects, stalling the reflation trade.

However, with hospitalisations rising only slowly, we believe that renewed lockdowns or stringent measures are unlikely, for now at least, across the West.

With that, peak growth fears have climbed as well. But we expect data to prove solid over a number of quarters ahead, and as releases confirm sustained strong growth, risk assets should move higher still. That said, the second half should prove more volatile than the first, in part because visibility on the outlook has faded.

The Fed's tapering timeline is coming into focus, negotiations on the infrastructure package are ongoing and earnings may not grow at the same speed as in the first half. Still, these supports remain present even if past their peak, which should support equities going forward.

We therefore maintain a preference for cyclicals, which should advance as growth fears recede. We therefore continue to favour sectors such as financials, energy, and materials. We also believe that European markets will benefit from the growth recovery in the second half of the year. Japanese stocks should benefit from improving sentiment surrounding the Olympics and the fact that bad news is priced in, so the second half should be stronger.

Fixed Income

After falling below 1.15%, yields on US 10-year Treasuries have rebounded somewhat, as investors weigh growth and variant fears with the reality of economic strength. Still, we believe that these levels are too low given the current environment, and yields should gradually rise as growth and inflation data remains high.

However, we expect the Fed to remain prudent and accommodative, and believe the European Central Bank will find ways to maintain support to its banking sector and the peripheral countries.

We remain more prudent on sovereign debt and prefer taking credit risk rather than duration risk. The longer duration of IG indices and the very tight spreads suggest less room to absorb higher rates than in high yield, though we remain selective. With high yield spreads widening recently, some opportunities have emerged.

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.

Currencies

The dollar is benefitting from inflation fears and a perceived more hawkish Fed, but the upside may be limited as growth outside of the US picks up and risk-on sentiment recovers. Still, strong growth and earnings, and higher carry should eventually limit the downside for the dollar as well. As such, we expect broad range-trading against major currencies, though some EM and commodity-linked currencies should benefit.

Commodities

With production cuts still in place, oil prices can move higher as confidence in the sustainability of the recovery grows again over the coming months, especially if demand recovers better than currently expected. However, overall supply remains abundant, which 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, along with low real yields, and high medium-term inflation expectations.

Alternatives

Alternatives continue to provide diversification and de-correlation opportunities. We believe that real assets can also help provide income in a world where interest rates will remain lower for longer.

Perspectives

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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