Weekly Digest

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John Wyn-Evans
Head of Investment Strategy

Keep Your Head!

This year I get to greet you on yet another important day in the Welsh calendar, when we celebrate our patron saint, Saint David. As you might imagine, my cup of sporting happiness is running over at the moment, with Everton's Merseyside derby victory followed by the Welsh rugby team's defeat of England on Saturday. Last week's Digest elicited more responses from readers than anything I have ever written, mainly from Liverpool supporters threatening (in jest, I believe and hope!) to "unsubscribe". I could well lose another chunk of readership this week.

If only financial markets were an equally happy place and there was no Covid, life would be close to perfect, but these things are sent to try us, and deal with them we must. On the Covid front, we continue to witness the battle between the three "Vs" – Virus, Vaccines and Variants. Our central view remains that the combination of current restrictive policies and accelerating vaccine distribution will lead to a gradual re-opening of the global economy, although some countries will achieve liberation earlier than others. The UK appears to be in the vanguard, but we must caution that if other countries are insufficiently protected we might end up in the equivalent of an open prison – free to wander, but not able to leave these shores. The latest news about the rogue passenger with the Brazil variant is an example of how even the best laid (?) plans can be scuppered.

The consensus amongst investors continues to support the re-opening trade, and this can be seen in the performance of potential recovery plays. In the UK, they received a strong boost from the Prime Minister's proposed timetable for an end to social restrictions.

However, the really big waves breaking last week were in the bond market, where we witnessed a sharp rise in yields. These moves unnerved investors on at least two levels. First, there is the threat to government finances from higher interest rates. Indeed, this is where rising bond yields can create a negative feedback loop, a phenomenon we have seen before in places like Greece and Italy. Second, and something we have

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alluded to several times recently, is the increase in the discount rate and what this means for the valuation of equities and for investor preferences.

On the valuation front, it is no secret that risk assets have been propelled higher, at least in part, by lower interest rates and bond yields. The mathematical effect of a lower discount rate has been to increase the net present value of future earnings and dividends. A rising discount rate will reverse that effect. However, that does not necessarily mean that equity markets have to collapse. Research from Bank of America illustrates that equities (in this case the S&P 500 Index) have risen during thirteen of the fifteen rising bond yield cycles since the 1950s. The reason for this is that rising bond yields are associated with growth, and growth is associated with higher earnings for companies. The key point is that earnings must grow faster than the valuation de-rating to preserve overall market levels. Although we cannot deny that much of this year's recovery has been priced in already, we are also impressed by the current rate of upgrades to both economic forecasts and earnings forecasts. They are far from suggesting that earnings are going to come under pressure. In fact, growth forecasts remain strong through 2022.

The wrinkle here, of course, is that the nature of growth will change in favour of companies that have been more negatively affected by Covid. These will tend to be more cyclical in nature, and the earnings will be of a shorter duration. Therefore, with rising discount rates also helping shorter duration assets, we should continue to see a rotation within the market that prefers, for example, Resources, Financials and traditional Consumer Discretionary stocks (I say traditional, because the sector also contains Amazon and Tesla – although that is just an observation, not an investment call).

Back to the bond market, then. Why was it so stressed last week? Yields have been trending higher since last summer's trough without imposing unduly on equity markets. This is not entirely unexpected. Last year the bond market feared a collapse into outright deflation, which would have had very negative implications for equity earnings. The recovery from that fear implied a more constructive economic and earnings environment. But now we are reaching what many believe to be some kind of tipping point, at which rising bond yield become a strong headwind.

The only trouble is, nobody knows exactly where that tipping point is. Goldman Sachs has suggested in the past that it's the pace of the yield increase that matters. When US 10-Year bond yields rise more than 39 basis points within a month, watch out. That happened last week. Jefferies posits that a US 10-year yield of 1.5% spells trouble, as that takes it higher than the dividend yield on the S&P 500. That occurred briefly last week, although it has now subsided to 1.41%. That would increase the attractions of bonds relative to equities. JP Morgan is more relaxed, believing that the negative correlation between bond and equity prices will hold up to 2%. MRB Partners think that 2.25% is the tipping point, while BCA Research cannily does not pick a level, but believes that equities will be fine as long earnings growth outpaces the de-rating effect – which is its position.

That's just a small selection of opinions, but captures something close to the consensus, I believe. The truth is, we will only really be able to identify any tipping point in retrospect, especially as this cycle is so different in many ways to any of its predecessors – and a lot of forecasting is heavily based on historical precedent. We are not betting the farm on any single outcome, but trying to have the best balance of assets for the times.

For the more technically inclined readers, I am going to add a little flavour from our bond analyst, Shilen Shah. He commented on Friday on the sharp rise in US bond yields, citing some specific drivers.

“The latest move in the US Treasury (UST) market continues a trend that has been in place since the start of the year. The combination of vaccinations and talk about further stimulus has led to a rise in UST yields. Given the importance of the UST market, the rise in government bond yields can be seen globally, with the UK 10-yr Gilt yield moving from 19bps at the end of 2020 to the current yield-to-maturity of 79bps. The move higher in Eurozone government bond yields also prompted the ECB’s chief economist, Philip Lane, to state that the ECB will purchase bonds "flexibly according to market conditions and with a view to preventing a tightening of financing conditions." (I would also note that the Reserve Bank of Australia kick-started its bond purchasing programme immediately, which helped to take some heat out of the situation. There remains widespread belief that central banks will only tolerate so much yield increase. We just don’t know what levels will force them to act - JWE)

UST yields have moved sharply higher across the curve past the 5-yr maturity band. However, until last night, intermediate dated UST’s had largely remained within a relatively tight trading range. Given the Fed’s commitment to allow a degree of catch-up inflation and not to increase interest rates in the near term, shorter dated UST yields had not materially changed since the start of the year.

However, after many weeks of steepening, the most significant part in yesterday’s sell-off was that the UST yield curve flattened, with the 5-yr UST yield rising by 22bps. One of the catalysts for the sell off at this part of the yield curve seems to have been a poorly received 7-yr UST auction.

An important feature to note is the impact that both the US mortgage market and risk-parity strategies can have on the UST market. US mortgages are typically issued for a 30-year fixed-rate term. However mortgage holders have the option to pre-pay and refinance their existing mortgages. This means that when long dated yields fall, holders of mortgage backed securities (MBS) typically get increased pre-payments – with the duration of their MBS securities falling. However, it also means when long-dated bond yields increase, expected pre-payments fall. This leads to an increase in their duration exposure. Therefore, to hedge this so called “negative convexity” risk, MBS holders reduce their duration exposure by selling long dated USTs (typically 10-yr USTs, either via futures or directly). The market impact of this can lead to a negative feedback loop, with higher yields leading to increasing selling pressure, pushing yields even higher. This is very different to the UK Gilt market, where the long-dated part of the market is dominated by liability-driven investors (typically final salary pension schemes), who will opportunistically try to take long duration exposure if there is a spike up in yields.

As with the UST market volatility that occurred in March 2020, a number of analysts also believe that risk-parity funds that use leveraged exposure across several asset classes could potentially be exposed to the volatility seen yesterday. A shift in the correlation between asset classes (i.e. government bonds and equities both selling off) can trigger stop-losses for this type of fund, leading to further sales of USTs.”

As you can see, lots of moving parts to keep an eye on here – and then we need to work out how they all affect each other. Having spent much of my career in a primarily equity-facing environment, I am painfully aware of just how easy it is not be fully informed of these external, but highly impactful, influences on different asset classes. In a multi-asset process it is easier to keep one’s finger on the pulse. It is also worth observing that the US 30-year mortgage rate has increased from a low of 2.82% just three weeks ago to 3.25% today. That will definitely put a brake on refinancing activity. Bank of England data has the latest (31/1/21) 5-year mortgage rate in the UK at 1.93% vs a low of 1.66% last March, but the Stamp Duty holiday and the rush to exit cities seem to be having a much greater influence on demand. The respective figures for a 2-year fix are 1.35% and 1.75%.

To round off then, I will finally get back to the title… and the rugby! As investors we know that nasty surprises are going to come along, whether from companies that have fiddled their numbers, adverse geopolitical developments or acts of God ranging from volcanoes and earthquakes to, yes, pandemics. But it's no use ranting and raving at things that have happened and cannot be reversed. It certainly doesn't help to let emotions get the better of you. And if you keep testing the limits of what is legal, you will end up being penalised. You have to keep playing the game in front of you and stick to tried and trusted processes (I will let others debate the merits of Eddie Jones's tactics, and whether they are actually worth sticking to!). That's what we are doing. We can't guarantee it's always going to produce the optimal result, but it certainly gives us the best shot at achieving it.

Last week's Economic Highlights

FTSE 100 Weekly Winners

Company	Change
Int. Consolidated Airlines	15.8%
Rolls-Royce Holdings plc	9.2%
Informa Plc	8.2%
Land Securities Group PLC	8.0%
BP p.l.c.	7.1%
British Land Company PLC	4.8%
DS Smith Plc	4.1%

FTSE 100 Weekly Losers

Company	Change
Scottish Mortgage Investment Trust Plc	-15.7%
Ocado Group PLC	-14.0%
Rightmove plc	-11.5%
AVEVA Group plc	-9.6%
Auto Trader Group PLC	-9.4%
Experian PLC	-8.7%
Intermediate Capital Group plc	-8.5%

FTSE 100 Index, Past 12 months

Source: Factset

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