Private Bank

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Rates, Recovery and Resolve

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- **We believe it is asking too much of markets to absorb a record-setting fiscal stimulus in the face of recovering economy without expecting further pressures on interest rates. This means the US Treasury needs to borrow substantially from others besides the Fed.**

- **There are many reasons to be optimistic about the next few years in equities. There are also reasons to expect more volatility in the medium term as markets come to understand where rates might go, to understand if sustained inflation materializes and to see if EPS expectations meet reality. There are three more treasury auctions coming this week alone.**

- **Just like four years ago, a new US administration may have some “sharp elbows” for world markets, despite ostensible actions to help both the US and world economy recover. We put money on the prospects of a longer-term recovery, even as there are periods of doubt and worry along the way. Specific recommendations are contained herein.**

Rates, Recovery and Resolve

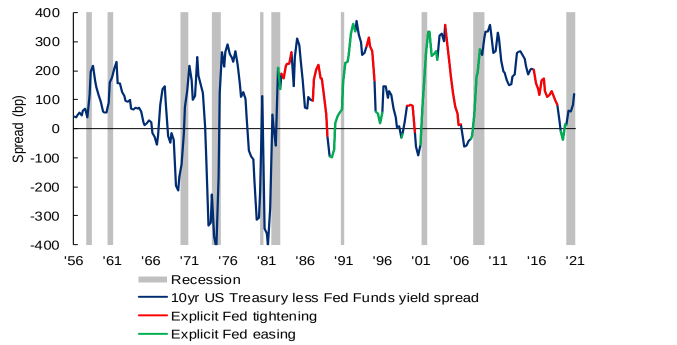
The Bond Market Reckoning Continues

For bondholders, the past few weeks have been rough. They are likely to stay rough until a new equilibrium in rates markets is secure. The return of long duration US Treasuries (20+ years) is about **-12%** this year. 10-Year Treasury yields have moved up 65 basis point in 2021 alone, having risen from 50bp in mid-2020 (the lowest ever recorded) by more than 1%.

With short term rates pinned down by the Fed, the likelihood that the yield curve steepens further at the beginning of this New Economic Cycle seems a near certainty. Since the early 1980s, cycle-after-cycle, inflation and nominal yields have made lower lows (figure 1). Yet, there is an even longer track record of steepening yield curves early in US economic recoveries (figures 2). When bond investors view Fed policy as unsustainably “easy,” long-term rates rise in anticipation of future increases in short-term rates. This has remained the case in every single recession/recovery cycle during the long, secular bull market in bonds.

Figure 1: US 10-Year Treasury Yield

Figure 2: US 10-Year Treasury Yield Less Fed Funds Rate



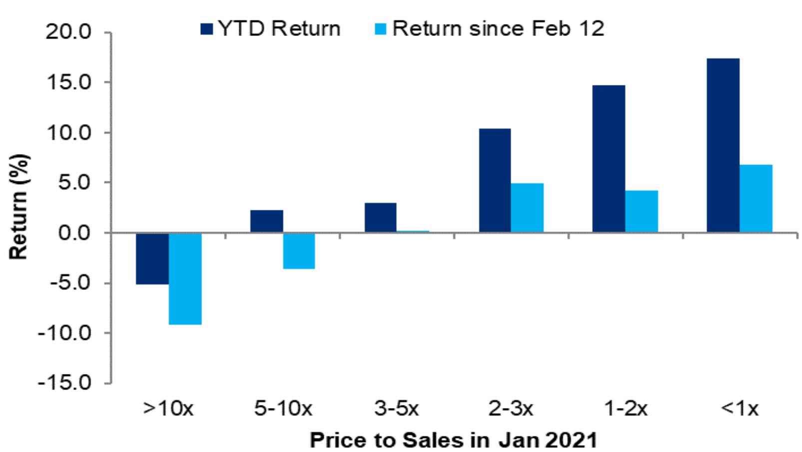
Source: Haver Analytics as of March 5, 2021

Higher Rates and Greater Volatility are Elements of the "Mean Reversion" Trade

Higher rates and gyrations in bond markets has created greater equity market volatility and sector rotations within equities. These are condition we anticipated as part of our Outlook 2021 theme "Exploiting Mean Revision". As we wrote in Outlook 2021, the end of the pandemic would signal a turning point for the economy and asset prices. "***Just as Covid changed the price of every security when it arrived, so will its departure.***"

As financial theory suggests, the abrupt rise in interest rates is pushing down higher valued "growth" equities more than lowly valued shares that are expected to be most profitable today, rather than in the distant future (see figure 3) – a trend we expect to continue. Within the US equity market, the S&P 500 has fallen 3.5% from its record high, the Nasdaq composite has dropped 8.9% and the Russell 2000 SMID (Small and Mid-Cap) shares have fallen 5.4%.

Figure 3: Poor Get Richer and Rich Get Poorer: US Price/Sales Ratio vs 2021 Returns



Source: Bloomberg as of March 5, 2021 Note: Using S&P 500 constituents. Past performance is no guarantee of future results. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment

You can see the "pandemic "distortion in markets even more clearly below. By dividing the market 50/50 into "COVID defensive" and "COVID cyclical" shares (figure 4) we saw a seismic huge shift in market value toward those firms that benefited from the pandemic economically and away from businesses crushed by shut downs, especially in services like leisure, recreation and retail. Then, we compared two baskets of equities, one "Stay At Home" and the other "Leave Your Home" (figure 5). These baskets, generally all components of the S&P 500, diverged mightily during the pandemic. That is why we continue to remind investors that following the benchmark index is such an incomplete view of market activity and why simply holding the index is not the optimal way to profit as the pandemic ends.

Figure 4: US "Covid Cyclicals" vs "COVID Defensives" as % of Market Capitalization

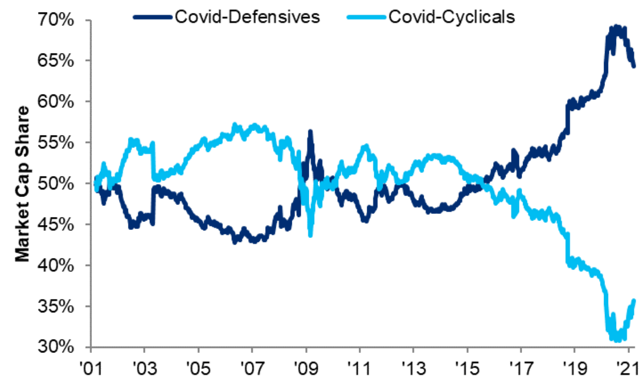
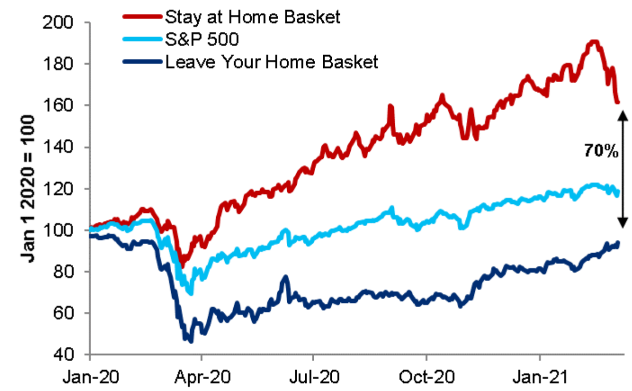


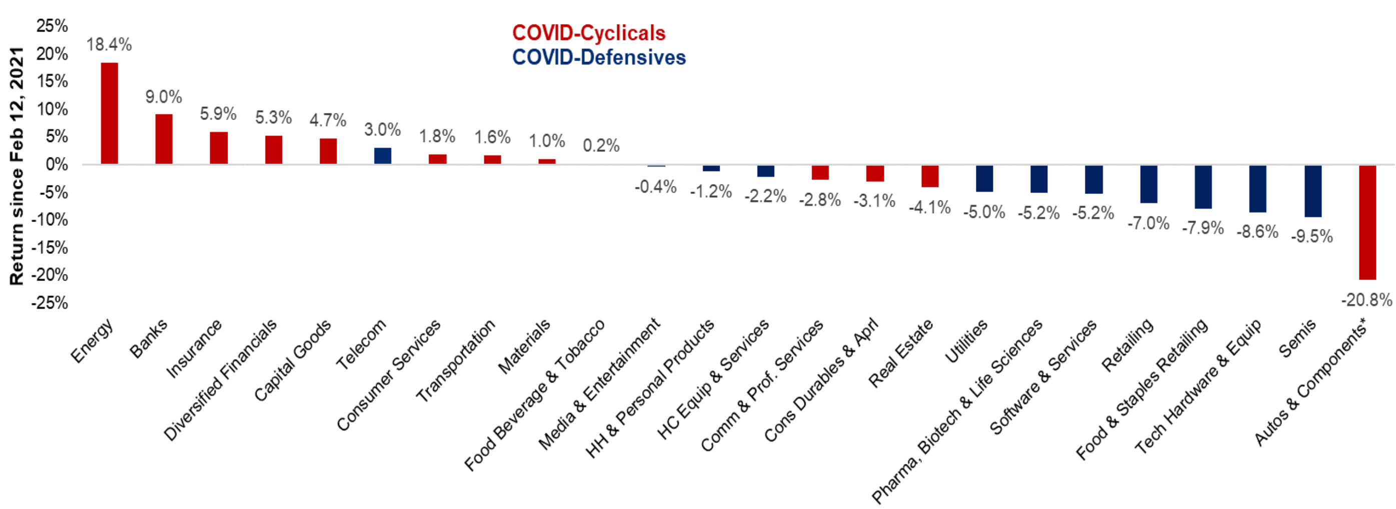
Figure 5: "Stay at Home Basket" vs "Leave Your Home Basket"



Source: Factset as of March 5, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. COVID cyclicals are Energy, Materials, Industrials, Financials, Consumer Discretionary (ex-ecommerce), and Real Estate. COVID defensives are Technology, e-commerce, Telecom Services, Healthcare, Staples and Utilities. "Stay at Home" basket includes names identified to benefit from COVID-related disruptions and a shift to working from home "Leave Your Home" basket includes Buy and Neutral Rated US names in the following sub-industries: Banks, Industrial Conglomerate, Machinery, Oil Gas & Consumable Fuel, Textiles Apparel & Luxury Goods, Energy Equipment & Services, Hotels Restaurants & Leisure, Building Products, Retail REITs, Construction & Engineering, Leisure Products, Airlines, Multiline Retail.

Mean Reversion in markets began in September 2020 when COVID cyclicals and most "value stocks" began to outperform "growth stocks". However, since February 21, 2021, the sectors most impacted by the end of the pandemic broadened and so did their divergent performance (figure 6). This acceleration has been directly fueled by the rise in interest rates.

Figure 6: "COVID Cyclicals" and "COVID Defensive" Share Returns Since 2021 Feb 12 (Start of US Yield Surge)



Source: Bloomberg as of March 5, 2021 Note: Using S&P 500 Industry Groups.
* S&P 500 Autos & Components is now 77% Tesla by market cap after recent rebalance. Note: COVID cyclicals are Energy, Materials, Industrials, Financials, Consumer Discretionary (ex-ecommerce), and Real Estate. COVID defensives are Technology, e-commerce, Telecom Services, Healthcare, Staples and Utilities. Past performance is no guarantee of future results. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment

As we discussed last week, the "delayed reaction" in the bond market is due to the very positive news on vaccines and stimulus that is now boosting the outlook for "COVID cyclical" industries. While we are reasonably optimistic about continued EPS gains for some parts of the "COVID Defensive" tech sector, we have long expected "COVID cyclicals" to rebound" from their depressed 2020 levels. The tech-laden Nasdaq enjoyed sharp outperformance in 2020 with a 43% return vs 19% for both US and Global equities overall. We do not expect a repeat.

Rising rates and **Mean Reversion** are very significant factors driving our tactical asset allocation. We have been deeply underweight the world's most expensive fixed income assets. While this doesn't eliminate some of the pain that rising yields impart on equities markets, in 2021-to-date it is helping us to outperform global benchmark allocations which have higher weightings in bonds. As of January 27, we are **-9.5% global fixed income** in medium-risk global portfolios.

What's Next for Markets?

There are many reasons to be optimistic about the next few years in equities. There are also reasons to expect more volatility in the medium term as markets come to understand where rates might go, to understand if sustained inflation materializes and to see if EPS expectations meet reality.

For example, US Treasury bond buyers can be sure they will get their coupons (and nominal) principal back at maturity. However, the future *market value* of bonds bought today is not knowable with precision. Implied volatility in the bond market has moved up measurably, and other asset classes should reflect this uncertainty for a while (see figures 7-8).

Figure 7: 7-yr US Treasury Note Auction Bid-to-Cover Ratio

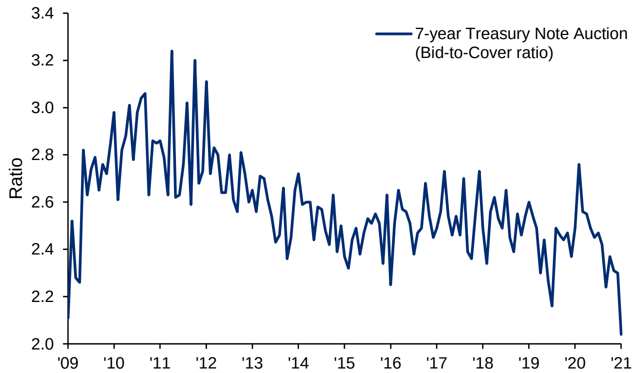
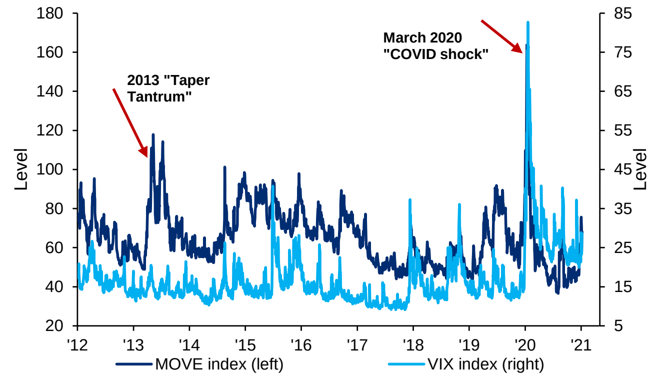


Figure 8: Implied Volatility: US Treasuries vs US Equities



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Here are the elements to watch as events unfold:

1. **At what yields will bond volatility settle down?**
2. **Who pays for the fiscal stimulus?**
3. **Are EPS growth expectations reasonable given bond yields?**
4. **Will higher yields entice foreign buyers, pushing up the US dollar?**

When Financing a Record Fiscal Stimulus. Who Pays for It Matters

There are many reasons for President Biden and the US Congress to "go big" and pass a record $1.9 trillion relief bill. With a large drop in the labor force, about 10% of the US is unemployed, even as the most recent data suggests the first hint of a rebound in services. Based on their experience in the Great Recession, the Biden administration, Janet Yellen and many economists agree that a faster acceleration of employment will generate both a stronger and more sustained recovery.

Yet, the size of the package and how it is financed are weighing on markets. For example, if the Fed was to buy every excess bond the Treasury issued, there would be no incremental demands on investors and all else constant, no incremental pressure on yields needed to attract them. At present, the Fed is currently purchasing $120 billion per month in US Treasury and Mortgage Backed Securities. The US Treasury, meanwhile, wants to borrow at a nearly $300 billion monthly pace. This means the US Treasury needs to borrow substantially from others *besides the Fed*. Only the Fed can "print" new money to finance the bonds.

We believe it is asking too much of markets to absorb a record-setting fiscal stimulus in the face of recovering economy without expecting further pressures on interest rates (see figures 9-10). Unlike the European Union, with its € 6.9 trillion ($8.3 trillion) in negative yielding debt instruments, the US still has a functioning bond market. In the US and most Emerging Markets, private savers can still be enticed to invest in government bonds, if only to store value within a defensive allocation. Therefore, their investment preferences and demand for yield will directly impact bond markets.

Figure 9: New Covid Infections as % of US Population

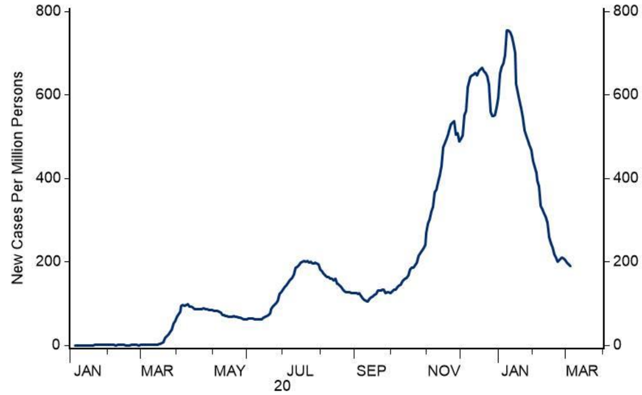
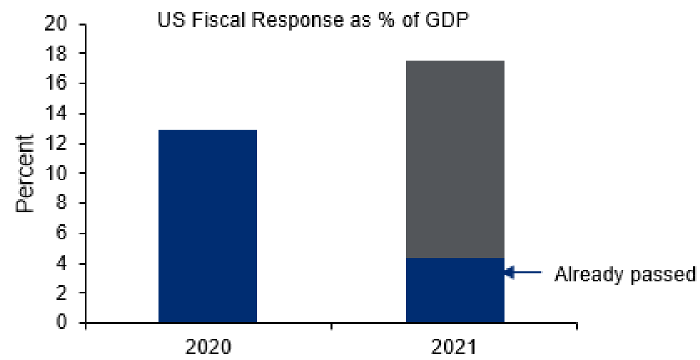


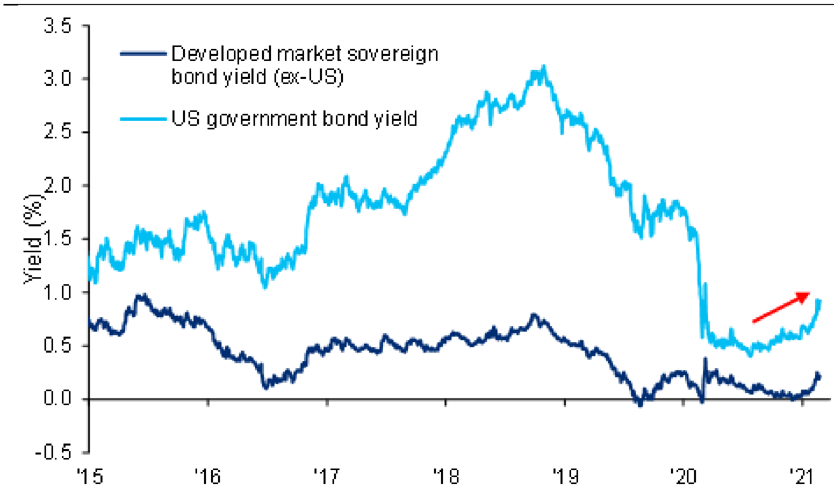
Figure 10: US Fiscal Stimulus in 2020 and Expected 2021



Source: Haver Analytics as of February 26, 2021

In our most likely scenario, the US Treasury borrowing will absorb savings that would finance other bonds and potential equity capital around the world. All else constant, the US Treasury will offer - and markets will demand - more attractive yields to finance the borrowing. This will impact savings flows throughout all world asset classes. For example, as figure 11 shows, US Treasury yields have edged slightly higher than those of other Developed Markets, who generally have less ambitious fiscal expansion plans.

Figure 11: US Long-Term Treasury Yield vs Non-US Composite



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EPS Growth Expectations Versus Bond Yields

The rise in bond yields is now forcing equity and credit investors to assess valuations with "less rosy" eye coverings. For equity markets, we do not believe the 110 basis point rise in yields is "worth more" than the expected 27% gain in global EPS for 2021, even after last year's strong rally. For now, higher rates are having their largest negative impact on investments with the most frothy valuations. However, we do expect that overall global equity returns in 2021 are more likely to be in the mid- or high single digits (again please see Outlook 2021 for discussion). By 2022, when we expect a 12-15% EPS gain, the valuation compression should be significantly behind us allowing for further positive equity returns.

In the meantime, if the bond market acts like a "thermostat," it will take out some air from the most frothy assets, including certain equities, yet this normal functioning will improve the sustainability for investment returns and even possibly the economic recovery.

Where to Invest

Just like four years ago, a new US administration may have some "sharp elbows" for world markets, despite ostensible actions to help both the US and world economy recover. As we've noted routinely in these pages, we'll put money on the prospects of a *longer-term* recovery, even as there are periods of doubt and worry along the way. Here are our predominant views.

1. **Remain invested and overweight equities**
2. **Remain invested in Covid-cyclicals and EM equities and dividend shares even in the face of some near-term pressures (figure 12).**
3. **As we noted last week, the most enduring growth opportunities such as *Hyper-connectivity* and *Greening the World* can be allocated to, particularly on pullbacks (figure 13).**

Figure 12: Emerging Markets Shares Relative to US and US Dollar Index

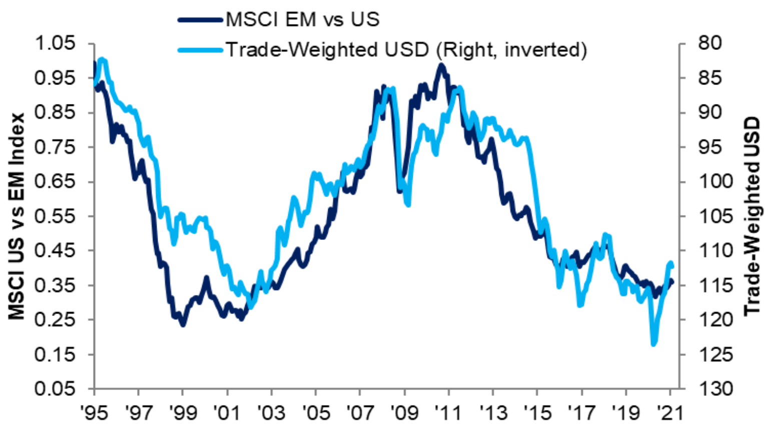

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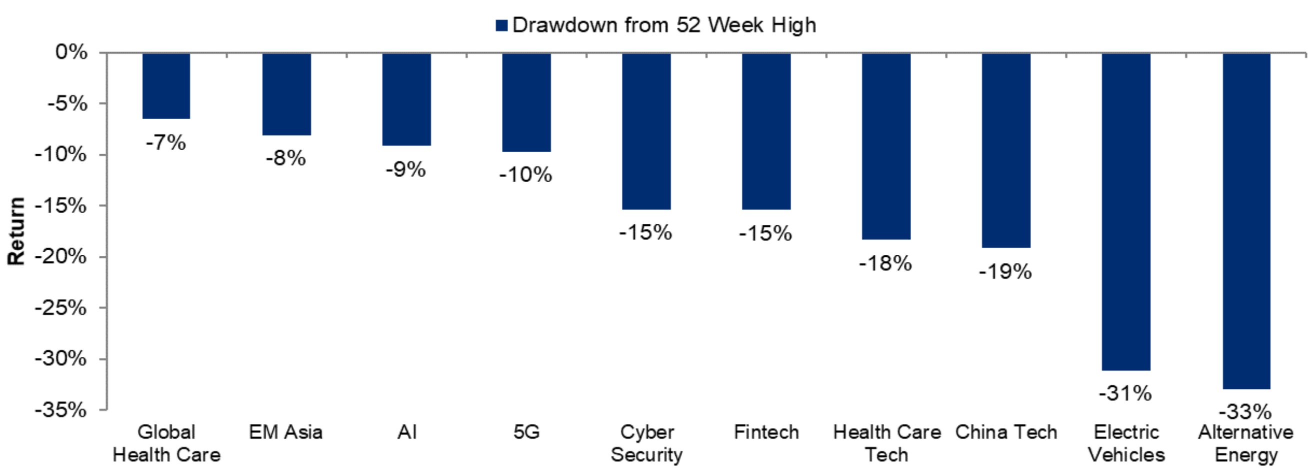
Figure 13: Drawdowns among CPB Unstoppable Trends



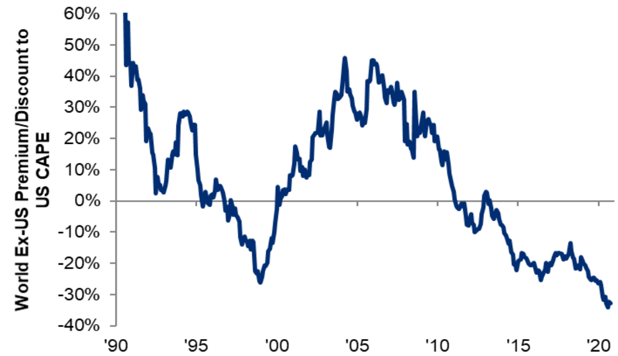
Source: Bloomberg as of March 6, 2021. Note: Thematic proxies are: MSCI AC World Health Care Index, BlueStar 5G Communications Index, Indxx Artificial Intelligence and Big Data Index, MSCI Emerging Asia Index, Indxx Global FinTech Thematic Index, ROBO Global Health Care Technology and Innovation Index, Prime Cyber Defense Index, CSI Overseas China Internet Index. Electric Vehicles proxied using equal-weighted average of Citi Research Theme Machine constituents with high exposure to "electric vehicles" theme. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

As figures 14 shows, US equity returns have trounced non-US equity returns in the decade past as the US economy outperformed and the US dollar rallied. Even the Fed's "policy normalization" steps of 2013-2018 didn't derail US equities until the Fed nearly ended the expansion early with both rate increases and quantitative tightening late in the period. US equities posted a 14.1% annualized return during the last tightening cycle. This included a 19% correction that ended the tightening phase.

During the “taper tantrum and beyond, non-US equity returns fared worse, returning 3.7% annualized from 2013-2018. This has left an historically large valuation discount in non-US equities that remains in markets today (see figure 15).

Figure 14: US equities Relative to Global Equities Since 1988

Figure 15: Non-US Equities Cycle-Adjusted Valuation Relative to the US



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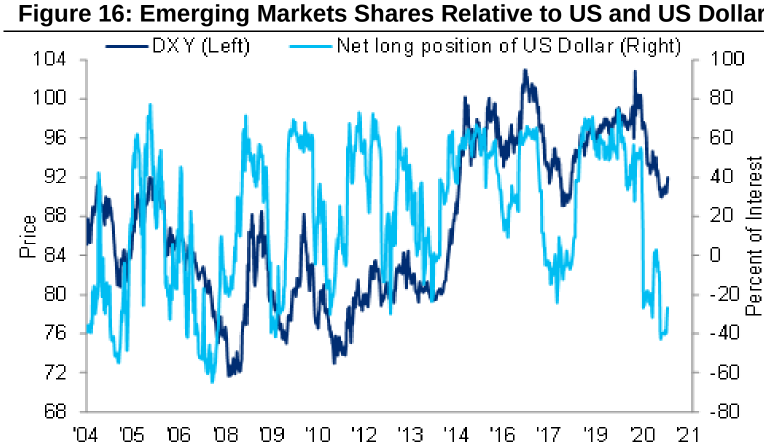
What to Worry About: Yields and Short-term USD pressures

Given the pandemic has not fully ended and the stimulus still needs final passage in the House of Representatives, stock, bond and commodity markets still need to “negotiate” a new equilibrium in bond yields that is consistent with an evolving growth and inflation outlook. The rise in bond yields thus far has actually been historically modest, as figure 1 shows, but given that the deficits will not be Fed-funded, where yields go remains a risk factor.   The very poor US Treasury auction on February 25 suggests that “Uncle Sam” is likely to need to sweeten the terms of its borrowing to entice bond buyers. US interest rate uncertainty now elevated and sweeping through other asset classes and regions. Yet we would also note, ironically, that many investing careers have been destroyed betting **on** a sustained rise in bond yields.

As figure 16 shows, the US dollar remains historically *high* in value against major currencies. In time, the Fed’s higher inflation target and vows to remain accommodative deep into a coming recovery should still weaken the dollar further. Yet net short positions in USD index futures are already at their highest level since 2009. As the figure shows, counter-trend rebounds and declines are common. A rebound could interrupt some of the progress in cheaply valued markets we favor.

Figure 16: Emerging Markets Shares Relative to US and US Dollar Index



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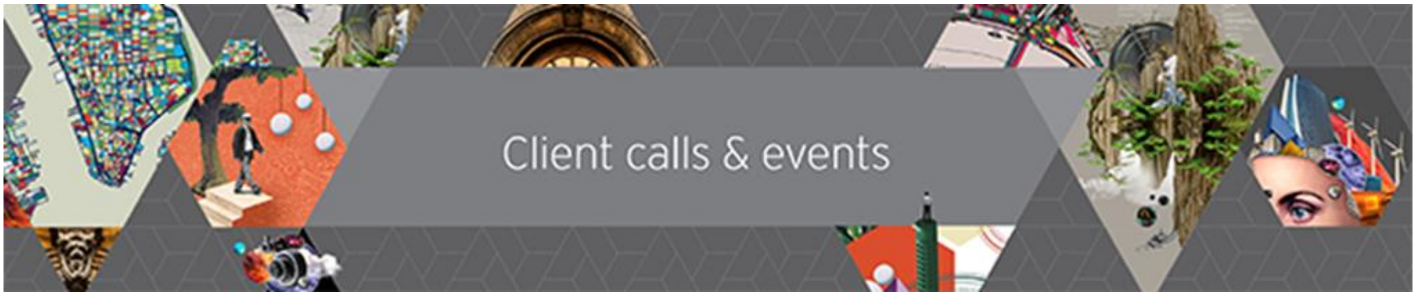

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