bridport & co

Strategy H2 2021

Strategy Review
July 9, 2021

by Gaëlle BOUCHER, CWMA

2021 TOP VIEWS – ABSTRACT

The Covid19 pandemic left its mark during the first half of 2021 but the economic response has been strong across the globe.

Where do we stand?

The global recovery is robust with different momenta depending on the regions. China along with the US led the pack, and growth is now shifting towards Europe and emerging countries.
With commodity prices higher and some supply bottlenecks in specific sectors, inflation has surprised on the upside but the FED's comments on the transitory nature of inflation have reassured market participants. With slow monetary policy normalization, are the FED behind the curve? The 2013 episode remains in market participants' memory. To avoid any sell-off on rates, as seen in the first quarter, the FED will have to communicate wisely. Developments on the labor market front along with fiscal policy decisions will be scrutinized closely. The ECB will likely stay dovish as Europe is beginning to recover. Covid19 variants and the effectiveness of vaccines will drive the flows.

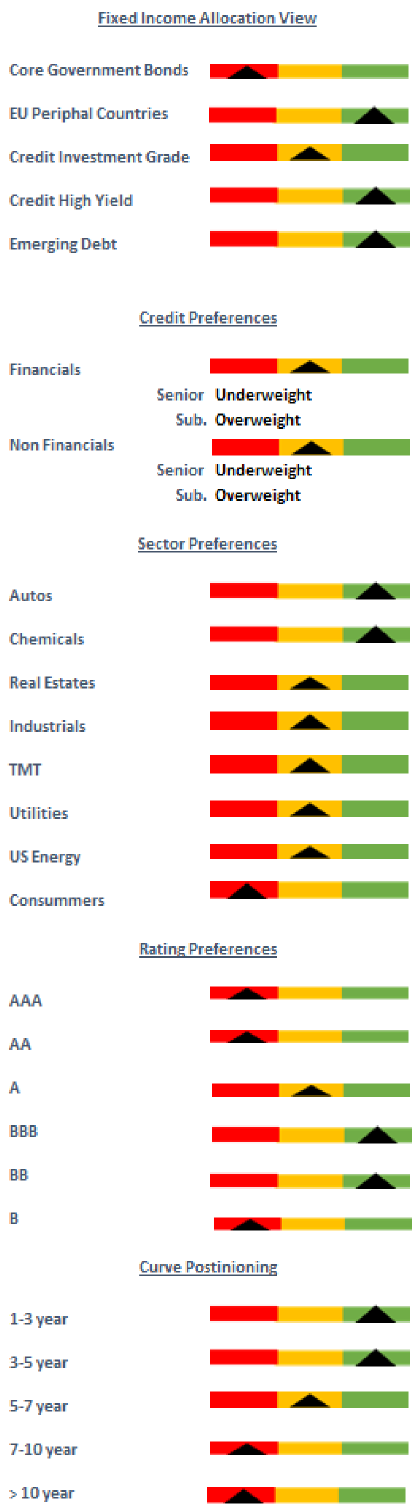
What does this mean for fixed income investors?

Despite the correction seen in Q1, US Treasuries are still rich to fundamentals. Tapering of asset purchases is around the corner, putting pressure on yields. Although the FED just put rate hikes on the table, possibly as soon as 2022, fiscal policy will remain supportive. We are more in a normalization monetary position rather than tightening. This will offer investment opportunities with no major sell-off expected on rates.
On the corporates front, fundamentals have improved with the default trajectory returning fast to its long term average. As spreads are at multi-year tights, quality carry will be king.
Emerging countries are not enjoying the same path of recovery and some are facing strong political uncertainties. Selectivity will be key.

Our favorite exposures

We believe that the hunt-for-yield will continue:

- **Sovereign –** Government bonds are unattractive on a risk adjusted basis. We are cautious on duration, with a target at 2% for the US 10-year tenor, and expect steeper curves. We expect Euro peripheral spreads to tighten slightly with ECB still supportive. We like inflation linked bonds exposure.
- **Credit –** We like the credit as a carry trade and recommend exposure on the BBB-BB spectrum. We prefer going down the capital structure (hybrids) than the rating spectrum.
- **Emerging Markets -** The tug of war between higher core rates and the emerging market environment is more balanced, as economic conditions improve globally. Nevertheless, taper discussions will impact the most vulnerable countries. We favor solid fiscal situations. On corporates, we would continue focusing on the crossover spectrum, especially on export-led issuers and Covid19 laggards.



by Gaëlle BOUCHER, CWMA

1H21 – KEY FACTS

Growth uneven across regions while inflation is spiking across the board

- Prompt and powerful policy responses to the pandemic have helped to **preserve the economy's capacity**.
- The **economic recovery took off in the first half of the year** as vaccinations ramped up, but was uneven across the globe, with huge gaps in access to vaccines and a bleak outlook for many poor countries.
- The fast reopening of the developed economies has been providing a **massive boost to the services sector while manufacturing has been facing problems in addressing supply constraints** in the face of the strong demand.
- **US (6.4% yoy in 1Q 21) and China (18.3%) led the way**, **while Europe lagged**. According to the World Bank, these two countries will each account for more than a quarter of global growth in 2021, with the US contributing almost three times its average level over the 2015-19 period
- **According to the World Bank, the global economy is expected to grow by 5.6% in 2021** (5.8% according to the OECD), showing a post recession rebound of the largest magnitude in 80-years.
- Basis effect on oil prices along with supply-demand imbalances, from supply-chain bottlenecks to labour scarcity, pushed prices higher. **Core inflation rate moved to a quarter century high in recent months**, stoking inflation fears. Inflation has been fairly muted in the euro area, but stronger than expected in the US, where headline CPI inflation surged to 5% in May, and core inflation to 3.8%.
- Major central banks kept their accomodative stance while **taper tantrum echoes began to come to the forefront**. Nevertheless, the June FOMC shifted the market focus from the FED tapering asset purchases to the timing of central bank rate hikes.
- **Policy normalization**, both fiscal and monetary, **has already started in some emerging markets**. Nevertheless, the **divergence between emerging and developed countries' growth is becoming more apparent**, as expressed in PMIs.

Solid core markets' performances

- Year-to-date, **risky assets have enjoyed decent performance**, with major stock indices posting double digit returns.
- **As reflation fears pushed US Treasury yields higher in Q1, a broadening conviction that the inflation spike will not last long drove yields lower during Q2, with 10-year Treasury yields even pulling back by some 25 basis points.** Concerns about the side-effects of supply bottlenecks have replaced fears of a potential overheating of the US economy. Mixed trading since the June FOMC is pointing to tougher conditions ahead.
- **Oil rallied strongly** as economies reopened and demand picked up**.** The **US Dollar was erratic** during the first half of the year.
- **Base metals enjoyed a strong rally**, with China accounting for more than 50% of the end-use demand.
- **Emerging corporates have been resilient to the upward shift in US yields**.
- In the risk-on environment**, demand-side factors have been supportive for credit as a whole**, especially the high beta spectrum, with US High Yield outperforming its Euro peers.
- **Credit spreads have absorbed the move higher in yield**.
- In hard currency, **emerging corporates posted lower returns compared to US credit**, especially due to idiosyncratic developments.

2H21 – OUR VIEW

Global recovery should gather pace ….

- Global economies are on track for a **strong post-pandemic recovery,** likely running above potential in H2, **inflation is surprising to the upside** and **central banks are paving the way to exit their exceptional measures**.
- The **broader emerging world has yet to enjoy the rebound** seen in the developed world.
- The inflation debate is alive and has different shades of grey. I**t seems unlikely that we will see US inflation back to pre-Covid19 levels** because i/ current inflation is due to non-cyclical factors and ii/ the inflation impulse coming from the growth cycle itself will be felt in the months to come. Moreover, some disinflationary forces are emerging.
- China's total credit growth has slowed from its peak in October 20 and **downward pressure could emerge on China's economic growth and inflation by year-end**, limiting global inflation pressures.
- **Major central banks are facing a strong dilemma**: decreasing policy support to prevent overheating or keep accommodative policy for longer with the risk of seeing higher inflation expectations.
- Engaged in a normalization process, the Federal Reserve want to avoid a repeat of the 2013 "taper tantrum" episode, which saw real yields rising by circa 150 basis points in only five months. **The FED should prepare market participants for tapering of asset purchases from early 2022 onwards**.
- The **ECB should not significantly reduce its PEPP purchases** any time soon to preserve favorable financing conditions.
- **Going forward, liquidity will likely be less abundant**. The ECB will lag and emerging central banks will have to manage the capital and currency outflow risk.

Real GDP (%) - IMF, April 21	2019	2020	2021	2022
World	2.8	-3.3	6.0	4.4
US	2.2	-3.5	6.4	3.5
Eurozone	1.3	-6.6	4.4	3.8
UK	1.4	-9.9	5.3	5.1
Switzerland	1.2	-3.0	3.5	2.8
Developped Countries	1.6	-4.7	5.1	3.6
Emerging Countries	3.6	-2.2	6.7	5.0
- China	6.1	2.3	8.4	5.6

…. Supporting carry exposures

- Vaccination progress, large excess savings and liquidity, along with surging earnings, make the **outlook supportive for risky assets**.
- In terms of asset allocation, the **rising stock-bond correlation is bad news for** diversification and makes us more cautious on equities.
- Fast improving fundamentals imply **better ratings and lower defaults. Default rates should be closely monitored.**
- The **current framework** characterized by i/ improving credit fundamentals, ii/ neutral central bank policy along with iii/ neutral supply-demand flows are historically supportive for **low but positive returns lasting for long periods. Mid-cycle environment** typically suggests **less volatility** in the market**.**
- In a context of continuing search for yield, **High Yield and Emerging debt should benefit from carry positioning**.
- **As seen during the first half, H2 2021 will not be a smooth ride**.

2H21 – KEY POSITIONING

- **Sovereign** – Expansionary fiscal policies on one hand and accommodative monetary policies on the other hand have created an environment for inflation pressures. Actual inflation rates have risen sharply over recent months without any impact on bond markets. Amid the ongoing economic recovery and the ensuing risk on the inflation front, we view the pullback in US yields in Q2 as a technical correction rather than a change in trend. The inflation background looks less tense in the euro area.

  Our positioning will be the following:
  - We expect **higher yields** on both sides of the Atlantic as economies continue growing, and **steeper curves** which will support liability-driven investors' demand (insurers, pension funds) and foreign investors (FX-hedged). We expect **the transatlantic yield spread to widen further** at the long end of the curve, as German Bunds will outperform US Treasuries (drop in net supply).
  - We **like inflation linked bond exposure** as an element of diversification in a fixed income portfolio. It represents an attractive hedge against rising rates with better value in Europe.
  - With the ECB committed to remaining supportive, this creates a favorable environment for carry trades. ECB buying and a drop in net insurance are supportive of peripherals. **Euro Peripheral spreads should tighten slightly in Q3** before the market begin to speculate about a decrease in ECB purchases.

	US 10-year	German 10-year	Gilt 10-year	Swiss 10-year
H1 2021	1.47	-0.21	0.72	-0.22
Q3 2021	1.80	0.00	0.80	0.00
Q4 2021	2.00	0.10	1.00	0.10
12 Months	2.25	0.25	1.25	0.25

- **Credit** – While evolving in a narrow range since the beginning of the year, spreads are at multi-year tights. Quantitative Easing taper will put low ratings at risk while the upward trend in yields will put long-end investment grade under pressure. For the time being, it is too soon to be concerned about tapering risk but it is a topic to keep in mind for the end of the year. First rate hikes will come much later. The ECB should keep its asset purchase program (APP) beyond 2022 while progressively stopping the pandemic emergency purchase program (PEPP). As the ECB makes the most of its credit purchase via the APP, this will make European credit resilient to the tapering debate. Euro credit spreads should be more resilient than their US peers as the rate move should be more contained and the ECB still supportive.

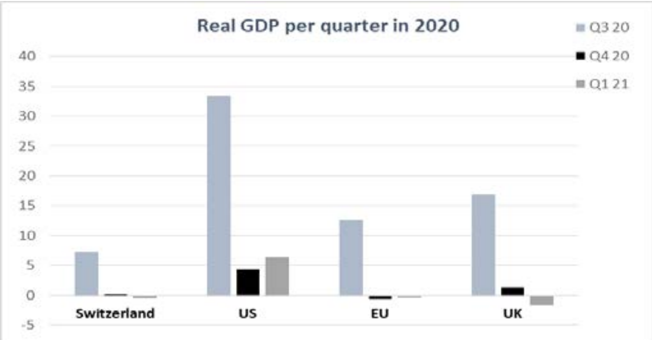
  Our positioning will be the following:
  - Curve: we are currently **cautious on duration exposures but acknowledge that the 2.00% threshold on the US 10-years will offer tactical investment opportunities** in US long-dated investment grade bonds, as credit risk is limited.
  - Rating: in a rising yield environment, we continue to prefer **carry exposure through BBB-BB rated bonds,** where the idiosyncratic risk is more moderate.
  - Sector: **We are neutral on Financials versus Non-Financials**. We recommend exposure on cyclical sectors to benefit from the solid recovery. We continue to **favor subordination risk to credit risk**.
  - Corporates: **We still like Covid19- sensitive sectors, as the global recovery is still on track**. We think that **European Hybrid Corporates and Additional Tier 1 provide an attractive duration-adjusted carry**. In the Euro denominated market, investment grade **Reverse Yankees offer attractive risk-adjusted carry**, while providing a hedge against any ECB tapering. In the US Dollar market, **we continue to like BB rated names,** which should benefit from rising stars and M&A activities. We think that **green and sustainability linked bonds** will continue to be a significant component in fixed income portfolios.

- **Emerging Markets** – The emerging market environment has improved with the acceleration of the vaccine rollout and a noticeable growth pick-up in some regions, but continues to face a number of headwinds: less fiscal stimulus than developed markets, tighter monetary policy and the Covid19 impact on their economies. Nevertheless, valuations are tight and room for further spread compression limited. The low level of spreads provides a limited cushion against a rise in core rates. Taper discussions in the US could increase volatility on the asset class from the third quarter.
  Our positioning will be the following:

  - Sovereign exposure: **Political risks, fiscal issues are still relevant**; hence a high dispersion across countries. The lack of spread buffers make us highly selective on our country exposure. We are **underweight Latin America** where political uncertainties remain a key risk which could negatively impact economic and fiscal policies. We are **neutral Asia,** which exhibits tight spread and a growth slowdown in the wake of China, and **overweight EEMEA** where fiscal deficits are lower. **EM commodity exporters** will continue to benefit from the surge in commodity prices.
  - Corporate exposure: **We favor the BBB-BB spectrum** and **sectors which will benefit from the continuing recovery (Exporters, Infrastructure). We would be cautious on duration** as any move upward on the US rates could imply volatility on emerging assets.

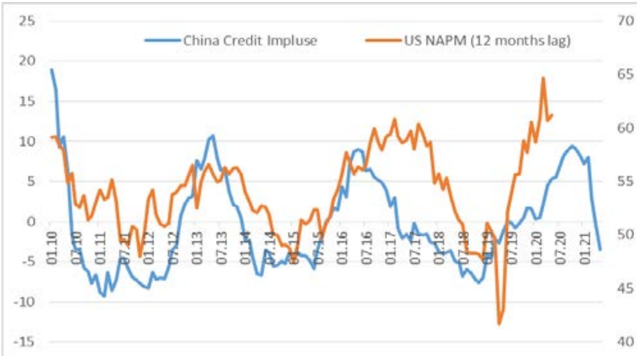
.

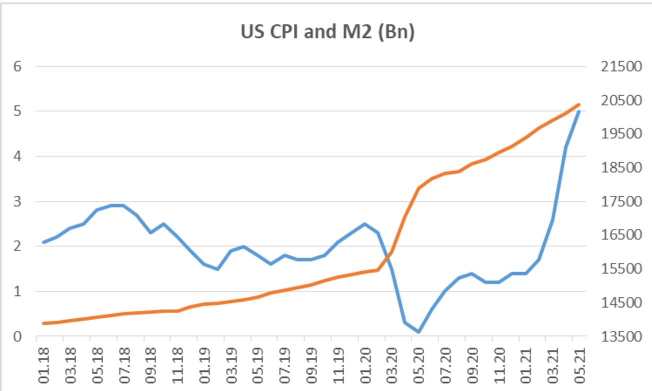
THEMATIC VIEWS MACRO ECONOMIC DEVELOPMENTS



The global economy has been recovering from the pandemic but renewed restrictions during the first half of the year weighed on specific sectors.

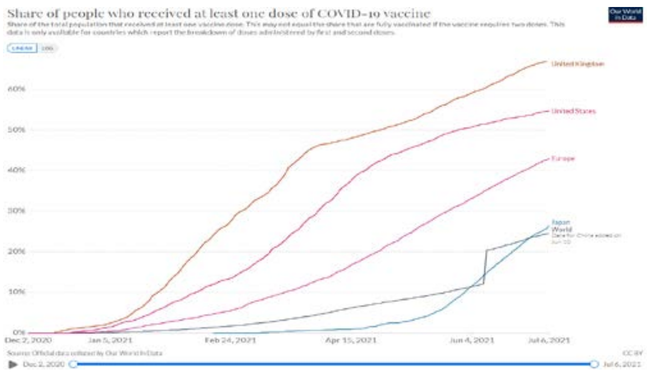
The decline in China credit impulse does not bode well for global demand. And could weigh on activity and growth.





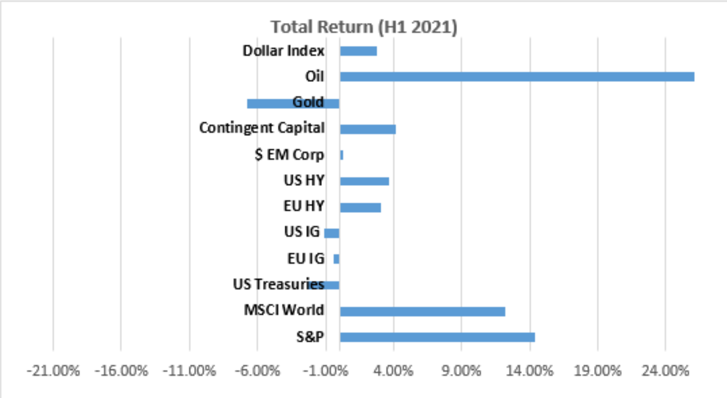
Inflation prints came higher while M2 drifted up. Supply bottlenecks have been a key factor behind inflation surprises and some of them may not be solved by the year-end, which could trigger wage pressures. Central banks' action will be crucial. For the time being, euro area inflation is under control. In the UK, inflation is back to pre-crisis level but remains below the 2% threshold

The economic growth momentum will shift towards Europe where vaccination is proceeding fast, allowing for a re-opening of the economies.



THEMATIC VIEWS MARKET DEVELOPMENTS

- **Overall Performance**



- **Developed markets – Spreads are tighter to pre-Covid19 levels except for the BB spectrum**

SPREAD VERSUS GOVERNMENT BONDS (pbs)

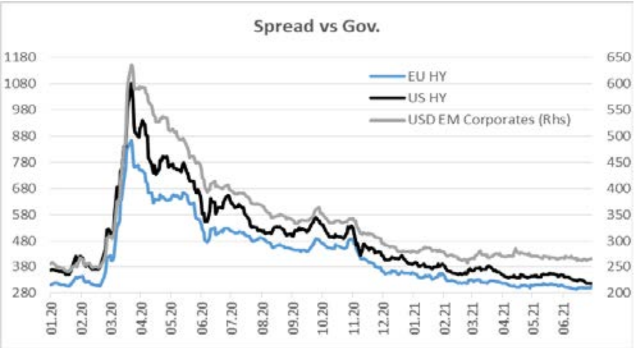
ICE Indices (as of June 30)	EU IG	US IG	EU HY	US HY	EU AAA	EU AA	EU A	EU BBB	EU BB	EU B	US AAA	US AA	US A	US BBB	US BB	US B
13.02.2020	90	100	316	371	50	54	76	110	226	452	53	54	75	129	218	370
31.12.2020	92	98	358	390	44	57	76	112	271	468	50	59	74	125	281	422
30.06.2021	83	82	306	318	49	53	71	97	240	411	41	49	62	104	231	367
Spread vs Pre-Covid levels	**-7**	**-18**	**-10**	**-53**	**-1**	**-1**	**-5**	**-13**	**14**	**-41**	**-12**	**-5**	**-13**	**-25**	**13**	**-3**

- **Emerging market – Strong resilience versus US peers. No much room for further spread tightening**

SPREAD VERSUS US TREASURIES (pbs)

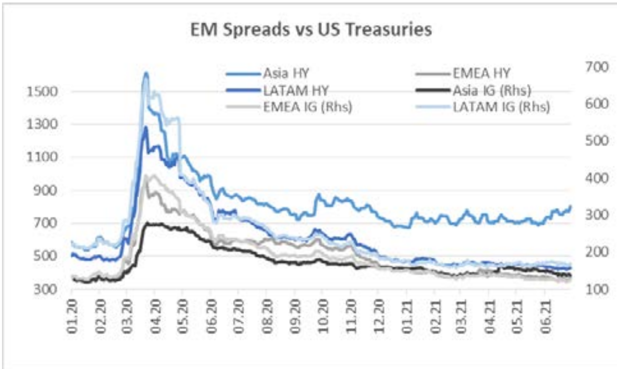
ICE Indices (as of June 30)	EU IG	US IG	EU HY	US HY	$ EM Corp	EM IG	EM HY	ASIA IG	ASIA HY	EMEA IG	EMEA HY	LATAM IG	LATAM HY
13.02.2020	90	100	316	371	249	147	471	123	569	132	352	219	476
31.12.2020	92	98	358	390	281	159	521	156	680	152	421	178	470
30.06.2021	83	82	306	318	266	141	522	139	802	124	364	169	431
Spread vs Pre-Covid levels	**-7**	**-18**	**-10**	**-53**	**17**	**-6**	**51**	**16**	**233**	**-8**	**12**	**-50**	**-45**

THEMATIC VIEWS YIELD TRENDS



In a context of supportive policy mix, high beta spread compression has continued, supported by the hunt for yield. In core countries, we are now below pre-pandemic levels. Despite low leeway, credit is not so expensive versus equities and commodities.

Emerging corporates spreads have been resilient to the upward move in yields, except for Asia HY which faced idiosyncratic risks.



US Treasuries drifted up strongly in Q1 in the wake of rising real rates and inflation expectations, dragging down other core yields. In Q2, the FED affirmed the transitory nature of rising inflation.

US 10-year Breakeven ended H1 at 2.33%. Real yields, measured by the inflation swap, remained well anchored in negative territory.

THEMATIC VIEWS EMERGING MARKETS OVERVIEW

2021 Total Return (ICE indices)		2019	2020	Q1	Q2	2021
Global EM						
	IG	11.87	5.76	-1.87	1.56	-0.34
	HY	13.49	9.02	-0.83	2.27	1.43
ASIA						
	IG	10.21	6.77	-1.36	1.09	-0.29
	HY	14.11	8.72	-0.45	-0.11	-0.56
EMEA						
	IG	11.89	6.28	-2.02	2.31	0.24
	HY	14.84	7.84	0.51	2.99	3.51
LATAM						
	IG	16.16	5.05	-3.60	2.50	-1.19
	HY	12.25	8.19	-1.95	3.60	1.58

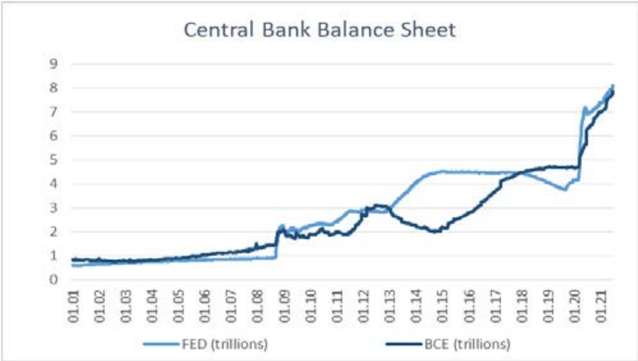
While investment grade suffered from the upward move in US Treasuries, high yield proved to be resilient.

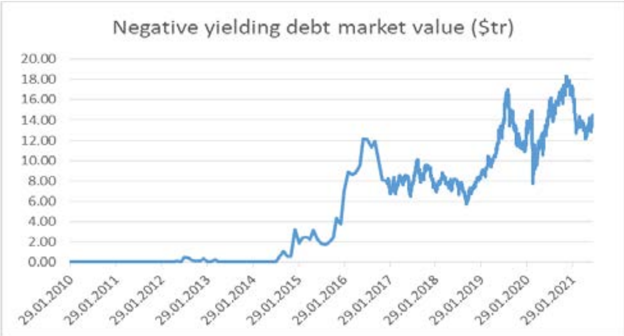
(ICE indices - As of 30/06)	Asia IG	LatAm IG	EMEA IG	Asia HY	LatAm HY	EMEA HY
Spread 31/12/2020	156	178	152	680	470	421
Spread 30/06/2021	139	169	124	802	431	364
Spread Variation	**-17**	**-9**	**-28**	**122**	**-39**	**-57**
Carry	0.77	0.88	0.75	3.37	2.33	2.09
Capital Gain	0.90	0.75	1.74	-2.92	2.00	2.10
Excess Return	**1.67**	**1.63**	**2.49**	**0.46**	**4.33**	**4.19**

Asia high yield rated bonds underperformed due to idiosyncratic issues.

THEMATIC VIEW CENTRAL BANKS' IMPACT

The balance sheets of the FED and ECB have exploded since the financial crisis with a major increase during the pandemic.





Until 2015, negative yielding bonds were rare. By mid-2019, central banks around the world engaged in unprecedented monetary easing. Covid19 hit the global economy and US rates converged towards the zero bound range already prevailing in Japan and Europe. Negative yielding debt represents circa one quarter of the total government bond market with around 70% of Eurozone government debt affected.
The total amount decreased from the peak seen at the end of last year.

Instead of the previous target of "below but close to 2%", the ECB agreed to raise its inflation goal to 2% and allow room to overshoot it. It is worth noting that inflation has consistently been below the ECB's goal for most of the decade.