MARCH 2021

# MONTHLY INVESTMENT OUTLOOK

UBP

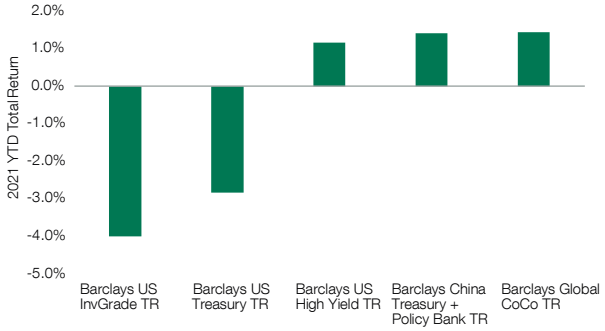
Union Bancaire Privée

MONTHLY INVESTMENT OUTLOOK

# INVESTING AMIDST A TANTRUM IN US BOND MARKETS

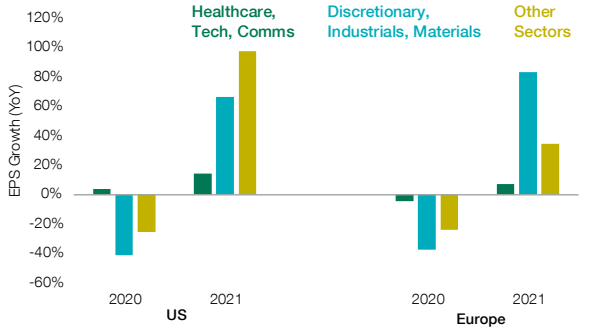
- February saw US fiscal authorities take the baton from the Federal Reserve and surprise on the upside in terms of proposed spending programmes in the months ahead. This served as a tailwind for global equities and a headwind for global fixed income investors in the month.
- While most expected Biden's relief measures to be downsized from their original USD 1.9 trillion proposed level, excluding some modest changes, it appears likely that a good portion of the outsized spending will make it through in early-March providing additional impetus to US growth.
- This fiscal optimism is proving a headwind for fixed income investors with US risk-free yields having breached the 1.5% level for the first time since the early days of the global pandemic. Credit investors found some shelter with spreads compressing. However, our short duration credit exposure in particular was a haven from rising yields.
- Moving away from the US dollar yield curve has proven to be valuable as well. High carry supported our preferred European bank Coco position and a more stable rate environment domestically in China provided shelter from the USD interest rate volatility via China sovereign bonds.
- The fiscal impetus enhances what has already been a strong earnings season among US and European corporates where revenues beat expectations by over 2% in both locations and earnings by 16-21%. Earnings revisions across all regions of the world continue to track higher and we expect the acceleration to continue into 2Q2021.
- Rising rates will be a headwind for elevated equity P/E multiples. However, we expect the accelerating earnings backdrop in aggregate as well as amongst individual companies and sectors to provide stock selection opportunities in companies with more durable valuation floors looking through mid-year.
- Indeed, earnings surprises combined with dividend hikes and an increased likelihood of share buybacks served as tailwinds for the cyclical/global mining leg of our equity barbell in portfolios. We added UK equites exposure in the month to provide additional cyclicality.
- Though the rising yield environment has provided temporary respite in the broader US dollar bear market, with US fiscal spending set to accelerate once again, we expect renewed pressure on the US dollar to favour our preferred currency exposure in EUR, GBP and CNY as well as Australian dollar among cyclical currencies.

Moving off the US dollar yield curve has been valuable in a rising yield environment



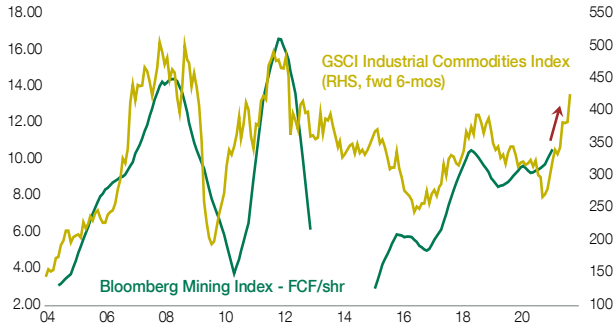

Sources: Barclays, Bloomberg Finance L.P. and UBP

Earnings should continue to drive total returns in cyclical sectors even as yields rise




Sources: Bloomberg Finance L.P., UBP

Rising commodity prices provide a tailwind for global miners looking ahead




Sources: Bloomberg Finance L.P., UBP

GLOBAL TACTICAL ASSET ALLOCATION

# IDENTIFYING OPPORTUNITY WHILE ACTIVELY MANAGING RISK

## Global economy / Asset allocation

- A still active pandemic combined with new variants and Euro area lockdowns keep short-term downside risks in view, particularly in the eurozone, but global activity seems resilient.
- As vaccination rollouts accelerate, lockdowns should be eased in several countries in coming weeks and months, leading to a strong rebound in activity and sustained levels of global growth in H2-21.
- Substantial budgetary support should come shortly in the US and the eurozone while monetary policy will remain accommodative in the short run.
- We maintain our focus on medium-term recovery and secular transformation themes. We seek opportunities to add additional cyclical exposure which should benefit from the next leg of earnings recovery through 2021.
- Proactive risk management remains valuable to allow us to stay invested in key long-term themes while being sheltered from near-term volatility and drawdowns.

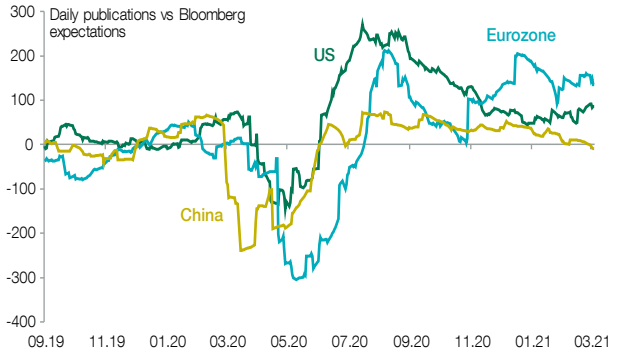
## Fixed income

- With low/negative interest rates around the developed world, we believe Chinese government bonds and Asia credit are anchors to income-oriented portfolios as 2021 progresses. With the dollar weakening story of 2020 set to continue in 2021, investors can also enhance returns via FX markets in the year ahead.
- Going forward, however, as the near-term outlook remains uncertain and with medium-term stimulus on the horizon, investors can benefit from a 'barbell' strategy between lower risk, moderate duration strategies and cyclical recovery-oriented exposure looking to the 2H of 2021.

## Equities / Alternatives

- We have added UK equities to portfolios to add exposure to the global and domestic cyclical recovery story while maintaining our barbell approach between high-quality cyclicals and growth stories.
- Long / short hedge fund exposure was particularly valuable in generating alpha in a highly volatile market environment, especially in emerging markets and China and acted as a complement to our strategic allocation built in 2020.

### Economic surprises remained positive despite headwinds




Source: Citigroup Global markets

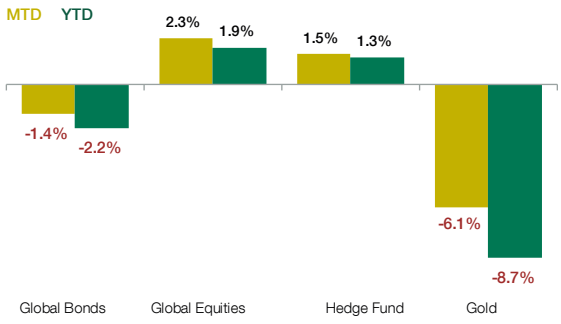
### The UK market look particularly cheap relative to global equities

12-month forward PER: UK relative to global equities


Sources: Refinitiv, MSCI and UBP

### Equities delivered positive performance

Major Asset Classes Performance




Performance is as end of February 2021
Sources: Refinitiv, UBP

UBP ECONOMIC OUTLOOK

# STRONGER GROWTH EXPECTED FROM Q2-21

## Key points

- Activity remained weak in Q1-21, still dominated by new variants and lockdowns; Q2-21 is expected to be a turning point for both the pandemic and economic activity thanks to a rising share of the global population being vaccinated.
- Government reflation policy is working and the reopening of economies expected from Q2 should lead to a strong growth momentum and prospects of a synchronised rebound in H2-21.
- The budgetary support should favour consumers and restore investment; monetary policy will remain accommodative but progressively more vigilant on inflation.

## US growth to accelerate after weak start

- Bad weather conditions, a volatile labour market and a virus which was still active were responsible for moderate growth in Q1, but thanks to the accelerating vaccination rollout a strong rebound is expected from Q2-21.
- The USD 1.9 tr package should come into effect rapidly, with less opposition than feared. Biden's administration is on track to present a new investment plan based on climate change, environment and innovative technologies.

## UK to reopen soon, while eurozone is still lagging

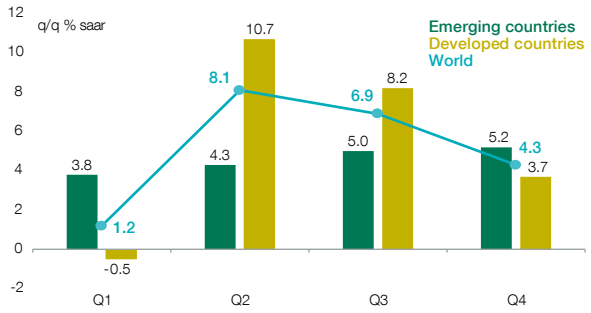
- After being penalised by Brexit and high levels of Covid infections, the UK should benefit from its rapid and widespread vaccination campaign. After a depressed Q1, reopening should boost activity from Q2, with growth set to recover by 5% in 2021.
- In the eurozone, slow vaccination rollouts mean lockdowns remain in place. Growth entered a double dip recession and stayed depressed in Q1, but manufacturing was resilient; a strong Q2 rebound is expected.

## Ongoing recovery in Asia

- In Asia, activity has regained some vigour but headwinds appeared due to shortages in transport and IT sectors. A sustained recovery is expected thanks to domestic demand and renewed budgetary supports.
- In China, exports and investment recovered but restrictions on travel weighed down on consumption during Lunar New Year. A stronger growth profile looks likely as economic policy favours consumption, local innovation and investment.

### Stronger growth expected from Q2-21

World growth in 2021




Sources: JP Morgan, UBP

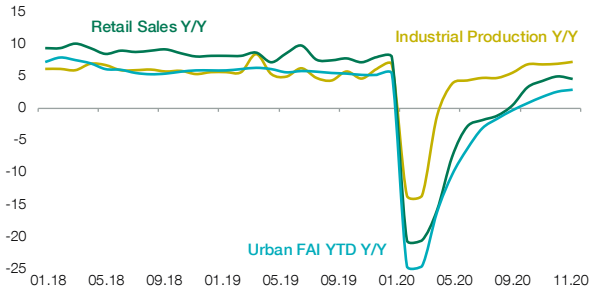
### Sustained recovery anticipated in 2021

| GDP y/y % | 2019 | 2020 | 2021 |
|---|---|---|---|
| WORLD - *MER* | 2.3 | -4.0 | 5.2 |
| *- on PPP basis** | *2.9* | *-3.3* | *5.6* |
| USA | 2.2 | -3.6 | 6.2 |
| Japan | 0.3 | -5.1 | 2.5 |
| Eurozone | 1.3 | -6.8 | 4.6 |
| United Kingdom | 1.5 | -9.9 | 5.0 |
| Switzerland | 1.2 | -3.1 | 3.8 |
| Brazil | 1.4 | -5.5 | 3.8 |
| Russia | 2.0 | -3.1 | 3.0 |
| India | 4.2 | -8.2 | 9.0 |
| China | 6.0 | 2.3 | 8.6 |
| Developed countries | 1.6 | -5.1 | 5.0 |
| Emerging countries | 3.7 | -2.1 | 6.0 |

Sources: UBP - Economic & Thematic Research,
MER: market exchange rates; PPP: purchasing power parity

### China's growth already on strong recovery

China: key activity trackers




Sources: NBS, Bloomberg Finance L.P. and UBP

UBP ECONOMIC OUTLOOK

# REBUILDING INFLATION IN 2021-2022

## A change in regime: inflation is back

- Inflation finished 2020 at a slow pace in all major countries due to weak trends in manufactured goods and services reflecting depressed demand under lockdown. It has now rebounded slightly driven by rising commodity prices.
- As stronger growth is expected in the next quarters, inflation should progressively rebuild in 2021 and could trend higher into 2022 thanks to the accumulated stimuli.
- After several years of staying below central banks' targets, inflation in the next quarters should come closer to the 2% reference, mainly in the US. This is at a time when central banks become more tolerant on inflation and accept a temporary overshoot. The rebuilding process of inflation should result from three major steps over the coming quarters.

## Rising costs push inflation up

- Commodities, security costs, freight costs and prices paid by intermediary manufacturers are up, fueling upside pressure on costs with some passing through to industry via the supply chain and sometimes on to consumers.
- This process is working in Q1 and should lead to a strong rebound in headline inflation in Q2, mainly due to base effects on energy prices. However, inflation could stay at a high pace due to stronger demand and rising pressures on labour in the future.

## Boost of demand on reopening economies

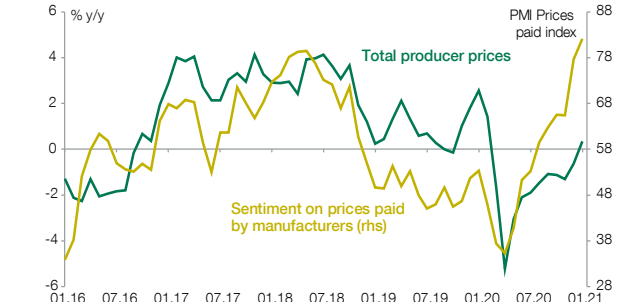
- The reopening of economies should refuel pent-up demand for traded goods and services, as seen in Q3-20. Reopening hospitality and access to seasonal goods should lead to higher prices thanks to fiscal stimulus and accumulated savings.
- Moreover, health costs could remain high due to needs for testing and updated vaccines. Finally, as governments are slowly but decisively moving forward regarding climate change, potential new environmental taxes in the coming quarters may add further to inflation pressure.

## Full employment factor of wage-inflation rises

- As central banks seem to target nominal growth and full unemployment in their exit strategy, more labour pressures could build as economies reopen. A higher employment demand in services and in industry could revive the pre-Covid moderate wage cycle at a time when labour force growth tends to slow down globally.

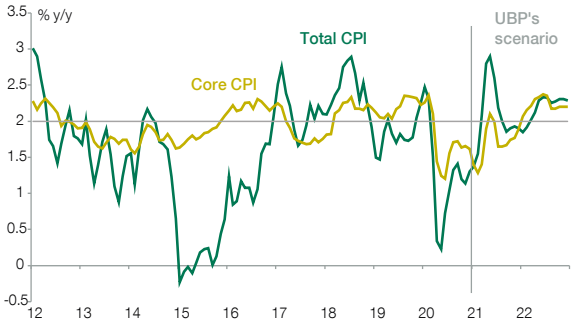
**Rising commodity and transport prices push costs higher for corporates**

US Producer prices & prices paid in manufacturing




Sources: ISM, BLS

**US inflation scenario: volatile and trending higher**




Sources: BLS, UBP

**Rising US wages should drive higher core inflation**

US wage growth & inflation


Source: BLS

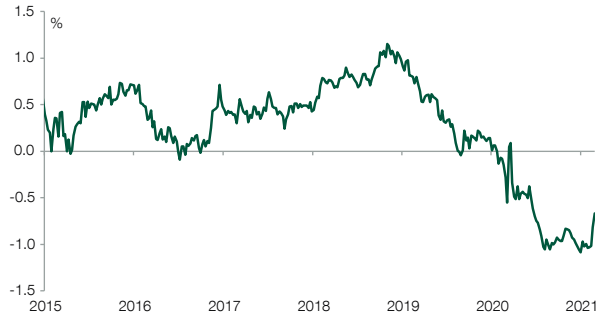
GLOBAL BONDS

# FAVOUR A BARBELL STRATEGY IN FIXED INCOME

- The bond markets stole the show this month with sudden increases in yields, greatly worrying investors. The markets seem to be banking on the US economy recovering quickly by the end of the year, whereas the Federal Reserve is staying true to its highly interventionist approach and choosing to focus on the job market's slow recovery.
- Strong economic growth fueled by government spending and an expansionary monetary policy suggest the prospect of a return of inflation, making low-yield bonds much less attractive. The increase in bond yields penalised the high-grade segment more severely where duration has been increasing as firms issue longer-dated to gain from the current low interest rate environment.
- Nevertheless, spreads have continued to tighten over the month, reaching multi-year lows on the back of strong overseas demand amid the backup in sovereign yields and limited primary market supply. High-yield credit has been doing particularly well helped by improving macroeconomic data and re-rating of sectors hardest hit by the pandemic.
- The energy sector in particular could be a major tailwind for the overall US HY market. Improving corporate fundamentals and a positive medium-term outlook for crude oil prices suggest the energy sector could drive spreads temporarily tighter in the coming months.
- While investor concerns about leverage ratios might have taken a back seat during the pandemic, frictions could start to appear in the medium term. For this reason, selectivity remains key with a focus on quality in the US and Europe and a preference for the high yield segment which offers a higher spread cushion and a lower duration.
- With low/negative interest rates around the developed world, we believe Chinese government bonds and Asia credit are anchors to income-oriented portfolios looking into the remainder of 2021. With the dollar weakening story of 2020 set to continue in 2021, investors can also enhance returns via FX markets in the year ahead.
- For higher risk appetite fixed income investors, European bank hybrid securities offer an attractive risk return profile and premium yields compared with European high yielding securities despite an implied backstop from the European Central Bank.
- Going forward, however, as the near-term outlook remains uncertain and with medium-term stimulus on the horizon – investors can benefit from a 'barbell' strategy between lower risk, moderate duration strategies and cyclical recovery-oriented exposure looking to the 2H of 2021.

### Real yields on US Treasuries rise on hopes for buoyant economy

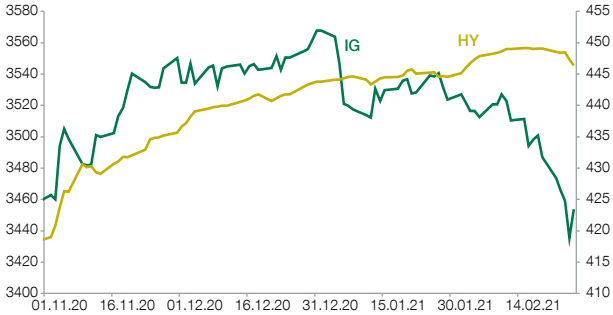
US real yield based on 10-year TIPS




Sources: ICE, UBP

### The increase in bond yields penalised the high-grade segment more severely

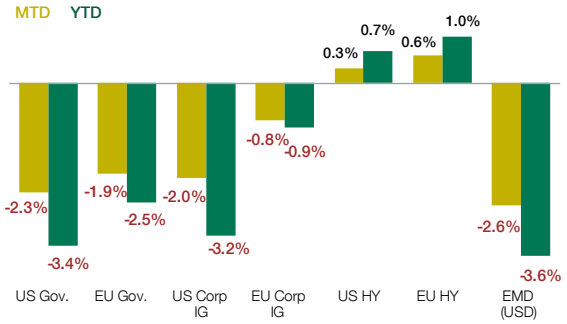
US Investment Grade and US High Yield (total return)




Sources: ICE, UBP

### Fixed income hurt by rising yields

Fixed Income Performance




Performance is as end of February 2021
Sources: Refinitiv, UBP

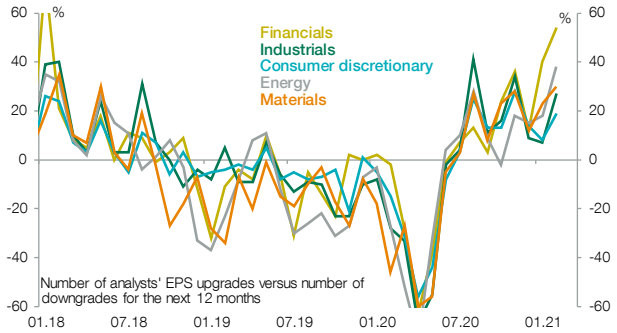
GLOBAL EQUITIES

# ADDING TO HIGH-QUALITY CYCLICALS EXPOSURE

- With investors worrying whether current valuations can be justified in a higher-yield environment, equities edged lower in late February, but still managed to return small gains over the month.
- Thanks to strong earnings beats during the latest reporting season and largely reassuring guidance, revision ratios moved significantly higher in all major regions, with the US again posting the strongest upward revisions. Importantly, earnings momentum remains by far the strongest for all cyclical sectors.
- As a result, 2021 expected EPS for global equities continue to rise and are anticipated to grow by nearly 30%. Differences are significant between markets and sectors, with most cyclical industries expected to post strong rebounds in profitability.
- This earnings recovery should serve as the key driver to total returns even if rising bond yields were to put some pressure on valuation multiples.
- As a result, it is important to seek out sectors which should post strong earnings growth but also positive earnings surprises in 2021.
- Since the start of the year, we have added exposure to industries which offer substantial leverage to the economic recovery such as global mining equities. Global miners' ROEs and free cash flows should continue to benefit from the ongoing rebound in commodity prices.
- More recently, we have added UK equities to gain exposure to the cyclical recovery story, especially as the UK is making excellent progress with its vaccination programme. Moreover, UK equities look the cheapest relative to their own history but also when compared to other major regions.
- We believe that the current environment continues to argue for the barbell strategy that we have put in place in recent months between our high-quality transformational growth themes and cyclical exposure.
- Moreover, given current rich equity valuations, we have taken advantage of market opportunities - with the VIX having returned to pandemic-era lows - to restore asymmetry in portfolios.

**Earnings estimates for cyclicals in particular are revised strongly upwards**

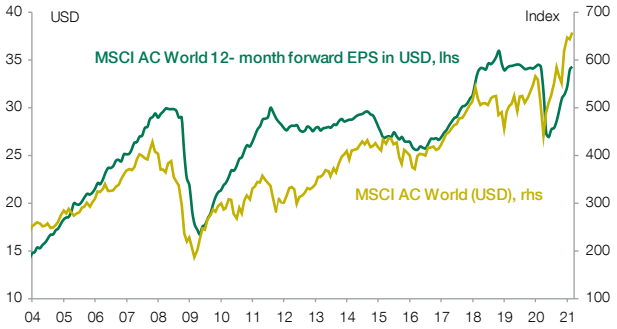
US earnings revision ratios: cyclicals




Sources: Refinitiv, UBP

**Equities pricing in a sharp rebound in earnings**

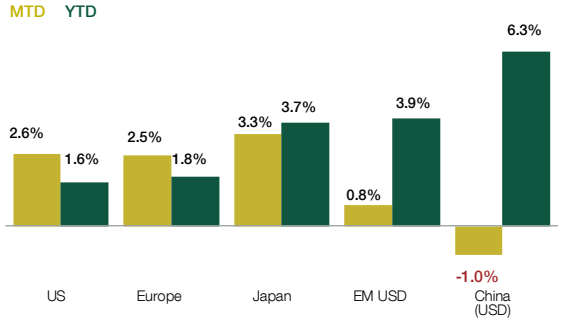
MSCI AC World and forward EPS in USD




Sources: Refinitiv, UBP

**Emerging and China underperformed during the month**

Equities Performance




Performance is as end of February 2021
Sources: Refinitiv, UBP

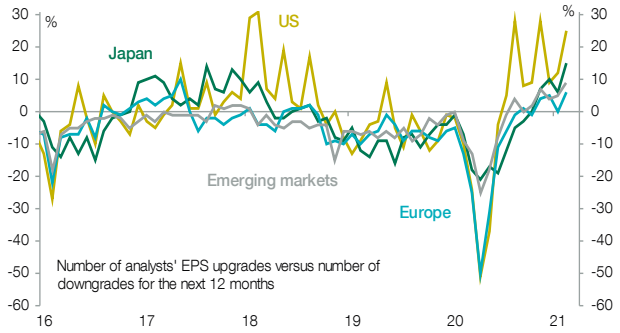
RECENT VIEW CHANGES

# ADDING GLOBAL RECOVERY THEMES AND ASYMMETRY

- In January, we deployed our cash into carry strategies such as emerging market, high yield and CoCo bonds. While central banks and governments around the world should continue to support the credit markets, selectivity is key in investing in these strategies.
- With inflation expectations rising since the start of the year, we introduced a new position into global inflation linked bonds to protect our fixed income portfolios against inflation. We also restored some of our government bond holdings in January which should provide some cushion should volatility rise once again.
- In the equity space, since last November, we gradually removed our portfolio protection and rotated some of our defensive strategies such as hedge funds and structured products into directional equities, adding to Europe and China.
- We extended these moves early in 2021. In addition to our long-term strategic holdings in technology and healthcare, we added exposure to quality cyclical themes that should capitalise on the recovery of the global economy. Global mining sector, small caps in Japan as well as quality industrial companies should be beneficiaries going forward. We also added UK equity in February.
- We continue to seek opportunities to transform our equity holdings balancing the transformational growth themes and cyclical recovery companies that should drive the next leg of earnings recovery.
- A proactive and dynamic risk management approach is increasingly required to navigate the bumpy road towards global recovery. As a result, we took advantage of the relatively cheap volatility in mid-January and mid February to restore protection through put options and structured products, which will protect us from downside market moves while continuing to allow us to participate in the markets' upside potential.

### Earnings are key going forward

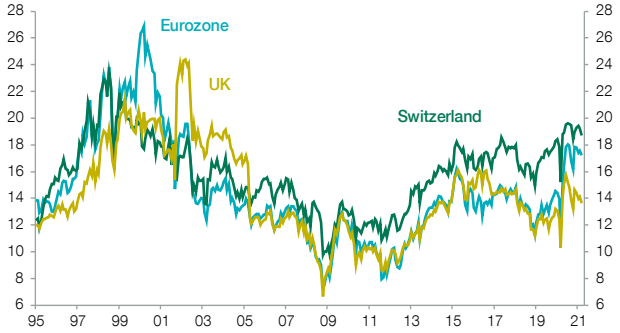
Earnings revision ratio US, Europe, Japan and EM




Sources: Refinitiv and UBP

### UK equities are relatively cheap

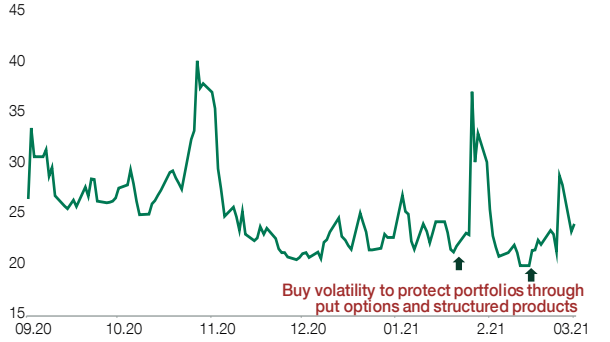
Eurozone, Swiss and UK equities: 12-month forward PER




Source: Refinitiv

### Buy volatility cheap to protect portfolios

Implied Volatility Index




Sources: Refinitiv, UBP

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