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Asset allocation update: some like it hot!

Multi-asset | March 2021

Maya Bhandari
Portfolio Manager

At the end of last year, I reflected that you "gotta have faith in low discount rates" for risk assets, such as equities, to continue to perform well in 2021. While on the one hand the economic and earnings recovery from Covid-19 was, and continues to be, more potent than expected, allowing companies to grow-in to elevated multiples; on the other hand, an increase in ultra-cheap capital costs, particularly of the sort we have seen in recent weeks, is a chief risk.

In particular, the sharp sell-off in sovereign rates markets in recent weeks appears to reflect mounting concerns of a "policy mistake", with real bond yields rising under ostensibly similar conditions as they did around the 2013 taper tantrum or in late 2018 as Powell's Fed reflected that they were "a long way from neutral".[1] The short end of rates curves have brought forward the first interest rate hike from the Fed (and Bank of England) by a full year or more, to 2023, and bond curves have bear steepened as rates volatility has increased dramatically back to levels of last March. So: is it time to lose faith in low bond yields, and what does it mean for investors in risk assets?

The answer is: *it really depends*. And it depends on the interplay of three forces: what is driving bond yields higher; how policy makers, especially central banks, respond; and if equity cash flows, or earnings, are able to grow at the heady pace they are presently anticipated to.

Breaking down the bond yield

Bonds can be dismantled into inflation expectations (or breakeven rates)[2] and real yields (the remaining component). And while gently rising nominal bond yields tend to be associated with rising economic growth – and so suit equities by boosting expected earnings or cash flows – what happens under the bonnet, that is to say whether it is real yields and/or breakevens that are driving yields higher, often matters more.

[1] Bloomberg, Powell Says Fed May Lift Rates to Levels That Restrain Growth,3 October 2018
[2] Conceptually, the difference between nominal bond and real yields, or inflation compensation, is the sum of expected inflation and the inflation risk premium over a set period (which is roughly the duration of a bond)

For most of the period from March 2020 through to February this year, bond yields were led higher by moves in breakeven inflation, with real yields plunging to fresh post-2003 lows.[3] This combination was a “sweet spot” for stock markets, particularly for the longer duration, growth-titled stocks: their expected cash flows were boosted in line with the better growth and inflation expectations captured by breakevens, and the rate at which they were discounted had rarely looked more attractive. In the past three and five years, for every one standard deviation rise in breakeven inflation, accounting for the change in real rates, returns on the S&P 500 increased by 0.6-0.7 standard deviations. Meanwhile, between early-November 2020 and mid-February, real yields shaved off around half the higher cost of equity implied by higher breakeven yields.

In recent weeks, the order of battle has shifted, with real yields leading the march higher as breakeven moves have stalled. While this suits value stocks, it is more problematic for growth stocks that have been huge beneficiaries of both higher breakevens and lower real yields. Rising breakevens are important for size, cyclicality and the relative performance of tech. Figure 1 captures some of these heuristics.

Figure 1: Correlations between yield moves and sector/style outperformance

	World Value outperforms Growth	World Small caps outperform Large	US Tech outperforms US	US Cyclicals outperform Defensives
US 10y nominal	18%	56%	13%	40%
US 10y breakeven	-7%	55%	33%	44%
US 10y real yield	35%	11%	-24%	2%

Source: Bloomberg, March 2021. Indices referred to are: World Value = MSCI ACWI Value; World Growth = MSCI ACWI Growth; World Small = MSCI ACWI Small Cap; World Large = MSCI ACWI Large Cap; World Consumer Discretionary = MSCI ACWI Consumer Discretionary; World Staples = MSCI ACWI Consumer Staples; US Cyclicals = Average of: S&P 500 Consumer Discretionary, Financials, Industrials, Information Technology, Materials, and Real Estate Indices; US Defensives = Average of: S&P 500 Consumer Staples, Energy, Healthcare, Communication Services, Utilities Indices.

Real yields can rise for very different reasons

Inflation expectations have moved a long way, in tandem with oil and other measures of cost pressures, so any prospective move higher in nominal yields would seem more likely to be driven by real rates rising from post-2003 lows. And here things get weedy, because changes in real yields can reflect a myriad of factors including growth expectations and Fed policy – and have risen for very different reasons in recent history.

For instance, higher real yields during the 2013 taper tantrum and in Q4 2018 were very disruptive for risk markets that perceived the Fed’s actions as a policy mistake. By contrast, the rise in real yields around Donald Trump’s tax reform/reflationary periods in 2016 and again in late 2017 were judged to simply reflect more bullish growth prospects and spurred punchy risk rallies. On balance, as life returns to normal, helped by the huge additional policy stimulus and vaccine roll outs, real yields could quite easily rise in a reflationary, risk-positive setting: our US growth forecasts are now at the upper end of the consensus for both this year and next; our expectations for Japan are similarly optimistic, and we have also edged higher our 2021 European growth forecasts.

[3] Bloomberg, March 2021

Central banks and cash flows

But, of course, a lot rests on the Fed (and other central banks) – both its ability to re-anchor the yield curve and to look through what will be a sharp rise in inflation as the economy normalises and growth rebounds quite powerfully in the second half of the year. Insofar as broader financial conditions have stayed remarkably easy despite more unsettled bond markets, with stable credit spreads, it is not clear that the Fed will feel the need to intervene with urgency. Equally, the whole premise of Flexible Average Inflation Targeting is to allow the economy to run hot, which is inconsistent with markets pricing a premature policy tightening and long-end bond yields that are only a whisker away from the Fed's estimate of neutral.

The final piece of the puzzle is, then, earnings, or cash flows. The fourth quarter earnings season has been amazingly strong across most geographies, and our expectations for 2021 and 2022 are modestly more constructive than currently bullish consensus expectations. Indeed, earnings growth is sufficiently strong to secure good total returns for equities, even with some de-rating, and a modest bear market in price-to-earnings ratios is already priced in over the next couple of years. The key question is how deep the bear market will be. Our focus in Columbia Threadneedle multi-asset portfolios has been to concentrate our risk exposures in equity markets with smartly growing profits, like emerging Asia and Japan, that are highly operationally levered to an improved global outlook. We hold together with higher quality US stocks and a mix of corporate bonds, and stay cautious on core government bonds at the current juncture.

Some like it hot!

Figure 3: Asset allocation snapshot

	Strongly Dislike	Dislike	Neutral	Favour	Strongly Favour
Asset Allocation		Government Index-Linked	Cash Property Commodity	Equity Credit	
Equity Region			UK Emerging Markets Europe ex-UK	Japan US	Asia ex-Japan
Global Equity Sector		Real Estate Financials Utilities Energy Staples	Industrials Consumer Cyclicals Materials	Health Technology Communication services	
Bond – FX Hedged		Japan	Germany US UK	Nordic Australia EM Local	
Credit			EMD	Corporate HY Corporate IG	
Commodity		Livestock Energy	Softs Base metals	Precious Metals Grains	
FX		USD	Euro GBP Nordics AUD	JPY	
Portfolio risk			X		

Source: Columbia Threadneedle Investments, 1 March 2021

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