QUARTERLY COMPASS

REYL
innovative banking

Q3 2021

Maintain a pro-cyclical asset allocation

Time to reduce interest rate duration again

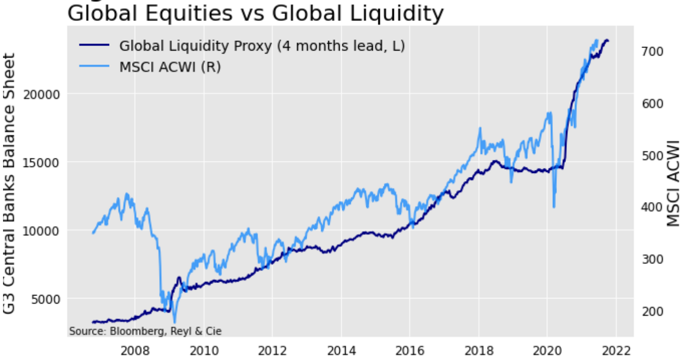
Long "hawks" (USD, CAD) vs "doves" (EUR, JPY)

Favour "uncorrelated" hedge funds

GLOBAL MACRO AND ASSET ALLOCATION

Since the Great Financial Crisis (GFC), financial markets have become heavily reliant on liquidity injections from central banks (c.f. figure 1). With the mounting number of central banks considering exiting their ultra-loose monetary policies as a result of a global macro backdrop shifting from the recovery phase to the boom phase, we need to brace ourselves for increasing equity volatility in H2 2021.

Figure 1
Global Equities vs Global Liquidity



Nevertheless, we maintain a pro-cyclical asset allocation positioning on the back of brightening prospects in the world economy, whilst keeping an eye on any hints about Fed tapering (Q3 21?).

At the macroeconomic level, the recovery is uneven across the world. We are observing a global desynchronisation of economic growth, depending on the ability to contain the COVID-19 spread or the speed of the vaccination take-up. China already peaked in Q4 20, the US will likely see a boom this summer, and Europe will likely enjoy peak growth in Q3 21.

In the US, inflation is staging a strong comeback, reaching decade highs, but we expect pressure on the pricing of goods & services to moderate in the coming quarters. Hence, for now, we side with the consensus that inflation is more of a transitory phenomenon. However, we also acknowledge the forces that could lead to more persistent inflation such as labour shortage, lasting supply chain disruption (notably in container freight and semiconductors) and the potential increase in US spending given the abnormally high saving ratio.

The Eurozone economy is turning a corner after two technical recessions in the last 12 months, as economies gradually reopen. The consensus is upbeat and growth in the Eurozone is expected to slightly outpace that of the US next year (Bloomberg consensus: 4.2% vs 4.1%). Most Asian countries continue to benefit from the strong recovery in the manufacturing sector, but some countries could suffer when the Fed begins its tapering. **Focus on EM/Asian countries with more solid fundamentals, in particular a current account surplus and sound fiscal balance**.

EQUITIES

We expect EPS growth to be ca. 40% in the US and 50% in Europe this year. Next year EPS growth should be less stellar and settle around 11% in all regions. Valuations should therefore tighten in the next 12 months from peak levels but remain on the expensive side. Typically, equities face a valuation derating at mid-cycle, but generate positive price returns through strong earnings growth.

The key to stock picking is in identifying the leaders and the rotation that takes place during a typical bull market. Global value stocks have outperformed growth stocks since Q4 20, as investors focused on earnings recovery. Despite the outperformance, value stocks still remain cheap. Attractive value plays can be found in US financials and European automakers. On the other hand, we see that US growth stocks are trading at the same premium (vs the value segment) as in 2018, so not particularly expensive. As we approach mid-cycle, a barbell strategy combining a secular growth segment (i.e. US tech) with some pockets of deep value is appropriate.

Besides value, the other attractive theme in the current macro environment is that of pricing power, as this feature is key for companies to maintain margins which are under pressure from increasing input/production costs (c.f. figure 2). Some sectors with strong pricing power are renowned brand names, semiconductors, software, shipping, industrial miners and gas, as well as infrastructure/concession players.

Figure 2
US Inflation should pressure margins

In our analysis, the US equity market is not in euphoria but too much complacency remains and equities continue to attract capital flows due to a lack of other attractive opportunities. Technicals remain very solid on most developed market indices, as the cyclical bull market that started in March 2020 remains in full force. Indices are trading above their pre-crisis peak and above a rising 200d moving average. Furthermore, market breadth is healthy and momentum is strong.

We remain tactically overweight equities and our base case scenario is for a 7.8% upside on US stocks and 5.3% on European stocks over the next 12 months. However, we expect more volatility in coming quarters given the macro context of diverging monetary policy expectations and diverging growth dynamics.

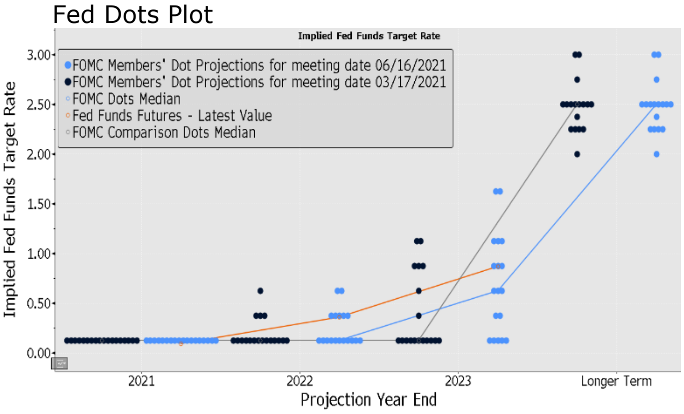
FIXED INCOME

This past second quarter has been characterised by very accommodative financial conditions, with the help of dovish Central Banks and government fiscal spending. The USD declined as well which provided relief most notably for Emerging Markets. Yields have been very stable across countries and anchored at low levels, with inflation expectations already robust but contained. Credit spreads and volatilities also contracted, underpinned by positive growth and earnings momentum - a sign of renewed trust… or is it complacency?

This “goldilocks” scenario may have continued, but further to the strong May inflation figures in the US, the Fed modified its stance, increasing both its growth and inflation forecasts and, more importantly, bringing forward its interest rate hike to 2023 (2 hikes of 0.25% versus none previously). Regarding liquidity “tapering”, it announced it will continue to buy assets at the $120 billion monthly pace until "substantial further progress" is made on jobs and inflation, but acknowledged the discussion was open about reducing its purchases. An announcement is probable in September for an implementation in Q1 2022.

The market reaction was very strong, with the curve flattening aggressively, inflation expectations declining sharply and the USD rising. A big unwind of the “reflation trade”. We think this move is overextended and market pricing excessive. Futures are more hawkish than the dots, and the Fed will be very careful and gradual going forward. It has learned from the 2013 “taper tantrum” episode and 2018 “automatic pilot” mistake. After all, it’s difficult to taper when you own 30% of the Treasury market! Market participants now seem to agree that inflation pressures are transitory, but they could be stickier than expected and may stay with us until later this year. So the Fed showing it is not behind the curve is rather good news.

Figure 3
Fed Dots Plot



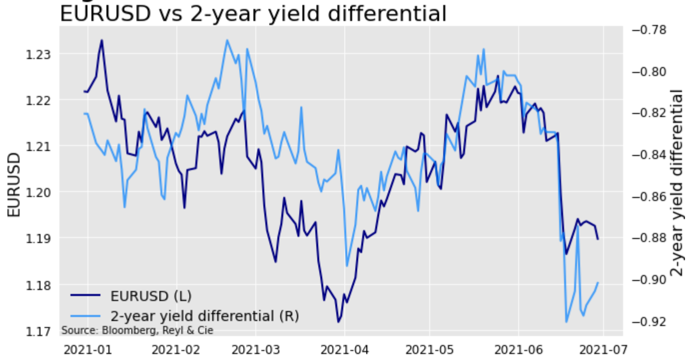
We consequently have decided to take profits on our duration lengthening and bonds exposure increase of last March, by selling our 7-10y US treasuries, readopting a slight underweight bias. We have kept our 30y exposure, which provides some convexity and should benefit from a curve flattening. **In Europe and Switzerland, we remain strongly underweight as, on top of the risk for higher yields, the negative carry is a strong penalty.** Inflation breakeven may decline further post FOMC, and we maintain our exposure as a hedge against unexpected further surprises and as the inflation carry will continue to be strong in the coming months.

In the credit world, the investment grade segment is quite expensive again with both spreads on the tight side and core yields low. Still, we don’t expect significant widening pressure as the current environment of easy financial conditions. Economic growth recovery is supportive and corporate fundamentals are sound. Therefore, we maintain our preference for the BBB segment in IG but mostly favour high-beta segments such as high yield (despite spreads also looking expensive, less so for leveraged loans) and subordinated financial debt where we see more value. Indeed, we feel it is still time to ride the wave and seize the carry/rolldown in the credit market, before the landscape darkens this fall with the Fed decisively taking the path of liquidity tightening.

FOREX

Monetary divergence is the key theme in FX, as the exit from ultra-loose monetary policy is not synchronised across the G10. The process of normalising monetary policy has already started in some economies (BoC, RBNZ, Norges Bank), while others are still deep in dovish territory (ECB, BoJ, SNB). The hawkish shift from the Fed at the June FOMC is a game changer for the short-term dollar narrative as it led to a surge in short-end yields and to a flattening of the curve, in a year when the dollar has tracked short-term rates differential well (c.f. figure 4).

Figure 4
EURUSD vs 2-year yield differential



The key question is whether markets will take time to adjust to the new policy path. We side with this hypothesis as historically the dollar moves substantially after a repricing of the monetary policy path. Furthermore, aggregate speculative positioning is still short and it will take some time to rebuild bullish dollar positions. We also believe that the front end of the curve will continue to gradually climb as the market starts to focus on the tapering during which the curve typically flattens. We note that there is a strong (lagged) historical relationship between the spread in core inflation EZ-US and EURUSD. All of these factors are supportive for the greenback, a view that is further confirmed by our technical analysis work. The medium-term outlook for the dollar depends on the conflict between how soon the Fed starts to raise rates, and how fast the global economy reopens and recovers. According to experts, 90% of the world's adult population could be fully vaccinated well before the Fed starts a new hiking cycle. Hence, we believe that the broadening of the global recovery will dominate the narrative in the medium-term and undermine US economic "exceptionalism". In this context, risk assets should fare well and risk appetite be high, a typical backdrop for a weaker dollar.

However, we foresee high divergence between the FX from central banks ahead of the normalisation curve (BoC, RBNZ, Norges Bank), and those behind the curve (ECB, BOJ, SNB). Against a macro backdrop of broadening global recovery and a resumption of the reflation trade, the greenback is likely to weaken more against growth-sensitive currencies than against the EUR or JPY. The ECB has no inflation to worry about and will likely be one of the last G10 central banks to exit its ultra-accommodative monetary policy. As the Fed is clearly going the other way, trying to escape the "ZIRP for long" trap, it will be hard for the EUR to appreciate strongly vs the USD. With the Eurozone's vaccine campaign catch up and growth prospects already priced in, we expect the FX market to start pricing in some political risk premium tied to next year's French election. This will likely put a cap on any EUR appreciation.

HEDGE FUNDS

As a reminder, the universe of liquid hedge funds can be split into four major categories/strategies, as defined by Hedge Fund Research. Equity Hedge is the largest one and includes hedge funds involved in stocks. Event-Driven includes funds involved in corporate changes across the whole spectrum of capital structure. Macro-CTA is a disparate category with most funds involved in a wide variety of asset classes. Relative Value Arbitrage mainly includes funds active in the bond market. These strategies are overseen by HFR Global Hedge index, which is used by many hedge funds as a benchmark.

A simple statistical analysis shows that, over different time horizons, the correlations of the different strategies with each other and against traditional asset classes have remained extremely stable. Indeed, all hedge fund strategies have displayed no correlation with sovereign bond indices. However, they are all highly correlated (except Macro/CTA) with global equity indices. Unsurprisingly, "Equity Hedge is the most correlated to equities. The performance of hedge funds over the past two years has been very good: between 5% and 11% per annum. All major strategies have performed with a strong dependence on global equity markets, but with a low sensitivity (beta). Indeed, the correlation of the Global Hedge Index with the MSCI World has been around 90% on a weekly basis over the last two years.

Despite these strong correlations and the very good performance of equities over the past decade, hedge fund strategies have had an average annualised return varying from 0.0% to 2.7%. This poor performance is explained by a low but stable beta against global equities (30% for the Global Hedge index) but also by a recurring negative drift in alpha. Alpha destruction is more pronounced within Equity Hedge and Macro/CTA.

As a result, alternative "correlated" strategies have historically not improved the risk-adjusted return of a diversified asset allocation portfolio composed of equities and bonds. **In order to improve the Sharpe ratio of such a portfolio, it is necessary to integrate funds that have two characteristics: little or no correlation with traditional asset classes, and good risk-return ratios.** This is our preferred solution in the current market environment. Our second choice is to focus on combinations of sub-strategies that have historically performed better than their respective strategies. Within Equity Hedge, we favour a combination of Quantitative Directional and Multi-Strategy. In the Event Driven category, we favour a combination of Merger Arbitrage and Credit Arbitrage. Within Macro / CTA, we prefer a combination of Discretionary Thematic and Active Trading. In Relative Value Arbitrage we look to a combination of Fixed-Income Corporate and Volatility. These various sub-strategies offer characteristics that we consider important in the long term, namely diversification, dynamic trading style, flexibility, relative value approach, and convexity.

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