BANQUE HAVILLAND

Q2 2021 OUTLOOK

APRIL 2021

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MARKET ENVIRONMENT

The bond market flexed its muscles in the first quarter of 2021, with yields finally moving off historic lows to rattle investors and central bankers alike as fears on inflation became more widespread. The great equity reflation trade, however, nervously continues amid growing expectations of higher prices as the economic recovery in developed markets gathers pace and remains underwritten by huge monetary support. Though sentiment has been rocked by a couple of unforeseen man-made events over the past weeks, the fact that the real worry for investors is a function of the markets themselves (i.e. higher yields and the symbiosis of financial assets), serves as a reminder not to be overly focused on current headlines when investing over the long term. The unfortunate blocking of the Suez canal by the container ship 'Ever Green' that accounts for about 12% of world trade and 7% of oil's passage was of course a significant occurrence, especially at a time that global supply lines are already subject to virus-restriction delays, but had very little effect on equity or commodity prices (though this is perhaps explained by the timing which coincided with the announcement of (demand reducing) further Covid measures in Europe. Likewise the implosion of the highly-leveraged Archegos fund has been a volatile episode for the companies held by the fund and painful for the creditor banks involved, but it has not triggered any wider ramifications for financial markets. Ultimately, markets are convinced by the recovery narrative and have sounded the starting gun for the end of the coronavirus crisis emboldened by the improving economic sentiment, a burgeoning vaccine effort and of course the small matter of a $1.9 Trillion US fiscal stimulus bill (with an intended $2.3 Trillion infrastructure plan to follow). American consumers, whose pockets are about to be filled with $1400 are unsurprisingly expected to start spending, and at least some of this money either directly or indirectly is likely to find its way to the stock market. We have written before about the peculiarities of the recent recession, but surely the most extraordinary feature is that US households' net wealth actually grew 10% in 2020 – so essentially American consumers are on aggregate emerging from the Covid 19 crisis richer than they were before it.

"Ultimately, markets are convinced by the recovery narrative and have sounded the starting gun for the end of the coronavirus crisis emboldened by the improving economic sentiment, a burgeoning vaccine effort and of course the small matter of a $1.9 Trillion US fiscal stimulus bill (with an intended $2.3 Trillion infrastructure plan to follow)."

Markets have quite possibly reached the point now that even new flurries of negative virus headlines are no longer sufficient to trouble the march higher of risk assets. At the time of writing Europe is being plagued by a third wave of Covid-19, which has officially become more deadly than it was at the same time last year with 20,000 people dying every week in the continent, according to the World Health

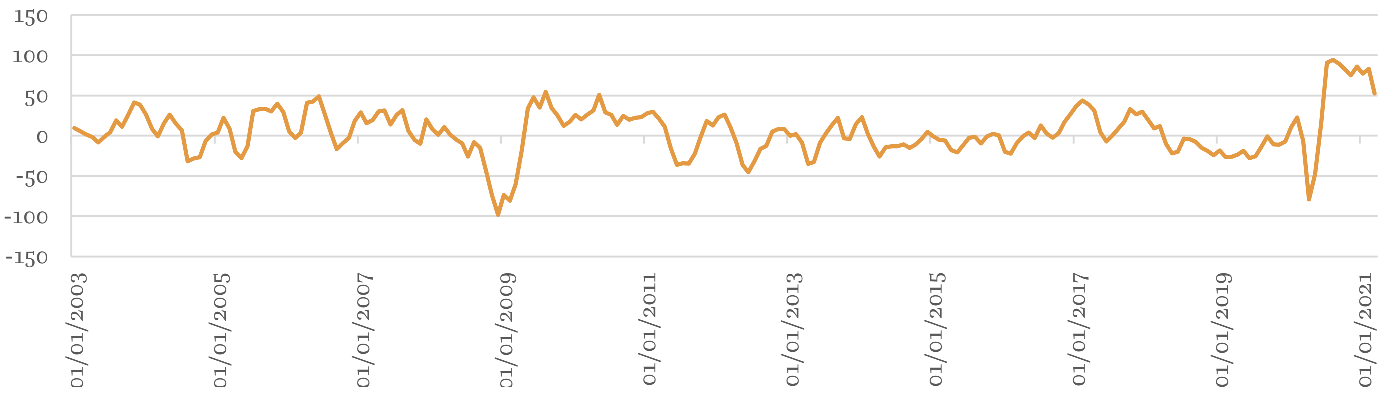
Organisation - and yet European stocks are riding high and outperforming other regions even as more restrictions and lockdowns are being announced. Of course much of the acute damage caused by the virus restrictions has been priced in, and the data shows that compared with the first lockdown developed economies have adapted to be more efficient. Furthermore, the 'reopening' theme that has seen commodities and cyclical companies surge is boosting beleaguered banks, energy, travel, and leisure stocks that feature prominently in benchmark European bourses. This rotation from growth to value has been seismic across all regions, signalling investors' optimism about the future in terms of cyclicality and also a more valuation-conscious approach, as participants seek to deploy capital but away from the negative real yields on offer in the bond market or the frothy tech and growth parts of the equity market. While we can't take credit for predicting what or when would precipitate this rotation to value, we are happy that our cautious approach to valuations and natural aversion to hype has seen our client's portfolios benefit in recent months. A selective approach to sector, region and style remains as important as ever with the recovery set to be uneven and discriminatory as restrictions are lifted in some areas and continued in others, pointing to winners and losers in a post-Covid world.

IMF World Economic Outlook Projections (% change)

	YEAR OVER YEAR	PROJECTIONS	
	2020	2021	2022
WORLD OUTPUT	**–3.3**	**6.0**	**4.4**
Advanced Economies	**–4.7**	**5.1**	**3.6**
United States	–3.5	6.4	3.5
Euro Area	–6.6	4.4	3.8
Germany	–4.9	3.6	3.4
France	–8.2	5.8	4.2
Italy	–8.9	4.2	3.6
Spain	–11.0	6.4	4.7
Japan	–4.8	3.3	2.5
United Kingdom	–9.9	5.3	5.1
Emerging Market and Developing Economies	**–2.2**	**6.7**	**5.0**
Emerging and Developing Asia	**–1.0**	**8.6**	**6.0**
China	2.3	8.4	5.6
India	–8.0	12.5	6.9

source: IMF
After the initial rebound this year, growth is expected to continue in 2022. We note the UK is the highest for developed nations.

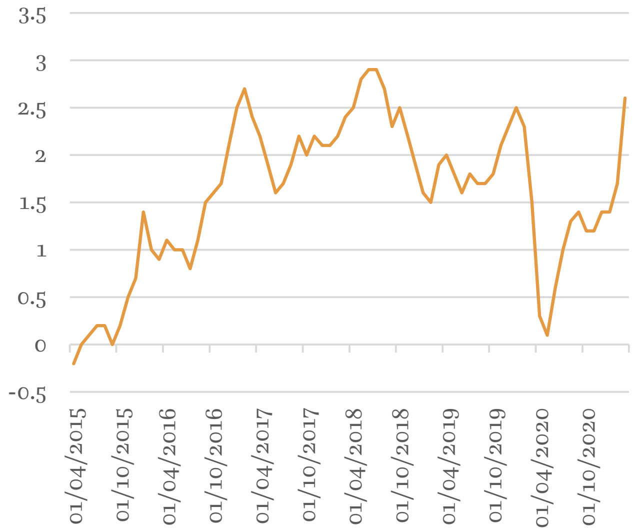
Citi Economic Surprise Index - Global



source: Bloomberg
The Citi Economic Surprise Indices measure data surprises relative to market expectations. A positive reading means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected. Sentiment is strong and looking to the eventual recovery.

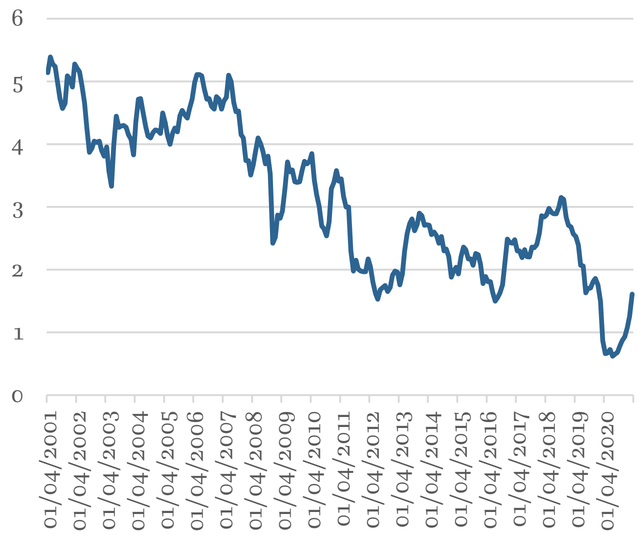
The rotation in stocks must also be attributed to the movements in the bond market, or more specifically the surge in yield of the US Treasuries demonstrated by the 10yr benchmark nearly tripling from its low of 0.53% in August last year to 1.7% at the time of writing. As yields on the US 'risk-free' asset approach more enticing levels in anticipation of the recovery, investors start to question the prospects for the pricey tech shares that flourished during the pandemic and the cost of shares priced for long term growth in general. However it is hard to imagine that someone may sell their Apple or Amazon shares for 1.7% a year income, and the greater reason for the selling of Treasuries points to markets questioning the US Federal Reserve. The Fed are supposedly focussed on the high unemployment rate, with Jerome Powell insisting the recovery is shaky and thus inflation is not of huge concern, while the bond markets are suggesting we are heading for a swift inflationary rebound and are starting to price this accordingly. US unemployment has dropped rapidly in recent readings, (with March's print indicating nearly a million jobs created in a month) suggesting we are heading for a key moment in the standoff between the central bank and the bond sellers. The wobble in the equity markets at the end of February/ early March suggests that the taper tantrum of 2013 is still a potent memory, and highlights the difficulty the Fed will have in normalising rates, though the fiscal stimulus this time round is so vast that perhaps changes to rates and monetary policy will be cushioned somewhat - meaning the pain is felt predominantly in the fixed income markets while stocks march on. US inflation itself is currently in 'rebound' territory, and we remain of the view that until CPI passes the 3% mark the Fed will not feel it needs to change its stance.

US Inflation (CPI Urban Consumers YoY NSA)



source: Bloomberg
Inflation has rebounded to pre-Covid levels and is nearing the key 3% level - the readings in the latter half of the year will be keenly watched for signs of runaway long-term higher prices.

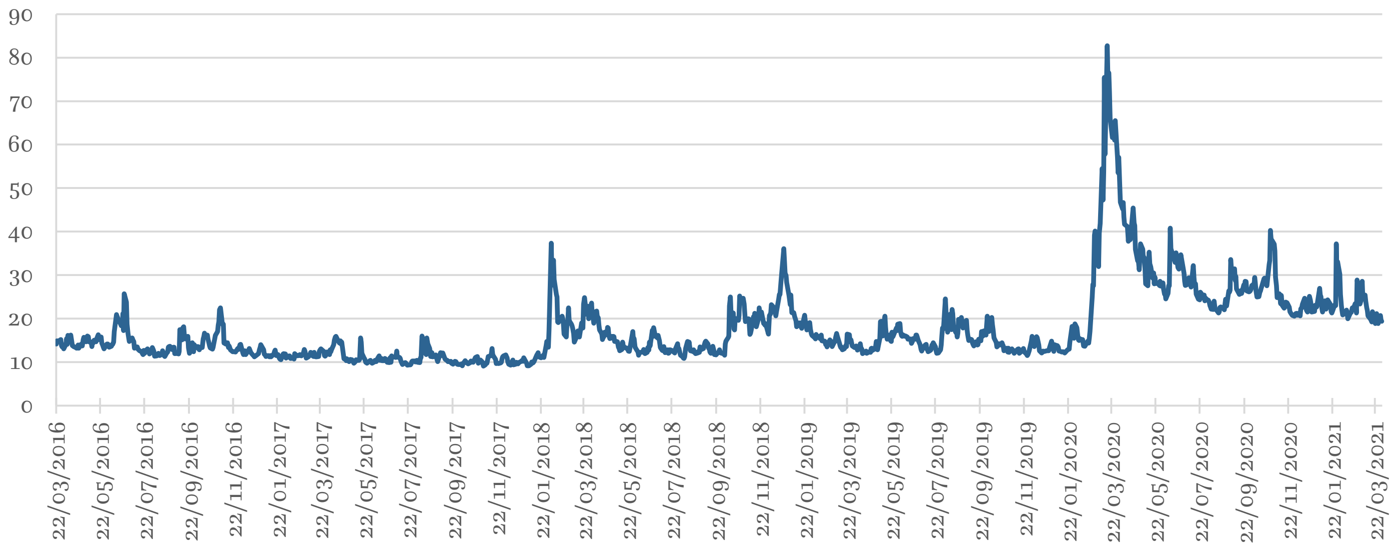
US 10yr Treasury Yield



source: Bloomberg
Bonds, as typified by the US 10yr Treasury have sold off in Q1 2021 with yields bouncing off historic lows. If yields reach 2.5%-3% the pressure on the Fed to act will become intense.

How quickly this number is reached is crucial, and if employment continues to climb at its current rate as vaccinated Americans start to spend their stimulus cheques then the Fed and the investment community will need to be agile. The months ahead are likely to be good for carefully selected stocks and cyclical commodities, but worrying for bonds with the ultra-low interest rate environment implying volatility as the smallest adjustment to inflation and real yield expectations are magnified in percentage movements, thus rattling sentiment.

The CBOE Volatility Index (VIX) - 5 years

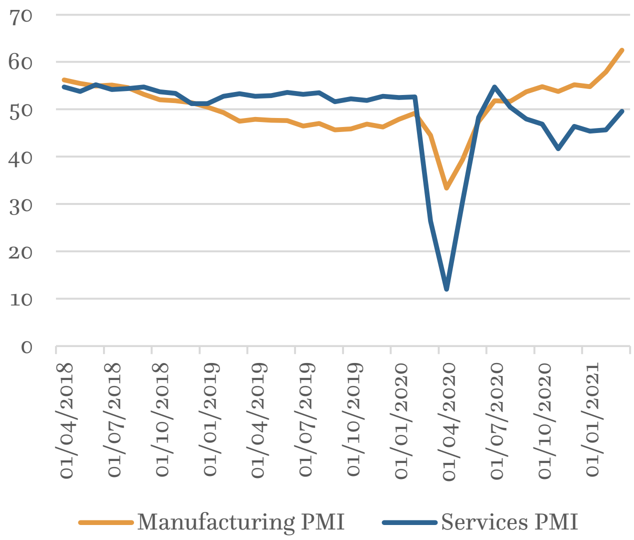


source: Bloomberg
Since the Covid crisis spike in March 2020, volatilty has been steadily dropping - any future spikes are likely to find their origins in the bond market.

EQUITIES

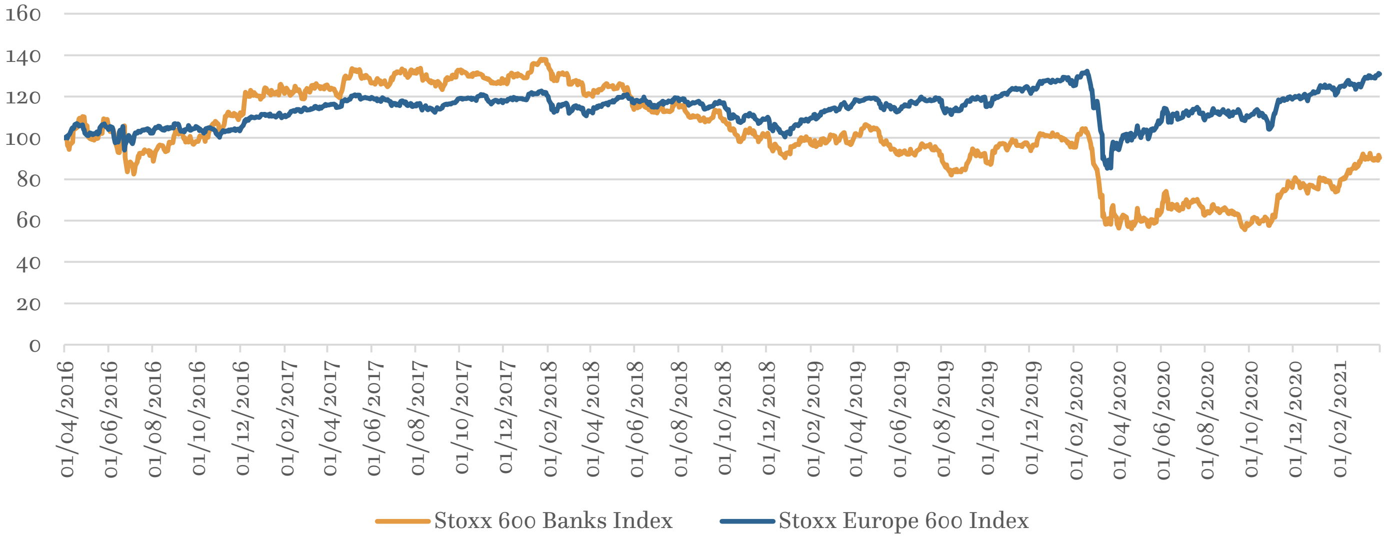
Just as old-economy stocks began to look set for their time in the sun after years of sub-performance, along came the Biden $1.9 trillion relief bill to once again wrench attention away from Europe and towards the supercharged growth prospects of the US. Even though the Eurozone's own stimulus measures amount to 7% of GDP, this is swamped by the 13% enacted by the US and suggests that Europe won't regain its pre-Covid GDP levels until 2022, a year after the US (not helped of course by a vaccine program that is being far outstripped). Nevertheless, as is often pointed out, stock markets are forward looking and are already focussed on the areas set to benefit most from a full reopening of the global economy as well as the ongoing rotation of growth to value. Naturally, the U.S. market trades at a much higher multiple to earnings than Europe does, thanks to the presence of the FANG internet platform stocks such as Apple Inc. But even if we exclude technology and telecommunications, the remainder of the S&P still trades at a premium to the Stoxx, in terms of forward earnings multiples, and this has widened since the pandemic. So do European stocks represent the bargain that they appear? Certainly, value sectors such as financials, industrial and energy which jointly comprise 38% of the Stoxx 600 Index look well set for recovery, with the beleaguered banks in particular representing a good opportunity when the economy picks up and if rates (bunds) rise too. Europe's manufacturers are doing surprisingly well, and this is shown by ISM data and the performance of the German DAX year to date, however, much of this is in fact more representative of China's activity than local economic demand. Moreover, the decoupling of the Manufacturing PMI from the Services PMI readings for the Eurozone points to the risk in the recovery narrative should the important services sector fail to catch up – we will need to carefully watch the earnings results of the sector as well as the employment numbers once government job-support schemes are wound down. On pure valuation terms (we use the CAPE P/E ratio) German stocks are 50% cheaper than American ones at 18.7x while Spain at 13.6x is cheaper than the UK FTSE 100 which itself looks increasingly attractive. Indeed, the stars are somewhat aligned for British stocks, with a combination of cheap valuation and high economic growth expectations, an advanced vaccine programme and, importantly, Brexit concerns now mostly in the rear window.

Eurozone PMI's Manufacturing v Services



source: Bloomberg
The outlook for Eurozone Manufacturing has decoupled from the Services outlook. The possibility of the Services sector not catching up is a risk for the recovery narrative.

European Banks v Overall European Equities



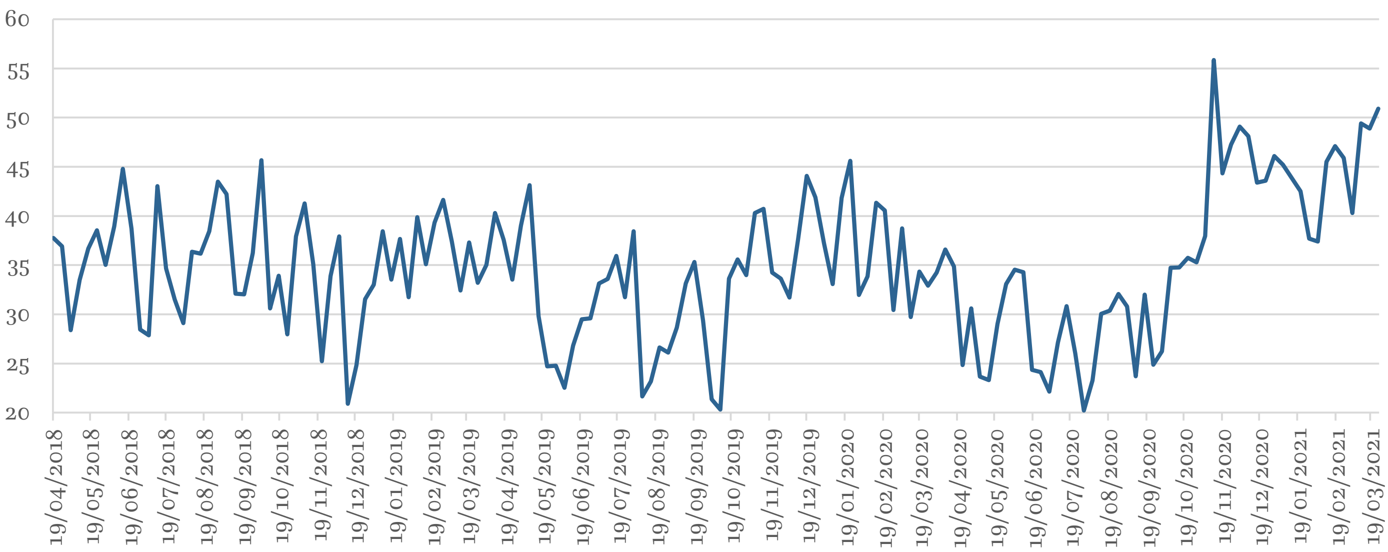
source: Bloomberg
European banks have long underperformed the main index and look like an attractive contrarian buying opportunity, and a potential hedge against tighter monetary policy.

The profit-taking in emerging market stocks was clear to see in Q1, as both small cap US equities and emerging Asian shares (which have been conviction calls of ours for the past few months) corrected significantly. While small-caps still remain an engaging prospect due to the growth dynamic of the US economy as well as being relatively attractive on a multiple basis – we think that emerging (specifically Chinese) markets require a rethink. Having rallied some 70 per cent off their lows of last year and delivered an 8 percentage point outperformance over global equities, emerging market stocks are no longer cheap. Growth momentum has shifted from China to the US while the dollar and real rates are both heading higher - an environment in which emerging markets typically struggle. Much like the pandemic response has created winners and losers socially, so too at a macroeconomic level are there wide dispersions: many nations face the prospect of having to defend their currencies and combat inflation by withdrawing policy support even as their recoveries are incomplete.

“(...) many nations face the prospect of having to defend their currencies and combat inflation by withdrawing policy support even as their recoveries are incomplete.”

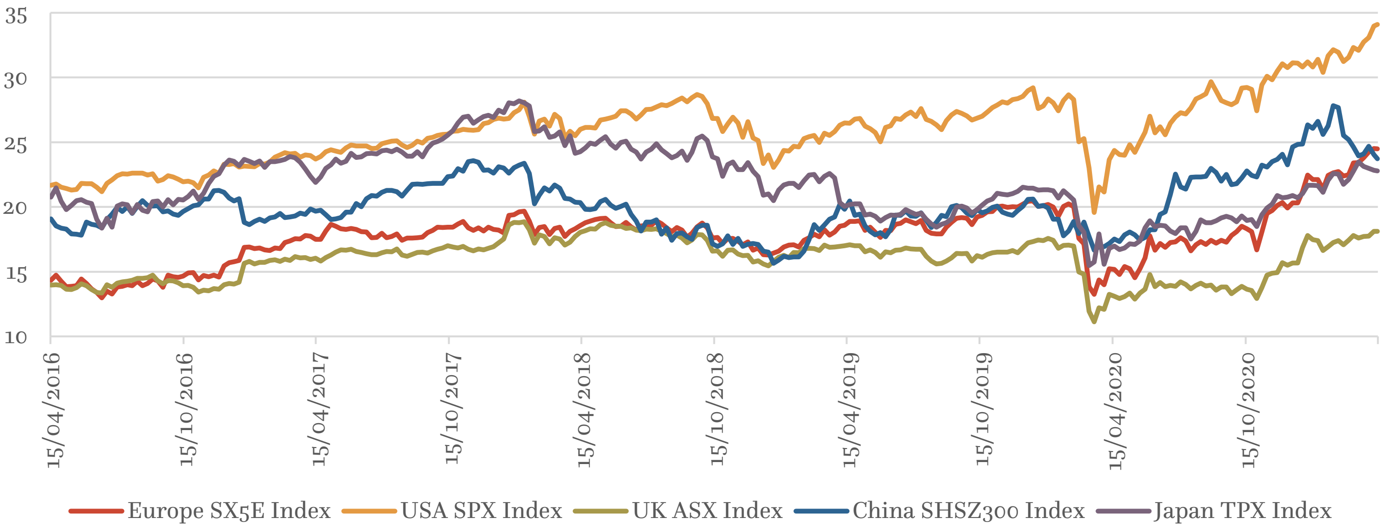
Brazil, Russia and Turkey have already moved towards normalizing monetary policy over the past month and their respective indices have been hit, and while China's economic recovery remains strong and sustainable (non-manufacturing activity expanded for 11 months in a row in March, while export growth is 32% above trend), it seems that this is triggering caution amongst Chinese policymakers. While in the long run a pullback in Chinese monetary support and tightening of credit may be a healthy thing for the global economy, in the short/medium term it would be a drag on emerging markets that rely on trade with China, as well as exporters such as Germany, and though a booming US economy would usually be a positive for EM assets if this is accompanied by higher US Treasury yields then the relative appeal will lessen. The higher debt burdens of EM countries following the pandemic, together with the heightened threat of geopolitical risk (Turkey, Russia, Taiwan, Brazil etc) means that a preferable entry point for emerging market stocks will likely present itself in coming months. Equity markets have once again reached new highs, and valuations in many aspects are stretched with the S&P500's P/E ratio now surpassing its pre-financial crisis peak, but with the Fed keeping monetary conditions ultra-loose (despite a booming economy) alongside extraordinary fiscal stimulus, the bull market looks set to be extended – especially with bonds looking unappealing.

AAII US Investor Sentiment Bullish Readings



source: Bloomberg
Bullish sentiment is elevated among individual investors in the USA.

Long term PE ratios - Major Indices



source: Bloomberg
The divergence in valuations was exacerbated in Q1: the US is now very high again, China rerated a little and the Uk looks cheap.

	-	=	+	
EQUITIES				The vaccine-enabled bull market will go on, though with certain aspects of the market looking very frothy and the cyclical rotation continuing, a selective approach is key.
US				Parts of the market are at extreme valuations, pumped up by retail buyers. The US economy is robust, however, so we like small caps and large cap value.
UK				British stocks are at their cheapest versus global stocks for many years, but may well outperform with a cyclical rally. Most of the Brexit fog has now lifted.
Eurozone				Cheaper valuation versus the US has seen continental stocks rally since November. Virus vaccination rollout is holding back growth.
Switzerland				Quality, defensive nature of the market may see the market lag more cyclical sectors as the economy recovers.
EM				We favour emerging Asia for the long term growth story with too much political risk elsewhere (e.g. Brazil).
Japan				Attractive valuation for a developed market, and we like the safe-haven qualities of the currency. Vast BOJ asset-buying is underpinning market, and growth is returning.

FIXED INCOME

Bonds look destined for a nervous few months as Treasury yields poke the ribs of the central bankers, who must come up with a different way of reassuring markets they are not going to raise rates at each monthly meeting, even while the US economic data points to rapid growth. Despite their efforts, an inflation narrative has taken hold and it is a brave investor that looks to increase duration at this point having seen the moves at the longer end of the yield curve year to date. The Fed does have at least one known rabbit left in its hat – that of yield curve control (see Japan), and the level at which it is forced to deploy this will be dictated by bond market participants who will be honing in on anything that suggests inflation will overshoot once growth has returned to pre pandemic levels. The taper tantrum of 2013 saw 3% as the (10yr) yield level at which risk assets started to panic, but it is likely to be lower than that this time around and we can expect some sort of Fed intervention before then. Having said this, many investors will be happy with a 2% income for holding US Treasuries so any rise in yields may be halted naturally at this level, at least delaying the point at which the Fed will need to react. While it might be profitable to be underweight or outright short duration in the short-term, the outcome usually favours the far deeper-pocketed global central banks. We are not prepared to side against them especially when the recovery is still in its fledgling phase and the structural forces that support the lower for longer theme remain very much in place, so maintain a neutral position with respect to duration in the medium term.

While we are uncertain that inflation will indeed shoot out of control once the global economy has completely re-opened (there is plenty of slack left in the labour market, and higher

“The strong Dollar year to date has not been helpful for our positive view on local emerging market debt, but a mixture of hard and local offers an acceptable level return providing a selective approach is taken.”

commodity prices are not a given), the bond markets remain useful really only as a volatility hedge against equites, with yields low amid a cyclical upturn - so we continue our neutral/ underweight stance. A diversified basket of bonds is a necessity, with no particular sub-asset class standing out as especially attractive - corporate bonds seem to essentially behave as a high beta version of Treasuries, but without the yield buffer at least offered by EMD and High Yield. Credit is at least supported by the various quantitative easing programmes of the various central banks, which should support the asset class, if not moving prices substantially higher. For agile fixed income investors the certain anchoring of short term rates has created a relatively attractive steep shaped curve, meaning the roll down effect in the total return for investors is now an option for yield pick up.

The strong Dollar year to date has not been helpful for our positive view on local emerging market debt, but a mixture of hard and local offers an acceptable level return providing a selective approach is taken. We are reluctant to chase yield at the expense of duration and credit quality, but see some income and diversification benefits from securitised (mortgage) bonds as the economy recovers, as well as in Chinese Onshore bonds. With respect to the latter, in light of China's reserve status and index inclusion, foreign investors are just beginning to become more familiar with the country's fixed income market while the scrapping of limitations on foreign ownership in securities and fund management firms will enable further information flow, which will in turn facilitate and deepen understanding of China's markets – providing yield-pick up opportunities for investors willing to do careful due diligence. Emerging market bonds were the only part of the fixed market that did not participate in the spread contraction of 2021 so far, and they have decoupled recently from US high yield bonds, making them an interesting relative value trade for a similar level of risk.

2 Year Bond Yields

COUNTRY	MATURITY	YIELD
Switzerland	SWISS 4 02/11/23	-0.805
Germany	BKO 0 03/10/23	-0.712
Finland	RFGB 1 1/2 04/15/23	-0.703
Netherlands	NETHER 2 1/4 07/15/22	-0.698
Austria	RAGB 0 07/15/23	-0.681
France	FRTR 0 02/25/23	-0.671
Belgium	BGB 2 1/4 06/22/23	-0.671
Ireland	IRISH 3.9 03/20/23	-0.630
Denmark	DGB 0 1/4 11/15/22	-0.593
Portugal	PGB 4.95 10/25/23	-0.579
Spain	SPGB 0 04/30/23	-0.500
Italy	BTPS 0.05 01/15/23	-0.370
Sweden	SGB 1 1/2 11/13/23	-0.316

COUNTRY	MATURITY	YIELD
Greece	GGB 3 1/2 01/30/23	-0.222
Japan	JGB 0.005 04/01/23	-0.145
Hong Kong	HKGB 0.16 02/22/23	0.009
Israel	ILGOV 0 3/4 07/31/22	0.010
United Kingdom	UKT 0 1/8 01/31/23	0.047
Australia	ACGB 5 1/2 04/21/23	0.060
United States	T 0 1/8 03/31/23	0.163
New Zealand	NZGB 5 1/2 04/15/23	0.220
Canada	CAN 0 1/4 02/01/23	0.237
Norway	NGB 2 05/24/23	0.401
Singapore	SIGB 1 3/4 02/01/23	0.431
Iceland	ICEGB 7 1/4 10/26/22	1.390

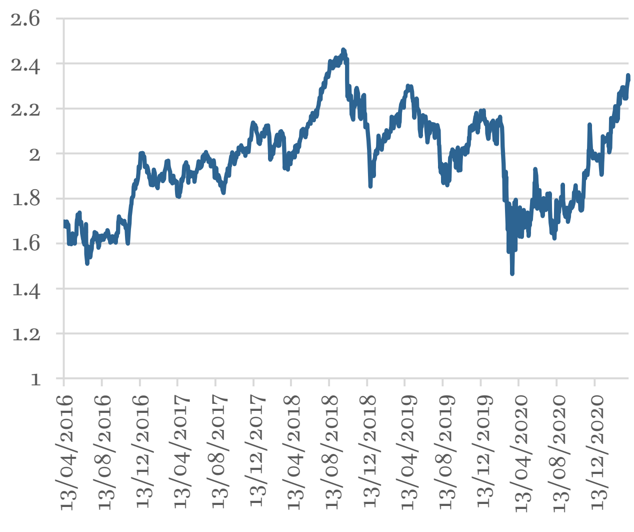
		-		=		+		
FIXED INCOME								**Low yields have started to rise in sovereign bonds and the market looks vulnerable to nflationary forces. Central bank action is important to monitor.**
Sovereign Bonds								Sovereigns offer safe harbour in time of market stress, but have limited upside remaining and negative real yields long-term.
Corporate I.Grade Bonds								Central bank asset-buying should be supportive for EUR and USD debt, yields not that attractive historically though. Should remain supported, but Total return is limited.
High Yield Bonds								Rebound has been fast and the easy money has been made. Yields remain compelling, but default risks are a worry, especially later as government support dries up.
E.M. Bonds								Local currency appreciation in an economic recovery, together with meaningful yield pickup make certain EM bonds relatively attractive. Short duration.

CURRENCIES AND COMMODITIES

The relative strengths of the Dollar has ramifications for nearly all asset classes, and the surge seen in Q1 was no exception as the reserve currency confounded expectations of weakening, rallying nearly 4% in the first quarter against a basket of other currencies. As the US economy once more pulled ahead of other regions helped by a superior vaccine response with treasury yields becoming more attractive, international cash flowed into dollars as the Eurozone region in particular, grappled with further lockdowns and vaccine delays. Safe-haven currencies have also started to lose their appeal in the face of recovering growth, with both Swiss Francs and Japanese Yen being the worst performing year to date while Gold has retreated 8% too. The Dollar strength is not set in stone, however, and we think that once the euphoria of the initial rebound and reaction to the stimulus plan has faded, there will be a refocus on the vast spending of the state and growing twin deficit, not to mention the fact that the other regions will catch up in time. The Euro, though weak in the short/medium term as the Dollar's largest pairing, should steady again once the vaccine rollout gets going and the ever-present political tensions are at least taking a back seat for now with the recent Dutch elections and the instalment of ex-ECB chief Mario Draghi in Italy to calm nerves. The Euro longer term should gain against the Dollar, while we think that GBP could be the stronger of the major currencies by the end of the 2021 as Britain awakes from its malaise of the past few years. Policy divergence between the Fed and the ECB is potentially materialising, with Christine Lagarde prioritising concerns over the side effects of unconventional policy (negative yields) compared to Jerome Powell's super Dovish outlook and apparent inflation apathy – this points to support for EURUSD. Bond yields and currencies are inextricably linked of course, and murmurs in that asset class could well push global currencies around – low yielding currencies such as CHF and JPY would be knocked by a sustained move higher in Treasury yields as cash moves to regions with better interest rate advantages.

After a period of consolidation Crude Oil and base metal commodities are also set to continue to strengthen as the recovery matures, aided too by a weaker USD, though the Suez blockage and recent attacks on the Saudi refinery remind us that Crude is always susceptible to short-term overshooting. The current level of crude looks comfortable for OPEC who are pumping at a very profitable margin while the US shale producers are consolidating into larger companies more willing to hold off fracking until

Gold/Stocks Ratio (S&P500 index in Gold)



source: Bloomberg

We know the S&P 500 is richly valued, and the ratio to spot Gold especially so. This suggests convergence will happen at some point.

crude prices justify it (smaller companies more desperate for revenues will pump at any cost). They are also aware that the green transition will be accelerated by a much higher price, so will not really want crude growing a great deal more expensive. Gold has been under pressure with many pointing to Bitcoin's latest high as evidence the cryptocurrency is the new 'digital' gold, and the rise in real interest rates seeing outflows from the precious metal. We certainly do not consider Bitcoin as a rival to Gold, as the former has shown itself to be very much a 'risk-on' asset rather than a portfolio diversifier and is unproven as a good asset to hold during inflationary times – it may be that Bitcoin is the place to be should the recovery story keep going, but gold still looks cheap compared with equities on a historical basis. The case for gold – sound money in an age of money printing - remains strong though it is prone to lengthy periods of consolidation.

		-		=		+		
ALTERNATIVES								**An increasingly important allocation with equities expensive and bond yields so low. Ideally we like holdings that are genuinely uncorrelated to the main asset classes.**
Precious Metals								Gold is off record highs, and is currently consolidating but the environment remains conducive for an extended run, and silver should follow.
Hedge Funds								Genuine alternative funds that behave in a different manner to traditional assets are a vital source of wealth preservation and diversification.
Oil/Commods								Commodities are booming in line with a recovering economy.

		-		=		+		
CURRENCIES								**Against consensus the Dollar has rallied ytd, as the US economy powers on aided by an accelerating vaccine rollout and higher relative yields. We expect it to resume its slide as the recovery picks up.**
U.S. Dollar (DXY)								Rates have shifted up, and the carry is back on. Huge stimulus bill will boost the economy but inflate the twin deficit pointing to a lower move long term.
Sterling (GBP)								The Pound has risen in relief following EU trade deal. An encouraging vaccine rollout and defined timescale is replacing worries over extended lockdowns.
Euro (EUR)								The Euro is perhaps flattered by the Dollar looking weaker. Central bank looks a little hamstrung, and the vaccine rollout is moving slowly.
Japanese Yen (JPY)								JPY has fallen back in 2021, but only back to pre-Covid levels and broadly in line with its 5yr average. A nice currency for diversification in risk-off times.
Swiss Franc (CHF)								Virus fears and US monetary policy have seen CHF strength continue though has weakened v EUR. Nice diversifier, though global recovery could dampen demand.
EM								Weakening Dollar and prospect of an affordable, practical virus vaccine should benefit EM nations. CNY has found a level at 6.5, with other economies catching up now.

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