The Reflation Trade

Since the lows in March of last year, the S&P 500 index has almost doubled, thereby far exceeding the drawdown of 35% from the pre-pandemic high. When looking at a five-year chart of the same index, it looks like US equities are not only back on their longer-term upward trend, but even rising at an accelerated speed. Who would have thought that in March 2020 and how could that happen?

As we've written in previous monthly newsletters, the pandemic was an exogenous shock to the world economy, not like the financial crisis in 2009. Powerful monetary and fiscal easing were put in place quickly.

Now we are witnessing the «reflation trade». After equities, US Treasury rates are beginning to take off. The Treasury curve is steepening as the longer end of the curve begins to price the possibility of higher inflation: the 2-year to 10-year spread has risen from 0.21% in February 2020 to 1.05%; the 10-year to 30-year spread is 33bps higher as of writing.

The blue sweep in the US triggered this move: if Biden manages to add $1.9trillion of spending to the $4trillion already put in place under Trump, then the total fiscal stimulus will be close to ¼ of US GDP in 2019.

If the news flow regarding vaccinations and the reopening of the economy continue to be positive, then the US economy could soon overheat and lead to a rise in prices.

It is therefore not surprising that talk of inflation and the repercussions on different asset classes is «en vogue». Both in equities and in fixed income signs are emerging that investors are adapting to the possibility of inflation: commodities and value stocks are rising, US Treasury yields are rising.

Only time will show whether these interpretations are right or wrong and whether we are slowly exiting a long deflationary period. Until then, volatility will likely tend to be higher in both equities and fixed income.

January 2021 Review

In January 2021 some recent trends continued within equities: the tech-heavy Nasdaq returned 1.42% while the S&P 500 index lost 1.1%. Small caps as measured by the Russell 2000 index rose by a whopping 5% in January alone. Europe lagged with the Euro Stoxx 50 index down 2% and the broader Euro Stoxx 600 index losing 0.8%. Outside of the EU, the two major equity markets also posted negative returns: the FTSE 100 fell by 0.82% and the SMI index ceded 1.05%. In Asia, the Japanese Nikkei 225 rose by 2.36% and the CSI 300 China index added 3.96%. Emerging Market equities returned 2.97%.

Sector performance also shows a continuation of recent trends: cyclical sectors such as energy, real estate and consumer discretionary continued to outperform, returning 3.63%, 0.48% and 0.39%, respectively. Among the worst-performing sectors were consumer staples and industrials, falling 5.32% and 4.34%, respectively. Tech fell by 0.97% as rising US risk-free yields rose, thereby decreasing the present-value of discounted cash-flows of companies in this sector which trades at already high P/Es.

Within currencies, the major event was a reversal of the recent tendency in EUR-USD: after six months of an appreciating euro, the greenback finally managed to regain some lost ground. The dollar appreciated by 0.74% vs. the euro. Dollar strength was visible across currencies. The USD appreciated 1.4% vs. the Japanese yen and 0.75% vs. the Swiss franc. The dollar index rose by 0.69%. Only the sterling was stronger and appreciated 0.28% vs. the dollar. Finally, the main victim of an appreciating dollar were Emerging market currencies which lost on average 1.17%.

Core interest rates did not move much over the period but saw some volatility intra-month: the US 10-year Treasury yield rose from 0.91% to 1.06% but traded temporarily as high as 1.15%. The German 10-year Bund yield rose from -0.56% to -0.51%. Investment grade spreads remained tight while high-yield spreads widened a bit on both sides of the Atlantic.

Finally, commodities are probably the strongest messenger of the «reflation trade» : the Bloomberg Commodity Index rose by 2.66%. Gold posted a small negative return while crude oil continued its quick rebound and ended the month well above the $50 level.

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	3 714	-1.93	-3.31	0.00	-1.11	-1.11	19
Nasdaq	13 071	-2.00	-3.49	0.00	1.42	1.42	27
Russell 2000	2 074	-1.56	-4.39	0.00	5.00	5.00	26
Euro Stoxx 50	3 481	-2.13	-3.36	0.00	-2.00	-2.00	15
Stoxx 600 EUR	396	-1.87	-3.11	0.00	-0.80	-0.80	15
FTSE 100	6 407	-1.82	-4.30	0.00	-0.82	-0.82	12
SMI	10 591	-2.38	-3.11	0.00	-1.05	-1.05	16
NIKKEI 225	28 091	1.55	-2.54	1.55	2.36	2.36	21
CSI 300 China	5 418	1.23	-3.70	1.23	3.96	3.96	14
MSCI EM Index	1 330	-1.56	-5.72	-0.00	2.97	2.97	14

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	3 714	-1.93	-3.31	0.00	-1.11	-1.11	19
UTILITIES	316	-0.55	-1.15	-0.00	-0.96	-0.96	17
ENERGY	297	-3.39	-6.62	-0.00	3.63	3.63	15
TELECOM	219	-1.89	-3.35	0.00	-1.51	-1.51	18
CONS STAPLES	659	-2.04	-1.56	0.00	-5.32	-5.32	19
REAL ESTATE	229	-1.02	-0.15	0.00	0.48	0.48	42
CONS DISCRET	1 308	-2.08	-4.42	0.00	0.39	0.39	27
MATERIALS	445	-1.95	-5.03	0.00	-2.38	-2.38	18
HEALTH CARE	1 341	-0.83	-2.19	0.00	1.28	1.28	15
INFO TECH	2 269	-2.40	-2.99	-0.00	-0.97	-0.97	24
FINANCIALS	481	-2.02	-4.59	0.00	-1.93	-1.93	12
INDUSTRIALS	717	-2.09	-4.20	0.00	-4.34	-4.34	18

Currency % Change	Price	1 day	5 days	MTD	QTD	YTD
DXY	90.557	-0.03	0.18	-0.03	0.69	0.69
EUR-USD	1.2126	-0.08	-0.11	-0.08	-0.74	-0.74
USD-JPY	104.72	0.04	0.93	0.04	1.40	1.40
USD-CHF	0.8919	0.18	0.38	0.18	0.75	0.75
EUR-CHF	1.0814	0.04	0.28	0.04	0.02	0.02
GBP-USD	1.3727	0.14	0.38	0.14	0.42	0.42
EUR-GBP	0.8833	-0.25	-0.49	-0.25	1.18	-1.18
JP EM FX Index	57.25	0.31	0.33	0.31	-1.17	-1.17

10 yr Yield Bps Change	Price	1 day	5 days	MTD	QTD	YTD
US	1.08	2	5	2	17	17
Germany	-0.52	-0	3	-0	5	5
UK	0.33	4	2	13	13	13
SWITZERLAND	-0.44	-2	3	-2	12	12
Japan	0.06	1	1	1	4	4
US IG Spread	105	0	2	3	3	3
US High Yield spread	324	4	18	-3	-3	-3
EUR High Yield spread	345	-7	8	-7	-6	-6

Commodity % Change	Price	1 day	5 days	MTD	QTD	YTD
BBG Commo Index	81.3	1.56	1.72	1.56	4.22	4.22
Gold Spot $/OZ	1862.9	0.83	0.38	0.83	-1.87	-1.87
Crude Oil WTI	52.2	-0.27	-0.10	7.58	7.58	7.58

Volatility	Price	1 day	5 days	MTD	QTD	YTD
VIX	33.1	2.88	11.18	0.00	45.45	10.34

Source Bloomberg: 01.02.2021

Macro Update : Unequal Recoveries and Inflation Fears

1- Economic activity Update

Due to the anatomy of the economies, the amount and nature of the different stimulus packages from Central banks and governments, the strictness and the timetable of various lockdowns around the world and finally the evolution of the Covid 19 pandemic and their response in terms of vaccination campaigns and their logistics, it is not really surprising that the expected global recovery for 2021 won't be homogeneous. This was already visible during the last two quarters of 2020 and the beginning of 2021 continues to underline those differences.

There is no doubt that Asia, driven by China, is leading the race to recovery and return to normalcy.

China was the only economy that did not contract last year and after a stunning +2.8% GDP growth in Q4, China is expected to grow by 1.4% in the first quarter this year and 9.5% in 2021. While not overly optimistic, those forecasts are built on the assumption that both the US and the Euro-Zone recover in 2021.

The US economy surprises by its resilience. After a positive fourth quarter, the US is expected to grow at 0.8% in the first quarter and 4.4% for the entire year 2021.

The first set of macro data in January suggests that the US are on track to realize those forecasts though expected growth over the coming quarters should be moderate.

In Europe, sentiment has once again turned sour. After a weak fourth quarter in 2020, down -2.6%, the Euro-zone looks to be the only one on track for a double-dip.

Growth forecasts for the first quarter is at -2.2% for the zone and -5,7% for the UK economy, reflecting the impact of the new, more or less severe lockdowns in the area. This is also clearly visible in PMIs, with an abrupt decline in January. On top of that, sentiment is deteriorating as the EU vaccination process is showing some failure, reducing the visibility on the timing of the recovery.

Manufacturing PMIs continue to recover.

	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21
Global	47.9	50.6	51.8	52.4	53	53.8	53.8	53.5
USA	52.2	53.7	55.6	55.7	58.8	57.7	60.5	58.7
Europe	47.4	51.8	51.7	53.7	54.8	53.8	55.2	54.8
Switzerland	41.9	49.2	51.8	53.1	52.3	55.2	53.7	59.4
UK	50.1	53.3	55.2	54.1	53.7	55.6	57.5	54.1
China	50.9	51.1	51	51.5	51.4	52.1	51.9	51.3
Emerging	49.6	51.4	52.5	52.8	53.4	53.9	52.8	52.1

Source Bloomberg

Services PMIs: lower due to lockdowns in some areas.

	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21
Global	48.1	50.7	52	52	52.9	52.2	51.8	51.6
USA	56.5	56.6	57.2	57.2	56.2	56.8	57.7	58.7
Europe	48.3	54.7	50.5	48	46.9	41.7	46.4	45.4
Switzerland	49.1	51.6	51.7	55.1	50.4	48	49.2	49.2
UK	47.1	56.5	58.8	56.1	51.4	47.6	49.4	39.5
China	54.4	54.2	55.2	55.9	56.2	56.4	55.7	52.4
Emerging	49.3	49.4	51.5	53.2	54.5	54.4	53.9	51.6

Source Bloomberg

GDP Growth: Realised and Forecasts

	Annual Growth (%,YoY)				Quarterly growth (%;QoQ) 2020				Quarterly growth (%;QoQ) 2021			
	2019	2020	2021	2022	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US	2.2	-3.6	4.4	4.1	-1.3	-9.0	7.4	0.8	0.3	1.2	1.6	1.2
Euro-Zone	1.3	-7.3	3.8	5.5	-3.7	-11.7	12.5	-2.6	-2.2	5.1	2.4	1.4
China	6.1	2.3	9.5	5.3	-10.0	11.7	2.7	2.8	1.4	1.2	1.2	1.1
Japan	0.3	-5.3	1.1	3.0	-0.5	-8.3	5.3	0.8	-1.2	0.9	1.0	1.0
UK	1.5	-11.1	4.0	8.6	-2.5	-19.8	15.5	-2.1	-5.7	10.1	4.2	2.3
EM Asia	4.0	-7.7	8.7	4.5	-0.3	-17.7	13.6	2.6	2.1	1.3	1.4	1.1

Source: National Sources/BNP Paribas

Macro Update : Unequal Recoveries and Inflation Fears

Nevertheless, there are reasons to be optimistic. First, the Euro-zone economy tends to outperform in a global cyclical recovery.

Benefiting of the summer re-opening, EU Industrial production has outperformed the US in November, recovering from post pandemic level while the US one is still 3.5% lower. The euro-zone has been historically much more sensitive to global recovery.

Secondly, European fiscal stimulus has proven to be much more efficient to support activity than in the US. In the third quarter 2021, the US GDP growth rose by 7.4% while the Euro-zone and the UK posted respectively 12.5% and 15.5%.

Finally, after stammering in the vaccination process, significant progress has been made with increasing populations' acceptance for the vaccine.

In this context, we should assist to a faster Euro-zone catch-up later in the second quarter. GDP growth forecasts for the Euro-zone and the UK stand respectively at 5.1% and 10.1% for the second quarter 2021.

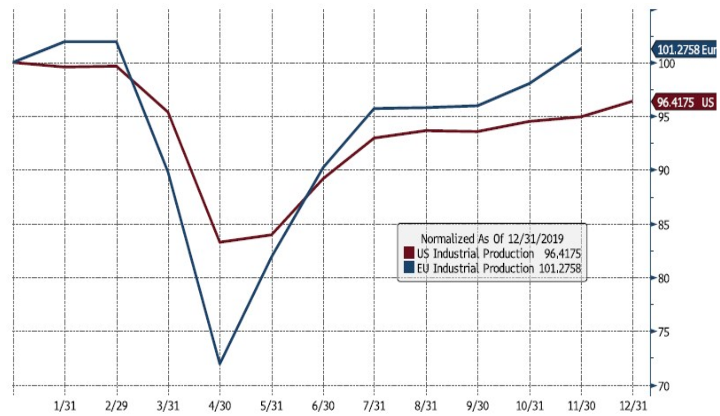
2 - Market Reaction over inflation expectation will be key.

Inflation expectation rose since the last 2 quarters on the back of the base-effect after the pandemic in March 2020 and the outstanding amount of stimulus injected around the world.

As the world economic activity recovers, expectations are now fueled by an exponential rise in commodities. Agricultural commodities rose globally and should the global recovery pursue in 2021, we could observe a kind of super cycle in this commodity segment that will feed further inflation expectation.

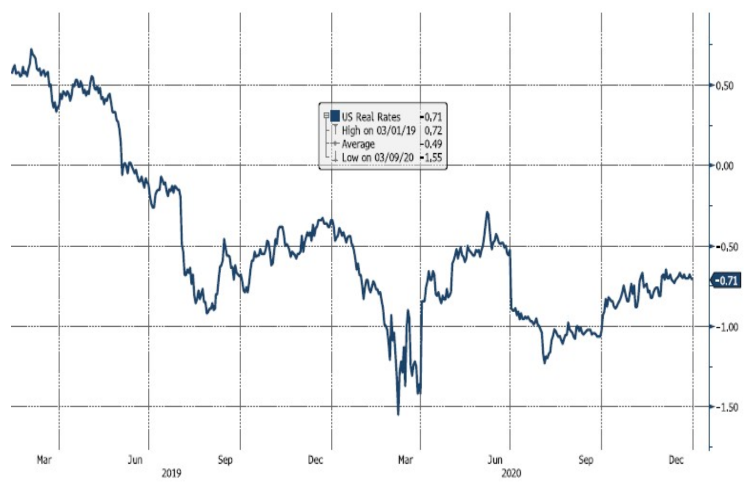
On top of that, oil prices could be boosted by political incentive and supply issues. Indeed, the green wave has mobilized a huge amount of CAPEX to the detriment of worldwide oil capacity. A boom in oil prices up to USD 80 per barrel will for sure increase inflation expectations, at least in the short-term.

EU Industrial Production: Faster Recovery.



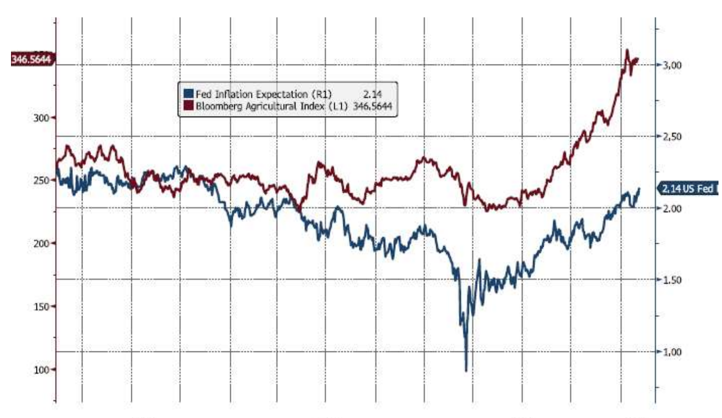
Source Bloomberg

US Real Rates well anchored in negative territories.



Source Bloomberg

Commodities fueling inflation forecast.



Source Bloomberg

Macro Update : Unequal Recoveries and Inflation Fears

Secondly, As of today, real yields remain steady as both nominal yields and inflation expectations moved in tandem. Real yields remain deeply negative and therefore, do not represent any headwind for financial markets so far.

The steepening of the curve appears normal relative to where we are in the cycle. However, nominal yields could preempt a sharp acceleration of the Consumer Price Index, pushing real yields in positive territory in a brutal and rapid move.

This could be the trigger for some turmoil in financial markets and the equity markets in particular. The interpretation of future inflation by market participants and the impact on nominal yields will be key for the global recovery. A mini-tantrum that would challenge investors and open a new "volatility chapter" cannot be excluded.

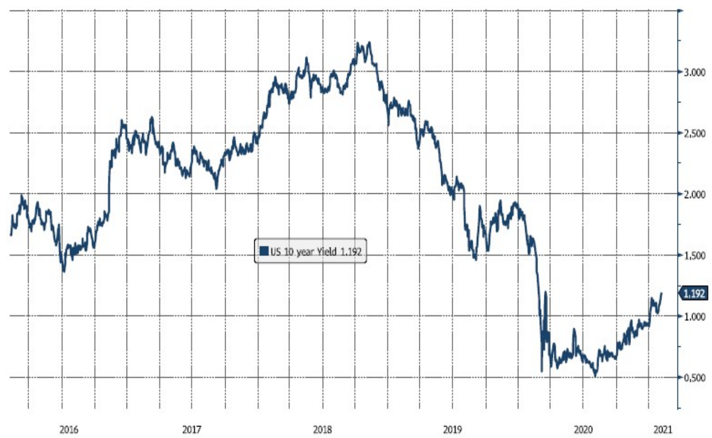
3- Vaccination process is gaining traction.

With the exception of few countries (Israel, UEA), early stages of vaccination process have been difficult, particularly in Europe. Things are hopefully moving fast and vaccination take-up is broadly successful.

The UK is on track to be the first developed country to return to normalcy. The US is also progressing rapidly in the vaccine race while Europe is finally taking-up though more modestly.

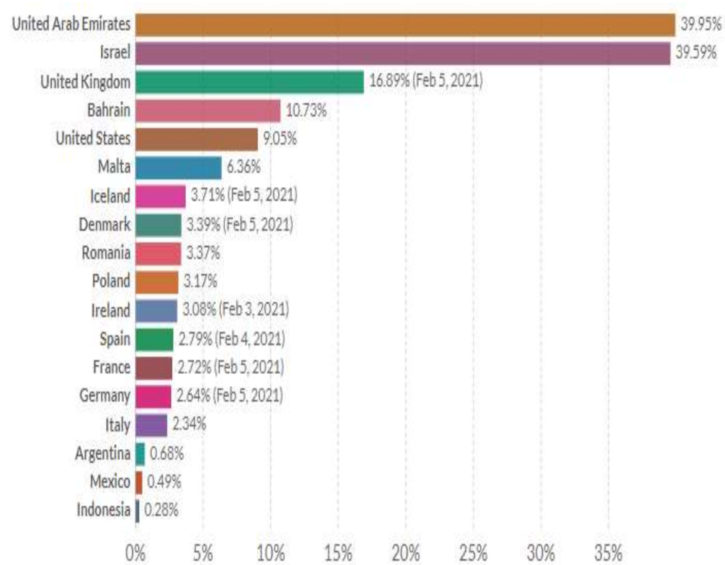
Hopes for a global return to normalcy in 2021 are in our view legitimate.

US Nominal 10 yr Yield still at low levels.



Source Bloomberg

Share of people who received at least on dose of Covid-19 Vaccine (07/02/21).



Source OurWorldInData.org

Fixed Income Strategy

Almost $20 trillion of fixed-income paper now trades at negative yield. This puts this asset class in the frontline if interest rates were to rise. Even a modest rise in interest rates to let's say 1.5% in the 10-year Treasury yield could shave off 5% or more of a portfolio's bond bucket.

The US 10-year Treasury yield is indeed in an upward-trending trading range since August of last year. Currently, the boundaries of this range are approx. 1.05% - 1.30%. We believe that this is a good «band» to keep in mind and follow. As long as the upward-trend remains «under control», the repercussions on fixed-income and also equities should be manageable.

The true risk lies in an unexpectedly quick rise in interest-rates – let's say an overshoot above 1.5% in the 10-year Treasury yield. As the COVID-risk to the economy seems to fade, and if the Democrats manage to push Biden's $1.9 trillion through the Senate, then such a move is not unrealistic.

Therefore, while we still believe that Treasuries are part of a well-diversified portfolio, we recommend to keep duration short.

Meanwhile, credit spreads are already very tight on both sides of the Atlantic. Investment-grade and high-yield will therefore provide you with a modest carry together with the risk to suffer in periods of risk-aversion. Given that our base-case scenario is one of a real economy gaining steam over the coming months, we believe that credit spreads should remain tight and some exposure to investment grade and high-yield remains warranted.

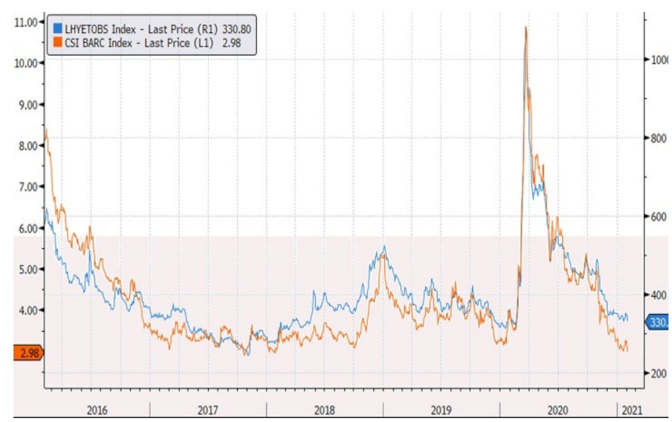
Generally speaking, there is no doubt that with rising inflation expectations both in Europe and the US, the relative attractiveness of fixed income is decreasing.

We recommend to look at alternative asset classes and strategies as a complement to fixed income. We have highlighted several hedge funds with strategies as varied as for example trade finance.

US 10-year Treasury yield

Source: Muzinich & Co

US and European high-yield spreads



Source: Muzinich & Co

US and Eurozone 10-year breakeven inflation

Equity strategy

As of writing, the 4Q20 earnings season is well under way and about half of all companies have reported so far. In the US (S&P 500), most sectors provide positive sales and earnings surprises. The strongest positive surprises on the sales-side came in the basic materials, financials and tech sectors. The strongest positive surprise on the earnings/net income side came in consumer services. There are two major deceptions: oil & gas continues to surprise on the negative side on both sales and earnings, utilities had weak sales. On average, US companies managed to surprise positively on both sales and earnings. In Europe, the picture is once again more mixed: as in the US, basic materials, financials and tech have the strongest positive earnings surprises. Interestingly, industrials in Europe are also in the group of positive surprises. Health care, consumer services, consumer goods and oil & gas, however, all published negative surprises in earnings, dragging the average earnings surprise of European equities south.

This relative weakness of European earnings published so far versus US earnings might be one reason for the underperformance of European equities YTD: while the Euro Stoxx 50 and the Stoxx 600 are down -2% and -0.8%, respectively, in the US at least two major indices (Nasdaq, Russell 2000) managed to print a positive YTD performance.

In their 2021 outlook BlackRock highlights the strong structural differences in return on equity (RoE) across sectors (MSCI All-Country): while consumer staples, IT and healthcare have RoE between 15% and 20%, utilities, financials and energy for example have RoEs between 5% and 10%. At Cité Gestion we therefore believe that «growth» like tech still has its place in portfolios, in spite of the challenging valuations. However, given that value is cheap and interest rates might grind gradually higher, we recommend to implement a barbell-strategy in portfolios, keeping exposure to both tech/growth and value.

Finally, as long as real interest rates remain low or negative, we remain constructive on equities overall. We recommend to be at least neutral in equities.

S&P 500 4Q20 earnings analysis

Industry (ICB)	Reported	Sales Surprise	Earnings Surprise
All Securities	264 / 500	3.74%	18.41%
> Oil & Gas	11 / 25	-0.51%	-210.91%
> Basic Materials	10 / 18	7.19%	29.94%
> Industrials	55 / 92	3.20%	4.73%
> Consumer Goods	29 / 57	4.18%	8.22%
> Health Care	34 / 55	2.60%	5.51%
> Consumer Services	26 / 63	2.78%	79.82%
> Telecommunications	2 / 4	1.57%	3.22%
> Utilities	5 / 28	-11.23%	2.93%
> Financials	63 / 99	6.67%	33.57%
> Technology	29 / 59	6.54%	20.12%

Source: Bloomberg

Euro Stoxx 600 4Q20 earning analysis

Industry (ICB)	Reported	Sales Surprise	Earnings Surprise
All Securities	113 / 442	-2.30%	-12.44%
> Oil & Gas	8 / 20	-6.83%	-67.56%
> Basic Materials	6 / 35	-15.61%	119.95%
> Industrials	20 / 85	4.13%	35.41%
> Consumer Goods	15 / 54	-0.41%	-5.50%
> Health Care	13 / 45	-3.57%	-45.47%
> Consumer Services	9 / 37	0.66%	-24.16%
> Telecommunications	8 / 18	0.24%	N.M.
> Utilities	2 / 21	-53.06%	N.M.
> Financials	21 / 94	3.97%	41.12%
> Technology	10 / 32	6.38%	25.52%

Source: Bloomberg

US 10-year real interest rates (using core inflation)

Source: Bloomberg

FX & Commodity strategy

1 - King Sterling and US Dollar

Sterling and the US dollar have been the best performers year-to-date. While this could be attributed to the recent dollar strength, the rise in nominal yields or the resilience of the US economy, it would be hard to say the same about the UK.

For sure, positioning is a factor. According to IMM data, Short US dollar positions reached a 10 year high at USD 33bn in January which confirms that the weak dollar was a popular trade in 2020. Similar story for Sterling, for which Brexit Deal uncertainties last year was the major input to build short GBP positions.

Coincidence or not, while the US and the UK have come under criticism for the way they managed the pandemic last year, both countries moved with success to the next phase with the attempt to inoculate their populations. As of today, vaccination totals in both countries already comfortably exceed the total number of reported Covid cases to date. It is not a claim that every country can make and certainly not any continental European country.

With both countries in advance with the vaccination process and heavy short positioning in their respective currencies, we expect further squeeze pushing Sterling and the US Dollar higher in the coming weeks.

2- Gold is not shining for now.

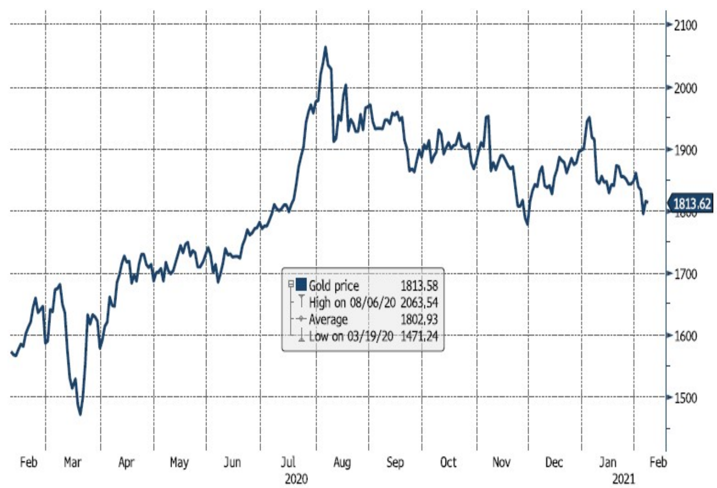
Stronger USD dollar index, higher US nominal yields and expensiveness relative to silver put Gold under pressure since the beginning of the year. Adding the risk-on environment and the need for safe havens, including the Swiss franc has diminished. We expect further pressure to come on Gold, in line with our USD short squeeze view. Technically, Gold has some room to test USD 1730 per ounce.

3 - Oil prices boosted by supply concerns

Oil prices came out of the range by the upside, boosted not only by the expected 2021 global recovery that could drive demand higher but also by some supply concerns. The green revolution that is taking place around the world have concentrated investments in the green sectors and other renewable energies leaving some concerns over the supply capacity in oil prices and could push the barrel towards USD 80 in excess.

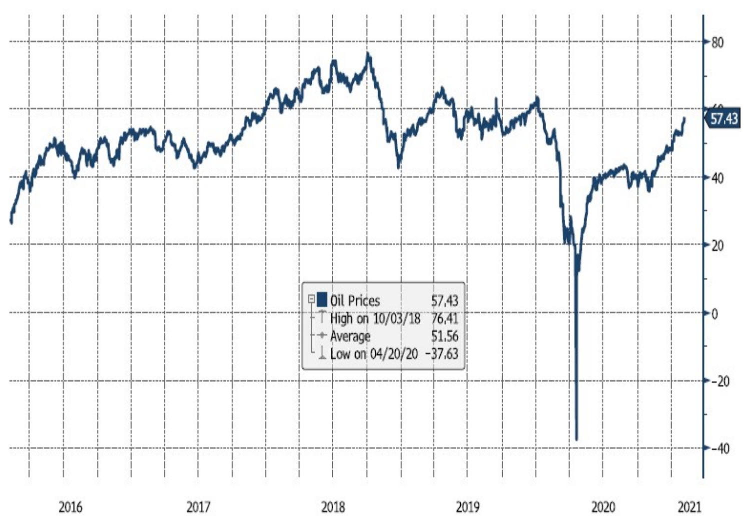
Currency YTD returns vs USD.

Gold is not shining anymore.



Source Bloomberg

Oil prices have further room to rise.



Source Bloomberg

By choosing Cité Gestion, you will benefit from our unique business model which sets us apart from most traditional wealth managers. Learn more on our website : www.cité-gestion.com

And follow us on LinkedIn to stay connected to all market news and perspectives.

Disclaimer and important information

This document has been published in Switzerland by Cité Gestion SA, Geneva, a custodian and securities dealer subject to regulation and supervision by the Swiss Financial Market Supervisory Authority (FINMA). It is not intended for distribution, publication or use in any jurisdiction where such distribution, publication or use would be prohibited, and is not directed to persons or entities to whom it would be unlawful to send such a document. All information provided in this document, in particular opinions and analyses, is for information purposes only and should not be construed as an offer, advice or recommendation to buy or sell any particular security or to enter into any transaction. Nor does this publication constitute - and should not be construed as - an advertisement for a particular financial instrument. The risks associated with some investments are not suitable for all investors and a precise assessment of the risk profile must be made. Nor should this document be construed as legal, accounting or tax advice. Although Cité Gestion SA makes every reasonable effort to use reliable and complete information, Cité Gestion SA makes no representation or warranty of any kind that the information contained in this document is accurate, complete or up to date. Any decision based on this information must be made at the investor's risk and Cité Gestion SA declines all responsibility for any loss or damage that may result directly or indirectly from the use of this information. United States: Neither this document nor any copies thereof may be sent, taken or distributed in the United States or given to a US-Person. This document may not be reproduced (in whole or in part), transmitted, modified or used for public or commercial purposes without the prior written consent of Cité Gestion SA.