J. SAFRA SARASIN
SUSTAINABLE ASSET MANAGEMENT

CIO Update

Investment Committee Bank J. Safra Sarasin
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Fortunately, interest rates are rising

The good news is: Rising interest rates signal a strong economic recovery and provide a good environment for cyclical equities.

Macro outlook – Back to economic normality
Last year's recession was five times as severe as the average recession since World War II, and in only a quarter of the time. At the same time, it was the only downturn in recent history in which disposable income rose, thanks to extensive fiscal measures. Governments have passed deficits on a scale that no one would have thought politically feasible before the pandemic. A large part of this transfer has been (involuntary) saved and should lead to a strong increase in demand and high growth rates in the second half of the year. This scenario is becoming more and more likely by the decline in infection rates and hospitalizations as well as the efficacy of the vaccines. So the recovery is on track.

But in the short term, uncertainty remains. Vaccine distribution continues to be slower than expected, especially in Europe. Containment measures will therefore remain in place in many regions in the first quarter, and with them the burden on businesses and consumers. Added to this are rates of change in macro data, which will be very volatile compared to the previous year due to base effects, and financial markets, which tend to react with greater volatility. This applies in particular to inflation. Inflation rates are likely to rise significantly this year, which is largely due to above mentioned COVID-related base effects.

Major central banks are therefore in no hurry to leave their expansionary monetary policy path. Already in August of last year, the US Federal Reserve presented its new policy framework. The central bank is now aiming for an average inflation rate of 2%. With this, the central bank explicitly allows for an overshooting of this target. This has a decisive implication: the central bankers are no longer concerned that the inflation rate overshoots, but have explicitly set this as a target. Unlike in earlier recovery phases, the central bank will therefore not be so quick to counteract a normalization of inflation rates towards the 2% target with monetary policy. The head of the US Federal Reserve, Jerome Powell, recently assured this again at his hearing in the US Congress.

Bonds – Bond market prices more aggressive Fed rate hike cycle
Nevertheless, the bond market has increasingly questioned this recently. Traders are pricing in a first Fed rate hike in early 2023, despite recent commitments. Not long ago, the market did not expect this until the beginning of 2024. And while the Fed sees the recent rise in inflation rates as temporary, long-term inflation expectations are already at the Fed's target level of 2%.

Ten-year US government bond yields have risen from 0.9% to 1.6% since the beginning of the year in this environment, a remarkable level for investors. Remarkable because it clearly separates the

Editorial
Dear Reader

It is hard to believe that one year has already passed since the lockdowns first began. The good news is there appears to be light at the end of the tunnel, with case counts and hospitalizations plummeting. With hopes of a return to normality, yields have also risen significantly since the beginning of the year, recently putting strong pressure on equity valuations in certain sectors. Rising rates have led to an acceleration of the rotation from expensive growth stocks to relatively cheap value stocks, which will benefit particularly from the economic recovery.

Although rising yields have created a lot of uncertainty in some sectors, they are above all a positive signal for the economic recovery. Even in Europe, we should be looking forward to the moment when rates will no longer be negative.

Philipp E. Bärtschi, CFA, Chief Investment Officer

yield regime before and after the outbreak of the pandemic. Most recently, the increase was driven by rising real rates, an expression of improved economic expectations. Thus, provided the rise in nominal yields represents a return to economic normality and the Fed remains true to its path - i.e. investors do not have to worry about a premature rate hike cycle by the central bank - the negative impact on other assets, first and foremost equities and emerging market bonds, should be limited. Short-term shock waves and higher volatility cannot be ruled out, but as long as the rise in interest rates is gradual, it should be seen as a positive sign of economic strength. Central bankers are best advised to do nothing and watch from the sidelines.

US Treasuries back to pre-pandemic levels

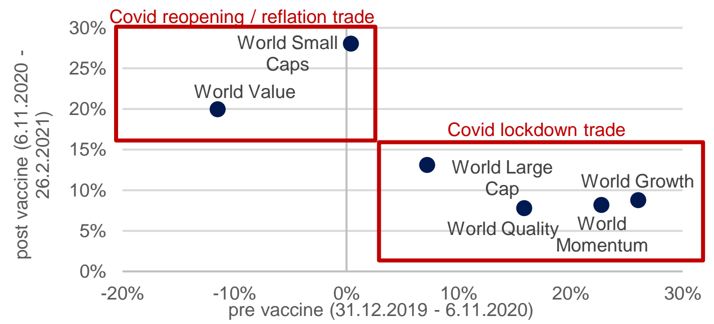
Source: Refinitiv, Bank J. Safra Sarasin, daily data, 1.1.2010 to 10.3.2021

The rise in US real rates and, in particular, expectations of an interest rate hike cycle starting as early as 2023 have led to a significantly stronger US dollar. The currency has stabilized recently and broken through its downward trend established since March 2020. This is unlikely to change in the short term due to significantly increased interest rate differentials. The US economy should recover faster and more strongly from the lockdowns relative to other regions.

Equity markets in transition process

Equity markets have been very sensitive to the dynamic rise in yields, especially at the sector level. The recent rise in yields has reinforced the trend away from growth stocks and towards cyclical value stocks. The end of the lockdown is in sight, high savings rates combined with pent-up demand and rising corporate sales and earnings expectations form a solid basis for the continuation of the reflation trade. Banks and energy companies, as well as small and medium-sized companies, had in the past always shown very robust return behavior in an environment of rising interest rates and inflation expectations. We therefore expect their outperformance to continue in the coming months. On the other hand, rising rates are likely to create further strong headwinds for equities and sectors with already very high valuations.

Performance before and after vaccine approval



Source: Refinitiv, Bank J. Safra Sarasin

Asset Allocation – Profiting from the economic recovery

Financial markets thus remain caught between two opposing forces. Namely, the expectation of strong economic growth and extensive fiscal measures on the one hand, and rising inflation expectations and higher interest rates on the other. This is likely to lead to periods of increased volatility and continued rotation in the coming months. However, as long as yields rise for the right reasons, namely the economic recovery, the positive effect from rising corporate earnings should more than offset the negative effect on valuations.

In our asset allocation we therefore remain overweight in equities, with a focus on cyclical sectors and regions such as Europe. The continent had lost positive momentum recently, but the cyclical orientation of the economy speaks for the region. In terms of vaccination progress, Europe is lagging a few months behind the US and the recovery will be delayed. But the trend is positive and governments are determined to boost nominal growth. This should contribute to a corresponding outperformance of cyclical regions. In addition, valuations are at a much more attractive level compared to US equities. We have taken some profits in emerging market equities. The region has performed very strongly at the start of the year and has been subject to greater valuation adjustments in the environment of a stronger dollar and rising interest rates.

With yields pointing upwards, we remain strongly underweight in government bonds. An improving growth environment and rising inflation rates should weigh on the segment. The underweight in investment grade bonds remains in place as well. We prefer high-yield bonds, which should benefit from stronger economic growth. We also remain overweight in emerging market bonds. The risk premium provides a buffer and the asset class has been resilient in such an environment in the past. Overall, we are sticking to our investment policy and see rising yields as a positive sign that confirms our pro-cyclical orientation.

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Attractiveness of individual investments

Asset class	Weighting	Relative attractiveness within the categories			
Equities	+	Developed markets =	Emerging markets =	Large caps –	Small caps +
Bonds	–	Government bonds – – –	Corporate bonds – –	High-yield bonds ++	Emerging markets ++
Alternative assets	=	Money market =	Convertible bonds =	Other alternatives +	Real Estate =

Source: J. Safra Sarasin

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