



March 29th, 2021

Better Growth Offsets Inflation Angst

- **US bond yields still heading higher, but the slower pace could settle nerves**
- **Inflation expectations priced into bond markets now at realistic levels**
- **European economic recovery finally seems ready for take-off good news for equities**
- **Emerging Market underperformance to moderate as investor inflows resume**

Bond tantrum fading, yields still rising.

The first quarter of 2021 was most notable for the bond tantrum as inflation expectations in the market started to adjust to the reality of higher prices. Evidence continues to mount that the economic stimulus is beginning to have the desired effect on economic output. While the market is pricing inflation more appropriately, the question remains whether bond yield volatility has settled down.

Bond market volatility has moderated, but in our view, the direction for US government bond yields is still higher. The MOVE index, which tracks rate volatility, spiked from its low in December at 40 to hit 75 in March. It has only slowly drifted down to 62, still high by historical standards. We expect the speed of the adjustment higher in Treasury yields may slow in synch. However, the medium-term trend is for yields to continue higher, adjusting for more realistic inflation expectations. In the quarter to date, the 10-year government bond yield surged from 0.91% to 1.66%. That represents a return to pre-Covid levels of early 2020.

By contrast, equity market volatility has adjusted lower far quicker than in the bond market. A feature of the equity market's reaction to the bond market sell-off in the first quarter was how quickly volatility receded after the initial shock. US and European equity market volatility measures (the VIX and V2X) jumped above 30 but have since eased below 20 for the first time since February 2020.

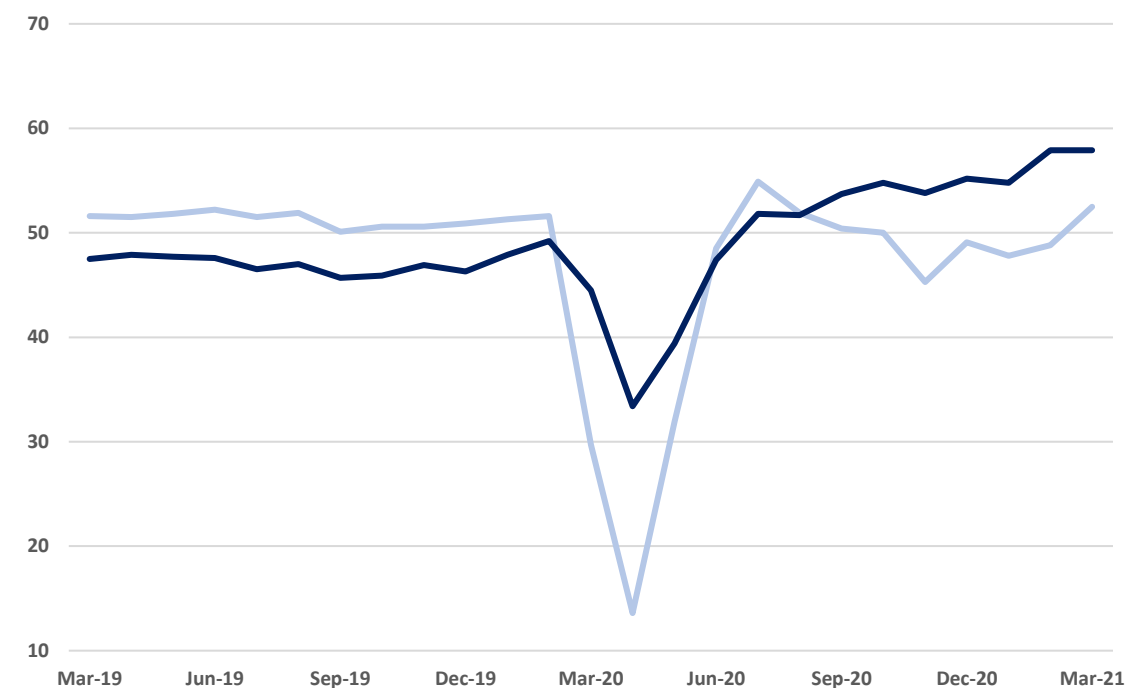
US Inflation expectations have continued to surge in the first quarter and are now running higher than at any point in the preceding five years, at 2.36% for the 10Y breakeven rate. The low for last year was at 0.5%, and at the start of January, it was still just below 2%. Looking at the more extended history of the inflation market, the current level of the 10Y breakeven seems pretty much spot on for accuracy.

The near-term challenge of inflation is becoming a more global phenomenon, exacerbated by the Suez Canal problems. The Citigroup G4 inflation surprise index has risen to a four-year high. In Singapore, core inflation was positive for the first time in a year. The challenges in the Suez Canal can only add to the near-term upward pressures on inflation. If the authorities have to take containers off the ship blocking the canal, the canal may not be clear for some weeks.

Helping a broader global reflationary theme is surging industrial confidence data, not just in the US but also in Europe. At the composite level, the European PMI index was up 3.7 points in March at 52.5. This number surprised most forecasters, who would have been expecting a decline, or perhaps a stable number at best. The surprise was all the more significant as it comes when virus infections are once again surging across all the major European economies, and new movement restrictions have been imposed in Germany, Italy and elsewhere. As the new restrictions bite in April and May, and the vaccine roll-out continues to be on the slow side, the overall PMI might

slow into Q2. However, the underlying momentum is hugely encouraging for a region that analysts have viewed as a laggard in its virus strategy.

Chart 1: Rebounding Eurozone PMI's



Source: Bloomberg

A further boon for Europe is clear evidence that its manufacturing sector has learnt to cope with Covid. It is also the beneficiary of robust global demand, led by the US and China. Last week, data showed a jump in the manufacturing output PMI by 5.3 points to 63, a new high. Data for new orders and new export orders also hit new highs. All of these augers well for the rest of the year in terms of growth, inflation, and likely corporate earnings.

In Emerging Markets, asset performance has been driven at the macro level by developments in the currency and US bond market, but at the local level by some questionable policy in certain places. The standout underperformer has been Brazil, where the weak Covid response continues to undermine hopes of a recovery. Local bond yields surged, and the Bovespa index is down 13% in USD terms YTD. Likewise, in Turkey, the decision to (once again) swap out Central Bank governors caused disruption. Just when it was looking that a return to some form of orthodoxy brought back stability, a change in governor prompted a sell-off in the Lira. Recovery had been well-entrenched, with the currency strengthening from 8.5 to the USD in November to 7.00 in February. All the good work came undone with renewed (and sharp) weakness to 8.1 by the end of the quarter.

Emerging market equity volatility levels have moderated but still run higher than their developed market counterparts. While developed equity markets are higher so far in Q1 (by between 5% and 8% in dollar terms), the overall MSCI Emerging Markets equity index has risen only 1.3%. Investors have taken note, and we are seeing signs of investors returning to the EM equity markets. In January 2021, the flow of cash into EM equity relative to DM equity (ETFs and Mutual Funds) reached a high, according to fund flow data compiled by Bank of America. In February, there have been further positive inflows into both the emerging market bond and equity markets. Investors will also have been encouraged by stronger export data from South Korea and Taiwan.

Gary Dugan
Johan Jooste
Bill O'Neill (Consultant)