Investment Strategy

Quarterly Investment View | April 2021

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Q2 2021 Outlook: A balancing act

Global growth prospects are really looking up. With the advent of several vaccines, the beginning of the end to this health crisis is now perceivable. As economies re-open, growth is expected to pick up rather strongly. At the same time, fiscal spends continue to be generous and monetary conditions are super accommodative. Of course, financial markets which are forward-looking have rallied strongly since their March 2020-lows in anticipation of the economic rebound that is likely to come. Against this backdrop, what should investors expect looking ahead, and especially in Q2 2021?

Economic optimism and associated reflation, alongside concerns about the potential return of inflation, have nurtured the recent strong rise in US long-term bond yields. We think in the near future, growth prospects and bond yields are likely to remain dominant drivers of the markets. Especially the outlook for inflation is rather uncertain and could drive the narrative of rising yields in the months to come. **This calls for a balancing act** – of staying focussed on structural trends (which tend to be high-duration) while also capturing the near-term upside (which is currently in low-duration cyclicality).

Sustainable inflation is a risk, but not a given. Much depends on the consumer behaviour in the future. As for the fiscal support packages and their impact on the economic outlook, multipliers are difficult to estimate. Further, the weak link between unemployment rate and inflation makes it even harder for someone to say with conviction what the inflation rate will likely be. So, to that extent, we consider inflation to be the 'wildcard'. The base-effects from last year might mean higher price rises this year. Rise in commodity prices coupled with increase in input prices point to a 'cost-push' inflation trend, which tends to be temporary in nature compared to 'demand-driven' inflation. Overall, we are in Fed's camp and believe that rise in price pressure will be temporary in nature. However the risk is that the upcoming inflation data could be read as 'inflationary' by the markets.

In our investment strategy section (pages 2-3) we discuss in detail the influence of the two key drivers – economic momentum and long-term bond yields – on various asset classes. According to our framework, equities are expected to do well over the next quarter, but bonds could exhibit a mixed picture. Commodities are likely to do well too – especially in a scenario of strengthening economy and rising bond yields. Precious metals could gain back some of the lost shine should bond yields start to fall from recent highs. In terms of our strategic asset allocation, we remain neutral equities, underweight fixed income, neutral alternatives (overweight gold and keep our exposure to hedge fund strategies that are less correlated to the market), and maintain an overweight on cash and liquidity as we look for opportunities to deploy. For a summary of our recommended positioning, see pages 4-5.

Fixed income (pages 6-7): with the central banks, especially the Fed, now allowing the yield curves to steepen as along as financial conditions do not tighten much, we do expect further steepening as global economies enjoy faster growth. We expect interest rate volatility to increase with continuing discord between the markets and the Fed. Accordingly, we recently reduced duration. We remain overweight US treasuries and UK gilts; have selective exposure to EM USD sovereigns and prefer Asia IG credit.

Equities (pages 8-9): we expect a rather rare third consecutive year of gains for the asset class. We stick with our strategic preferences for structural growth opportunities (overweight US by geography, IT and communication services by sector, and growth and quality by factors). However, we also hedge this high duration positioning through our cyclical positioning (overweight UK by geography, energy by sector, and some vaccine availability trades).

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Index

Investment strategy (page 2)
Porftolio positioning (page 4)
Fixed income (page 6)
Equities (page 8)
Alternatives (page 10)
Currencies (page 12)
Disclaimer (page 14)

Investment strategy

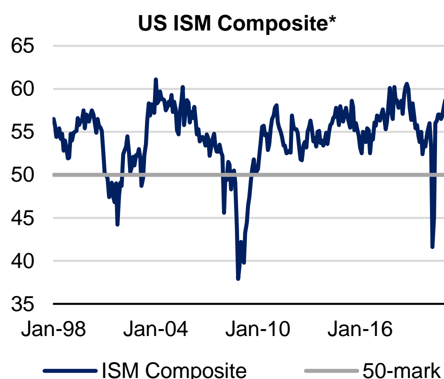
The cycle and its influence

Economic momentum (exhibit 1) and behaviour of long-term bond yields (exhibit 2) arguably have been the two most important drivers of financial markets in recent months. Not surprisingly most discussions around the recent strong rise in rates were centred on whether it is the economic optimism that is driving yields higher. US Fed Chair Jerome Powell has stated several times in the recent past that he believes it is so and we agree. Indeed, putting in context the improving health situation thanks to vaccines, ongoing policy support (especially a strong fiscal impulse In the US associated with the USD1.9trn American rescue plan) has led to many economists (including those at IMF and OECD) raising their economic projections for this year and the next. This economic optimism, alongside concerns about the potential return of inflation, has nurtured the recent strong rise in US long-term bond yields. We think in the near future, these two drivers are likely to remain dominant and market participants are likely to constantly re-assess the outlook for both the economic growth (also inflation) and implied levels of bond yields. Accordingly we put this issue at the heart of this quarterly publication. In this section of the report, we look at how various assets have behaved in phases of strengthening/weakening economic momentum and rising/declining bond yields.

If history is any guide…

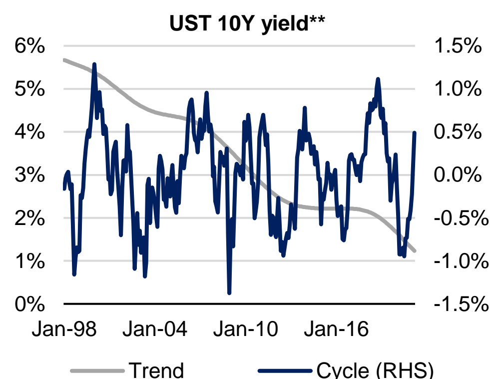
Using US ISM composite as the measure of economic momentum and UST 10Y yield as the measure of long-term bond yields, we analyse the data since 2003 to see how various assets have performed under different scenarios. Exhibit 3 summarises the results. **Equities** deliver strong returns when the economic momentum is strengthening and fall when economy is weakening. However, interestingly when the economy is strengthening and bond yields are rising, equity performance tends to be the best. This is perhaps because while strengthening economy improves fundamental outlook for equities, rising bond yields trigger some repositioning into equities as well. **Bonds** tend to exhibit mixed performance under scenarios we consider. In an environment of rising yields irrespective of whether the economy is faring well or not, DM sovereigns fare poorly. However, rising yield environment does not impact EM sovereigns, corporate credit and high yield segments when the economy is strengthening, provided this is not met with increased interest rate volatility and central bank tightening prospects. Best performance for fixed income comes when economy is strengthening and the yields are normalising from high levels. **Commodities** do well when economic momentum is improving and bond yields are rising. But performance turns rather mixed in other scenarios. Intuitively, performance of the precious metals group decouples from the rest, across scenarios. The impact on **currencies** is rather more nuanced. However, the picture with USD is rather clear – the greenback being a counter-cyclical currency is expected to do less well when economic momentum is strengthening. **Hedge funds** work through all environments and provide the much needed diversification. **REITs** recorded their best performance when economic momentum is strengthening and bond yields are falling, but did worse when the conditions reverse.

Exhibit 1: Economic momentum remains strong



Source: ISM, Bloomberg and ADCB Asset Management | Notes:*Economy-weighted manufacturing and non-manufacturing composite

Exhibit 2: Long-term trend of UST yields is intact



Source: Bloomberg, and ADCB Asset Management | Notes: **Using the Hodrick-Prescott filter with smoothing parameter of 129,600

Our expectations

Over the next months, absent a major health shock, we do expect the economic momentum to strengthen as economies come out of lockdowns and vaccines become widely available. Ongoing fiscal support and continued easy monetary policy are likely to underwrite the recovery. Further as services sector reopens, it is likely to add to the strong ongoing momentum in the manufacturing sector. Accordingly, we do expect the ISM to remain firmly in the expansionary territory i.e. above the 50-mark (exhibit 1).

On 10Y UST yields (exhibit 2), while the trend remains firmly to the down, cyclical component seems to have risen sharply recently and this may have further room to rise. This in turn could create more volatility in USTs and feed further into other asset classes. However, should the cyclical component begin to mean-revert after a sharp rise, UST yields could fall given the strong downward trend.

Bottom line

With economic momentum remaining strong, but bond yields being volatile, we expect the outcomes in financial markets to remain within the scenarios highlighted in blue colour in the table below (exhibit 3). Equities are expected to do well over the next quarter, but bonds could exhibit a mixed picture. Commodities are likely to do well too – especially in a scenario of strengthening economy and rising bond yields. Precious metals could gain back some of the lost shine should bond yields start to fall from recent highs.

In terms of our strategic asset allocation, we remain **neutral equities** (see pages 8-9 for our equity strategy), **underweight fixed income** (see pages 6-7), **neutral alternatives** with overweight gold and keep our exposure to hedge fund strategies that are less correlated to the market (see pages 10-11), and maintain an **overweight on cash and liquidity**. For discussion on currencies, see pages 12-13.

Exhibit 3: Economic momentum, yields and asset class performances - analysis based on monthly data since 2003

	Average monthly performance*				Hit ratio** of performances			
	Eco ↑		Eco ↓		Eco ↑		Eco ↓	
	Yields ↑	Yields ↓	Yields↑	Yields↓	Yields↑	Yields↓	Yields↑	Yields↓
# of instances	*62*	*47*	*51*	*57*	*62*	*47*	*51*	*57*
MSCI ACWI Index	2.6%	1.2%	-0.2%	-0.4%	76%	66%	57%	49%
MSCI World Index	2.5%	1.2%	-0.1%	-0.4%	74%	64%	59%	49%
MSCI EM Index	3.3%	1.5%	-0.7%	-0.1%	71%	64%	49%	53%
BBG Barclays Global Sov	-0.2%	1.0%	-0.4%	1.1%	45%	79%	37%	81%
BBG Barclays DM Sov	-0.5%	1.1%	-0.5%	1.3%	44%	74%	37%	79%
BBG Barclays EM Sov	0.6%	1.4%	-0.5%	1.1%	71%	83%	51%	82%
BBG Barclays Global Corp	0.1%	1.1%	-0.5%	0.9%	52%	81%	41%	81%
BBG Barclays: EM USD Corp	1.1%	1.4%	-0.6%	0.5%	73%	85%	59%	70%
BBG Barclays Global HY	1.7%	1.1%	-0.2%	0.2%	79%	68%	61%	65%
BBG Commodity Index	1.6%	-0.6%	-0.6%	-0.8%	68%	49%	45%	44%
BBG Industrial Metals	2.8%	0.9%	-1.4%	-0.3%	73%	51%	45%	49%
BBG Energy	1.8%	-1.9%	-0.4%	-2.4%	65%	40%	51%	37%
BBG Agriculture	1.2%	-1.0%	-0.3%	0.0%	61%	34%	45%	51%
BBG Precious Metals	1.0%	1.3%	-0.8%	1.3%	56%	53%	39%	61%
WTI Crude Oil Spot	5.5%	-2.1%	1.3%	-1.8%	77%	36%	57%	49%
Dollar Index spot	-0.2%	0.0%	0.2%	0.0%	47%	55%	55%	44%
EUR-USD	0.2%	0.1%	0.0%	0.0%	52%	45%	51%	54%
GBP-USD	0.8%	-0.7%	-0.3%	-0.2%	65%	38%	45%	42%
USD-JPY	0.8%	-0.8%	0.7%	-1.0%	63%	36%	59%	30%
EM FX	0.8%	0.4%	-0.2%	0.2%	68%	60%	51%	67%
Cash	0.1%	0.1%	0.1%	0.2%	95%	94%	96%	96%
HFR Fund wtd. composite	1.3%	0.7%	0.2%	-0.2%	82%	72%	65%	53%
HFR Eqty Hedge Total	1.7%	0.7%	0.2%	-0.4%	82%	70%	65%	47%
HFR Event-Driven Total	1.5%	0.8%	0.3%	-0.3%	92%	70%	67%	47%
HFR Macro Total	0.4%	0.7%	-0.1%	0.5%	52%	72%	43%	58%
HFR RV Total	1.0%	0.7%	0.2%	-0.1%	90%	77%	75%	61%
HFR FOF Composite	0.9%	0.6%	0.1%	-0.2%	81%	70%	59%	54%
HFR FOF Conservative	0.7%	0.4%	0.1%	-0.2%	89%	77%	67%	54%
HFR FOF Diversified	0.8%	0.6%	0.1%	-0.2%	82%	72%	59%	58%
HFR FOF Market Defensive	0.2%	0.6%	0.0%	0.2%	53%	70%	47%	61%
HFR FOF Strategic	1.1%	0.6%	0.1%	-0.3%	77%	64%	61%	53%
Global REIT	0.9%	2.4%	-1.2%	0.0%	56%	77%	49%	68%

Source: MSCI, Barclays, HFRI, Bloomberg, and ADCB Asset Management | Notes: *Economic strength measured by US ISM Economy-weighted manufacturing and non-manufacturing composite. Yields based on total yield on US 10Y treasury. ** Hit ratio is defined as the share of instances where the returns were positive.

Porftolio positioning

Exhibit 4: Recommended portfolio positioning

Asset Allocation	Underweight	Neutral	Overweight	Comments
Equities		■		Expect average return on equities during 2021
Fixed income	■			Constrained by faster recovery and steeper curve
Alternatives		■		Prefer gold and market hedge strategies
Cash and liquidity			■	Looking for deployment opportunities
Equities*	**Underweight**	**Neutral**	**Overweight**	**Comments**
Regions				
US			■	Higher quality, higher RoE/RoA
Canada		■		Stick with the benchmark
Europe ex UK	■			Light on structural drivers of growth
UK			■	Prefer global large caps with quality-tilt
Japan		■		Prefer 'new economy' enablers
Asia Pacific ex Japan		■		Focus on new China vs. old China; neutral India
EM LatAm	■			Constrained by commodity-dependence, debt vulnerabilities, outflows and weak currencies
EM EMEA	■			
GCC		■		Stick with the benchmark
Global sectors				
Comm. Services			■	Diversified telecoms and Media
Consumer Discr.		■		Hotels, Rest. & Leisure.
Consumer Staples		■		Food, Beverage & Tobacco
Energy			■	Focus on capital discipline and makeover stories
Financials	■			Impeded by lower interest rates
Health Care		■		Biotechnology and Health care technology
Industrials		■		Capital Goods and Transportation
IT			■	Tech Hardware & Equipment
Materials	■			Structural weakness on a shift to 'new economy'
Real Estate		■		Real estate management & development
Utilities		■		Gas utilities and Renewable Electricity Prod.
Factors/styles/sizes				
Large cap			■	Strong balance sheet, earnings visibility
Mid cap		■		Likely to be market-performers
Small cap	■			Strained by leverage
Growth			■	Prefer non-cyclical growth
Value		■		Avoid value in sectors facing disruption
Dividend yield			■	Prefer quality dividends and dividend growth
Quality			■	Quality in the environment of low risk-tolerance
Momentum		■		Benefits from 'new economy' orientation
Legend	*New*	*Old*	*No change*	

Source: MSCI, Barclays, HFRI, Bloomberg, and ADCB Asset Management | Notes: *Positions recommended based on MSCI ACWI Standard/IMI benchmarks

Exhibit 4: **Recommended portfolio positioning (continued)**

Fixed income**	Underweight	Neutral	Overweight	Comments
Duration	■			Reduce duration to 5yr bonds
US Treasuries			■	Prefer US Treasuries acting as a hedge
US Credit				Preference for HQ corporates over HY corporates
- Investment Grade		■		Bottom-up approach is key: BBB sector attractive
- HY (off benchmark)	■			Bottom-up approach is key: BB sector attractive
European Bunds		■		Slow vaccine progress and COVID restrictions
European Credit				Weak growth concerns to remain
- Investment Grade		■		QE program in the form of CSPP to support
- HY (off benchmark)	■			Weak growth prospects to weigh
UK Gilts			■	Excessive pricing in of tightening cycle
EM USD Sovereign		■		
- Brazil			■	Rising UST rates to weigh on various EMs, selectivity is key
- Russia			■	
- High quality GCC			■	
EM LC Sovereign		■		Tightening monetary policy cycles
- India Govt. bonds			■	Preference for short-dated government bonds
EM Corporate	■			High leverage is concern, but opportunities in Asia
- EM Asia			■	Preference for Asia IG

Alternatives	Underweight	Neutral	Overweight	Comments
Gold			■	Potential hedge against geopolitical risk shocks
Oil		■		Looking for a balanced market
Other commodities	■			Commodity super-cycle is difficult to realize
Hedge funds		■		Strategies that are less correlated to equities

Currencies	Negative	Neutral	Positive	Comments
USD			■	Driven by positive growth and yield differentials
EUR	■			Lagged reopening and widening yield differential
JPY	■			BoJ yield curve control creates a negative bias
GBP			■	Faster vaccinations and re-opening
EM currencies		■		Driven by idiosyncratic developments

Legend	*New*	*Old*	*No change*

Source: MSCI, Barclays, HFRI, Bloomberg, and ADCB Asset Management | Notes: **Positions recommended based on Bloomberg Barclays Global Aggregate (USD unhedged) Index benchmarks

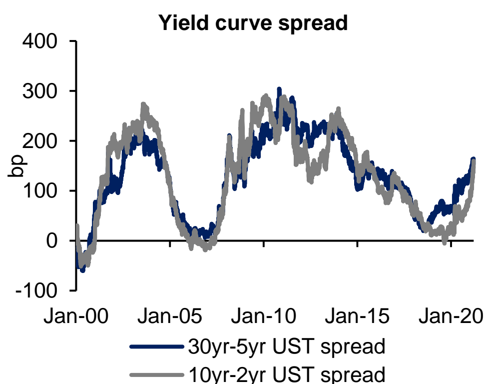
Fixed income

Faster recovery, steeper curve

One way in which the Fed has surprised us (also the bond market) is the fact that the central bank remains comfortable with the rise in long-term bond yields. Over past month in several speeches and now finally at the FOMC meeting, the Fed has confirmed that the recent rise in bond yields is a sign of improving growth confidence in the economy. With its stance of no rate hikes until 2023 and being complacent with rising long-term UST yields, the Fed seems comfortable with the steepening UST yield curve. As a result, the cap that we expected the Fed could provide on long-term rates looks difficult to happen now, keeping the long-end rates susceptible to market volatility. The Fed could take action only when and if the US financial conditions start showing signs of tightening. At current levels of UST yields, US financial conditions remain loose (exhibit 6). The first signs of any stress in US financial conditions will be evident through tightening of credit spreads. So far, corporate bond spreads have been relatively resilient to the sell-off in US Treasuries. It is difficult to determine at what levels of UST yields will start signalling tightness in US financial conditions and as a result, bond markets will continue to test that level. In addition, given the fast pace of recovery that we are likely to see this year (unlike previous business cycles), there is more scope for the UST yield curve to steepen (exhibit 5). In previous business cycles, the 10-2yr UST curve had steepened by almost 200-300bp (from trough to peak). While the 10-2yr UST yield spread has risen close to the widest level seen in 2016, it has not widened to the same extent as typically seen during the previous recovery periods. As a result, we **recommend reducing duration to the belly (5yr) of the curve**.

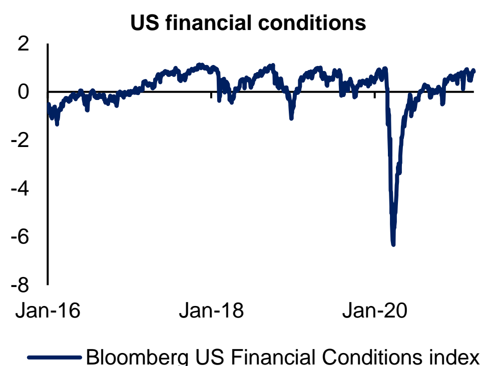
We also expect interest rate volatility to increase with continuing discord between the markets and the Fed when it comes to upcoming inflation risks and beginning of the tightening cycle. Higher growth expectations have driven market expectation for inflation, also bringing forward concerns of an early than indicated exit from loose monetary policies. The Fed has affirmed the improving economic growth prospects in its latest FOMC meeting where the central bank upgraded its growth projection but has been persistent that it will overlook the jump in inflation pressures as it expects an uptick in inflation to be temporary. But despite Fed's assurances, the markets don't seem to believe the central bank as inflation expectations continue to grind higher. Overall, we are in Fed's camp and believe that rise in price pressure will be temporary in nature. Rise in commodity prices coupled with increase in input prices point to a 'cost-push' inflation trend, which tends to be temporary in nature compared to 'demand-driven' inflation. However upcoming inflation data could be read as 'inflationary' by the markets.

Exhibit 5: Let the curve steep…



Source: Bloomberg, and ADCB Asset Management

Exhibit 6: …as long as Financial conditions remain loose



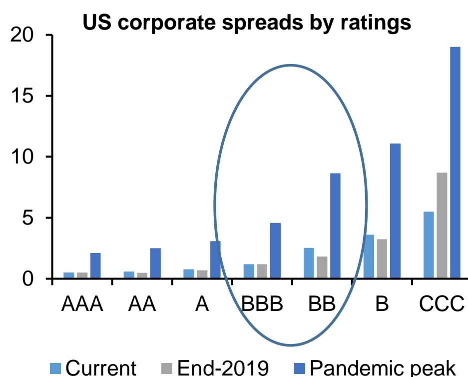
Source: Bloomberg, and ADCB Asset Management

Neutral on US and EU IG, Underweight on US and EU HY, Preference for BBB and BB rated bonds
Developed market corporate bonds have been rather insular to the interest rate volatility. Corporate spreads have in fact tightened even with long term rates rising. In terms of total return basis- Corporate bonds have suffered losses in the first quarter of the year. The sell-off was mainly concentrated in the US and EU Investment Grade bonds. On the other hand, High yield (HY) bonds have been the best performers in fixed income space with European HY bonds performing better than the US counterpart. The outperformance has been mainly driven by the low duration of HY index as well as protection in the form of higher spread premium which HY bonds offer. Historically, corporate bonds have been vulnerable to volatility in the long-end UST rates, but have performed well during periods of steady rise in UST yields. The recent volatility in the interest rates has not been as aggressive as seen during previous periods of sell-off including the taper tantrum period. Having said that, corporate spreads have significantly tightened to new lows, leaving little room for further spread compression. This also leaves them more vulnerable in the event of increased volatility in the long-term rates. Hence, we remain neutral on US and EU Investment Grade bonds while remain underweight on US and EU HY bonds. In the near term, low duration characteristics and the reflation trade could support appetite for HY bonds. However, looking at the nature of preference, spread compression shows it has been skewed towards the CCC-rated bonds. The CCC-rated spreads are now trading almost 3% below the pre-pandemic levels. On the other hand, BBB and BB rated segment still trading high compared to pre-pandemic levels and we do see scope for more spread compression in these segments.

Neutral on EM USD sovereigns, Overweight on EM Asia credit
On a total return basis, EM USD sovereign bonds have been one of the worst performers, recording heavy losses. Rising UST yields and dollar strength have weighed on the appetite for EM USD sovereign bonds. EM USD spreads have, however, managed to tighten during the rising UST yield environment. This is not unusual given EM USD spreads and UST yields tend to move in opposite direction over long period of time, in absence of UST volatility. However, during periods of increased volatility in UST rates, EM USD spreads have shown signs of vulnerability. The 2013 taper tantrum period and 2018 quantitative tightening were two episodes during which EM USD spreads have significantly widened with the rise in UST yields. Hence an increase in interest rate volatility remains a risk for EM USD bonds. Moreover, EM USD do not offer much spread premium given they have tightened to lowest levels since 2018. However, on absolute yield basis, EM USD sovereigns still remain attractive compared to USD HY bonds. Hence we remain neutral on EM USD sovereigns.

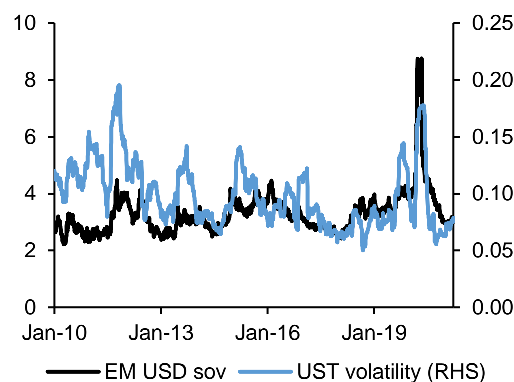
In EM corporate, we maintain our preference for Asia credit through our overweight stance on Asia IG bonds. EM Asia credit looks attractive with growth stabilization in Asia led by China, better control and management of the virus and attractive valuations of EM Asia credit when compared to the US and Europe counterpart. China's economy is likely to stabilise, after recovering from the pandemic impact, yet will continue to lead the growth in the EM.

Exhibit 7: BB segment is attractive



Source: Bloomberg, and ADCB Asset Management

Exhibit 8: EM USD debt vulnerable to volatile UST



Source: Bloomberg, and ADCB Asset Management

Equities

The year of 'unabnormal' in progress

In our note The Equity Strategist: Global Equity Outlook: The unabnormal, January 19 2021, we wrote that coming on the heels of an abnormal year 2020, we think 2021 will likely prove to be 'unabnormal'. Whilst it is unlikely to be anything like 2020, 2021 will not be like any other 'normal' year too, in our view. We expect average returns on equities in 2021 and this is unusual because it follows two years of above-average returns. Further, whilst we are at the start of a new economic cycle, some of the cyclical indicators are currently not at levels that they are expected to be. For example, unemployment is not at the crisis peak, financial conditions are at the easiest on record bankruptcies are very low, consumer confidence outlook is not as positive as it should be, savings rate and house prices are high while personal delinquencies have not materialized.

Further, our thesis was and continues to be that 'in terms of how various macro drivers/risks pan out over the year of 2021, we see a plausible year of two halves'. Based on growth, inflation and policy developments, different equity styles can be in vogue in each of the two parts. Exhibit 9 summarizes this. Whilst in a normal cycle (for example think about the post-Global Financial Crisis period) each of the phase could have lasted for several quarters to years, this time around, we think the cycle could be shorter overall and hence the possibility of seeing both rebound and recovery rather quickly. In the rebound phase which tends to be a lot more reflationary (and potentially inflationary too), cyclicals, cheap surface valuations stocks, small caps etc. are likely to do well. As we move from the 'rebound' phase to the 'recovery' phase, growth and inflation are expected to moderate (for our three-stage conceptual model of an economic sudden stop, see The Equity Strategist: Cautious tactically, constructive strategically, August 12 2020). We expect the recovery to be led by consumers and services in H2 2021 as strong household sector balance sheets support consumption and widespread vaccinations help the return of the services sector. Monetary policy can stay accommodative but hawkish comments from some central bankers could start to feed into market volatility in the back half of the year. Fiscal policy impulse too should start to fade in H2 2021 simply as base effects take hold. Of course, the USD3trn infrastructure plan could add additional fiscal push but this could very well be over several years and should support secular themes more. All this means structural growth opportunities could very well take over the leadership in the second half. However we think 'build back better' themes not only benefit from the fiscal stimulus in the near-term but also present long-term structural growth opportunities.

Exhibit 9: 2021 – a year of two halves

	H1 2021	H2 2021
Growth phase	Rebound	Recovery
GDP growth	↑	→
Growth led by	Manufacturing	Services (consumer)
Inflation	↑	→
Monetary policy	→	≈
Fiscal policy	↑	→
What works when?	Cyclicals, cheap surface valuations, small caps. UK, EM LatAm and EM EMEA. Energy, financials and materials by sectors. Beta normalization trades. High dividend yielders.	Structural growth, better ROE/ROA, quality, earnings visibility, large caps
What works most of the time?	Build back better themes: Digitization/digitalization, Green recovery and healthcare innovation	

Source: ADCB Asset Management

So in terms of our equity strategy, whilst we do stick with our strategic allocation to structural growth stories, we have hedged the near-term risks of higher rates impacting growth segments (given their higher duration) by being overweight UK (a cyclical play and low duration) and some cyclical industry group level trades ('beta normalisation trades'). For details see The Equity Strategist: COVID-19 induced changes to market sensitivities present opportunities, September 21 2020.

Recent rise in real yields in bond markets has created jitters in equity markets. We believe that this is an episode of repricing of risk and note that almost all such episodes are associated with a short-term rise in volatility. On the more fundamental impact of rising bond yields on equities, if history is any guide, bond yields need to be much higher than the current levels and be consistently rising in order for them to have a meaningfully negative impact on equities. Our analysis using US data since 1871 suggests that equity returns over the subsequent 12 months are the lowest when long-term bond yields are above 3% and rising. In such cases, equity markets moved higher over the following year only 54% of time (hit-ratio) and returned 2% on an average. However, when bond yields were above 3% but falling, equity returns over the subsequent year were strong at c12% on an average and the hit-ratio was 77%. When bond yields levelled between 2% and 3%, equities posted gains over the subsequent year 80% of the time and returned 13% on an average. When bond yields were between 1% and 2%, average equity returns of the following 12 months were even stronger at 17% with an improved hit-ratio of 85% (exhibit 10).

Regions

By regions, we remain overweight the **US**. Equities here not only benefit from higher quality, higher return on equity (ROE) and higher return on assets (ROA), near-term growth premium in the US over the rest of the world should help too. However, with the acknowledgement that higher duration of US equity benchmarks makes them more vulnerable to near-term reflationary trends, we hedged this with an overweight on **UK**. Equities in UK also benefit from the scope for reversal of the past underperformance (especially as the overhang relating to Brexit gets lifted), cyclical rebound that helps in earnings recovery and of course, relatively cheap valuations. We fund these overweight positions from our underweights in **Europe ex UK and EMs outside Asia**. Both the regions are likely to lag their peers in terms of the economic growth over the next few quarters. We remain neutral Asia (both Asia Pacific ex Japan and Japan) and Canada. Within Asia Pacific ex Japan, we focus on structural growth opportunities.

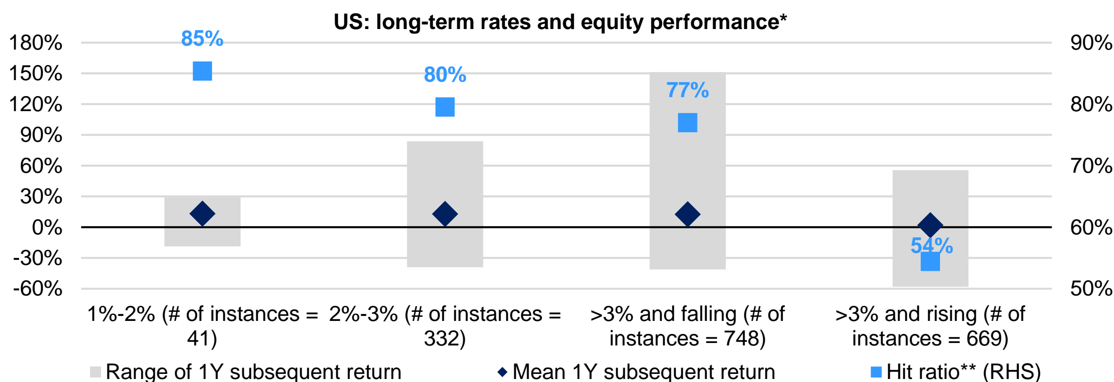
Sectors

We are **overweight IT and Communication Services** as structural plays. We are **overweight energy** for cyclical reasons. We fund these overweight by being strategically **underweight financials and materials** sectors. Over the past months, both financials and materials sector have performed well and overall too, our positioning is strongly growth-oriented and vulnerable to rising rates. Hence, we have hedged this by a set of **17 industry group level trades (6 of them are cyclical, 4 financials and 7 defensive)** that can benefit from reopening of the global economy and also cyclical improvements.

Factors and themes

Strategically, we hold a **preference for large caps** where investors benefit from their strong balance sheets and earnings visibility. We are more **cautious on small caps** which in a normal phase of the cycle can be constrained by leverage. Of course, as we highlighted in exhibit 9, small caps can do well in a rebound phase but can lag significantly later. We also have a good **growth tilt** in our positioning – this should help when the economic momentum normalises to the new normal, which we believe will be of moderate growth. Contrary to popular opinion, we do not see growth and **value** as mutually exclusive therefore, we are neutral on value while being overweight growth. Also, we believe our **preference for quality** will pay off over the strategic time frame.

Exhibit 10: Long-term rates should be much higher than the current levels to derail the equity outlook



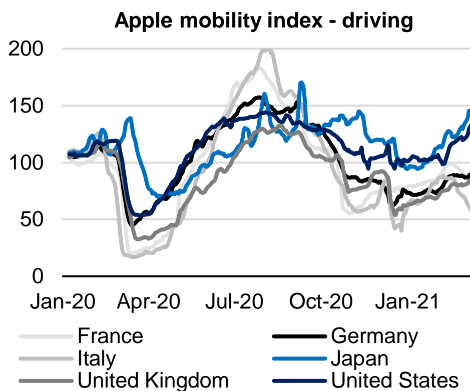
Source: Robert J Shiller, and ADCB Asset Management | Notes: *based on real total return of S&P composite. **Hit ratio is defined as share of instances which delivered positive returns over the subsequent 1 year.

Alternatives

Oil

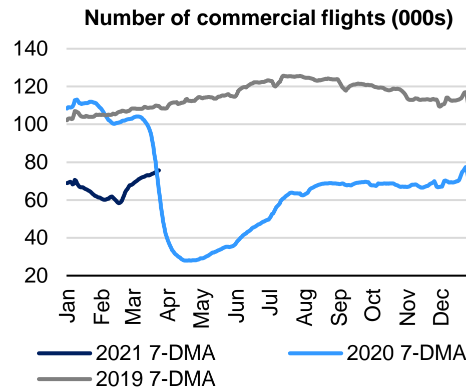
The near-term outlook for oil is influenced by a range of factors including the re-opening of economies, supply outlook and USD strength. Especially increasing mobility – both driving (exhibit 11) and increased commercial flights (exhibit 12) is likely to be the most influential factor. Worth noting that oil prices rallied quite strongly between November and mid-March and fell subsequently. Perhaps with mobility not increasing as expected in Europe (in fact falling in some cases), the positivity has taken a back seat in last two weeks of March. Of course, a strong supply discipline of the OPEC+ members has alleviated some of the concerns relating to potential over supply. But in its meeting April 1, OPEC+ has agreed to gradually increase the output. We think this increase will likely be gradual and disciplined over the next few months – at least till the point there is more clarity on demand from Europe. Also, worth watching the increasing virus infections in India and Latin America which could impact the demand there. For discussion on USD, see page 12. Taking the rough with the smooth, we think oil prices can remain sustained at current levels through next three months and potentially grind higher over H2 2021.

Exhibit 11: What is 'driving' oil prices?



Source: Apple, and ADCB Asset Management

Exhibit 12: Commercial flights far from normal

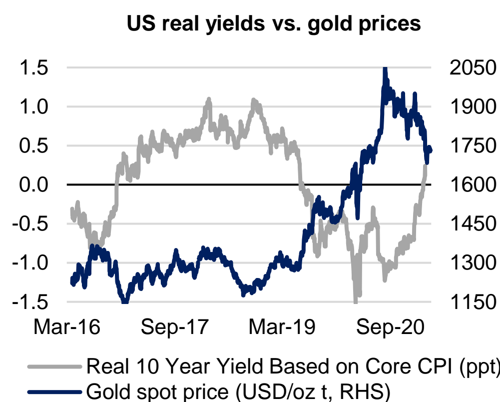


Source: Flightradar24, and ADCB Asset Management

Gold

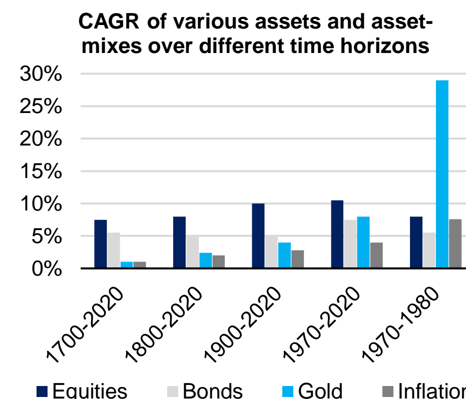
After having rallied since mid-2019, gold prices fell from their peak in August 2020. This coincided with the rise in real yields on US long-term bonds (exhibit 13). This could continue and put further rises in gold prices under check, especially until the real yields in the US peak out. Historically gold has been considered a hedge against inflation. For example during 1970s, hyperinflation saw gold outperform strongly. Yet, during normal times, holding gold comes with high opportunity costs (exhibit 14). Whilst we are not particularly bullish on the yellow metal prices, we keep our overweight on gold as a hedge against potential geopolitical and inflationary risks.

Exhibit 13: A real driver of gold prices



Source: Bloomberg, and ADCB Asset Management

Exhibit 14: Gold is a hedge against hyperinflation

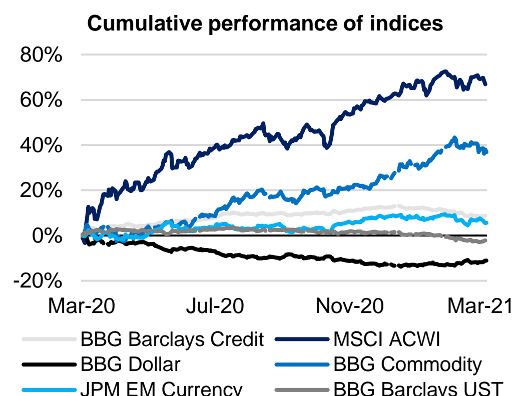


Source: Bloomberg, Fidelity, and ADCB Asset Management

Industrial metals

Commodity prices broadly have performed strongly since the market bottom in late March 2020 (exhibit 15). Industrial metal prices strengthened quite significantly too due to increasing Chinese demand (exhibit 16), supply constraints, and as investors increasingly holding industrial metals as an inflation hedge. Also, a weaker USD during 2020 has helped – however that seemed to have changed in Q1 2021. For discussion on USD, see page 12. All this has fed into the narrative of a commodity super-cycle. We don't believe that we are in one, and this could have profound implications for inflation expectations too. Whilst there is likely to be an infrastructure push in the developed world, we believe it is likely to come in the form of 'new age/digital/green infrastructure' and to the extent there is an 'old economy infrastructure' investment, we need to be mindful that most of the materials here are recycled. Chinese growth is likely to gradually rebalance towards consumer-led recovery from an investment-led rebound. This, in turn, is likely to slow the demand for commodities. Further very broadly, China is at a different stage of economic development than that which supported commodity super cycle in the past. Of course, environmental friendly green infrastructure needs some commodities like copper and the demand there is likely to sustain.

Exhibit 15: Commodity prices rose strongly…



Source: MSCI, Barclays, JPM, Bloomberg, and ADCB Asset Management

Exhibit 16: …but is it another super cycle?

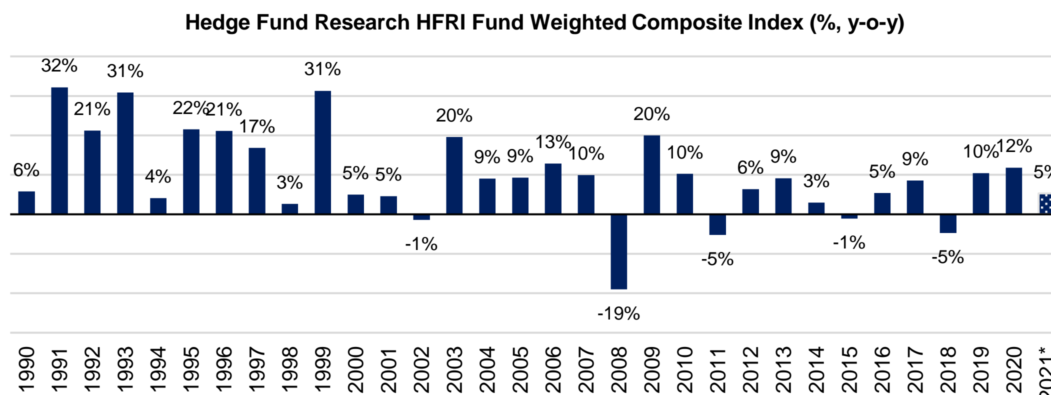
Source: CRB, Bloomberg, and ADCB Asset Management

Hedge funds

Given the weak performance of many hedge funds in the prior years, investors were sceptical about the outlook for this fund group in early 2020. However, 2020 proved to be a rather strong year for the hedge fund industry. For the context, HFRI Fund weighted composite index delivered a return of 12% in 2020, the highest since 2009 and compares strongly with an average return of just 4% over the previous ten year period. This strength continued into 2021 with the HFRI Fund weighted composite index returning 5% in the first two months of the year.

Looking ahead, we think exposure to hedge funds (especially those that are uncorrelated to equity markets) can provide the much needed diversification and capital preservation (like in Q1 2020) benefits.

Exhibit 17: Hedge fund performance in 2020 has been the best since 2009



Source: HFRI, Bloomberg, and ADCB Asset Management | Notes: *based on data till end of February 2021

Currencies

US Dollar- Balance between forces

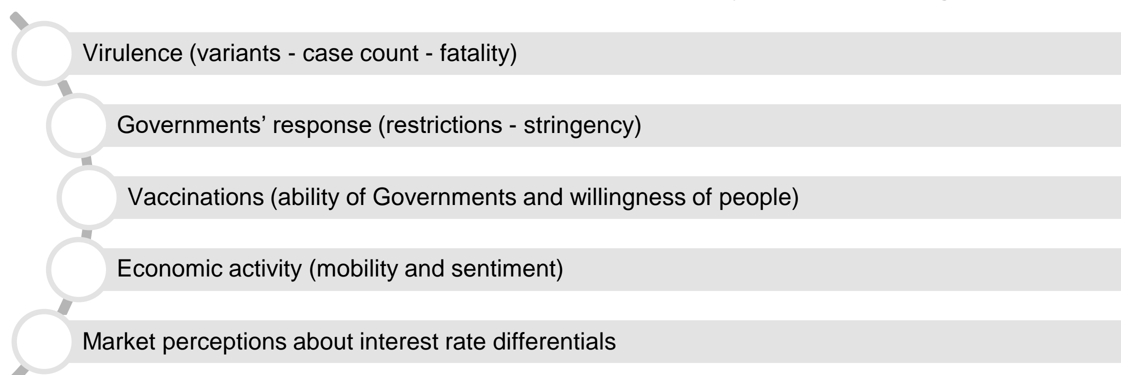
After being under pressure for much of last year, the dollar is making a comeback this year. This is despite the global reflation theme remaining dominant and US leading in terms of releasing the big bang stimulus measures compared to other advanced economies. The recent advance of the greenback versus major currencies has been mainly driven by the vaccine progress as well as management of the virus in the US outpacing other regions, particularly Europe. In addition, the first three months of the year, economic data has surprised to the upside in US, increasing hopes that US will be leading the global growth recovery and thus building the dollar 'exceptionalism' sentiment. While prospects of dollar strength are higher, rise could be controlled as US also leads in stimulating the economy.

The race of vaccine

There are several driving factors for the dollar in the near term. The global reflation theme in which expectations of stronger global economy reduce the appetite for a countercyclical currency like the US dollar. Upward surprises in global growth could lead to increased dollar weakness. However, with US data surprising more on the upside, there is an increasing confidence building that the US growth could outpace that of its global growth peers. Hence, the case for dollar strengthening versus the euro looks more convincing. Overall, currency movements will be mainly driven by the country's handling and management of the virus and return to normality. Prospects of growth boost from the US is accelerating with the progress in the vaccination drive and the recent stabilization in the Covid-19 cases. The Biden administration has doubled its goal of providing doses to 200mn within his first 100 days of the administration. Many US states have also now opened the vaccines to all adults with the Biden administration's promise of vaccine eligibility for all adults by May 1. At the time of writing, 43 out of 100 people have received single dose in the US.

On the other hand, Europe has been struggling with the vaccine progress, lagging significantly behind many developed market countries. Slower progress in securing vaccine, delays in vaccine supplies and more recently the rift with AstraZeneca decreasing confidence amongst people to get the shot are the underlying issues that have resulted in slow vaccine rollout. At the time of writing, European countries rank amongst the lowest in the world with only 15 out of 100 people receiving their single dose. At current pace, it looks extremely challenging for the EU to meet its goal of vaccinating 70% of the population by end-summer. Slow vaccine rollout will further delay the prospects of the EU reaching herd immunity by 2021 whereas the US and even the UK remain on track. To make matters worse, rising Covid-19 cases in Europe have forced extended movement restrictions, further postponing the re-opening of economy.

Exhibit 18: A framework to think about the COVID situation and currency performance during Q2 2021



Source: ADCB Asset Management

Fed vs ECB

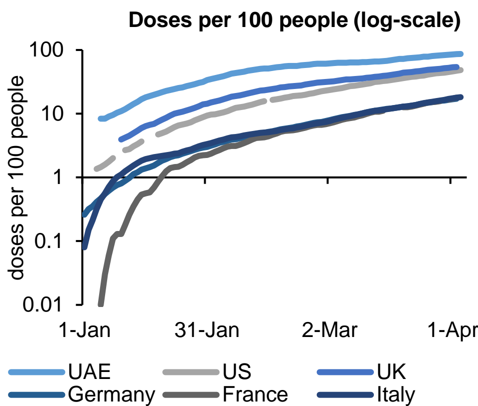
Another factor that could drive dollar outperformance against the euro is the rising difference between the monetary policy communication between the Federal Reserve and the ECB. The sell-off in long-term US treasury yields has impacted the European bond yields. The Fed and the ECB had different ways of responding to the rising bond yields. While both the central banks stressed on their accommodative stance, the Fed has expressed its comfort with the recent rise in UST yields, as long as the rise is orderly and does not threaten the financial conditions. ECB, on the other hand, had an opposite reaction to the rise in bond yields. The ECB accelerated the pace its asset purchases in order to arrest the rise in bond yields which undermine its loose monetary policy stance. Given the widening gap in terms of growth prospects in the US versus the EU, Fed's monetary policy rhetoric is likely to be less dovish compared to the ECB.

The pricing of cyclical component typically plays out through the interest rate differentials, mainly the short-term interest rates. So far, the short-term interest rates in the US have remain anchored with Fed unlikely to raise rates until 2023. However, with the economic cycle turning faster in the US, Fed is more likely to embark on removing policy support compared to the ECB. As a result, the dollar could strengthen against the euro if US continues to outperform in terms of the growth outlook.

Pound sterling

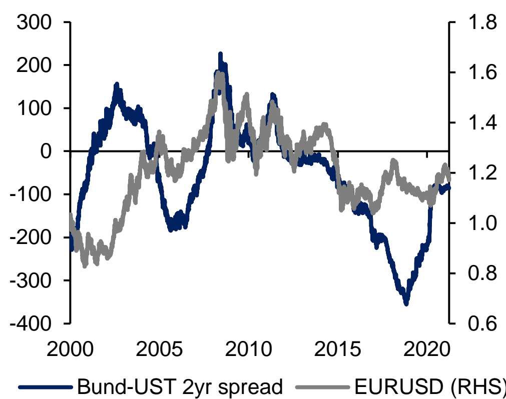
The Pound sterling has performed well in the first three months of the year and has relatively strengthened against both the dollar as well as the euro. The pound sterling against the USD has reached the highest level in 3 years and 12-month high against the euro. Similar to the US dollar, the outperformance of the pound sterling has been driven by the UK leading in terms of vaccine progress and on track to re-open the economy by summer. With the diverging progress on vaccination side in the UK and the EU, the pound sterling could be biased higher, especially versus the euro. However, given the significant run seen in the pound sterling, the re-opening and vaccine story may already be priced in.

Exhibit 19: COVID-19 Vaccine Tracker



Source: Our World in Data, and ADCB Asset Management

Exhibit 20: 2yr bund-UST spread versus EURUSD

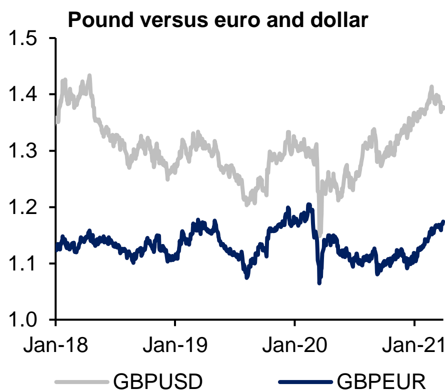


Source: Bloomberg, and ADCB Asset Management

Japanese Yen

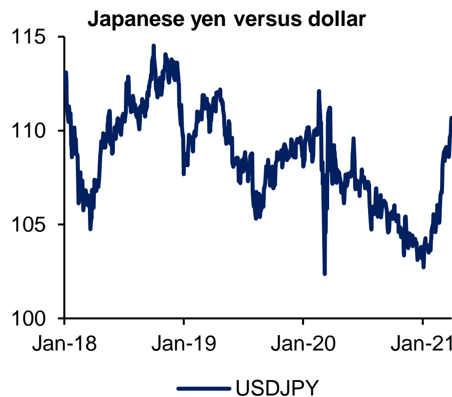
The Japanese yen has weakened versus the dollar in the first three months of the year amidst the broad dollar strength and overall risk-on sentiment in the market. As confidence on global growth recovery builds further, the yen is likely to lose out given its safe-haven characteristics. In addition, the yen is biased to be weaker as the differential between the US treasury yields and Japanese yields is likely to increase. The Fed is flexible with the orderly rise in treasury yields, in contrast to the Bank of Japan's yield curve control policy.

Exhibit 21: Pound has strengthened



Source :Bloomberg, and ADCB Asset Management

Exhibit 22: Yen has weakening bias



Source: Bloomberg, and ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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