On the Mark – Multi Asset Strategy

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March 2021 – Life is a roller coaster; you've just got to ride it.

Forgive our brief break in transmission but we have been rather caught up in markets and felt that we could add little to our comments in the run up to year end. What better way to return, than with the dulcet tones of Mr. Ronan Keating:

'…So don't fight it. Life is a rollercoaster, just gotta ride it…' *Life is a Roller Coaster – Ronan Keating.*

We left you with some thoughts about the developing economic cycle. We pointed out some comments by Simon Ward of Money Moves Markets which pointed to the significant drivers for better growth in 2021.

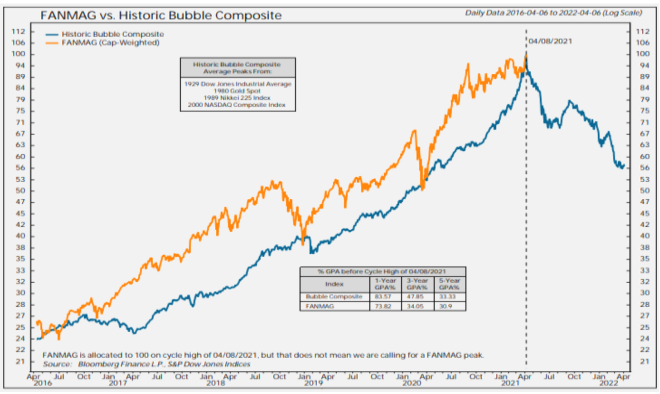
Ward states that "The upshot is that all three cycles are now acting to push up global economic growth, with their combined impact likely to outweigh any fading of fiscal / monetary stimulus in 2021-22."

Cycle upswings usually last at least two years, with an initial upthrust giving way to an interim correction before a final push into the peak.

The judgement here is that the initial move higher has started and may carry into Q2 2021, which would dovetail with the narrow money signal of a moderation of economic momentum around then.

We also said "We see a path to better growth and further rotation to more cyclically orientated sectors with some stalling out of the tech titans. Here is a chart that we have previously published on this point (Figure 1)".

Figure 1: NDR FANMAG vs. Historic Bubble Composite.



Source: Garraway, Ned Davis Research (NDR).

So, let us bring ourselves up to date and look at what's changed?

It sems that bond investors suddenly went from a rather sanguine view to a more alarmist interpretation of the inflation outlook when they started to fully appreciate a trifecta of factors.

- The combination of Biden administration and control of both houses meant an aggressive step up in the potential for further massive fiscal stimulus.
- Progress with vaccines and particular success stories in roll outs – most notably the US and UK amongst G7 members.
- A rather fumbled message from the US Federal Reserve and of particular note Chair Powell. Don't say that we didn't warn you that the promised improvement in communication from the Fed wouldn't materialise.
- Additionally, the year-on-year base effects of headline inflation have added to the above concerns.

In turn these factors had a violent and severe impact on several asset prices: In an almost repeat of the asset price moves on the vaccine breakthrough news in November we have seen historic moves in markets with yield curves dramatically steepening and value (especially cyclical) stocks massively outperforming growth stocks.

In a matter of a few weeks, a steepening of yield curves launched into a disorderly sell off. The long end of the US bond market reached oversold levels not seen since the early 1990s. The pace was such that in a couple of weeks, it matched the previous four months to six months of steepening. With this bond volatility as measured by ICE Bank of America (BofA) MOVE Index spiked from 45.95 on 11th February to 75.66 on the 26th February 2021.

The scale of the US bond market selloff in the first two months of 2021 is very unusual. By the end of February, this already ranked as the third worst year for bonds since 1988 according to Bespoke Research.

They also point out that an upward shift of 75 basis points within six months, as we have just witnessed, is also very unusual. "Past shifts to the current level have generally been followed by an even more precipitous move. But both the last two instances, in 2000 and 2008, came just as a recession was starting and not, as now, when one appears already to be over." John Authers – Bloomberg.

Lagarde of the European Central Bank addressed the sharp rise in euro-zone bond yields. She told the European parliament that the ECB would maintain "favourable financing conditions" throughout the pandemic period. This showed that the ECB was worried enough to resort to jawboning yields down and was what the market wanted to hear.

The rotation within the equity market, did not really affect the overall level of the S&P500 and perhaps for this reason initially, the Fed did not appear to be alarmed. Beyond repeating what was obviously an agreed form of words, Powell made no hints as to what the Fed might do about it.

However, by March it appears that the 10%+ correction in the NASDAQ and further steepening of the curves focused the Fed's mind and led to more forceful comments. Whilst they considerably upped their growth forecast at the March Fed meeting, they stated "Our best view is that the effect on inflation will be neither particularly large nor persistent.". This appears to have persuaded the market not to test them any further.

The Fed yet again were found wanting in our opinion with some very lackluster signaling of their intentions which did not consider market participants and the potential for a severe tightening in financial conditions.

In our opinion a policy error was narrowly missed and remains a considerable risk.

We, along with many others, could see the factors that would continue to see a gradual steepening in the US yield curve and related marginal outperformance of value related stocks, as amply shown by the previous comments. But we did not envisage the type of moves in bonds and equities that we witnessed from mid-February to early March. We are still a little puzzled about the exact event that triggered these moves and why they suddenly ignited into a rout, but an unsuccessful auction of seven-year Treasuries certainly did not help. We have written this before, but it could not be truer; we underestimated the speed and magnitude of the moves.

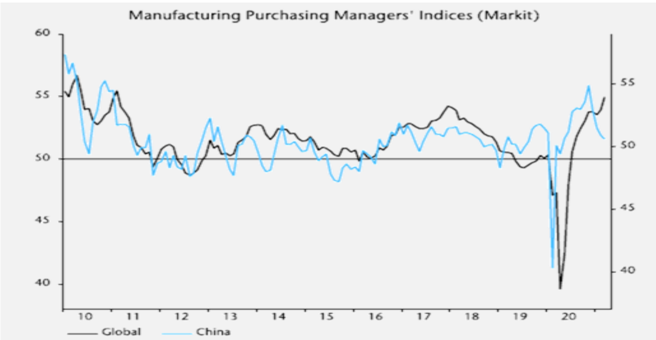
Where does that leave us now?

In our Multi Asset funds, we have been bruised from the multiple rotations, but the following charts offer a great opportunity to all investors who may have been caught off guard.

Interestingly, if we examine the bolded part of Ward's statement, we can see that it would now be realistic to expect that the upthrust could give way into an interim correction in Q2 2021. We can see that Ward's China vs Global PMI Chart (Figure 2) would suggest that a deceleration in Chinese growth is about to lead a pullback in global PMI's.

Equally John Authers of Bloomberg states "Pradhan of Barclays PLC, shows the implied "headline" (including fuel prices) inflation rate derived from the swaps market. Everyone is alive to the fact that base rates will give us scary-looking inflation of 3.5% later this year; but the market expects the headline figure to settle down at about 2.5%. As consumer price inflation tends to be a few tenths of a percentage point higher than the PCE measure that the Fed prefers to target, this shows the market thinks the Fed will get what it says it wants — inflation averaging a little above the target of 2% for a while, without accelerating".

Figure 2: Manufacturing PMI Suggests China Pull Back.



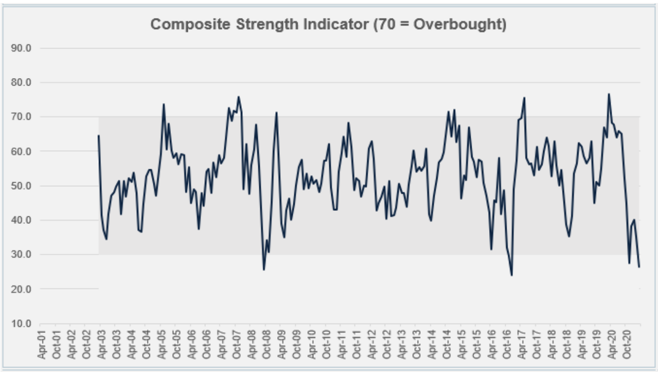
Source: Garraway, Simon Ward – Money Moves Markets, Refinitiv Datastream.

We can see from our in-house models that the MSCI AW Global Growth Index has suffered a severe correction relative to the MSCI AW Value Index (Figure 3). It now leaves it as deeply oversold as it has been in the last twenty years.

The information ratio of the MSCI AW Global Growth Index relative to the MSCI AW Value Index has reverted close to the zero line (Figure 4), which has generally acted as basing pointed since 2008.

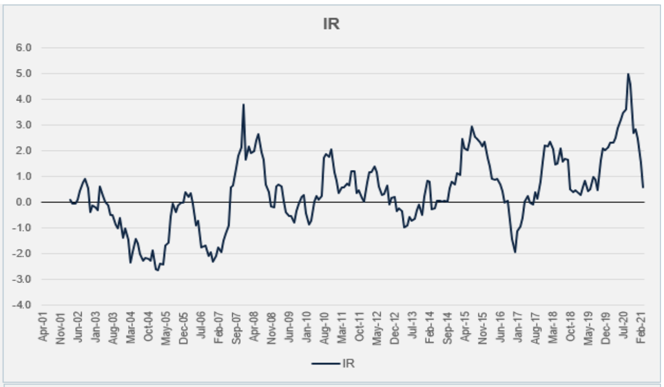
Additionally, our proprietary signals indicate that we should be at or very close to a turning point. This does not mean that the MSCI AW Global Growth Index growth need outperform to the extent it did in 2020, but it should outperform and at a minimum maintain performance relative to the MSCI AW Value Index for a period.

Figure 3: CSI for MSCI ACWI Growth vs Value Index.



Source: Garraway, Bloomberg L.P.

Figure 4: Information Ratio for MSCI ACWI Growth vs Value Index.



Source: Garraway, Bloomberg L.P.

In our opinion the French writer Jean-Baptiste Alphonse Karr, famous statement “plus ça change, plus c’est la même chose” is pertinent.

Covid-19 has wrought dramatic acceleration of change to a secular shift. This means that numerous sectors now defined as value, have been, and will remain challenged in the long-term. Secular shifts are exactly that, long-term phenomena that get challenged/obscured in the short-term but win over extended time periods. However, the push and pull of this argument will play out over the next six to nine months, and with it, the lack of resolution will mean more bouts of volatility.

Investors should focus on the longer term but have to realise that the price you pay for such conviction will be extreme tests of nerve. This recent episode has done just that, and we have been tested.

The Multi Asset Team.

Important Information