How to think about the issue of rising interest rates for investors

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In our **January Note**, we warned that that "market developments in 2021 may prove to be trickier than is commonly thought". Events in these first days of March have lent credence to our warning. Financial markets have begun hyperventilating over the prospect that the recent uptick in long-term interest rates will continue, particularly in the United States. And as interest rates have a nasty habit of suddenly accelerating their initial movements, we feel it could be helpful at this point to elaborate on how we view the issue. Experience suggests that rising interest rates initially mean good news for equities, given that they usually portend an economic upturn but without creating a higher cost of capital in the short term. Such an assumption is supported today by the fact that in absolute terms interest rates are still miles away from the levels that have caused problems in times past for the prices of risk assets. That explains to a large extent why stock markets have been so unruffled by the surge in bond-market volatility since the beginning of the year. Though the yield on US 10-year Treasuries has climbed from 0.9% to 1.47% in just two months, the MSCI World Index for equities has gained another 4% over the same time span. But as soon as you look at the broader backdrop, you start thinking in terms of a less straightforward investment outlook.

Markets on steroids in 2021

As discussed in our January Note, a combination of unprecedented fiscal and monetary stimulus, an exceptionally favourable basis of comparison and increasingly heartening news on vaccine effectiveness will most likely lead in 2021 to some of the highest year-on-year GDP growth rates since the 1980s, in any event in the United States. So we shouldn't be surprised to see that speculative trading – facilitated by a surfeit of liquidity – coupled with increasingly upbeat fundamental analysis has driven equity indexes sky-high. Nor is it surprising that the pickup in inflation, which will likewise be fuelled by a favourable base effect a few months down the line (as inflation plummeted in spring 2020, together with consumer spending and oil prices), has thus far been interpreted as a healthy symptom of the economy's much-awaited "return to normal". Higher inflation will automatically reduce real interest rates (i.e., nominal rates minus inflation) and therefore make debt loads easier to manage and equities even more attractive. So the key question is this: considering that it's getting increasingly hard to justify negative real rates and further quantitative easing at the same pace as before in an economy growing at a 5% to 6% clip, when will central banks venture to announce monetary-policy tightening – in other words, when will they take the punch bowl away?

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First signals

In his testimony before the US Senate Banking Committee on 23 February, Fed chief Jerome Powell reiterated that he had no plans to tighten monetary policy in the near future. (Equity markets promptly pulled out of their nervous mood of the preceding days in response to this welcome news.) Powell's remarks were in line with his statement last summer at the annual central-bank symposium in Jackson Hole that his institution would be targeting medium-term rather than short-term inflation going forward. This means that even if inflation accelerates sharply in the coming months (driven primarily by a favourable base effect), the Fed will stand pat on its new doctrine. And yet just a few days later, bond yields headed back upwards, jolting stock markets in the process.

Markets influence monetary policy at least as much as the other way round

What's causing this state of turmoil? In today's bullish market atmosphere, the Fed's insistence on a wait-and-see approach is beginning to worry investors that, if strong GDP growth continues beyond 2021, the US central bank might then have to drastically tighten the screws to keep the economy from overheating. The accelerating increase in long-term yields reflects precisely that. Not only have medium-term inflation expectations risen, but so have real interest rates (i.e., nominal rates corrected for inflation). It's worth noting that the Fed currently expects US GDP to expand by a "mere" 4.2% in 2021. We consider that forecast far too modest. The Fed seems to be giving short shrift to the $1.9 trillion Rescue Plan already passed by the House of Representatives, which will likely by paired soon with a similarly huge infrastructure bill. Moreover, with the United States well on its way to herd immunity to Covid-19, consumer spending can be expected to shoot up before long. Once the Fed's policymakers recognise a bit later in the year that they have underestimated growth, they will have adequate grounds for re-examining their ginger approach. In other words, by incrementally pushing up real long-term interest rates, the market is telling the Fed that there is a rising cost to not acting.

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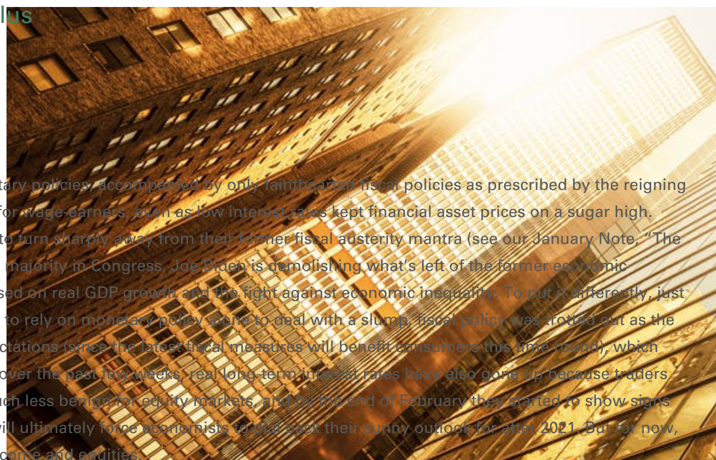

Regime shift is the crux of the matter for financial markets

The decade following the 2008 financial meltdown saw extremely accommodative monetary policies, accompanied by only fainthearted fiscal policies as prescribed by the reigning financial orthodoxy. The outcome was mediocre GDP growth, and therefore scant gains for wage-earners, even as low interest rates kept financial asset prices on a sugar high. That approach took a first major hit when the recession in 2020 compelled governments to turn sharply away from their former fiscal austerity mantra (see our January Note, "The Virus and the Rubicon"). Next came the US presidential election. Bolstered by his party's majority in Congress, Joe Biden is demolishing what's left of the former economic paradigm by committing to unprecedented fiscal stimulus – a programme explicitly focused on real GDP growth and the fight against economic inequality. To put it differently, just when we were reaching the limits of how effective – and how socially acceptable – it was to rely on monetary policy alone to deal with a slump, fiscal policy was trotted out as the new frontier of economic policy. This regime shift initially triggered higher inflation expectations (since the latest fiscal measures will benefit consumers this time round), which have to a large extent cushioned the impact of rising bond yields on equity markets. But over the past few weeks, real long-term interest rates have also gone up because traders believe the Fed will eventually have to tighten policy. This state of affairs is obviously much less benign for equity markets, and by the end of February they started to show signs of stress and strain. It's too early to tell whether the bond-market correction under way will ultimately force economists to dial back their sunny outlook for after 2021. But for now, the current regime shift in financial markets calls for a cautious approach to both fixed income and equities.

What this means for investors

A market regime that has held sway for several decades can't be swept aside overnight. Such a change will undoubtedly be preceded by greater volatility, a trend already under way in fixed income, and equity markets are likely to soon follow suit. In the last few weeks, we have accordingly scaled back risk across all our fixed-income and equity portfolios with hedges particularly on the Nasdaq, as well as on long-term US yields. At the same time, continued real GDP growth after the 2021 upswing will require further fiscal spending, which the unfolding bond-market correction could well interfere with. Next to our reopening names, we are therefore hanging onto our portfolio of high-quality growth names, whose predictable earnings growth and pricing power in the event of higher inflation will prove to be valuable assets under any and all market conditions.

Source: Carmignac, Bloomberg, 01/03/2021

Investment strategy

Equities

Over the first months of the year, investors increasingly rotated their portfolios from growth to value stocks on the expectation that economies would re-open just when the United States was kicking off an unparalleled surge in fiscal spending. Such macroeconomic enthusiasm eventually prompted a correction in the least cyclical market sectors like consumer staples, utilities and technology, as investors began to worry about rising long-term interest rates, particularly in the US.

With fewer factors sustaining equity markets in recent weeks, we took profits on the most highly valued names – notably in China – and put in place carefully targeted hedges on US stocks. We plan to stick with this cautious approach in the short term, until valuations appear to reflect fundamentals more adequately and a new interest-rate paradigm begins to take shape. We have chosen to make exposure to the "re-opening of the economy" a feature of our equity portfolio through a selection of companies offering attractive short- and long-range prospects. Those investments provide a counterweight to our secular growth-oriented core holdings. For example, we will remain invested in Europe's travel industry, alongside our exposure to luxury goods, as we feel they stand to gain from a pickup in consumer spending now that savings rates have reached historic highs.

Our primary stock-picking yardstick is still predictable, medium-term earnings growth – the best way to eliminate poor-quality names. Our research focuses on companies that will be able to keep profit margins up, particularly when inflation rises; adjust to secular shifts in manufacturing methods and consumer spending patterns; and stand their ground even if GDP growth falls short of expectations – a scenario that can't be ruled out at this stage. Though the share prices of such companies often raise doubts, it's worth pointing out that recent developments have aligned the medium-term valuations of growth and value stocks.

Fixed income

The yield on US 10-year Treasuries, which largely dictates prices for other financial assets, has gone from under 1% at the start of the year to over 1.6%. The first phase of that upward movement was accompanied by improved inflation expectations, but real interest rates are still extremely low. In recent weeks, however, the rising yield trend has picked up speed, and this time it has been accompanied by higher real interest rates and a mild decrease in inflation expectations. That combination spells risk for the most interest-rate-sensitive assets.

In response, we are managing our fixed-income portfolio cautiously yet tactically. Europe and the United States have recently experienced similar shifts in core yields although conditions differ in the two geographies. In Europe, there is still uncertainty on the economic and public-health fronts, whereas the US economy can count on support from an unprecedented fiscal stimulus programme and much more efficient vaccination rollout. We have therefore continued to short US Treasuries. In contrast, though we are still avoiding most European sovereign bonds for now, we feel that opportunities may emerge if the market correction goes further. Corporate credit markets have meanwhile held relatively steady. But a fair amount of caution is still required, as current spreads will provide very little protection against a sharp rise in interest rates. We have therefore reduced portfolio risk by exiting our main positions and establishing hedges.

We are hewing to our highly selective positioning in emerging-market debt through targeted investments in countries like China and Romania. We have also put in place short positions in the economies most vulnerable to resurgent inflation. An example is Poland, whose central bank is likely to tighten monetary policy sooner than planned in order to keep a lid on inflation. In sum, while the swift, across-the-board global market correction under way may create tactical opportunities, an upcoming paradigm shift is keeping us on our toes.

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