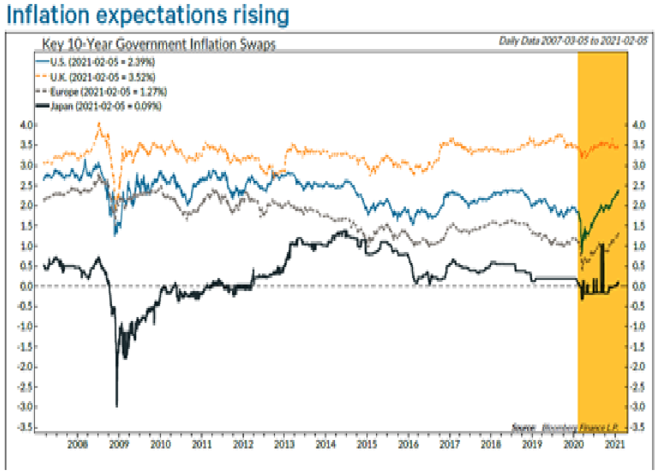
Low and slow

During this covid lockdown, I have attempted to smoke the best beef brisket in Singapore, Johor Bahru and some say Bintan. The beef brisket is a tough cut from the pectoral muscles and is full of fibers and connective tissues. If cooked right, the alchemy of smell, flavour and texture is parallel to none. There are two ways of getting the best of this meat either by going hot-and-fast or low-and-slow. The benefits of hot-and-fast is obviously shorter cooking time required. However, when it comes to overall finesse, the low temperature and slow smoking method is by far the best. This method requires patience and attention. It can take up to 6-8hrs for a 2kg brisket and if you include the time needed to trim, season, start the smoke, and rest the meat, that is another 2-4 hours for the whole process. You might ask what is the relevance of low-and-slow smoked beef brisket to the capital markets? In our January 2021 webinar, [After the storm, what comes next?](), we cited a few key risks and one of them is rising inflation and how that will test the central bankers' gambit to keep interest rates low for longer and will only slowly calibrate rates even as inflation surpasses their long-term target. We did not have to wait long for markets to test central bankers' resolve on this issue.

Since the start of the year, inflation expectations (Chart 1) have risen not only in the US but everywhere including the perennial deflationary country of Japan. The 10-year inflation swaps have risen to 2.39% in the US, 3.52% in UK, 1.27% in Europe and Japan out of its deflationary trap at 0.20% with an average of 20-50bps across the regions.

<u>**Rising inflation expectations globally (1)**</u>



Source: NetDavis Research

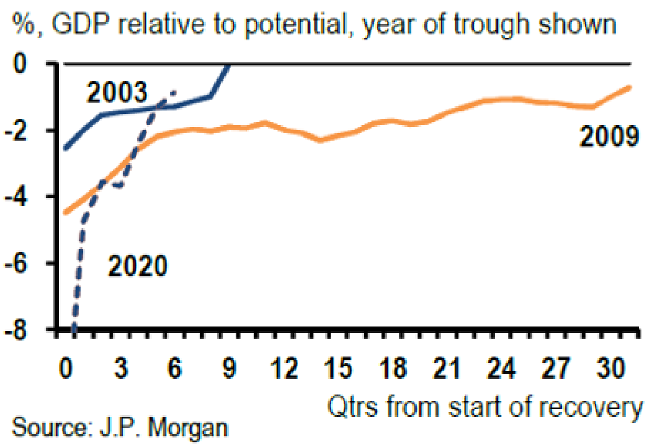
At the start of the year, we have commented markets could be too complacent about inflation risk both in the short and longer - term. In the short term, we see several drivers of higher inflation (i) the optics of an easier year-on-year comparison which saw a dramatic collapse in demand in the first half of 2020 due to the pandemic, and (ii) our more sanguine view of economic growth for 2021. Economic forecasters have since upgraded their global GDP numbers from 5.2% at the start of the year to 5.4% (Chart 2) with the US leading the upgrade. The output gap is not only shrinking faster than initially expected (Chart 3), but also shrinking much faster when compared to the last two recessions of 2003 and 2009.

2021 GDP forecast raised in the past 2 months (2)

	GDP Forecast		
	2021 (F) Jan 21	2021 (F) Currently	bps Change
World	5.2	5.4	0.2
Advanced Economies	4.0	4.3	0.3
Emerging Markets	5.1	5.2	0.1
Emerging vs Advanced Economies	*1.1*	*0.9*	*-0.2*
US	4.1	4.9	0.8
China	8.2	8.4	0.2
Euro Area	4.3	4.3	0.0
Japan	2.6	2.7	0.1

Source: Bloomberg

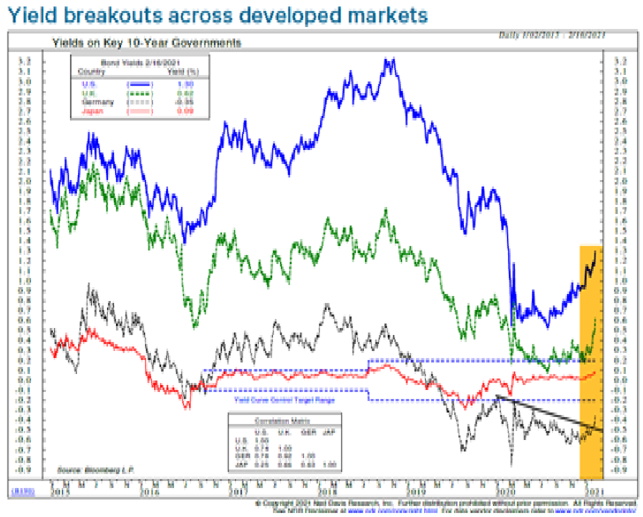
Output gap shrinking inflationary pressure rising (3)



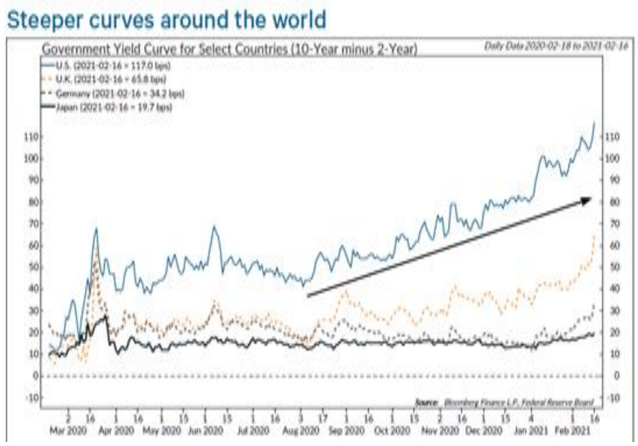
In the longer term, China as a force of global goods deflation for the past 20 years is coming to an end and instead will become a next exporter of inflation as it encounters rising wages, higher trade barriers and tariffs, exacerbated by a stronger RMB. Other deflationary forces that are reversing include (i) Benefits of globalization has peaked and is set to reverse as politicians seek populist policies, (ii) slower growth of e-commerce adoption therefore slowing the pace of goods deflation, and (iii) and potentially higher costs associated with our green efforts toward a better and more sustainable economic model.

We are therefore not surprised nor perturbed that long-term yields are breaking out everywhere and poignantly curves are steepening (Charts 4 and 5). Central bankers' commitment to keeping rates low does not mean yields will stay low as the latter is determined by market forces looking through the lenses of growth, inflation, deficits, and last but not the least central bankers' communique. Is the steepening of longer-end rates that worries the markets most as many economic decisions and valuation metrics are based off long-term rates.

Global yields breaking out (4)



Accompanied by steepening of the curve (5)



Source: Net Davis Research

But we need to differentiate the drivers behind the increase in yields and the steepening of the curves. If the reason for the increase/steepening is due to improving

growth dynamics, risk assets perform well (Chart 6) beyond the initial sell-off that typically last less than 1-2 months. Equities perform best with small-caps, financials, and Japan equities particularly. Fixed income spreads narrow and high yield narrows more than investment grade-debt as expected. Dollar strengthens across the board, commodities such copper and oil outperform safe-haven asset, Gold.

Performances during growth-driven higher yields(6)

	Change
Equities	
S&P 500	1.0%
Russell 2000	6.1%
Nasdaq Composite	-3.6%
KBW Bank Index	9.1%
Eurostoxx 50	4.0%
DAX	3.6%
Nikkei 225	3.6%
HSCEI	0.1%
MSCI EM	0.2%
FX	
EURUSD	-1.4%
GBPUSD	-0.9%
JPYUSD*	-4.3%
AUDUSD	-1.7%
NZDUSD	-2.1%
CADUSD*	-0.7%
CNHUSD*	-0.3%
KRWUSD*	-1.0%
NOKUSD*	-2.3%
SEKUSD*	-1.3%
BRLUSD*	-1.2%
MXNUSD*	-1.0%
Commodities	
Gold	-17.4%
Copper	0.9%
Oil	1.5%
Credit	
US IG (bp)[1]	-4
US HY (bp)[2]	-32
Rates	
UST 5Y	0.43
UST 10Y	0.62
UST 30Y	0.69
DEM 10Y	0.32
Breakevens 5y	-0.13
Breakevens 10y	-0.03

Source: Goldman Sachs

Within Equities, Energy, Communication Services, Healthcare, and Consumer Staples perform best (Chart 7) While it seems that Financials is one of the worst performers in an environment of rising inflation, we caution against this verdict as many of these past episodes of negative returns were accompanied by significant balance sheet stress due to either rising corporate or consumer bankruptcies. However, this current episode is different as banks and insurers had strong capital buffers heading into 2021 crisis. In fact, by 4Q20, many major US and European banks capital adequacy have return to pre-covid levels in part due to both their pre-emptive and aggressive provisioning taken as well as the significant and well-orchestrated government fiscal and monetary policies implemented globally.

However, if the rise in yields/steepening of the curve is driven by an unexpected tightening of Fed monetary policy, no asset classes do well in this scenario (Chart 8). Growth equities such as Nasdaq, EM and small caps equities fared the worst, USD gains as the flight to safety ensued, even inflation protection instruments such gold and oil prices collapse. Fixed income fares much better than equities with a smaller degree of widening in spreads for both credit and government bonds.

Performances during policy-driven higher yields(8)

	Change
Equities	
S&P 500	-7.8%
Russell 2000	-7.9%
Nasdaq Composite	-10.1%
KBW Bank Index	-4.8%
Eurostoxx 50	-5.3%
DAX	-5.9%
Nikkei 225	-3.5%
HSCEI	-0.6%
MSCI EM	-5.3%
FX	
EURUSD	-1.7%
GBPUSD	-2.0%
JPYUSD*	-2.9%
AUDUSD	-2.6%
NZDUSD	-2.8%
CADUSD*	-1.7%
CNHUSD*	-0.5%
KRWUSD*	-2.2%
NOKUSD*	-4.8%
SEKUSD*	-2.3%
BRLUSD*	-3.3%
MXNUSD*	-4.5%
Commodities	
Gold	-15.7%
Copper	1.9%
Oil	-6.3%
Credit	
US IG (bp)[1]	9
US HY (bp)[2]	29
Rates	
UST 5Y	0.34
UST 10Y	0.44
UST 30Y	0.44
DEM 10Y	0.13
Breakevens 5y	-0.26
Breakevens 10y	-0.19

Source: Goldman Sachs

We would categorize this current jump in yields as growth induced hence will be buyers of dips rather than scurry for cover. Still, the market is fixated on the resolve of central bankers to tamper any excessive move in yields. But before we turn to that, let's validate if the current moves are excessive or in tandem with improving macro fundamentals.

Sector performances during rising inflation: Energy, Comm Svcs, Healthcare perform well (8)

Energy has consistently outperformed when inflation has been rising

Sector Performance During Periods of Rising CPI Inflation*

Case	1	2	3	4	5	6	7	8	9	10?		
Months	30	40	8	47	24	45	21	25	40	8	SORT	
S&P 500 Sector	6/30/1972 to 12/31/1974	12/31/1976 to 3/31/1980	7/31/1983 to 3/31/1984	12/31/1986 to 10/31/1990	3/31/1998 to 3/31/2000	1/31/2002 to 9/30/2005	10/31/2006 to 7/31/2008	8/31/2009 to 9/30/2011	4/30/2015 to 7/31/2018	5/31/2020 to 1/31/2021	% Cases Outperforming**	Median Return**
Energy	-5.0	42.2	14.7	56.8	10.3	94.9	30.5	13.2	-5.6	1.7	**77.8**	**13.9**
Communication Services	-18.5	-13.8	-1.0	34.7	56.5	-16.1	-16.1	19.9	51.2	20.8	**66.7**	**9.5**
Health Care	-20.2	-1.1	-8.1	66.9	7.7	-4.7	-3.8	11.2	24.1	11.9	**55.6**	**3.3**
Consumer Staples	-38.7	-18.5	5.3	100.7	-27.9	9.0	6.5	20.3	10.7	8.8	**55.6**	**7.7**
Information Technology	-44.8	-11.0	-10.6	-15.6	198.7	-12.0	1.9	18.1	67.0	32.0	**44.4**	**-4.4**
Industrials	-49.4	8.8	-3.4	10.4	14.3	10.5	-1.7	16.1	34.7	25.8	**44.4**	**10.5**
Materials	-17.0	-17.1	-0.4	9.3	-10.6	25.0	20.5	3.4	18.5	27.7	**44.4**	**6.4**
Consumer Discretionary	-58.6	-37.7	-12.4	2.6	29.6	22.5	-23.7	35.7	60.0	30.5	**33.3**	**12.5**
Utilities	-38.3	-17.1	-5.0	11.2	-2.4	24.2	6.8	15.9	19.4	4.6	**33.3**	**5.7**
Financials	-61.7	-12.5	-5.6	-30.5	1.7	14.0	-40.2	-25.0	39.5	24.1	**22.2**	**-9.0**
S&P 500 Index	-36.0	-5.0	-2.1	25.5	36.0	8.7	-8.0	10.9	35.0	22.0	**na**	**9.8**
CPI Rise***	**963**	**562**	**234**	**519**	**238**	**354**	**429**	**535**	**315**	**128**		

* CPI Y/Y change rises 200 basis points or more

** % cases outperforming and median return exclude recent case (case 10)

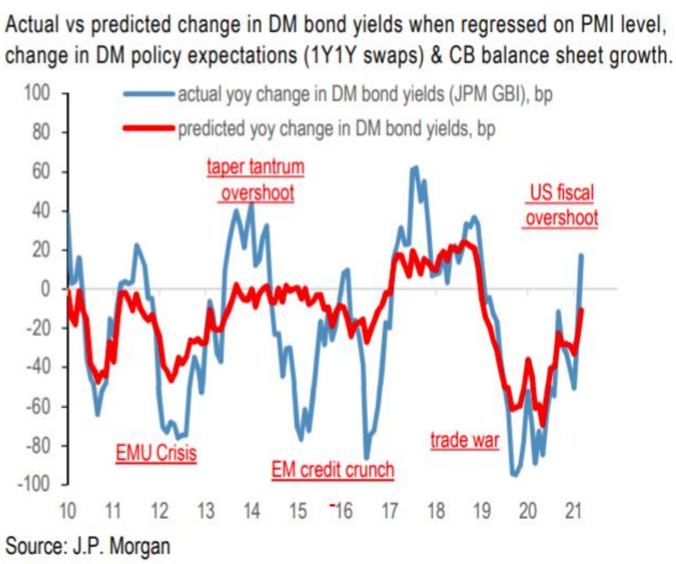
***CPI rise is the increase in the Y/Y growth rate, trough to peak, in basis points

Green shade means sector has outperformed the S&P 500 while red has underperformed. Real Estate excluded due to lack of history. Source: S&P Dow Jones Indices.

Ned Davis Research T_IF21_07.1

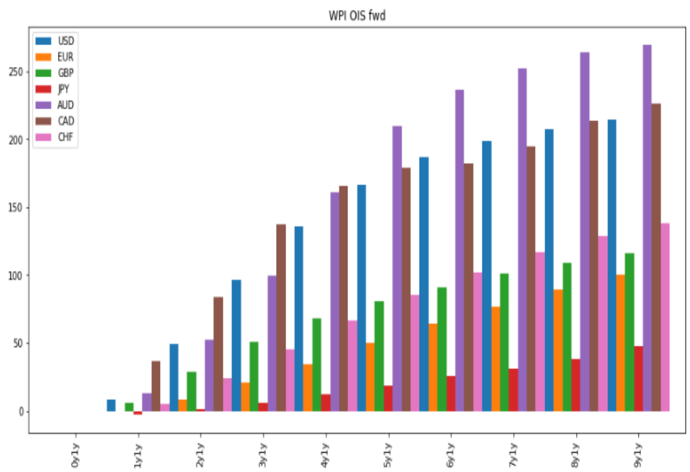
If we regress several variables such as level of PMI, policy expectations, and the growth in central bankers' balance sheet, this JPM analysis shows that the market has probably overshot ten-year yields by 20bps at its recent peak of 1.50% (Chart 9)

Recent rise in yields have overshoot fundamentals (9)



Another way is gauge what market participants are pricing for future short-term rates as evidenced in the OIS market. Chart 10 informs us that the market is now pricing 20bps Fed hikes by end of 2022, another 51bps by Dec 23, plus another 92bps by the end 2024. **In other words, they are expecting seven 25bps hikes from Dec 2022 till 2024 which we think is too bearish.** Furthermore, based on Fed normalization sequencing, a first hike in the Dec 2022 would mean Fed commence its tapering program in 1Q22. While we are bullish on growth and by association bearish on rates, the latest consensus forecast is for PCE (Fed's preferred measure of inflation) to climb to 2.1% by 2023 in the US; still below Fed's desired target of 2.5% to 3.0% and nowhere near their "white of the eyes of inflation" musing. **We conclude that the market may have over-reacted in the short-term though we maintained our year end UST10 yield to be in the range of 1.7% to 2.00%.**

Markets pricing hike Dec22, 2 in '23 and 3 in '24 (10)

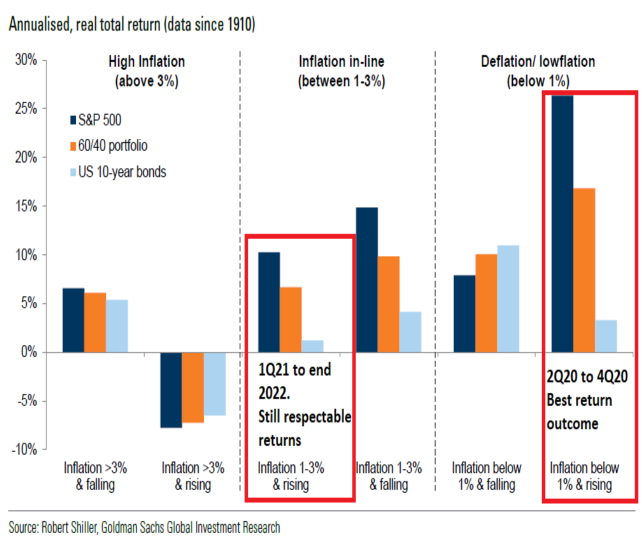


Source: Goldman Sachs

What then can central bankers do to curb over-excessive bearishness in the long-end of the curve? Plenty actually. The cheapest form of intervention is open communication and both the Fed and ECB have made it clear they see the current spike in inflation as transitory and not permanent and are committed to staying the course of achieving an inflation overshoot. **The more potent maneuver could be a restart of buying more bonds at the long-end of the curve. The Fed and BOJ have done this before via Operation Twist and Yield Curve Control respectively**. Fed's Operation Twist was very successful when Fed Chair Ben Bernake announced in September 2011a $400bn buybacks of long-dated Treasuries funded by using the proceeds from matured short-term notes and bonds. UST10 yield fell ahead from 3.00% as rumours abound of an impending change in Fed's buying program to a low of 1.86% by end of Dec 2011 and by the time it ended in Dec 2012, UST10 year traded in the tight range of 1.50% to 2.00% throughout the year. The latest central bank to use this powerful too was the Royal Bank of Australia when it announced this week it planned to buy more than $3bn of longer-dated securities in addition to buying even more shorter-term bonds to flatten the curve. **The market is also speculating that sometime in March, Fed could restart Operation Twist and to also increase the rates of excess reserves and overnight repo operations by 50bps to increase liquidity in the short-end** therefore curbing short-end of the curve as well.

The final point on rising inflation is to remember inflation and economic strength moves hand in hand like love and marriage. **What is driving higher inflation is a stronger economy, which in turns leads to a commiserating rise in yields across the curve, which eventually leads to a tightening of monetary stance. Rising inflation generally is not bad for risk markets.** A 60/40 equities/bonds portfolio performs the best when inflation is below 1.0% and rising, which was what we experienced in 2Q to 4Q20. **As we are expecting inflation to rise from 1.5% to 2.0% in 2021, this has in the past produced an annualized total return of 8% pa (Chart 11).** However, should inflation surpass 3%, it will be detrimental for all asset classes; but we are far away from realizing that.

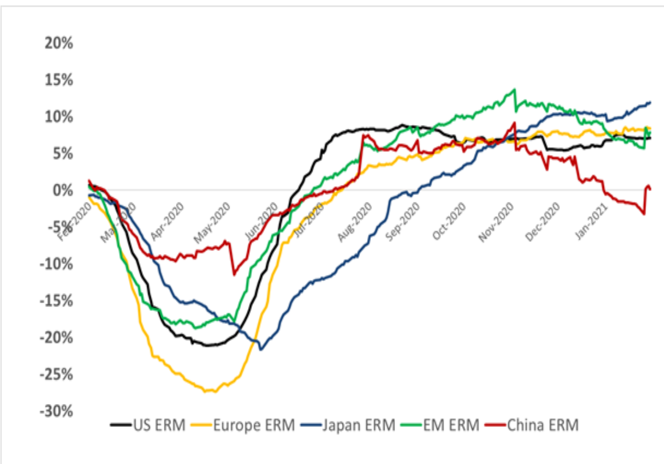
Rising inflation isn't bad for asset prices (11)



Asset Allocation Strategy

Equities: Maintain Overweight. The broad contours for bullish equities have not changed. GDP (Chart 2) and earnings revision momentum (Chart 11) remain positive. Valuation of equities versus fixed income favours the former. Despite a substantial increase in flows into equities recently, cumulatively since 2019, equities inflow is small relative to its own historical context as well as in comparison to the bond inflows. So far, $225bn of shares buyback has been announced, eclipsing the 2018-2019 level of $180-190bn and double of 2020 level is another fillip to owning equities.

Earning revision momentum +ve in all regions (11)



Source: Bloomberg estimates

Compared to our last Navigator in November, [No blessing goes uncontested](), we have re-size our tech exposure to Neutral and are concentrated in semiconductors as we are witnessing an unprecedented shortage of chips in many end products. We think this issue will persist over the two quarters. We have also taken advantage of the recent price declines in SaaS stocks to increase our position in this structural theme. But the larger focus of our equities portfolio is in reflationary trades like financials, bombed-out consumer discretionary stocks that will benefit from the accelerated path of vaccinations. There is no change at the regional level with overweight in Asia and largely neutral in the rest of the world. We have also added another L/S North Asia focus equities manager that has low correlation to China Equities and a high Sharpe ratio.

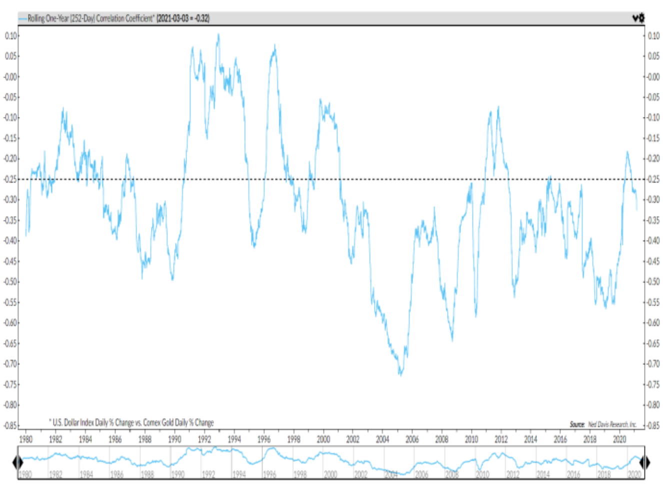
Fixed Income: Still underweight but increasingly less concerned. We wrote back in November 2020 that "a 40-50bps rise between the short-long end of the US curve for 2021 can be expected" and we have achieved that in the first 2 months of the year. As we have opined earlier, we do think the yield of UST10 to reach 1.70% to 2.00% as the economy strengthens throughout the year, but the bigger delta of upward move from below 1.00% at the end of 2020 to the current level has already happened. We will be adding some position in investment-grade debt which has performed poorly relative to the other spectrum of credit. The rest of the fixed income portfolio remains unchanged with a focus to keep the duration short, high-grade focus, and preferring non-US government bonds.

FX: Retaining our view to short the USD but we are carefully monitoring the risk of a potential shock exit of Fed's policy eliciting a flight to safety (an unlikely outcome until much later part of the year) or a narrowing of real rates differential between the US and rest of the world.

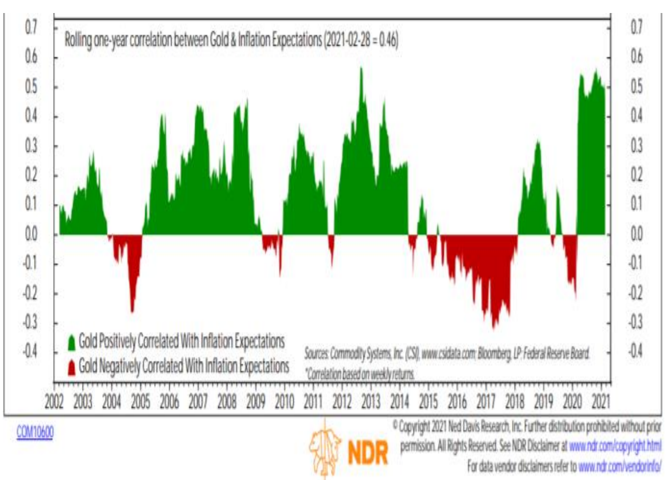
Commodities: Underweight as we struggle to balance the long-term existential threat of lower oil-dependency to the short-term spike driven by cyclical uplift in growth and geopolitics. We have been using

Gold as a portfolio hedge and is expected to fare poorly when the growth environment strengthens as they have been since the middle of last year. In addition to a risk-off asset, Gold has also historically been negatively correlated to the dollar (Chart 12). However, Gold as an inflation hedge has been more tenuous (Char 13). Two out of three reasons why one would hold gold (safe heaven status, dollar hedge, and inflation hedge) are functioning as it historically has been led us to conclude to continue owning Gold in the portfolio.

Gold consistently negative correlated to USD (12)

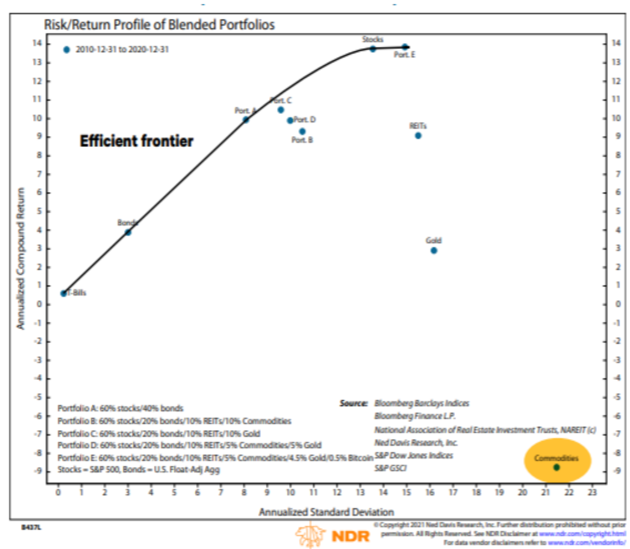


But has been inconsistent as an inflation hedge (13)



Of great intrigue is Bitcoin as an alternative to Gold for the same three reasons why one would hold Gold. In this discussion, we will not focus if Bitcoin is a bubble or not that will be left to greater experts or doubters. Instead, give that there has been a ten-year trading history of Bitcoin, we objectively analyze if holding some Bitcoin provides some benefits of portfolio diversification. This is especially urgent when yields are so low now, bonds as a diversifier to equities are increasingly being challenged as we have witnessed since 2018 frequent episodes of very painful correlation convergences between bonds and equities. We rely on NDR research on this matter. NDR analysed over the past decade the performances of different portfolios. A traditional Portfolio A: 60/40 Equities/Bonds portfolio, Portfolio B: 60/20/10/10 Equities/Bonds/REITs/Commodities, Portfolio C: 60/20/10/10 Equities/Bonds/REITs/Gold, Portfolio D: 60/20/10/5/5 and (5) Portfolio E: 60/20/10/5/4.5/0.5 Equities/Bonds/REITs/Gold/ Commodities/Bitcoin.

60/40 still works, adding BTC increase returns and risk Port E (14)



Several worthy conclusions. (1) The traditional Portfolio A still performs well sitting right at the Efficient Frontier returning 9.86% during this ten-year period, (2) Portfolio B with a combo of 10% each in REITS and Commodities is the least ideal and (3) The small inclusion of Bitcoin does enhance returns but at a considerably larger increase in risk versus rest of the other portfolios at 13% annualized return off 15% volatility.

Alternatives: Added a North-Asia focused long-short equities manager.

Featured Picture/Quote:

Beer-Five spice powder brined beef brisket smoked with lychee wood accompanied with chimichurri

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Risk Disclosure: