# MONTHLY BRIEFING MARCH 2021

## Comments (Portfolios and Mascareignes Financial Management Model)

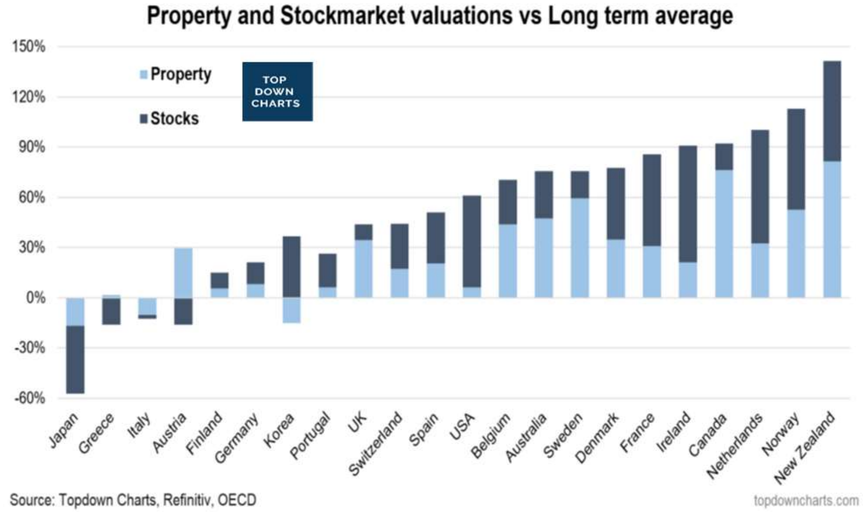
Most U.S. earnings for Q4 2020 are now out: two third reported earnings beat consensus by the standard deviation or more (that's a lot!). This is the second-best reading in 23 years - the best being the previous quarter! With these promising microeconomic elements, investors will now focus on macroeconomics, which is also encouraging; given the favorable sanitary situation in China and the progressive deconfinement in the United States, the global economy should run hotter this year, which may help the buying frenzy to go on. But for some historically high valuations to hold on, inflation must remain contained, and bond yields low. This is where we do have a problem.

Some people seem to be surprised by the resurgence of the inflation thematic, yet you don't need to have worked at the ECB to observe prices soar for every kind of assets: houses, cars, SPACs, bitcoin, copper, oil - almost everything other than commercial office spaces is skyrocketing.

In short, **the market is starting to see inflation, and that has to be reflected in interest rates** : the T-Note (US 10-year bond) jumped from 1.37% to 1.61% in a single session last month. For most of us, a 0.24% increase in the US 10-year sounds like no big deal. However, the violence and ferocity with which rates tightened on February 25 set off the alarm bell; maybe **it is worth mentioning that the T-Note has tripled from a low of 0.52% in August 2020 !**

We are currently dealing with a 300% jump in yields (the largest year-over-year increase was 77% in 2013... the famous year of the Taper Tantrum): obviously it looks like exceptional situation involves extraordinary adjustment! **Also, a continuous uptick in the treasury yields may push up mortgage rates, potentially impacting on the US real estate market**, quite hot like most industrialized countries (see chart). That would affect many more people in their daily lives than the gyrations in "meme" stocks, crypto-currencies and other manias.

| MFM/Athénée Mercury Certificate (International Stocks Long Only) | +4,25% YTD (26/02/2021) | +25,66% (from 27/03/2020 to 26/02/2021) |
|---|---|---|




The question is whether the yields rise is just one of many exaggerations, or whether the start of something more lasting - and if so, whether it really threatens the stratospheric trajectory of equities.
Though it is early to say, **it looks like the ingredients for a sustained pick-up in inflation over the next coming months - or even years - seem to be falling into place, at least in the USA.** Indeed, the massive stimulus measures decided by the Biden administration are adding to the list of inflationary factors: e.g Asian exporters are raising prices for the first time in 20 years, which is a major change compared to recent trend. Commodity prices have been sharply up for several months. Also, there is evidence of tensions in the US labor market - even though we are far from full employment, which could cause wage pressure to intensify.

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**Inflation is inviting itself to the stock market ball, without signaling the party is over, as the real trend conductors are and will remain Central Banks.** This is truer than ever : central bankers are willing to maintain monetary policies accommodative as long as full employment is not met; the fiscal taps remain open to an extent never seen before.

In this context, it would be imprudent to turn bearish on stocks. However, the rotation from tech stocks to cyclicals could well continue, as it is quite difficult to see what underlying trend could bring US interest rates below 1% again, beside an unpredictable black swan.

**The loss of momentum since mid-February paves the way for a flat consolidation** in equities, **but free money continues to flow and could fuel many other new manias,** supported by global growth, share buyback programs and loads of cash waiting to be invested in US money market funds (currently around 5T$ versus 1T$ from a year ago).


Thus, we are avoiding bonds (except opportunities on European debt); **we are maintaining our current exposure to equities, even increasing it in case of pullbacks**; worth mentioning that stock picking is a must in the current environment! Also, the T-Note yield recently exceeded the S&P500 dividend yield. According to some experts, the tipping point for pension funds shifting from stocks to bonds could be above the 1.75% area. When this threshold is reached, rather sooner than later, we will watch very closely the Fed's intentions and may readjust our allocation, if necessary.

## Central bankers' meetings : words, words, words!

Last week, the ECB clarified its position on rising bond yields, surprising the market with plans to increase asset purchases: Christine Lagarde confirmed it is more or less open bar on EU bonds!

**This week, the Fed is expected to respond to rising yields, probably with words rather than any concrete actions.** During the next meeting (this Wednesday), Fed officials will most likely push back that rate hikes are coming into view. Powell will probably remain relaxed regarding current levels of yields while leaving the door open to intervening if junk bonds spreads (a sign of financial stress) were to widen; a 20% decline in equities could also force his hand.

In this regard, let's remember how 2018 ended : the Fed said that it would continue to raise rates no matter what, even if economic data were to deteriorate and markets were to falter. Well, all it took was a 15% drop of the S&P 500 between early December and Christmas Eve for Powell to change his mind. **The market has therefore learned not to take the Fed at its word. Actually, traders fear that by allowing themselves to fall behind the curve too much, the Fed is setting itself up for a very abrupt tone shift** and some tightening well before 2023.

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### Why are technology stocks under pressure ?

Higher inflation - **or fear of higher inflation** – causes interest rates to rise and tech stocks to tumble. It doesn't mean something is wrong with technology stocks, but the problem is their current valuation, as mentioned several times in our Monthly Briefings.

Rising interest rates are poison for high growth companies. **The reason is math. Tech stocks derive most of their valuation from cash flows in future years**: in other words, even if a tech company is not profitable today, its capacity to innovate will generate substantial profits in the future: and these future earnings enable financial analysts to determine a company valuation, as they can't rely on current profits.

**But future money is always discounted to a value today by an interest rate, because $100 today is worth more than $100 in 5 or 10 years.** Example: if I have $100 in my wallet today, I can buy 10 burgers worth $10 each. Assuming a constant inflation of 1%, the cost of my burger will be $11.04 in 10 years and I will only be able to buy 9 burgers instead of 10 -> $100 today is worth more than $100 in 10 years. This is even more obvious if inflation rises by 2.5% a year: in this case, the price of the "burger in 10 years" will rise to $12.80 and I can only get 7 burgers with my 100$! ☹

| Performances | 2021 at 12/03/2021 | 2021 at 26/02/2021 | 2020 | 2019 |
|---|---|---|---|---|
| **STOXX600** | **+6,03%** | **+1,49%** | -4,04% | +23,16% |
| CAC | +8,92% | +2,73% | -7,20% | +27,86% |
| SMI (CHF) | +1,27% | -1,69% | +0,82% | +25,95% |
| **S&P500 $** | +4,99% | +1,47% | +16,26% | +28,88% |
| **NASDAQ $** | **+0,38%** | **+2,36%** | +43,64% | +35,23% |
| MSCI Emerging $ | +4,49% | +3,72% | +15,84% | +15,42% |
| EUR / USD | -2,15% | -1,13% | +8,94% | -2,22% |
| Gold $ | -9,02% | -8,58% | +25,12% | +18,31% |
| **Rendement 10 ans USA** | **+1,635%** | **+1,407%** | 0,91% | 1,92% |
| **Allocation Tracker Classique** | **+1,45%** | **+0,91%** | **-0,83%** | **+7,05%** |

**The SMI underperforms : it is less weigted in cyclicals than its European peers!**

**The Nasdaq is suffering from rising yields. The Russell 2000 (mid small caps) is the winner : +19,13% YTD !**

**The T-Note is surfing on the inflation wave !**

The same logic works for so-called growth companies. **As inflation increases, interest rates (applied to cash flows) rise and thus reduce future earnings** : all other things being equal**, a $100 profit today is only $78.12 in 10 years if we discount a 2.5% inflation rate** - which naturally lowers the company's current valuation and therefore its price on the stock market.

This cash flow valuation method leads to mechanical reallocations when yields are up, currently a rotation from technology stocks (sensitive to future flows) to cyclical stocks (whose value depends on the economic cycle at a given moment). **This rotation explains the recent divergence between the S&P500 and the Nasdaq, but also the good resistance of European indexes,** which lack technology stocks, compared to their American peers.

*Thank you for the inspiration : Top Down Charts, Capital Economics and Barron's (Al Root, Jack Hough and Ben Levisohn)*