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MARCH COMMENTARY

17.03.2021

The dominant market story of recent weeks has been the rise in US government bond yields and the implications for asset markets and policy makers. Longer-dated government yields have been gradually rising from a low base since the middle of last year, reflective of recovering growth and inflation prospects. However, with vaccine distribution well under way, fiscal policy on full-tilt and a savings fuelled spending boom expected later this year, 10-year yields have climbed above pre-pandemic levels to 1.60% and financial markets are now pricing a US rate hike as early as December 2022 in response an accelerating US economy. As rate expectations have shifted, so too have asset prices sensitive to US yields. The US Dollar has strengthened and we have seen weakness in investment grade bonds, emerging market stocks, gold and the US technology sector, which had previously enjoyed a subdued growth outlook and collapsing yields. At the same time, strong growth and firmer inflation expectations have triggered equity market rotations with cyclical sectors such as energy, financials and materials all benefiting.

Although financial market performance has been mixed recently, the move higher in US yields has been orderly and steadily absorbed by wider asset markets, that said the risk of a more volatile spill-over has led some market commentators to speculate on US Fed policy intervention. Nothing in recent communications from Fed officials suggests an intervention is imminent. The rise in yields has been viewed as a function of economic optimism, not inflation fears, and there has been no suggestion of a rate hike before 2023. At the time of writing, the March meeting of the US Federal Reserve (Fed) was about to get underway - the committee's statement and accompanying forecasts will be keenly watched.

In Europe, higher government bond yields have been received with more concern. At last week's European Central Bank (ECB) meeting, policy makers committed to looking through any temporary rise in inflation this year and increasing the pace of government bond purchases in order to contain yields and maintain "favourable financing conditions."

On the fiscal policy front, President Biden's $1.9tn American Rescue Plan was signed into law, delivering another round of direct payments to most households, extending enhanced unemployment benefits, and providing support for state and local governments. Direct payments of $1,400 will start being received before the end of March. In the UK, the government's budget announcements should underpin economic recovery this year and extension of the furlough scheme will avoid any cliff edge to unemployment.

On balance the tone of global economic data releases over the past month has been positive, but increasingly show variations in regional momentum. After a strong rebound last year, Chinese data remains firm, but the pace of improvement has faded as official policy support starts to reduce. In the US, activity data suggests the loss of momentum in Q1 2021 will be far more limited than originally expected, current Federal Reserve Bank of Atlanta estimates indicate that Q1 growth tracking is at an annualized rate of 8.4%. The recent US labour market report positively surprised with unemployment falling to 6.3% and survey data across businesses and consumers points to a strong 2021 economic rebound. By contrast, Europe's slow vaccine rollout and more modest fiscal support are leading to a slower and delayed recovery.

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Changes to asset allocation over recent months, increasing equity risk and reducing exposure to interest rate sensitive fixed income, have positioned client portfolios to benefit from the global growth upswing, but also help to navigate the transition in government bond yields.

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