

**HSBC IO 2021 March Monthly View – Willem Sels Video**

Markets are currently driven by cyclical optimism related to the vaccine rollout, to fiscal spending and the economic reopening. But what this is also leading to, is a pickup in bond yields.

And therefore, of course, investors are wondering how far this will go and whether it will start to affect equities, credit and emerging market bonds.

Now, what is comforting is that most of the rise in the Treasury yields comes from inflation picking up from a very low base.

And although it is picking up, some of the upward pressure should be temporary as well, especially that related to oil prices and to bottlenecks in the supply chain.

We think from a fiscal perspective, fiscal spending is not necessarily inflationary if it is simply compensating for a drop in cash flows or in wages.

Now, what would be more damaging is if real yields were to pick up sharply and significantly.

But the Fed and the ECB are very focused on this, and we point out that real yields are still significantly negative. And therefore, the situation currently is very different from the taper tantrum situation in 2013.

As inflation continues to rise over the next few months, we believe the market will continue to wonder what kind of scenario we're in from an economic perspective and from an inflation perspective.

And we think there are four scenarios going from 'too cold' to 'too hot'.

The first scenario is a delayed and a very slow recovery.

The second scenario is our core scenario, where we have a gradual recovery with temporary inflation.

The third one is the current focus of the markets: on that reflation, on fiscal stimulus and on the rising inflation expectations.

And the fourth one is a risk scenario where inflation is so sticky that the market starts to worry about a rapid tightening and a taper tantrum.

In the first scenario, one would want to be in quality equities and bonds.

It is a mild risk-off scenario and therefore diversification is very important.

In the second scenario, our core scenario, we want to be invested in cyclical assets because of the recovery. But because of the low yields, we are also invested in carry assets including BBB, global high yield and emerging market bonds.

The third scenario is the current market focus and we think we will continue to oscillate between scenario two and three over the next few months.

So therefore we want to include some inflation and rate hedges: for example, our overweight on financials, materials and industrials cater to this.

The last scenario is a real risk scenario, not likely for now, but it would be damaging for risk appetite.

In that scenario, the appropriate strategy would be to reduce duration, to focus on hard assets and on diversification.

So the scenarios one and four – the ‘too cold’ and ‘too hot’ scenarios – are unlikely in our view, and therefore we remain invested.

It is clear that bond yields have become more volatile and therefore equity markets can see some volatility as well.

But in the context of this global recovery that is in place and structurally low bond yields, the 2021 trend of ‘Recovering in a Low Yield World’ remains in place.

And therefore we are still overweight on equities, on credit and on emerging market bonds.