



Market Flash Overheating?

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Rising interest rates and their impact on markets



Introduction

100 basis points: is the yield variation in the 10-year U.S. Treasury note between the 2020 lowest point (0.51%¹ on April 8), at the peak of the health crisis, and the highest point reached at the beginning of the year (1.52%¹ on February 25). More than half of this movement occurred in 2021, as **investors started to anticipate a rapid recovery** and increase in inflation.


With the exception of the UK and the eurozone, **the improvement in the macroeconomic outlook is substantial and can be observed in recent figures and activity surveys:** this improvement leads to upward revisions in global growth, driven by the United States and China, as well as the increase in commodity prices. This supports inflation expectations that have risen above their pre-crisis levels (Euro and US swap curve)! The outlook is clearly positive on oil demand, thanks to the vaccine rollout and the massive American budget plan. On the supply side, the tightening is temporary (breakdowns and strikes in Libya, Russian exports reduction, support from Saudi Arabia and compliance with OPEC agreements). Prices therefore remain high in a context where inventory reduction continues in the United States despite positive seasonality.

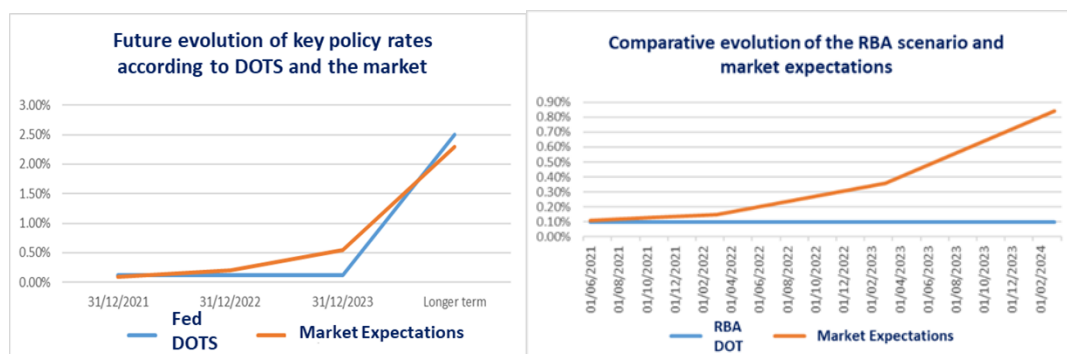
Central banks have confirmed their very accommodative stance for months but the **divergence with market expectations has increased** since the beginning of the year and is contributing to the rise in nominal rates. Thus, the market anticipates a first Fed rate hike in December 2022 (nine months earlier than in January); it is currently well above the DOTS², which will be revised at the next meeting committee on March 17. The Fed does not expect a rate hike before 2024. Concerning AIT³, the Fed's message remains unchanged: a year of inflation above 2.25% and a return to full employment will be necessary to raise policy rates.

¹ Closing levels

² Designated Order Turnaround System

³ Average Inflation Targeting





Source : Bloomberg, La Française Asset Management

The same applies in Australia, where despite implementing yield curve control policies (3-year maturity), the central has had to renew its asset purchase program to achieve its inflation target.

The recent sharp rise in bond markets volatility has urged us to adopt a cautious stance on equities, without questioning the risk-on positioning and flows into this asset class. The US real rates, which are very negative, present a strong asymmetry: they have so far slightly contributed to the rise in nominal rates despite the macroeconomic upturn and the extraordinary fiscal stimulus. Like other Central Banks, the Fed is concerned about the evolution of financial conditions and is not worried about the recent evolution in interest rates. Finally, **the steepening of the curves is rather good news for banking activities**, and we favor the subordinated debts of this sector in the universe of private debt.

High Yield market

Historically, the rise in interest rates has had a limited and even positive impact on the performance of the High Yield sector in both the United States and Europe. The latter relies more on growth prospects and therefore default rates.

Thus, a rise in interest rates (or a steepening of the risk-free rate curve) generally reflects investors' expectations of better economic growth prospects and generally leads to a tightening of high yield spreads (lower default expectations). Conversely, a fall in interest rates (a flattening or even inversion of the risk-free rate curve) reflects a deteriorated economic outlook and this generally leads to a rise in HY credit spreads and therefore a negative performance of the asset class.

The following table highlights the phases of rising and falling interest rates in the United States and Europe from January 1998 to the present. Out of all the phases of rate increase, in both Europe and the United States, the only negative performance recorded by the High Yield was observed between April 2011 and July 2012 and was limited to -1% (corresponding to a spread of +18 bps in the United States and 29 bps in Europe). Looking at all other rate increases, the performance of the HY market was positive (on average +10% in total return in the United States and Europe).

Risk free Rate go down	US Treasury 10Y	US HY Perf TR	US HY Spread (in bps)	German Bond 10Y	EUR HY Perf TR	EUR HY Spread (in bps)
Jan.98 – Jan.99	-100	4%	+177	-171	10%	+90
Feb.00 – Sept.05	-220	45%	-51	-255	7%	-147
Jun 09 – Aug 10	-120	33%	-162	-140	45%	-333
Apr.11 – Jul.12	-212	8%	+146	-231	5%	+246
Feb.18 – Dec.18	-29	-4%	+174	-53	-5%	+219
Jan.20 – May 20	-130	-6%	+266	-20	-7%	+220

Risk free Rate go up	US Treasury 10Y	US HY Perf TR	US HY Spread (in bps)	German Bond 10Y	EUR HY Perf TR	EUR HY Spread (in bps)
Jan.99 – Feb.00	200	1%	-91	197	10%	-152
Sept.05 – Jul.07	70	18%	+33	130	10%	-22
Aug.10 – Apr.11	90	11%	-210	128	9%	-155
Apr.15 – Jul.15	50	-1%	+18	82	-1%	+29
Sept.16 – Feb.18	126	8%	-114	86	8%	-122
May 20 – Feb.21	70	14%	-257	15	11%	-194

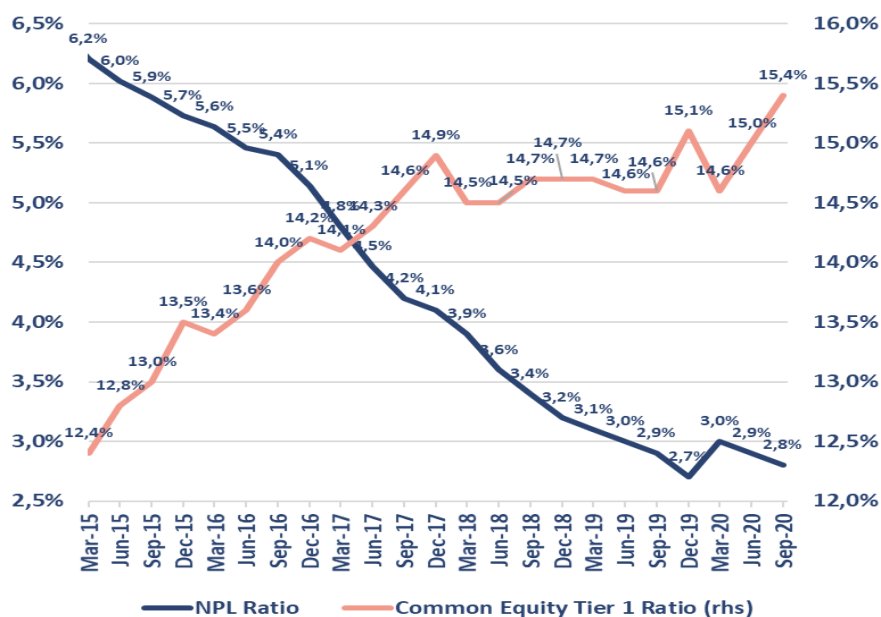
Source : Bloomberg, La Française Asset Management

Subordinated debt markets

From a fundamental point of view, the reflation followed by the steepening of the yield curve is always positive for future revenues on the banking sector. This is evidenced by **the fact that the performance of banks' shares is well ahead of European indices**. Nevertheless, bank subordinates, and in particular AT1, remain a High-Beta asset class. The existing correlation with other risky asset classes (equity, credit) weighs on performance during periods of high volatility. But beyond the short term, **subordinated debt remains a fixed income asset class with little exposure to a rise in government interest rates**. The average duration for a global index is low at 3.6 and has a high spread base allowing to cushion a part of the rate increase (OAS⁴ at 330 bps).

⁴ Option Adjusted Spread

Average Non-Performing Loan (NPL) ratios (in % of loans)
and regulatory capital ratios of European banks



The main question will remain what impact the Covid crisis has had on the solvency of the sector. Today, **balance sheets are still very solid, and the provisioning pace is contained in most jurisdictions** (except Greece and Portugal). The Q4 data available are still reassuring and solvency is at its highest. We will be watching balance sheets more closely in the second half of the year when the European economies' support is expected to come to an end.

This is not the same picture for hybrids or insurance subordinates, which have higher average durations and lower spread bases. These assets behaved traditionally less well in rising interest rate periods and institutional investor flows can lead to valuation jumps.

Equity market

While the beginning of 2021 was expected to be mainly driven by the earnings season, the recent rise in long-term interest rates caused by rising inflation expectations has led to a **spike in equity market volatility**. Overall, despite a drawdown of around 5%⁵, mainly affecting technology, growth and quality stocks, **equity markets are still performing positively**.

⁵ Gap between the highest and the lowest points recorded on stock markets indices in February 2021

Historically, the correlation between long rates and equity markets has been structurally positive over the past twenty years. However, periods of significant decorrelations have occurred (mid-2006, mid-2013, late 2018), causing investors to fear an inappropriate FED policy. In the first two cases, the drawdown was relatively limited, while in the last case, fears of rising long rates were replaced by fears of recession, forcing the FED to capitulate.

The current configuration is different, and the equity markets should be able to withstand U.S. long rates around 1.5%. Indeed, equities have mainly suffered when the dividend rate has been lower than the 10-year rate. This leaves room for an increase in U.S. yields to rise and a large margin for other geographical areas (see graph below).



Source: Bloomberg as at March 3rd 2021

Finally, **various catalysts support the equity markets**: vaccine rollout, economic recovery, support measures (fiscal and monetary), and the basis for easier comparison of results. **In the short term**, sector exposure and choice of styles will undoubtedly be more important than the level of exposure: we have increased our exposure to **value stocks, a style that is decorrelated and rather lagging the others** as we are not at the inflection point causing a sharp decline in equity markets, but rather in a **market rotation more conducive to the outperformance of cyclical and low-valued stocks**. This rotation is particularly beneficial to the energy, commodities, and banking sectors, which benefit from still attractive valuations and a well-oriented earnings momentum for 2021. **In the long term**, our overall strategy has not changed and we still rely on our internal research to identify high quality companies demonstrating promising growth potential.

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Edited by La Française, Société Anonyme à directoire et conseil de surveillance au capital de 78 836 320 € - RCS PARIS 480 871 490.

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