CS INVESTMENT MANAGERS

VIEW FROM THE SQUARE

February 2021

Bond Rout

The bond market had one of its worst months in years in February as benchmark yields rose consistently throughout the month. The US 10-year yield (a bellwether for the bond market) peaked at 1.5% at month end, after starting the year below 1%. Whilst it is not terribly surprising that bond yields should rise as the economy improves, the speed of the rise is what has taken investors by surprise – with bond yields reaching year-end forecasts in just a couple of months. A stronger growth and inflationary environment were the catalyst for the move, with the market believing that interest rates will be increased sooner and faster than expected. The effect of rising bond yields spilled over into other assets too with varying degrees of impact.

Regular readers will know that we have been writing on inflationary pressures building for over six months now. Market expectations of inflation also reached new highs in February. Whilst many (including Fed Chairman Jerome Powell) believe inflationary pressures will be short lived, and transitory in nature, the market appears to perceive the risk being to the upside of this view.

The effect of the move in bonds was also acutely felt in certain sectors of the equity and commodity markets. Within equities, "growth" companies – which benefit from a low-rate environment, where the opportunity cost of waiting for their future value to emerge is lower – were hardest hit. In commodities, gold, whilst often being considered an inflation hedge, also came under pressure, as rising yields (particularly relative to inflation expectations) make holding gold less appealing.

Relative safety was found in the "COVID losers" – those companies that fared worse in the pandemic. This is because part of the shift higher in bond yields was due to the imminent reopening (of the economy), likely to lead to strong economic growth and a reflationary environment. Cyclically focused businesses – such as airlines, pubs, banks, house builders, etc. – are best placed to benefit from such a backdrop. This is the area of the market known as "value" and has been broadly outperforming its "growth" counterpart since news of the vaccine first emerged in November. However, much of the easy money has now been made in the "value" section of the market – going forward, stock selection will need to be more nuanced to determine those companies that will thrive, and not just survive, in 2021.

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