The Consequences of Ultra-Easy Policies

GLOBAL ECONOMIC RECOVERY + EQUITY MARKETS + BOND MARKETS + RISING POLICY CONCERNS

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Contents

Scope

In this report, we examine the intended and unintended consequences of the extreme measures taken by central banks and governments, to avoid a full-blown financial crisis and prevent loss of livelihood, on the equity and bond markets. Moreover, as evident as it becomes that it is easier to close an economy than to reopen it, we highlight the biggest concerns going forward, particularly expectations of rising inflation and real yields. We also share snippets on responses of key central banks to address these concerns as they continue to attend to the ongoing fragility of the financial system. The withdrawal of over accommodative monetary and fiscal policies, particularly as economies reopen, however remains a speculation, especially with mixed signals on US benchmark rates from Jerome Powell, the Fed Chairman, continuing with his dovish stance, and Janet Yellen, the US Secretary of the Treasury, stating that higher interest rates would be a 'plus' while supporting a massive $6tn fiscal budget to further boost the US economy.

The Great Lockdown

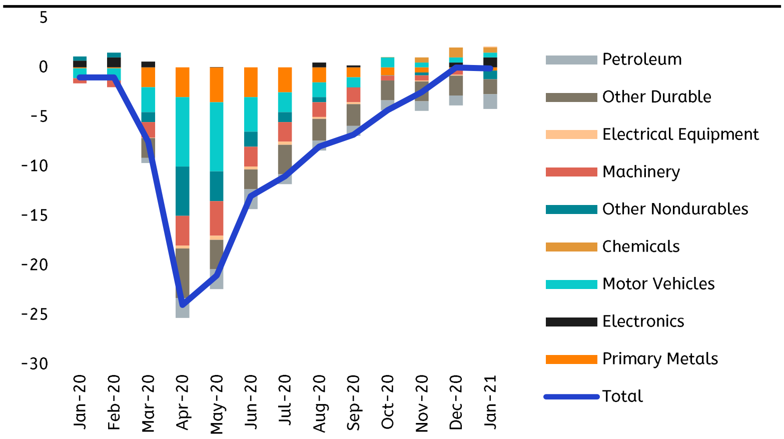
A forceful, swift, global policy response

In CY20 the global economy underwent a deep recession, contracting 3.3% with global output declining ~3x as much as during the global financial crisis of CY08 and in half the time. With the spread of COVID-19, 1HCY20 witnessed a slump in global economic activity as demand collapsed, international trade contracted sharply, and uncertainty in financial markets soared. Following the trough, in 2HCY20 as the pandemic and containment measures eased and news of effective vaccines emerged, the global economy began to recover. While risks to global activity continued to tilt to the downside, the year ended with strong vaccine success and hope that the pandemic and the economic distress it caused would recede.

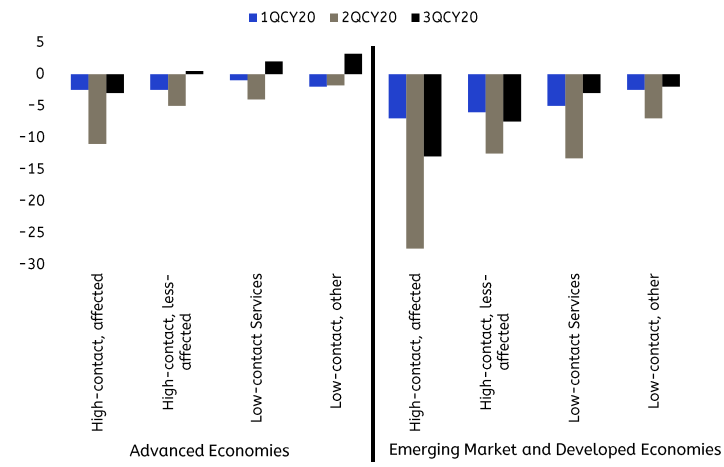
As the world locked down and masked up in CY20, policy makers ensured that the life support of economic activity remained strong. Central banks substantially eased their monetary policy to ensure favourable and stable financing conditions and continued access to liquidity. Simultaneously, fiscal authorities channelled relief to households and firms through transfers, wage subsidies, and liquidity support. According to IMF, for the first time, in 60% of the global economy, including 97% of advanced economies, central banks had pushed policy interest rates to below 1%, and in 20% they were negative. With little room for further rate cuts, central banks of developed economies were forced to simultaneously deploy unconventional quantitative measures resulting in historic exponential growth in their balance sheets. Since 1QCY20, central banks in US, Europe and Japan have been on a $9tn spending spree, swelling their combined assets to $24tn. Moreover, discretionary fiscal support crossed over $14tn in CY20, eclipsing previous records.

The unprecedented policy responses helped preserve economic relationships, cushioned household income and firms' cash flow, and prevented amplification of the shock through the financial sector. As per IMF, absent these measures, the global growth contraction in CY20 could have been ~3x worse. Furthermore, these actions helped maintain a foundation from which global activity was able to recover quickly. According to the Spring 2021 edition of the IMF's World Economic Outlook, the global economy is projected to expand at a rate of 6% in CY21, up from the 5.5% growth rate projected in Jan'21, due to the faster-than-expected recovery of advanced economies.

Economic support drove L-shaped recovery in global manufacturing (1)



Employment recovered the least in high-contact services (2)

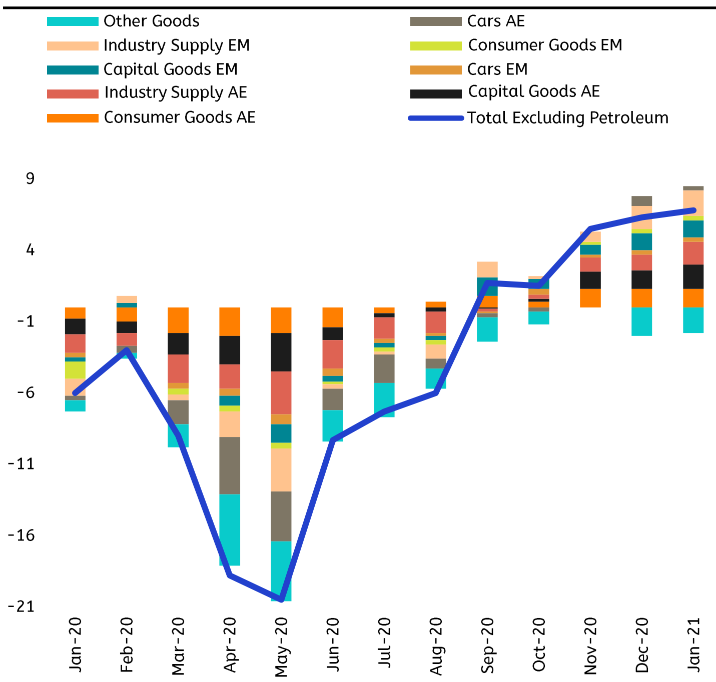


Emerging divergences in recovery pose challenge for policy

The economic recovery however is diverging across countries and sectors, reflecting variation in pandemic-induced disruptions and the extent of policy support.

- Countries: Many countries entered the crisis in a precarious fiscal situation and with limited capacity to mount major health care policy responses, which forced stricter lockdowns to contain the spread of the virus and witnessed greater contraction in economic activity and GDP.
- Products & Services: Products that supported working from home witnessed strong demand momentum through CY20. The quick release of pent up demand boosted consumption of durable goods (especially automobiles). On the other hand, contact-based services such as travel, arts, entertainment, sports, hospitality, and brick-and-mortar retail continue to operate at a fraction of their capacity since the pandemic.
- Unemployment: The employment and earnings impact of the pandemic has been highly unequal across groups of workers with lower-skilled workers being hit the hardest. Despite expansive monetary and fiscal support and subsequent recovery in manufacturing, unemployment remains elevated and labour participation at historic lows.

Sharp rebound in international trade in 2HCY20 was led by pent-up demand for consumer durables (cars) from advanced economies and resumption of supply chains in emerging markets (3)



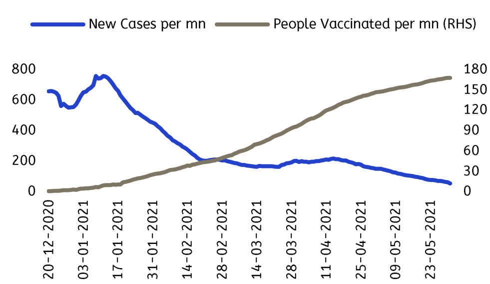
Source: IMF, Bloomberg
Footnotes: 1) Global Manufacturing, by Industry (Contribution to YoY change; in %)
2) Employment, by Sector Group (Total hours worked, cumulative percent change from 2019:Q4)
3) Global Imports: Contributions, by Types of Goods and Regions (Contribution to YoY change in %, based on value in USD)

Uneven Global Economic Recovery

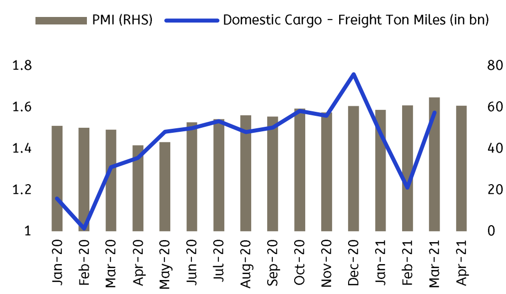
US boom fuelled by consumers roaring back to life with a vengeance

With the vaccination program well under way in 1QCY21, US announced a massive fiscal $1.9tn America Rescue Plan to speed up economic activity and tackle unemployment. These factors combined successfully boosted supply in 1HCY21, evident from the continued growth in the composite PMI index, which was reported at 60.7 in Apr'21 and with all 18 manufacturing industries registering continued expansion. As per the Federal Reserve, manufacturing capacity utilization, a measure of plant use, rose to 74.1% in Apr'21, while total industrial capacity increased to 74.9%, however the total remained~3% below the pre-pandemic level in Feb'20. The growth in manufacturing however continued to suffer from pandemic related supply chain disruptions which resulted in temporary shutdowns, especially in the automobile sector, and rising commodity prices, such as those of steel and lumber. As per STR, the US hotel industry has also recovered, having posted its highest demand and occupancy levels since the start of the pandemic at ~60% in Apr'21, however, occupancy is likely to remain plateaued until the summer leisure travel boom.

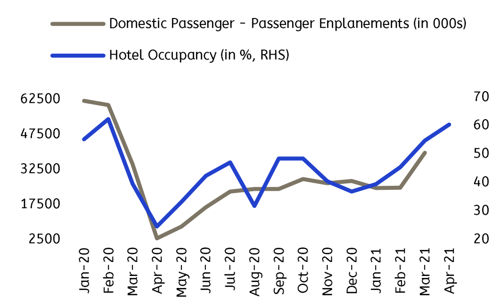
With more than 2.3bn shots given....



...factory output picked up to meet demand...



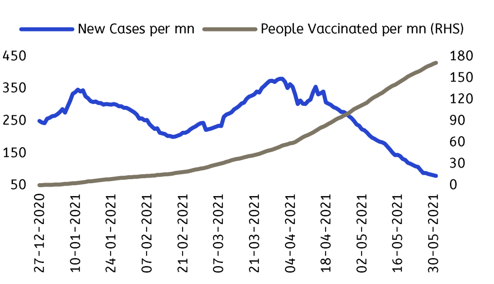
...and travel and hospitality sectors recover



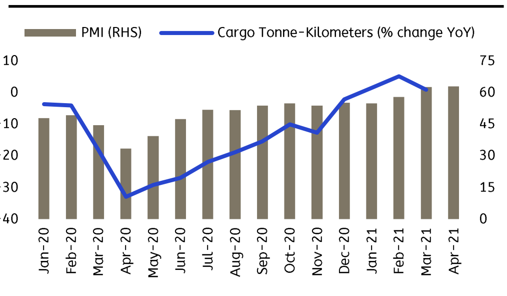
Europe's economic rebound delayed due to lag in vaccination drive

After a slow start in vaccinations and several countries in lockdown till Jan'21, a strong recovery in the EU's dominant service industry boosted the manufacturing sector with the bloc's initial flash composite PMI reported at 56.9 in May compared to April's 53.8, and the highest since CY18. Euro area exports reported a swift recovery to pre-pandemic levels at €564bn in 1QCY21, with net surplus of €49.5bn in 1QCY21 vs €54.6bn in 1QCY20, further supporting local manufacturers. The recovery was primarily attributable to China; in 1QCY21 exports to China grew by 21% YoY and trade deficit declined to -€50.4bn vs -€38.9 in CY20. EU's hospitality sector remained battered with occupancy in Apr'21 at 11.4% and passenger traffic in 1QCY21 was down by ~88% compared to 1QCY19. Similarly in UK, IHS Markit composite PMI reached record heights of 62.0 in May'21 up from 60.7 in Apr'21, supported by growth in British services firms. UK retail sales nearly doubled MoM to 9.2% in Apr'21 as the economy aims to reopen in June'21 having successfully vaccinated ~45% of its population by Mar'21. UK hotel occupancy was also higher at 29%.

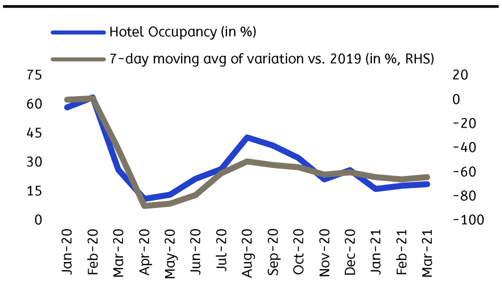
Despite vaccinations being far from sufficient...



...PMI soared supported by services and exports...



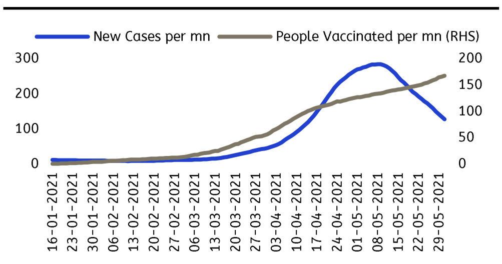
...however the hospitality sector is far from recovery



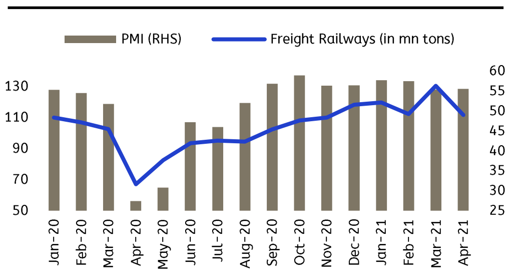
India's PMI falls to 10 month low as economy battles a second wave of COVID-19

Private consumption in India contracted by 9% in FY21, set off by a sharp recovery in urban consumption, evident from normalization in passenger vehicle sales, from 2QFY21 and a resilient rural economy. With strengthening demand and receipt of orders in bulk the IHS Markit India PMI index recovered to 55.5 in Apr'21. However, following a second COVID-19 outbreak, that resulted in a series of independent lockdowns across key states such as Maharashtra, Karnataka, Tamil Nadu, among others, the index contracted to 50.8 in May'21. Discretionary consumption, particularly on transport, hotel and restaurants, recreation and culture, with a combined share of around 20% in PFCE, remains much below pre-pandemic levels. In view of the limited share of government consumption demand in GDP (at ~13% in FY21), for a self-sustaining GDP growth trajectory post-COVID-19, a durable revival in private consumption and investment demand together will be critical, as they account for ~85% of GDP.

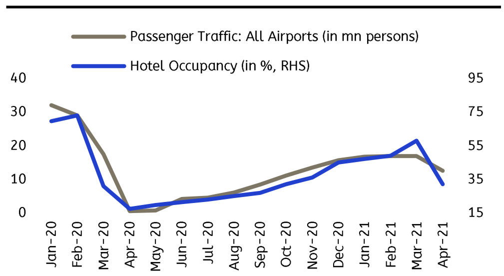
A second wave due to lag in vaccinations...



...has relatively moderate impact on revival...



....however disrupts the hospitality sector



Source: OurWorldinData, bts.gov, iata.org, CEIC, STR, Anarock, Eurocontrol, investing.com

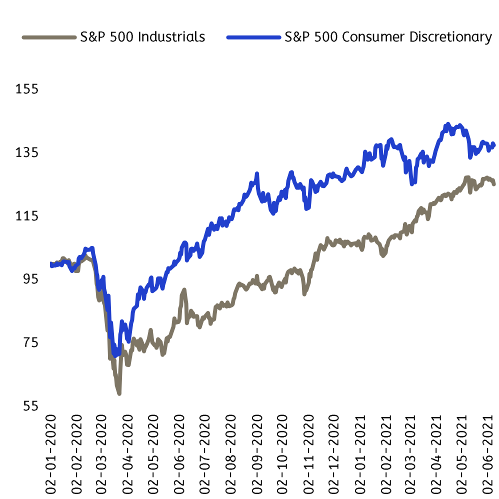
A Bullish Narrative Disconnected from Reality?

Running with the bulls has been tricky

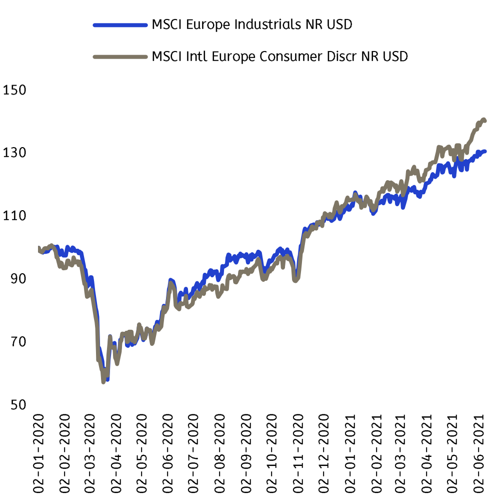
Financial markets, the discounting machines that they are, powered ahead in 1HCY20 in anticipation of a sharp recovery in consumer spending, termed as "revenge buying", which was strengthened by fiscal stimulus, which powered even the lower income consumer, and vaccine rollouts. Investors also targeted the Infrastructure sector as governments pledged to splurge on infra-projects to map their path back to growth. Among all the sectors, technology was favoured the most by investors, in anticipation of higher spending on digital services by companies to adjust to a "new normal" - of work from home and a permanent change in consumer preferences - and accelerated trends in e-commerce and e-services. Interestingly, CY20 did witness quicker than expected release of pent-up demand by consumers especially for automobile and real estate; and in contrast to previous crises, companies did report a sharp 35% YoY increase in corporate spending on tech hardware.

Further, as the global economy gradually reopened, investors began to favour small-cap versus large-cap equities, copper versus gold and corporate credit; strategies that have historically performed strongly following a recession. However, with economies running hotter in 1HCY21, investors have displayed swift rotations out of early cycle winners and companies with long duration cash flows, such as technology.

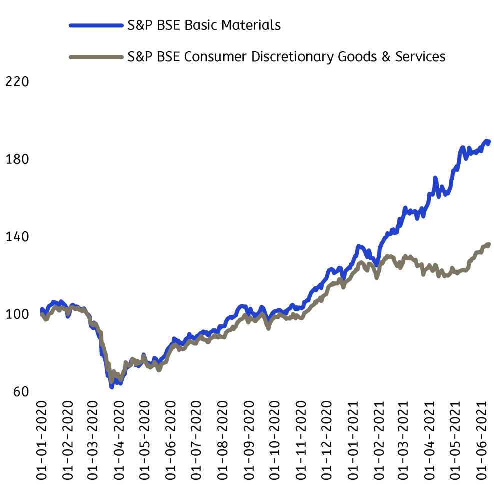
While globally industrials led in the early phase of the recovery, despite challenges in supply…



…discretionary has caught up with expectations of release of pent-up demand as economies reopen..



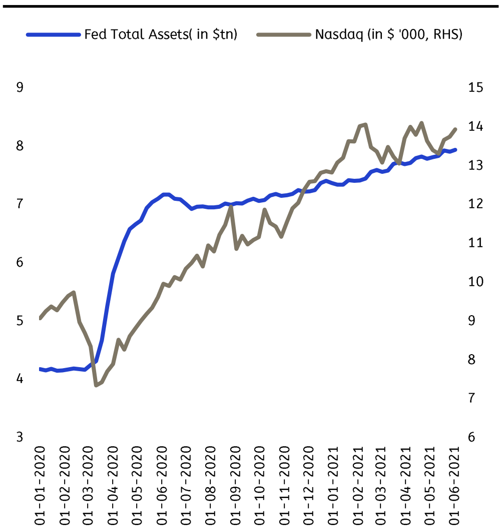
…however resurgence of Covid-19 in India has pushed expectations of such a release further out



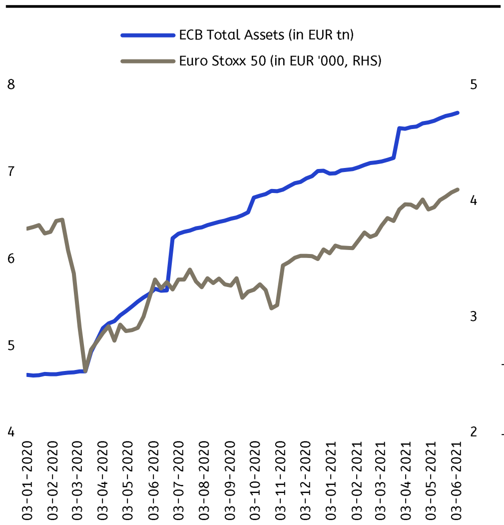
Central Banks come as close as they can to saying 'bubble'

The exuberance displayed by the market, driven by the combined impulses of monetary and fiscal policy, has pushed asset and commodity prices to a point that is widely being regarded as a disconnect with the real economy. In fact, this disconnect between the markets and the economy has been highlighted by the Federal Bank in its Financial stability report in May'21 where it stated that the "elevated valuation pressures imply a greater possibility of outsized drops in asset prices". It was echoed by RBI in its FY21 annual report as "the widening gap between stretched asset prices relative to prospects for recovery in real economic activity (has) emerged as a global policy concern". RBI further stated that while the economic prospects have contributed to movement in the stock market, "the impact is relatively less compared to money supply and FPI". However, with central banks choosing to continue with their ultra-easy accommodative stance, stating that they will discuss tapering "sooner rather than later", the markets are likely to continue displaying the exuberance. On the other hand, income seeking investors have faced a challenging time as any surprising weakness in the bond market, such as the global yield sell-off in 1QCY21, has been met by more stimulus, such as by ECB with its PEPP, and RBI with its OMOs.

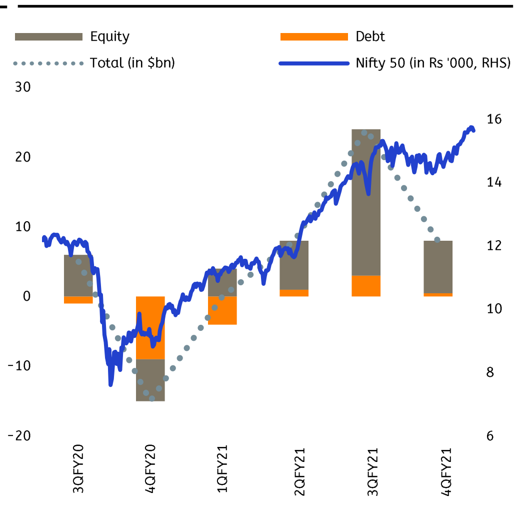
Direct interventions by Central Banks into the ETF and Bond markets and coordinated fiscal support…



….to promote financial stability and support economic recovery revived investor confidence and…



…has had unintended consequences with markets reaching all time highs in AMs and EMs alike



Source: S&P Global, Investing.com, Fed, ECB, RBI, Bloomberg

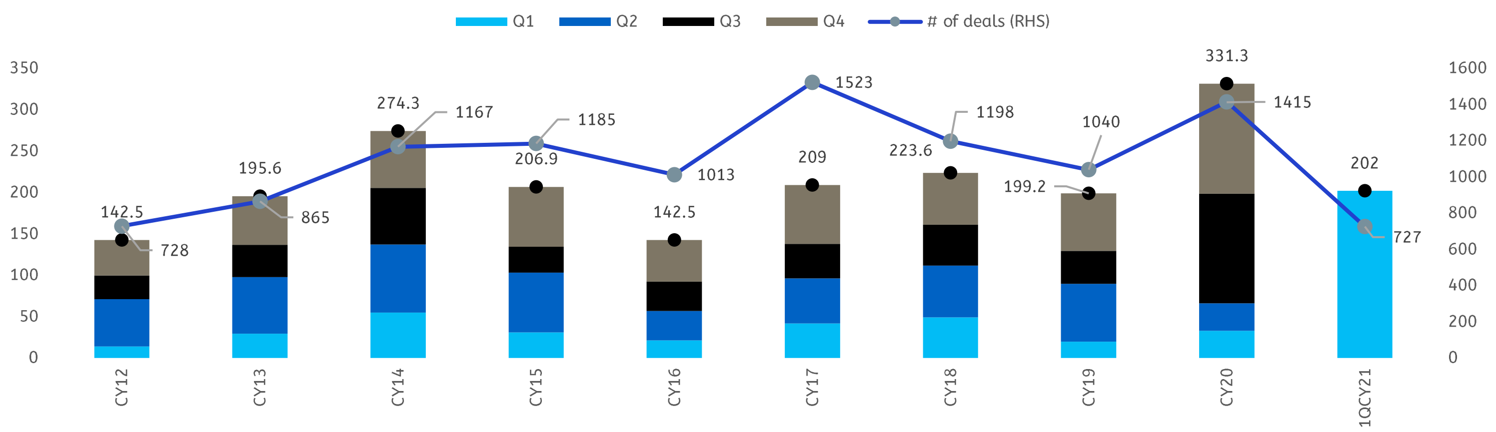
IPO Market Parties Like it's 1999

Low interest rates and expansionary monetary policies help the IPO market deliver stellar performances

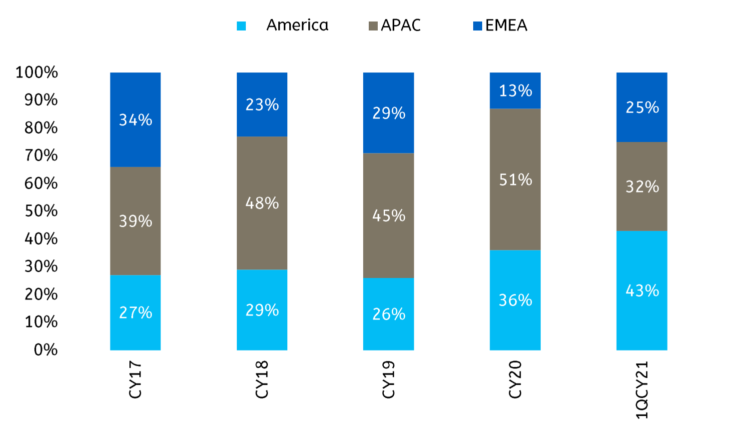
In a year that saw a pandemic upend economies and financial markets around the globe, 1415 companies raised a record $331.3bn in IPO proceeds in CY20, the highest since CY10 when US$290.2bn was raised via 1,361 IPOs. Needless to say, the most active sectors were technology, industrials and health care, which accounted for 59% of global deals and 64% of proceeds.

The frenzy of global IPOs continued into CY21 at breakneck speed with 727 deals raising a total of $202.9bn in 1QCY21 alone, equivalent to more than 60% of full year CY20 proceeds and more than 50% of the total number of IPOs that took place in CY20. Technology IPOs continued to lead in both numbers and proceeds in 1QCY21. Energy IPOs made a comeback as one of the better performing sectors, particularly renewable energy, as investors rotated their portfolios to gain exposure to cyclical stocks and those that would gain from the economic re-opening.

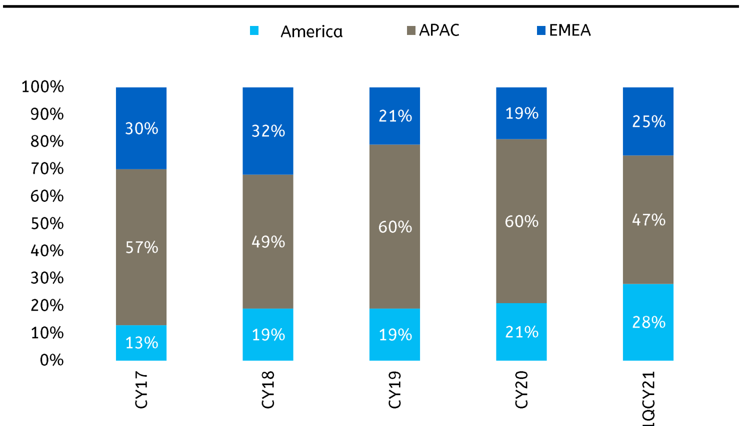
The global IPO market has defied expectations despite uncertainties. Below is a 10-yr view of global money raised via IPOs and FOs (in $bn)



America dominated regional share of IPO proceeds (in %) while....



APAC led in regional share of number of IPO deals (in %)



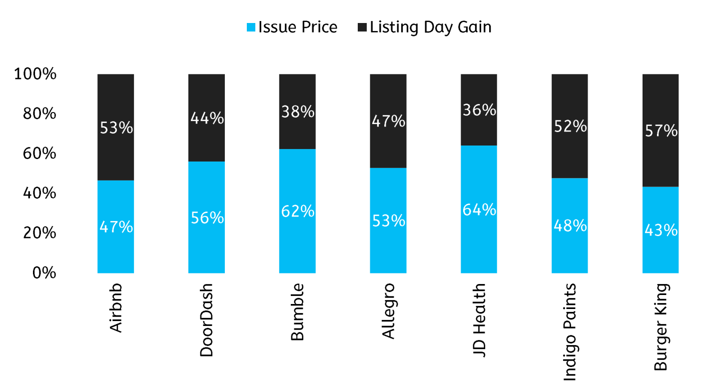
US dominated the IPO market by proceeds with mega tech IPO such as Snowflake ($3.9bn), Airbnb ($3.8bn) and DoorDash ($3.4bn), each of which recorded among the largest NASDAQ tech IPOs since CY12. In 1QCY21, Coupang Inc (consumer discretionary) raised $4.6bn to become the largest IPO for the quarter in US, followed by Bumble (tech) which raised $2.5bn. Similarly in APAC, Tech dominated IPO deals since the pandemic with Kuaishou Technology ($6.2bn) being the largest, followed by JD Health ($4bn, Consumer Discretionary) and China Bohai Bank Co Ltd ($2.1bn, Financials) among others. Some of the largest deals through CY20-1QCY21 in EMEA were, InPost ($3.9bn, Industrials), Allegro.eu ($2.7, Technology), and JDE Peet's NV ($2.9bn, Consumer Goods).

The IPO market was too good with listings leaving money on the table

Airbnb, which opened 115% above its IPO price of $64, was among the biggest day one pop for a US IPO that raised over $1bn. Showing that the company could've raised $4bn more, the IPO further ignited the long debate about how to price an IPO. As per Bloomberg, of the top 10 US trading debuts on record for companies that raised more than $1bn, five were logged by businesses that went public in CY20, including Snowflake (112% above IPO price of $120) and DoorDash (78% above $102).

Similar trends were witnessed in India with Indigo Paints (109% above Rs1490), Europe with Allegro (89% above PLN81.45), although modest in China with JD Health (56% above HKD70.58).

Listing day gains stoke debate on pricing IPOs



Source: Dealogic, EY, PWC, Bloomberg
Footnote: Data as of COB Mar 24, 2021

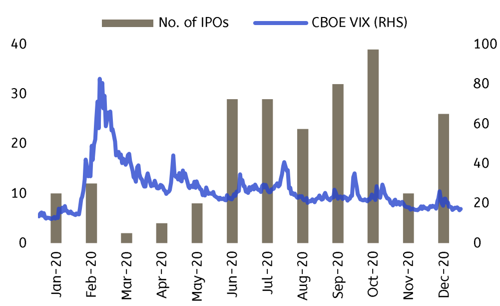
A Need for the Traditional IPO Model to Evolve?

US IPO market transformed by retail and speculative investors

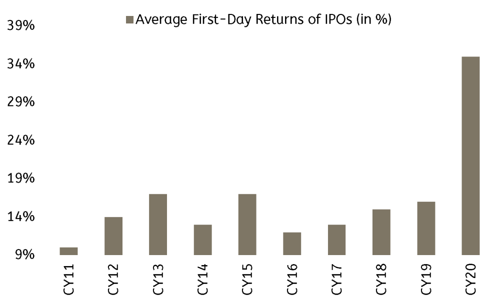
The euphoria of CY20 which led to 224 IPOs raising $86.2bn in proceeds, grew exponentially in 1QCY21 recording the highest first quarter IPO activity in over two decades of US market history with 121 deals raising $45.2bn. The tremendous success of freshly minted tech companies such as Airbnb, Snowflake and Unity Software in CY20 is clear evidence of investors have looked beyond the economic, political, and corporate-profit uncertainties. The rise in risk appetite also resulted in 99 cross border IPOs since the pandemic, of those 51 deals involved Chinese companies that raised $17.3bn in proceeds, despite the US-China trade tension.

At the same time, average first-day returns of IPOs reached the highest levels in a decade especially of well-known tech names, with average levels of companies that raised over $1bn reaching 81%. This has brought into question the effectiveness of traditional IPO pricing models that focus on institutional investors rather than retail and speculative investors, who have been an instrumental factor in the markets this past year.

IPO activity gained momentum in 4QCY20 supported by lower volatility



Average First-Day Returns of IPOs (in %) reached historical levels surpassing decadal highs



Sectors favored by investors in CY20 were

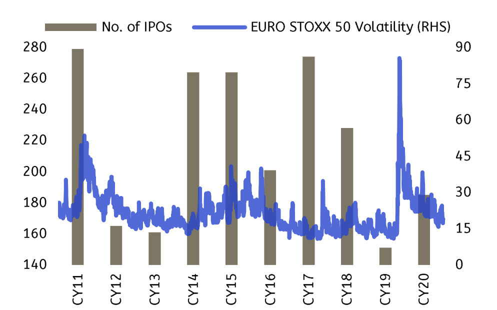
Sectors	# of Deals	Value Raised (in $bn)
Healthcare	112	25.7
Technology	68	38.7
Consumer Products	9	3

EMEA IPO market proved resilient and adaptive to continued lockdowns and vaccine delays

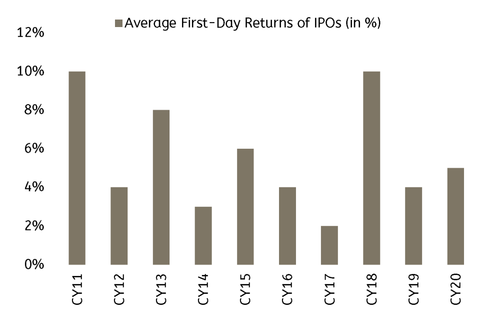
European IPO market recorded similar momentum as its US counterpart in 1QCY21 with 86 deals raising ~$27.3bn in proceeds, in comparison to 185 deals that raised $27.4bn in CY20. Investor appetite similarly increased for digital companies that have benefited from the lockdown. London stock exchange was the most active in 1QCY1 with 21 IPOs raising ~$10bn in proceeds (largest being Deliveroo at ~$2.18bn) followed by Euronext – Amsterdam - in terms of proceeds with 4 IPOs raising ~$5.7bn (largest being inPost at ~$3.9bn).

Indian IPO market recorded 22 IPOs in 1QCY21 with proceeds of $2.3bn, including 5 in the SME space, compared to 30 companies that raised $4.34bn in CY20. Most IPOs came from sunrise industry sectors such as speciality chemicals, automation, financial services, and IT.

IPO activity in 4QCY20 at 101 deals, surpassed all quarterly levels since CY16



Average first-day returns were balanced at reasonable levels



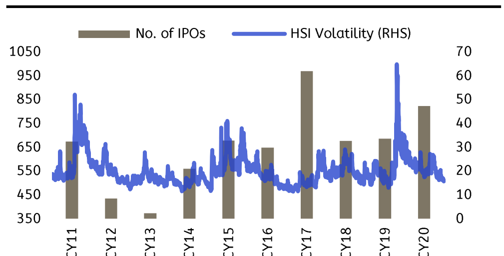
Sectors favored by investors in CY20 were

Sectors	# of Deals	Value Raised (in $bns)
Technology	67	10
Industrials	43	2.6
Health care	28	2.6

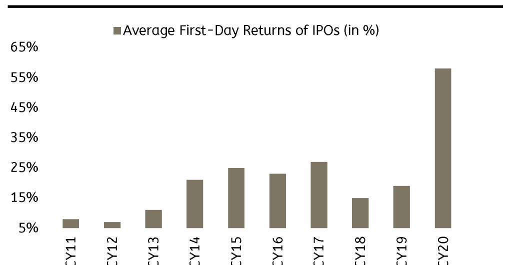
Asia-Pacific IPO market recovery led by China despite Ant's controversy

An active 2HCY20 resulted in Asia-Pacific reporting a total of 822 IPOs raising $136.2bn in proceeds in CY20, a YoY rise of 20% and 45% respectively. However, unlike other markets, 1QCY21 witnessed only 200 IPOs raising $34.2bn, equivalent to ~1/4th of CY20 proceeds. Despite the controversial halt in Ant's IPO, China reported a significant YoY jump in deal numbers of 47% to 536 and a YoY rise of 55% in proceeds to $119.1bn, the highest since CY10 (433 IPOs, $135.1bn). On the other hand, Japan's IPO market remained timid with 94 deals raising a total of $3.3bn, and no single deal worth more than $0.5bn, compared to $51bn in Hong Kong. Nonetheless, Japan's companies recorded the biggest opening gains since 1999 with tech dominating the list; the top 3 tech IPO names were: Headwaters Co., which jumped 1,090% on its first trade, followed by Image-recognition software maker Ficha Inc., with a 806% gain, and Tasuki Corp., which rose 655%.

IPO activity in 3Q & 4QCY20 at 286 & 268 respectively, reached 5 year all time highs



Average first-day returns were elevated despite relatively higher volatility



Sectors favored by investors in CY20 were

Sectors	# of Deals	Value Raised (in $bns)
Industrials	181	20.8
Technology	38.7	38.7
Materials	95	7.4

Source: Dealogic, EY, PWC, CBOE, Investing.com, Bloomberg

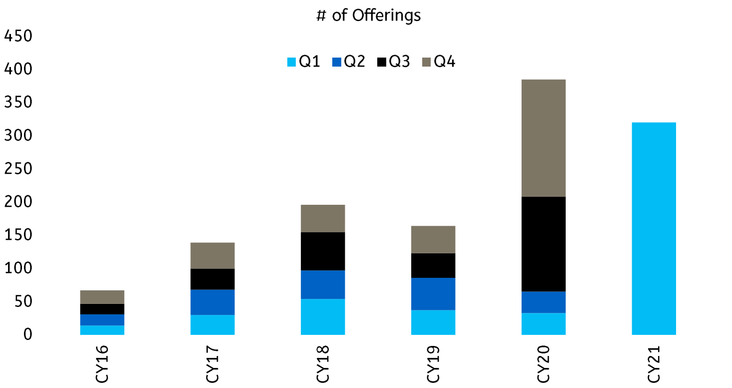
SPACs, the Hottest Stocks of 2020

It's the blank-check year, the IPO frenzy welcomed an influx of Special Purpose Acquisition Companies (SPACs)

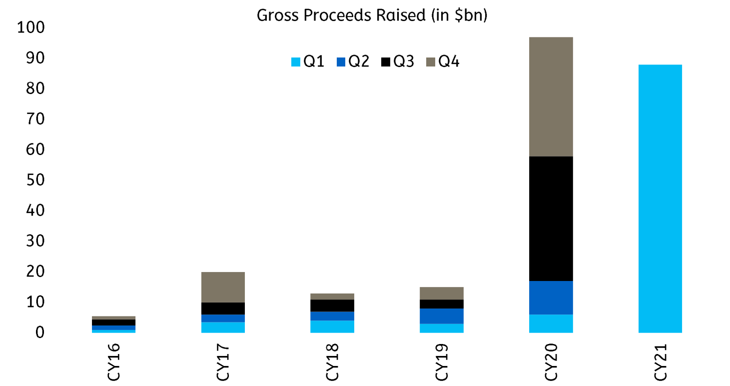
Betting that SPAC's sponsors will complete a well-received merger is an inherently speculative exercise, an activity that the heightened investor risk appetite has embraced in unprecedented volumes. In CY20, 385 SPACs raised a total of $97bn capital from IPOs, ~6x more than the $14bn raised in CY19, and exploded in 1CY21 with 320 raising $88bn, equivalent to more than two-thirds of the haul from all US listings.

More than 240 SPACs went public in CY20 in US alone raising $81bn for potential acquisitions and comprising over 50% of US IPOs in CY20, reaching by far the highest number on record. US continued to dominate SPAC activity in 1QCY21 with 300 IPOs raising $93.4bn in proceeds, surpassing its full year CY20 record. Europe recorded 7 SPAC IPOs raising $1.8bn, accounting for 8% of European exchanges' IPO activity and 7% by proceeds. The unprecedented boom has attracted the attention of the SEC which issued investor alert warnings, including those relating to shell status, financial reporting, and audit considerations; similar concerns have been reflected by regulators in Europe and UK.

SPAC IPO activity surpassed previous levels with number of offerings growing over 10x YoY in 4QCY20 and 2x QoQ in 1QCY21...



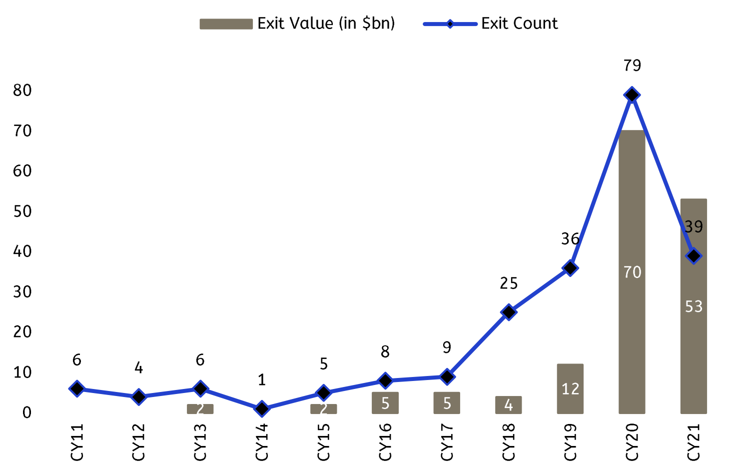
...The listing boom drove record proceeds of $97bn in CY20 and $88bn in 1QCY21, of which $63bn was raised in Jan'21 alone....



DeSPAC deals lag the pace of new SPAC IPOs despite aggression

From CY20 to 1QCY21, 118 SPACs have closed on an acquisition, representing over $120bn of value that is now public. Over 50% of de-SPACs completed were in the fast-growing Info Tech, Consumer Discretionary, and Healthcare (mostly BioPharma) sectors, followed by Industrials, Financials, and Energy sectors. This was in sharp contrast to SPAC acquisitions between CY10 and CY19, which was dominated by the Industrials, Financials, and Energy sectors followed by Info Tech and Healthcare. The largest SPAC combinations closed to date include United Wholesale Mortgage valued at $16bn, Multiplan at $14.7bn, Paysafe at $9bn, and Grab deal valued at $39bn. Even with this explosion in activity, the pace of deSPAC deals still lags the pace of new SPAC IPOs, as a result there remains a multitude of SPACs still actively looking for a target. As of early Feb'21, approximately 300 SPACs were in search of acquisition targets.

...Momentum was also witnessed in SPAC acquisitions, with 118 SPACs closing on an acquisition, representing ~$120bn since CY20 (1)

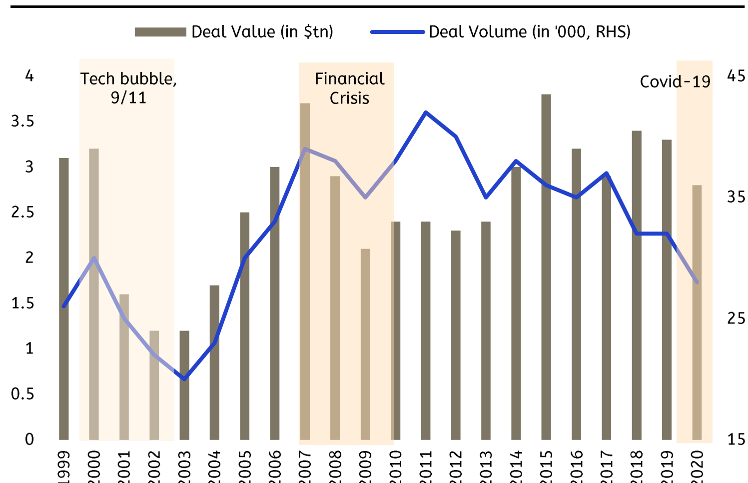


M&A market resilient but cautious

Similar to SPAC acquisitions, the general M&A industry witnessed the strongest activity in sectors least impacted by COVID-19 such as Tech, Healthcare, and Financial Services, while deals were scarcer in areas that lacked a near-term path to recovery, such as Commercial Aerospace, Energy, Real Estate, and Retail. In contrast to the euphoria witnessed in the SPAC market, the M&A industry declined by 10-15% YoY in both value and volume terms in CY20, with Americas registering the sharpest decline, followed by Asia-Pacific and Europe, the Middle East, and Africa.

Moreover unlike equity market investors, corporates continued to be dissuaded by the political and economical uncertainties and limitations of target company due diligence due to COVID-19, evident from a continued decline in cross-border M&A.

Unlike SPACs, Covid-19 slowed down global deal momentum in M&A as corporates continued to be dissuaded by economic risks



Source: Dealogic, S&P Capital, Bain & Co., Bloomberg
Footnotes: 1) SPAC acquisition activity as of Apr 15, 2021

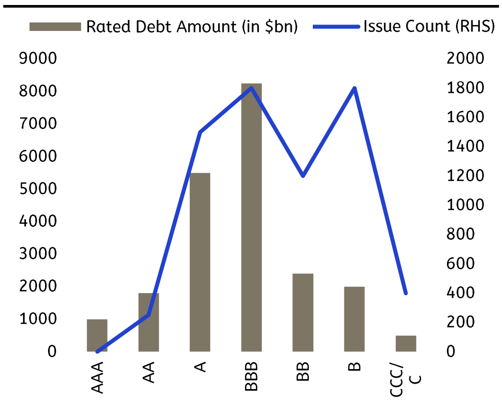
Credit Mayhem Forces Central Banks' Hand

Central Banks stepped in as the first line of defence in a risky corporate bond market

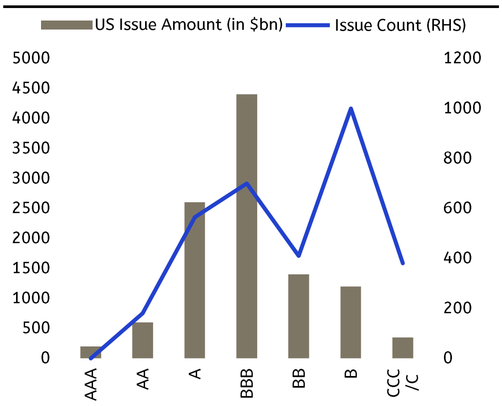
Prior to the pandemic, the US 'BBB' category non-financial debt stood at ~$3tn, representing ~48% of the US IG bond market and ~20% of the global IG market. The US speculative bond market stood at ~$2.8tn, equivalent to ~28% of the US corporate bond market. The dominance of the 'BBB' and its combined share with speculative bonds at 60% of the $10tn US corporate debt market threatened the stability of the US financial market as risks of corporate downgrades and defaults rose significantly at the onset of the pandemic. Moreover, the vulnerabilities of the US corporate bond market, which is equivalent to ~55% of total marketable US treasury debt and constitutes ~50% of global corporate debt, forced the Fed to directly intervene with primary and secondary market corporate credit facilities, which had a combined size of $750bn, in Jul'20.

EUR IG bond market, which stood at ~$6tn pre-pandemic, displayed similar vulnerabilities with 'BBB' category bonds accounting for ~50%. While its speculative bond market stood relatively lower at ~$1.2tn, equivalent to ~16% of the EUR corporate bond market, ~40% of its nonfinancial companies had reported a decline in net income in CY19, and ~20% met the BIS definition of "zombie firms" with a persistent pattern of EBIT not covering interest costs. As a result, ECB too was forced to ramp up its bond buying under its Asset Purchase Program (APP) to €120bn from €20bn per month and launch a €750bn Pandemic Emergency Purchase Programme (PEPP) focused on both private and public sector securities.

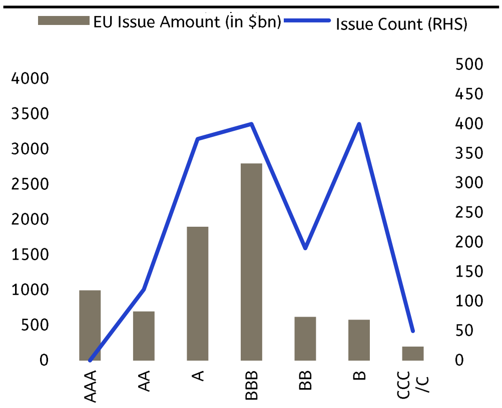
Distribution of global, US and Euro corporate debt market (in $bn) by S&P rating category...



...shown in the graphs below, highlights the dominance of 'BBB' & speculative bonds...



...and the vulnerability of the respective markets at the onset of the pandemic (1)

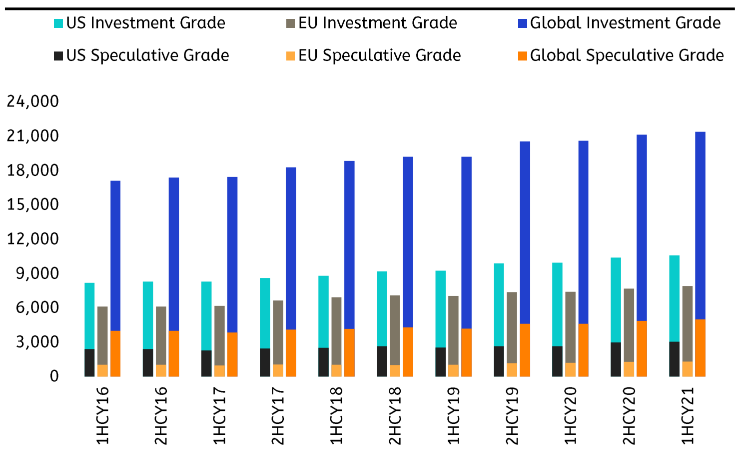


Strong and supportive financing conditions led to record bond issuance

The monetary policy response by key central banks was a crucial stabilising force and helped restore investor confidence. As a result, non-financial fallen angel debt in US and EMEA was recorded at ~$350bn in CY20, far below the ~$650bn projected by S&P in Sep'20, which based it on the sharp contraction in economic activity in 1HCY20.

Record low rates across the yield curve also supported elevated issuance volumes especially in BBB market in CY20. US non-financial 'BBB' bond issuance was recorded at over $500mn, far greater than ~$300mn raised on average over CY15-19. The rise was led by BBB- debt issuance at ~$200mn which surpassed BBB+ issuance of ~$150mn and BBB issuance of ~$180mn. Similarly, EMEA non-financial 'BBB' bond issuance at ~$200mmn was higher than ~$150mn raised on average over CY15-19, led by BBB rated issuance at ~$100mn.

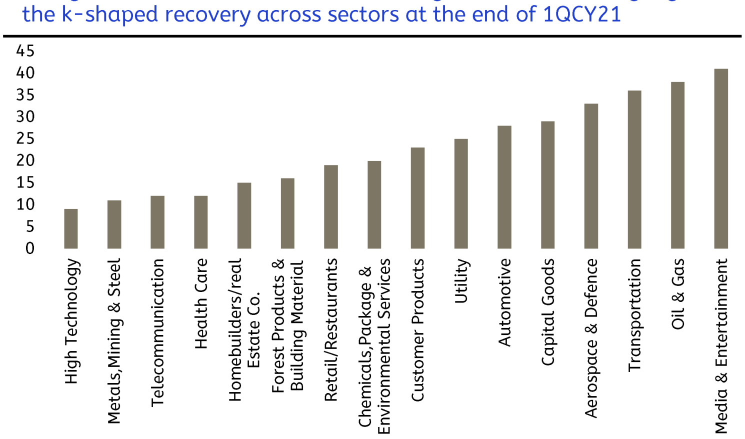
Global issuance rose after the announcement of relief measures in 1HCY20, with total US & EUR SG grade issuance crossing $3bn and $1.2bn respectively in 3QCY20 (figures are in $bn)



The uneven K-shaped recovery continues to threaten riskier credits

Given the asymmetrical impact of the pandemic, wide variations in sectoral recovery have emerged. The telecommunication sector which dominates 'BBB' category debt, with more than $850 billion (just 14% of which is 'BBB-') benefited from the increased necessity of mobile and broadband services. Within the consumer products sector which has the second-largest amount of 'BBB' category debt (less than 13% of which is 'BBB-'), providers of consumer staples, such as packaged and branded food and personal and home care, recovered swiftly with the gradual reopening. In sectors like media and entertainment (which includes leisure), transportation, and aerospace, the path to recovery remains uncertain due to the uneven rollout of vaccines in different regions and some permanent shifts in consumer behaviour.

S&P global non-financial sectors: net negative bias (in %) highlights the k-shaped recovery across sectors at the end of 1QCY21



Source: S&P Capital, Fed, ECB, Bloomberg
Footnote: 1) Data as on Apr 1, 2020. Charts represent Global, US and EUR dent markets respectively

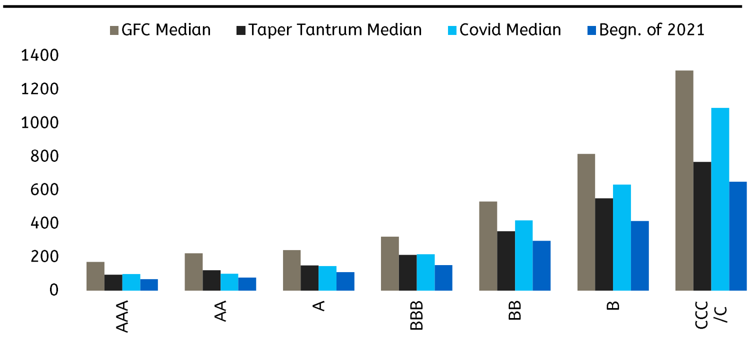
Fed Bails Out a Highly Levered Corporate Bond market

Financing conditions made accommodative, with spreads easing down to pre-COVID levels

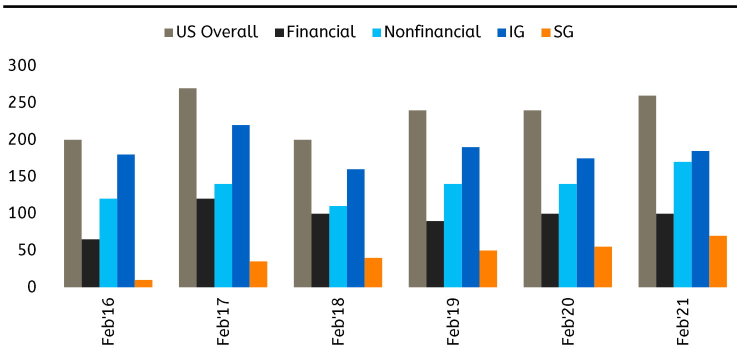
Similar to the US equity markets, the corporate bond market witnessed exuberance due to positive news on vaccine rollouts, passage of the $1.9tn stimulus package, and continued accommodative monetary policies. Investment grade spreads narrowed to 126bps in 1QCY21, 16bps lower than pre-pandemic levels, and less than half of the peak level of 366 bps seen in Mar'20. Similarly, speculative grade spreads also tightened from their March peak of 1,057 bps to 377 bps, despite the steep rise of 0.5% in US treasury yields in 1QCY21 to 1.4%.

This access to cheap credit led to investment grade companies raising $1.75tn in CY20 with issuance in Jan'21 & Feb'21 being 52% higher than the same period in CY20, as financing conditions remained supportive. The speculative grade market reported relatively stronger performance in Jan'21 & Feb'21 with growth in issuance of 36% and 85% over CY20 and CY19 respectively during the same period. As per S&P as on Apr'21, ~73% of the US non-financial corporates were rated speculative grade, compared to 32% of financial services, and a total $3.1tn outstanding debt was 'BBB' rated.

US Corporate credit spreads (in bps) fell below pre-covid-19 levels, after tightening significantly in 1QCY21, supporting…



…new bond issuance YTD (through Feb, in $bn), which remained above pre-pandemic levels, with IG constituting 70% of the total…

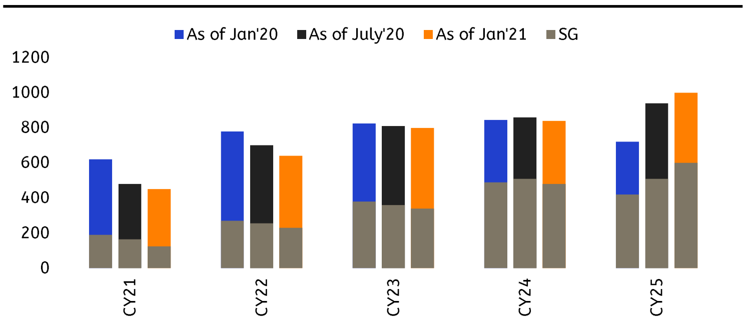


The tightening of credit spreads helped bail highly levered companies

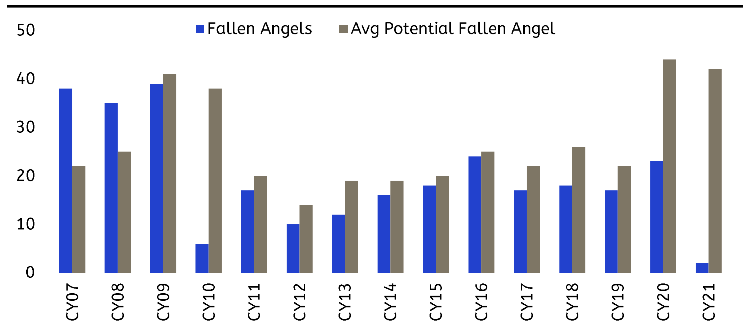
Easy availability of credit provided by Fed's backstop on credit helped non-financial companies reduce CY21 maturities by 26% to $485bn over CY20, as well as opportunistically reduce 6% of debt maturing in CY22-24 via refinancing operations. Specifically, speculative grade bonds of non-financial companies maturing in CY21 reduced by 37% to $122bn and those maturing in CY22-23 declined 13%.

The ease with which the riskiest US companies were able to borrow money reduced the S&P's US corporate distress ratio from an all-time high of 35.2% in Mar'20 to 3.4% in Mar'21. Moreover, the lengthening of maturity walls halted the number of downgrades from investment grade to speculative grade in North America at 25 in CY20, far below the downgrades by S&P during the credit crisis, and with only one fallen angle recorded YTD in CY21. However, ~$130bn, or ~4.2% of the outstanding total long-term 'BBB' debt as on Feb'21, was still vulnerable to downgrade to speculative grade in CY21, as per S&P.

…raising the duration of US non-financial corporate bonds, with $3.85tn in debt maturing through CY25 now (figures below in $bn)



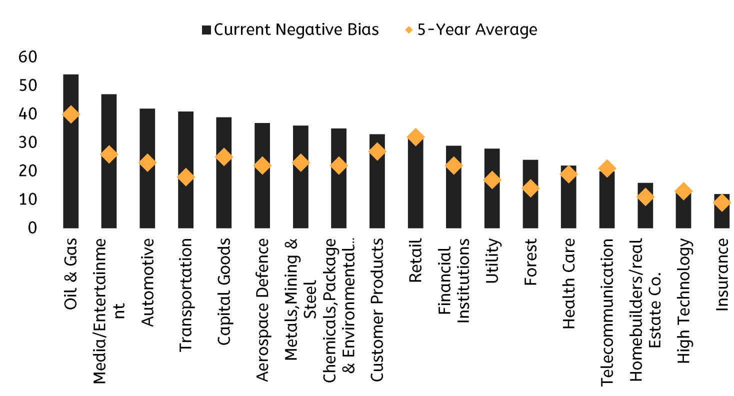
The number of issuers downgraded by S&P from IG to SG in North America was recorded at 25 in CY20, (the count is as follows)



Despite economic recovery, S&P downgrade potential remains elevated

Alongside the US economic recovery, non-financial sectors such as technology, health care, and those that are export-driven, cash flows have returned to pre-crisis levels and operations are largely normal; however for those dependent on unrestricted human contact, the crisis remains acute. In 1QCY21, cruise ships remained docked and hotel rooms, casinos, restaurants and airplanes were still operating at below pre-pandemic levels. Oil and gas, media, and lodging and auto sectors continued to face the highest downgrade risk. With US non-financial debt maturities peaking at $1tn in CY25, a rise of 35% YoY, of which $588bn is speculative in nature, these sectors which have been most affected by the pandemic may have sufficient time to resume operations and achieve the cash flows required to service their debt.

Oil and gas, media, and lodging and auto sectors continue to face the highest downgrade risk as per S&P's data of negative bias (in %)



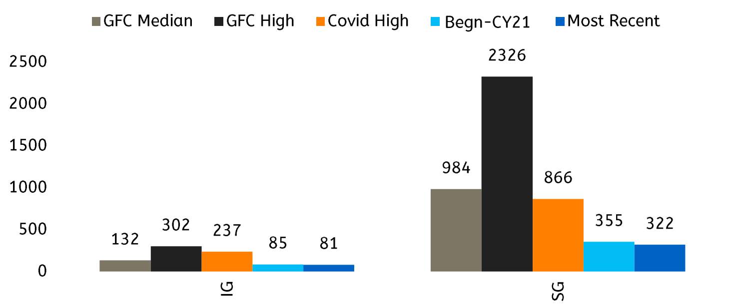
Source: S&P Capital, Fed, Bloomberg
Footnotes: All charts as of Mar'21

ECB Keeps Corporate Yields on Lockdown

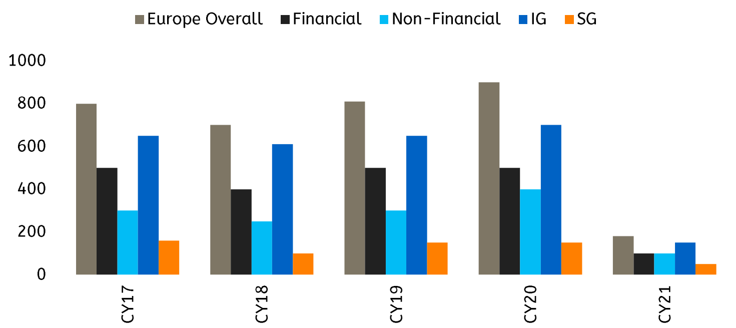
ECB conducts money-printing at significantly higher pace to convince bond market sceptics

At the end of CY20, ECB's APP holdings amounted to €2.9tn of which ABSPP accounted for 1% (€29bn), the CBPP3 for 10% (€288bn) and the CSPP for 9% (€250bn). Out of the private sector purchase programmes CSPP contributed the most to the growth in APP holdings with €66bn of net purchases. The quantitative easing (QE) program narrowed the investment grade spreads to 85bps at the end of CY20, 1/3rd the peak level of 237bps seen in CY20. Similarly, speculative grade spreads also tightened from their peak of 866bps to 355bps. Subsequently, non-financial companies raised the highest investment and speculative debt in a year since CY17 in CY20. IG issuance in the eurozone rose 24% YoY as of Oct'20, while SG volumes declined by 8% YoY. However with the rise in US treasury yields that triggered a global yield sell-off, corporate issuance of IG and SG declined by 17% and 9% YoY YTD Feb'21. ECB, which had slowed its pace of QE to €19bn a week in 1QCY21 from €23bn in 4QCY20, was thus forced to accelerate the pace at its Mar'21 meet to counter the rise in yields that threatened to derail the region's economic recovery.

Although spreads tightened due to ECB's QE, those on lower rated borrowers remain elevated, reflecting elevated default rates...



...IG issuance (in €bn) overtook the pace of CY19, however, declined in YTD through Feb'21 following the volatility in US T-yields...

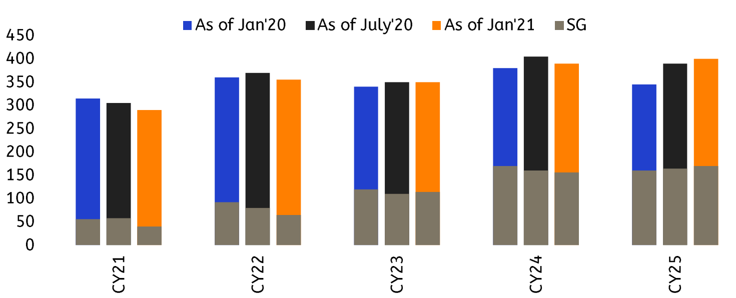


Credit quality decline less severe than in the Financial Crisis

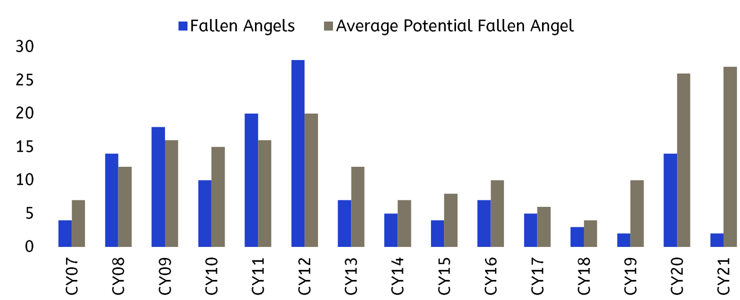
Easy availability of credit provided by ECB's APP helped non-financial companies to reduce debt maturing in CY21 by 9% during CY20 to €290bn. While maturities for CY22-24 remained unchanged averaging €366bn a year, debt issuance in CY20 resulted in rise of CY25 maturities by 17% YoY. Within the speculative-grade, non-financial companies reduced CY21 maturities by 12% YoY to €48bn, lengthened maturities in CY22-24 by 13% YoY and issued fresh debt resulting in rise of CY25 maturities by 9% YoY to €174bn.

Despite refinancing and fresh issuance, the number of defaults reached an all-time high in CY20 but the default rate was lower than that during the sovereign crisis in CY09. As per S&P the default rate stood at 5.4% YoY in Feb'21 more than double the rate in Feb'20. Positively, while there were 14 fallen angels in Europe in CY20 only one was reported YTD Feb'21 by S&P. However, in 2QCY21 as per S&P, ~38% of speculative grade issuers continue to face downgrade risks, while ~41% of risky credits were still vulnerable to credit deterioration.

EUR non-financials raised the duration of their liabilities, with €1.8tn in debt maturing through CY25 now (figures in €bn)



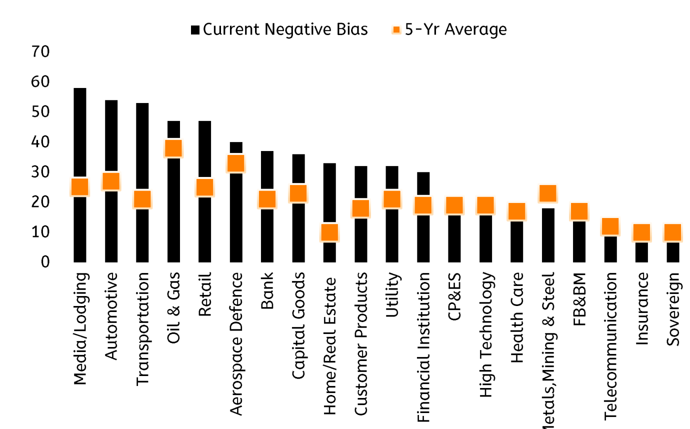
The count of fallen angels in CY20 stood at 13; automotive sector recorded the most downgrades at 4 by S&P



Insolvency remains a major concern, especially for contact-based service companies

As per ECB's financial stability report on May'21, extensive policy support has kept corporate insolvencies unusually low unlike during previous crisis periods and it warned of a rise in insolvency cases despite economic recovery, partly driven by a backlog of insolvency cases. The report further highlighted elevated refinancing risks as corporate earnings expectations for the euro area remain below pre-pandemic levels and stated that higher (risk-free) rates would increase debt servicing costs from historical lows and could raise medium-term risks for both sovereign and corporates. With €1.9tn European non-financial debt maturing through CY25, of which €575bn is spec-grade in nature, the euro zone has to maintain the delicate balance between prematurely adjusting support measures, which may contribute to triggering a wave of corporate insolvencies, and maintaining support measures for too long, thereby keeping unviable corporates alive.

Negative ratings actions by S&P slowed in CY21, but a third of European non-financials still have a negative outlook (in %)



Source: S&P Capital, ECB, Bloomberg
Footnotes: All charts as of Mar'21

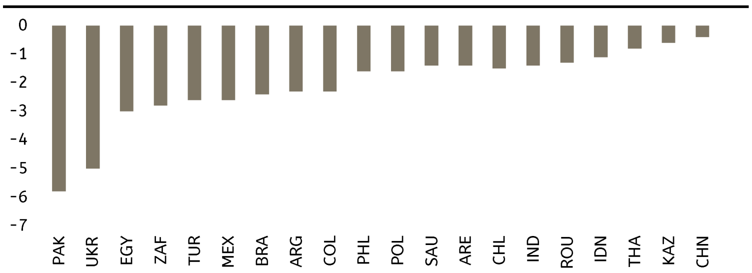
EM: Improved Prospects, Albeit Prone to Setbacks

Emerging Market (EM) Central Banks piggy back on Advanced Market (AM) Central Banks to stabilize corporate bond markets

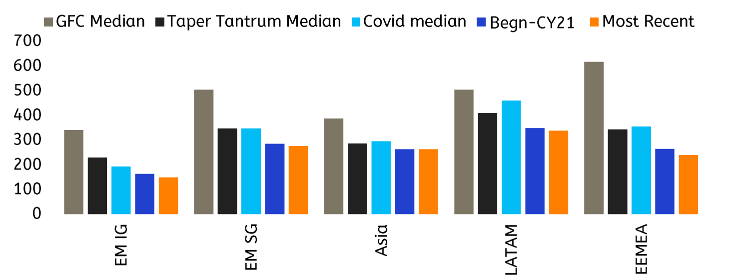
Central banks across EMs mounted a strong counter-cyclical monetary policy response by applying a broad set of policy tools – inclusive of conventional policy rate cuts and unconventional APPs – to reduce sovereign default risk premiums and cushion the subsequent impact of portfolio outflows. Further, in coordination with fiscal policy action, they supported the flow of credit and aggregate demand. As a result, credit spreads compressed significantly across markets by end CY20, though they remained slightly above those at the beginning of CY20.

Risks from Fed's monetary policy, which spills over strongly to domestic government bond yields in EMs at all maturities, remain elevated. As per IMF, a surprise tightening of 100bps by the Fed translates into a 47bps rise in 2-yr government bond yields in EMs. ECB monetary policy surprises have smaller effects. However, risk premia remained broadly stable in 1QCY21 despite the downside risk from the recent rise in US yield curve, primarily due to the improved prospects of economic recovery and continued loose stance of policymakers. Similarly, corporate spreads continued to remain tight compared to prior crises' norms, including GFC(CY08) and Taper Tantrum(CY13), with investment grade at 149bps and speculative grade at 276bps, as on Mar'21. Further, with resurgence of COVID-19 across EMs in 2QCY21, specially in Taiwan, Brazil, and India among others, the outlook remains uncertain, especially since EMs have little room to provide additional stimulus without jeopardizing their credit quality.

Policy Rate Cuts by EM Economies, on the heels of central banks in advanced economies, between Mar-Aug' 20 helped...



...tighten spreads in CY20. Credit conditions looked brighter YoY in 1HCY21, despite the volatility in US T-yields

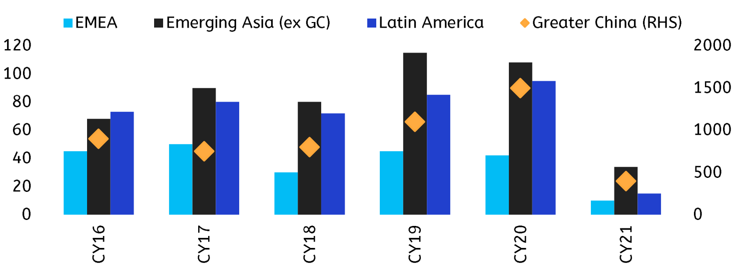


EM non-financial corporate debt rises modestly

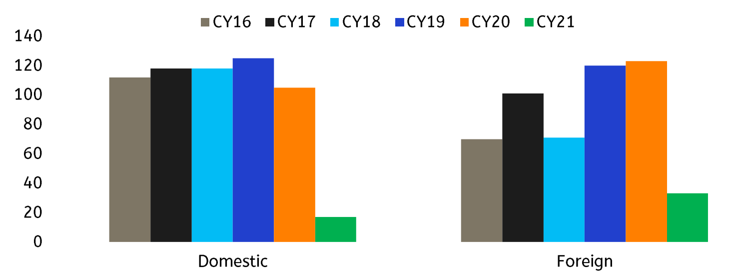
Post the pandemic, EMs continued to attract strong investor demand for fixed income instruments. Fiscal and monetary support along with favourable economic conditions resulted in corporate issuance of ~$1.6tn across EMs in CY20, albeit skewed by China. Corporate domestic issuance for EMs excluding China stood at $105bn in CY20, recording a YoY decline of 16% and below even CY16's level of $112, while foreign issuance remained marginally flat YoY at $123bn in CY20. Further, despite the global yield sell-off, in 1QCY21 new issuance totalled $343bn, marginally slower than 1QCY20. Overall, capital market and bank funding was recorded as ample for the larger, investment grade, or more diversified issuers.

Despite the favourable conditions, credit conditions for rated corporate issuers in EMs were far from stabilized at the end of 1QCY21. As per S&P, EM Asia (excluding China) downgrade potential was 41%, much higher than both 5- and 10-year historical averages. Similarly, LatAm's downgrade potential in Mar'21 stood at 44%, well above both historical averages. For China, the March downgrade potential (13%) was slightly below its 5-year average (17%) and 10-year average (18%).

EMs continued to attract strong investor demand for FI instruments, albeit skewed by China, in CY20 and YTD through Mar'21 (figs in $bn)



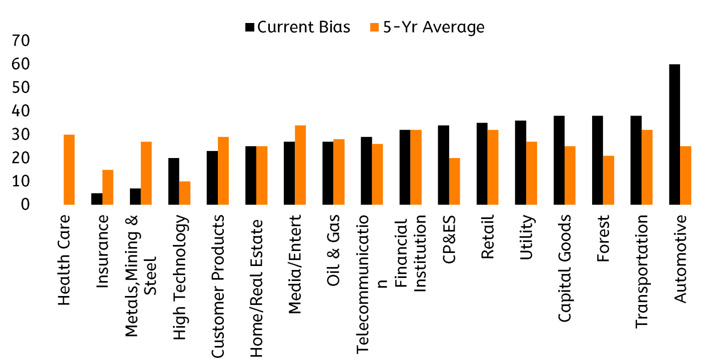
EMs (ex GC) recorded greater foreign than domestic corporate issuance in CY20 and YTD through Mar'21 (figs in $bn)



Prevalence of Covid-19 across key EMs, high fiscal debt and pressure on corporate earnings may delay recovery

Economic recovery in most EMs remains fragile especially given backloaded access to vaccinations and limited policy space to provide further lifelines and support economic activity. The manufacturing sector is expected to lead the recovery as the region's overall exports reported recovery in 1QCY21 driven by demand normalization in US and China. However, the automotive sector, along with transportation, continued to lead Feb'21 sector downgrade potentials, as per S&P. Apart from rising cases threatening the recovery, tightening of policy by central banks amid rising inflation and challenging fiscal dynamics, such as by Brazil, is a potential risk. Overall, access to funding is likely to remain a major credit differentiator in EM in CY21.

Negative rating actions by S&P have plateaued, however Ratings' negative bias (in %) remains historically high for several sectors



Source: S&P Capital, IMF, Bloomberg
Footnotes: All charts as of Mar'2021

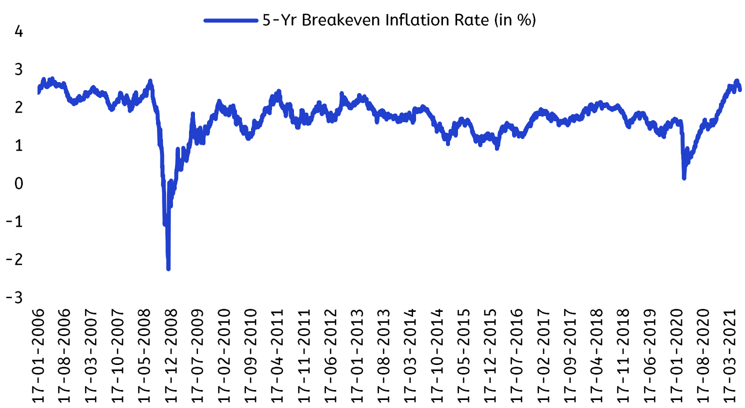
The Tug of War of Inflation and Worries of Rising Real Yields

Inflation expectations are at a critical point; Fed believes inflation to be transient, the market has discounted otherwise

Since the start of the Pandemic, Jerome Powell, the current chair of the Federal Reserve, has displayed a clear preference for maximum employment even if it means letting the US economy run “hotter for longer” before raising rates. He expects the unemployment rate to fall to 4.5% in CY21 and then tick down closer to pre-pandemic levels of 3.9% in CY22 and thereafter to 3.5% in CY23. Subsequently, the Fed expects GDP growth to reach 6.5% in CY21, up from its previous projection of 4.2% and the fastest rate since the 1980s. However, a side-effect of this massive stimulus induced recovery is inflationary pressure. The Fed expects inflation to jump to 2.4% in CY21, above its 2% target. However, it expects the rise in inflation to be transitory, justifying it to be a result of imbalances between supply and demand as the economy revives.

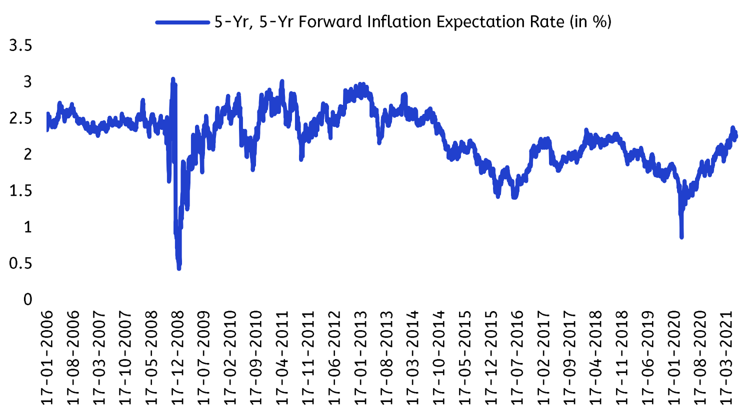
The market, on the other hand, has remained intently focused on the prospects of inflation and its longer term impact on the economy. Between Aug’20-Apr’21, ~$22.3bn has flowed into mutual funds that buy Treasury Inflation-Protected securities according to EPFR, marking 29 straight weeks of inflows, the most in over a decade. Of the total, ~$3.38bn had flowed into these funds in April’21 alone. This is despite the negative yields on TIPs, indicating that investors are expecting to be compensated when adjusted for inflation.

Bond traders lift 5-yr inflation outlook to highest since CY06



The 5-yr breakeven rate, a proxy for the annual inflation rate bond traders expect over the span, breached 2.7% in May’21, the highest since Mar’06. The rise has primarily been led by actuals of producer prices, industrial production and retail sales being greater than expected along with the largest US fiscal stimulus outside of war times, stoking fears that the Fed will be too slow in reacting to rising inflation.

The 5-yr, 5-yr forward B/E inflation rate reached a seven-year high



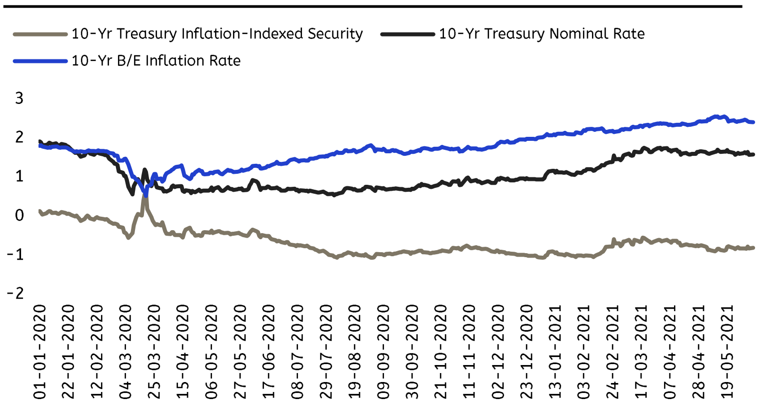
The 5-yr, 5-yr forward breakeven inflation rate reached a seven-year high in May’21 of 2.55%, which translates into an average of over 2% annually during the half decade beginning CY26. In other words, the Fed is effectively on course to achieve its average 2% inflation goal in the eyes of investors, and are signalling that it needs to start laying the groundwork for shrinking its massive bond-buying program.

The double-edged nature of real yields and the rise since Feb’21

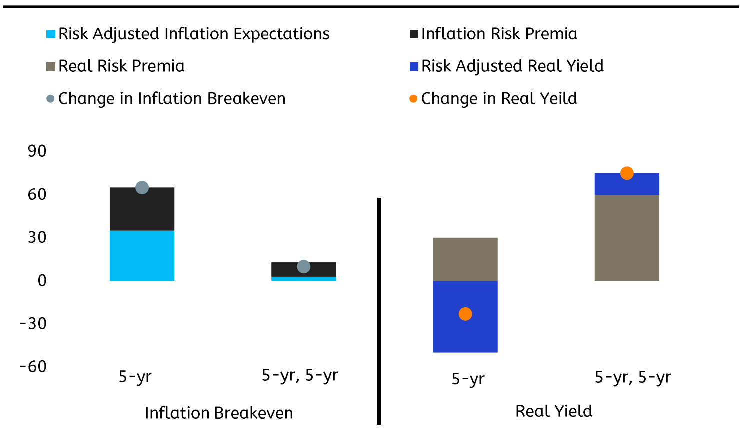
For all the fear and angst about the risk of long-term Treasury yields lurching even higher, a true warning for global investors would be a surge in real rates. While higher real yields signal the economy is gaining traction and are excellent news for both jobs and corporate profit, a sharp rise would bode poorly for the cost to borrow. Moreover, a rise in yields might create potential rivalry for other asset classes that have benefited from negative real rates, including stocks, which are currently trading near all-time highs

This double-edged nature of real yields has also caught the market’s attention since Feb’21. The real 10-yr yield had been stuck around negative 1% since Aug’20, a historical extreme; while still negative it climbed 35 basis points to -0.65% in 1QCY21. These levels -- still 40 to 50bps below the average in the five years before the COVID-19 crisis -- may well be justified given still contained core inflation, but they pose a risk given the US economy is expected to grow by 6.3% in CY21.

While the increase in the 5-yr T-yield was driven by a steep rise in short-term breakeven inflation, (figs in %)...



...by contrast, the increase in the 5-yr-5-yr forward was primarily due to a sharp rise in real yields, (breakdown of 10yr T-yield in bps)



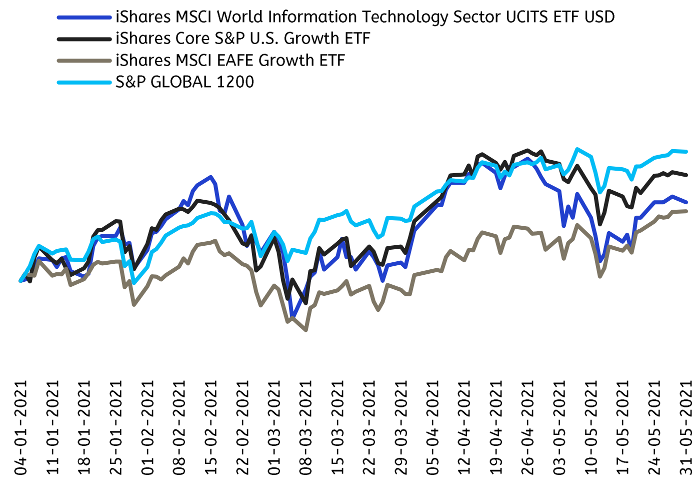
Source: S&P Capital, Fred, IMF, Bloomberg

Is the Boom Turning Into a Bust?

Sharp rotations tumble tech rally; growth stocks move out of favour as quickly as they became one

Exuberance has given way to fear since the start of CY21, with concerns of rising inflation looming over markets as global economies heat up, boosted, in part, by pent-up demand and the combination of continuing accommodative monetary and fiscal stimulus. The resultant rise in the US benchmark 10-yr treasury yield has weighed heavily on growth stocks, especially those with high duration cash flows. The tech sector, which has been among the biggest pandemic winners, and whose valuation often depends on earnings prospects far into the future is now at the centre of the inflation debate. Despite the declines caused by investors rotating their portfolio exposure from growth to value stocks, tech and other growth stocks continue to trade ~30% above their pre-pandemic levels. Furthermore, the economic rebound that is fuelling inflation is likely to benefit value stocks in sectors such as energy, banks, travel & leisure, etc., that are sensitive to the reopening and have lower duration cash flows.

Markets continue to expand in CY21 but with sharp rotations

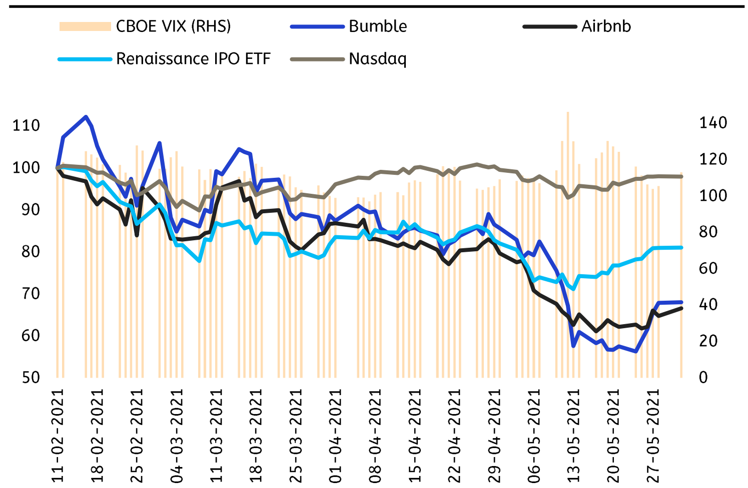


Inflation expectations bust the IPO frenzy; deals delayed as market uncertainty spooks debutants

The market selloff also stung some of the hottest stocks to recently go public, with Bumble falling to its IPO price of $43 and both Airbnb and Coinbase falling below their IPO price of $148 and $250, respectively. The Renaissance IPO Index, which tracks companies for two years after they go public, has lost ~18% since its highs in Feb'21.

Investor reactions to new IPOs have also become muted with the avg listing day pop falling to ~20% in Mar'21 and Apr'21 and ~18% in May'21. With the heightened volatility, three companies postponed their deals in early May'21, namely Enact Holdings Inc., an insurance unit of Genworth Financial Inc., which had planned to raise $542mn, Zenvia (IPO:$226mn), based out of Brazil and which provides a communications platform to businesses, and Hear.com NV (IPO:$324mn), a hearing-aid service provider backed by private equity firm EQT AB.

Recent listings erase surge amid market turmoil

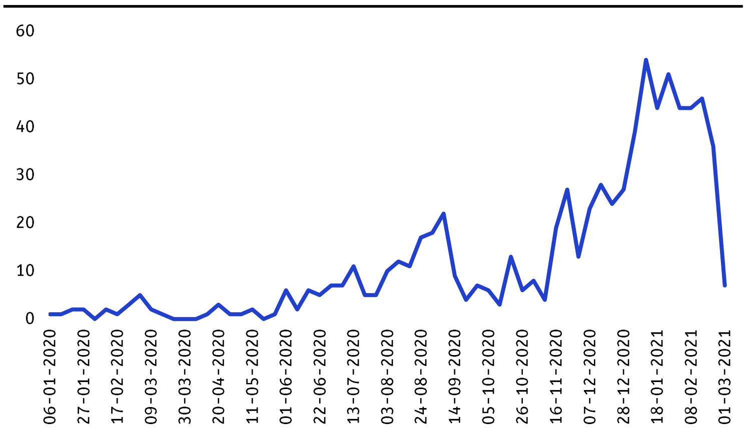


Is the SPAC party over?

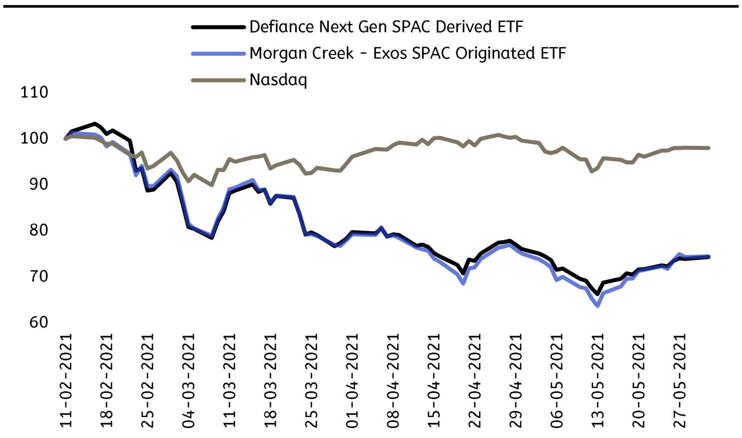
In line, the euphoria of SPACs is dissipating as evident in relative dearth of new SPACs filing to go public and in the stock-price performance of already listed SPACs. The Defiance Next Gen SPAC Derived ETF, which holds more than 230 SPACs and SPAC-merged companies, had declined more than ~35% in mid-May'21 from its high in mid-Feb'21. Similarly, the Morgan Creek-Exos SPAC Originated ETF, had declined ~37% in the same period. The IPOX SPAC Index, which tracks the performance of a broad group of special purpose acquisition companies, had also fallen in eight out of the nine sessions in early May and was down more than 20% in mid-May'21 from its mid-Feb'21 peak.

The rotation out of growth companies, including likely targets for blank-check firms, and a dissipation of retail dollars -- which many SPACs were tailor-made for -- from the market could be the factors contributing to a waning appetite for SPACs. The silver lining is that the pullback has opened up numerous arbitrage opportunities for yield-seeking investors.

Weekly new SPAC filings in US declines from record highs



SPAC ETFs fall sharply from highs achieved in Mid-Feb'21



Source: S&P Capital, Financial Times, Pitchbook, Bloomberg

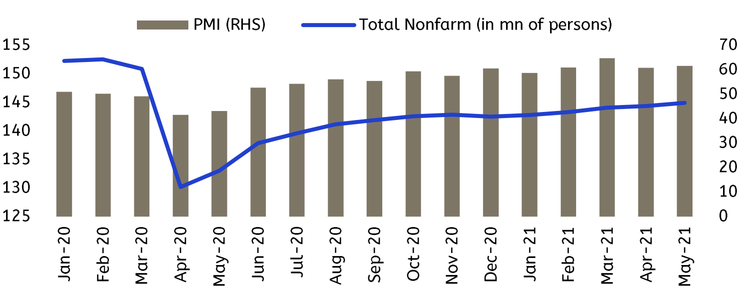
Is the Fed Backed Into a Corner?

The Fed is focused on maximum employment; The Bulls are with the Feds, the Bears not so much; The US Govt calls for wage hikes

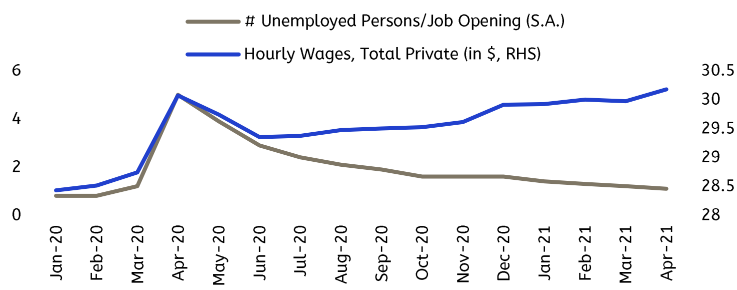
The recent jobs reports have been of little help in ending the debate between the Fed policy makers and investors. While non-farm payroll employment rose significantly by ~0.8mn in Mar'21 it took a big step back in Apr'21 reporting a rise of only ~0.3mn, leaving unemployment rate little changed at 6.1%. Interestingly, BLS also reported that the average hourly earnings for all employees on private nonfarm payrolls increased to $30.17, higher than pre-pandemic levels of $28.51, despite there being 1.1 unemployed workers for every job opening in Apr'21. The mis-match resulting from rising demand for workers and continued labour shortage leading to wage hikes, despite ~10mn Americans being officially unemployed, has been blamed on the safety net, strengthened during the pandemic by the government, to provide a temporary lifeline to wage earners. However, adding further to the complexity, for the week ended 22nd May, initial jobless claims for state unemployment benefits fell by 38k to 406k, the lowest since mid-Mar'20 and marked the fourth straight weekly decline in applications.

From one perspective it can be stated the US labour market still requires support as the vaccination drive continues and restrictions ease thereby supporting the Fed's mandate to continue with its accommodative stance. From the investor's perspective it shows that demand for higher wages by laborers could result in significant rise in cost-push inflation and thereby further over-heat the economy. The fiscal stance is pro-wage hikes with president Biden renewing his call for Congress to raise the federal minimum wage to $15 an hour stating that "When it comes to the economy we're building, rising wages aren't a bug, they're a feature"

Despite record PMI levels, jobs growth remains below expectations…



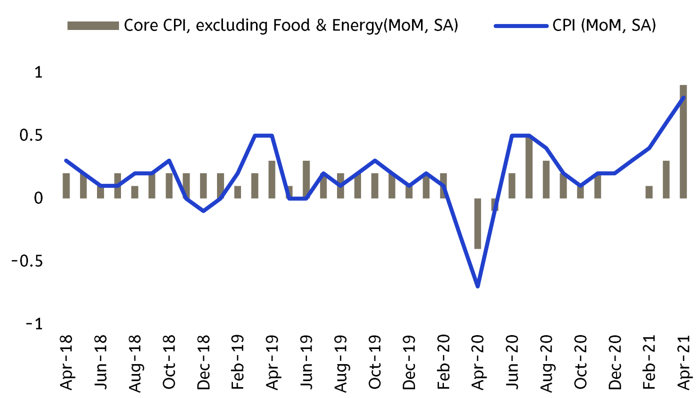
… as labourers demand higher wages to return to work



The Fed: Its transitory; The Bulls: Its good for equities in the ST and will pass in the MT; The Bears: Too much of anything is bad

Annualized inflation has shown clear MoM acceleration over the past three and six months. As per BLS, US April CPI surged to 4.2%, the most since CY08, while the index for all items less food and energy rose 0.9% MoM, its largest since April 1982. The indexes for consumer discretionary products, in particular such as for used cars and trucks, shelter, airline fares, recreation, motor vehicle insurance, and household furnishings and operations, were among the indexes with a large MoM impact on the overall increase. Fed officials have acknowledged the boost as temporary, and the result of a gap in demand and supply due to quicker than expected release of pent-up demand as vaccinations reach critical mass, and bottlenecks, such as from shortage in shipping containers and semi-conductor manufacturing, constraining supply. It further expects these temporary factors to persist to the end of CY21 as it may take some time for supply to rise up to demand.

US CPI accelerates MoM, driven by Core CPI and rising demand for discretionary products as economy picks up pace

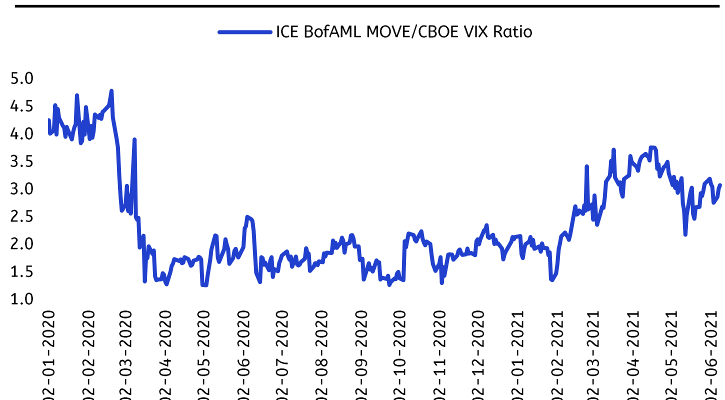


However economists believe as an instance that a 13.2% YoY rise in S&P CoreLogic Case-Shiller National Home Price Index to $253.66 in Mar'21, marking 10 straight months of accelerating home prices, is a sign that the housing market no longer requires the Fed's support and that the Fed should consider tapering its buying of $40bn mortgaged backed securities per month to avoid further over-heating.

The Fed: Monetary policy is in a good place; Equity investors rejoice; Bond investors on wait-and-watch mode

With unemployment rate still ~3% above pre-pandemic levels, Central bankers thus far have stuck to the script stating that the economy needs to make "substantial further progress" toward the Fed's inflation and employment goals before it begins to tighten policy. The repeated affirmation of continued dovish monetary policy in the face of rising CPI has garnered positive support from equity investors, as evident from lower volatility of CBOE VIX, given that it would improve corporate earnings prospects. Meanwhile, volatility in the Treasury bond market as measured by the ICE BofA MOVE Index is at its lowest since the global yield sell-off, while the 10-Yr treasury yield has also declined to 1.46% in May'21, having peaked at 1.7% in 1HCY21, suggesting that bond investors are looking for an indication of confidence in the trajectory of the economy.

Fed dovishness has heightened volatility in bonds and lowered it in stocks



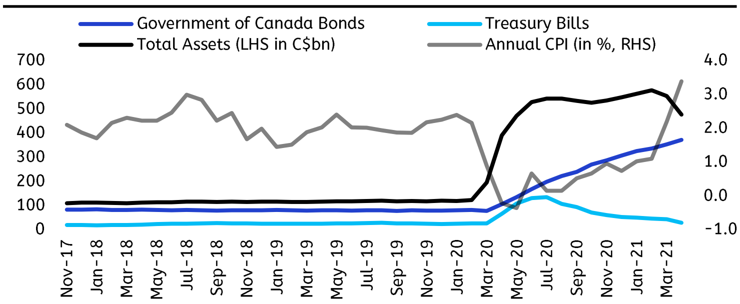
Source: Fred, BLS, Bloomberg, Financial Times

Short Takes on Moves by Other Developed Central Banks

Bank of Canada first to exit among developed economies

Among the developed economies, BoC became the first to reduce emergency levels of monetary stimulus in Apr'21 after having purchased ~C$300bn (US$247bn) since the pandemic. It announced a scale back of its weekly purchases of government debt from C$4bn to C$3bn and accelerated the timetable for a possible interest-rate increase, currently at 0.25%. The exit came as it revised higher its growth estimate for CY21 by more than 2% to 6.5%, followed by ~4% in CY22, and ~3.5% in CY23. It further expects CPI to be at the upper end of its 1-3% inflation-control range for the next few months before returning to 2% on a sustained basis later in the 2HCY21.

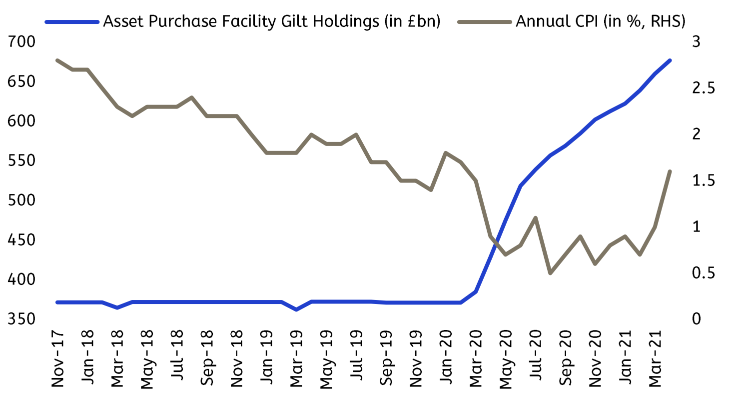
Record buying of government debt forced BoC to raise inflation concerns and reduce emergency levels of monetary stimulus



Bank of England delivered a big forecast upgrade and a slowdown in bond purchases

With the vaccination drive reaching critical mass and clear evidence of economic revival emerging, BoE revised its economic growth estimate upward to 7.25% in May'21 from 5% in Feb'21. Subsequently, it announced a slowdown in its weekly purchases of UK government bonds by ~£1bn to £3.4bn ($4.8bn). However, BoE decided to keep the total target stock of bond purchases unchanged at £895bn and maintained its benchmark interest rate at all-time lows of 0.1%. BoE further optimistically revised down its estimate of unemployment peak to 5.4% from 7.8% for 3QCY21 and its estimate of long-term economic scarring to 1.25% from 1.75%. However, it stated that inflation is likely to slightly overshoot its 2% target in 2HCY21 due to temporary factors mostly related to energy prices.

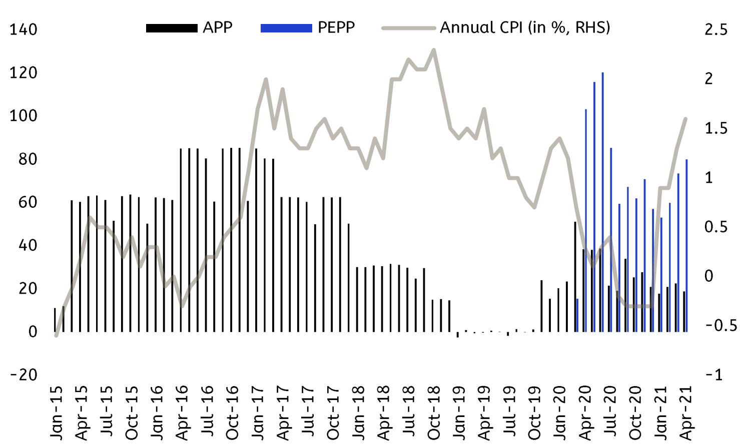
BoE slows bond buying as UK economic recovery gathers pace



European Central Bank accelerated bond buying after temporary slowdown

Compared with Canada's, UK's and US's, EU's GDP is expected to recover at a slower pace of 4.2% in CY21 and 4.4% in CY22, as per ECB estimates. As a result, ECB announced further stimulus in March'21 in the form of significant acceleration in bond purchases under its €1.85tn ($2.2tn) Pandemic Emergency Purchase Programme (PEPP) to shield euro government yields from rising US T-yields and keep borrowing costs for companies, households, and governments across the euro area favourable. The PEPP is due to run until at least the end of Mar'22. At the end of CY20, PEPP amounted to €754bn with public sector accounting for 94%. However, ECB's holdings varied sharply between issuers, ranging, for instance, from 25% for Italian bonds to 44% for Dutch bonds. On inflation, ECB estimates an inflation rate of 1.5% in CY21 and of 1.2% in CY22, well below its mandate of 2% over the medium term.

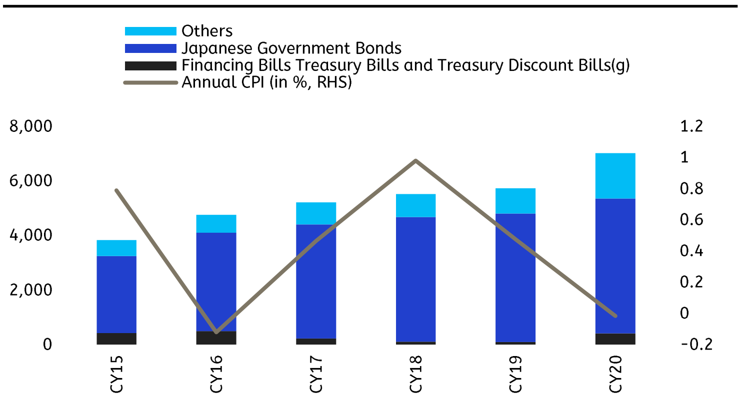
Monthly net bond purchases under APP and PEPP (in €bn) haven't yet returned inflation to pre-pandemic levels



Bank of Japan continues its long quest to revive inflation but with minor tweaks

Contrary to fears of rising inflation the world over, BoJ in March'21 prepared itself to weather a prolonged battle to fire up inflation. In efforts to revive inflation, BoJ widened the band at which it allows its long term interest rate to move by 25bps and stated the possibility of cutting rates deeper into negative territory to encourage lending. To balance the stimulus from its loosening grip on interest rates, BoJ withdrew its explicit guidance to buy ETFs at an annual pace of ~¥6tn (~$55bn) stating that it would buy ETFs only when markets destabilize and that it would target only those linked to the Topix stock price index, thereby removing the Nikkei stock average. As a result, it marked neither a tightening nor an easing of policy, but rather tweaked it to be effective and sustainable in the long run.

As BoJ tapers, inflation remains distant from its 2% target (LHS in 100bn ¥)



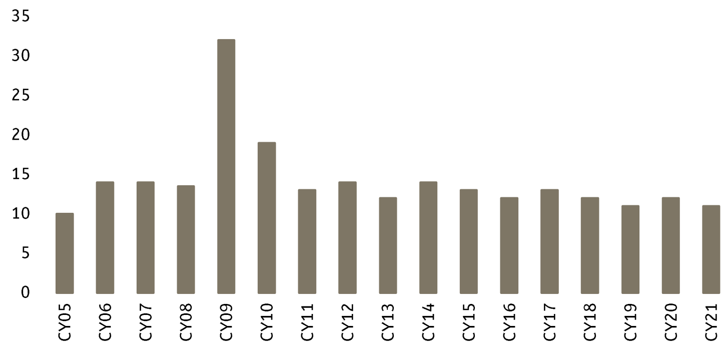
Source: BoC, BoE, ECB, BoJ, Bloomberg

Short Takes on Moves by BRIC Central Banks

People's Bank of China asked banks to limit credit supply for rest of the year

With the coronavirus largely contained and the economy rebounding, PBoC shifted its focus to curb risks, citing worries of bubbles in the nations financial and real estate sectors as well as foreign markets. Subsequently, PBoC asked banks to curtail loan growth for the remainder of CY21 at levels similar to last year of ~11%, the slowest pace in more than 15 years. It further asked banks to focus on lending to areas such as innovative technology and manufacturing. In CY20, banks loaned out ~$3tn of credit, with ~20% directed to inclusive financing such as small business loans. They further advanced ~5tn yuan (~$0.77tn) of new loans in the first two months of CY21, rise of 16% YoY.

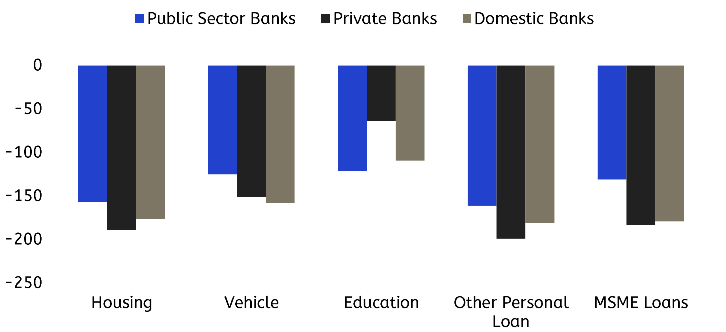
Growth in total loans outstanding (in %) in CY21 restricted to CY20



RBI: Outlook is highly uncertain and clouded with downside risks

With a total of Rs13.6tn ($0.19tn, 6.9% of nominal GDP for CY20-21) liquidity augmenting measures announced between Feb'20-Mar'21, RBI has been relatively successful in keeping borrowing costs low to support a recovery in Asia's third-largest economy. Further to fight the pressure from yield sell-off, RBI announced its G-SAP 1.0 program to purchase G-secs from the secondary market amounting to Rs1tn through 1QFY22, of which Rs0.25tn and Rs0.35tn have been conducted thus far, in Apr'21 and May'21 respectively. Speaking on the new variant of the Covid-19 virus, RBI stated that India's economy has not moderated to the extent it did during the first wave. Touching on normalization of policy, RBI stated that there is "no thinking at the moment", especially with inflation well within the central bank's bandwidth.

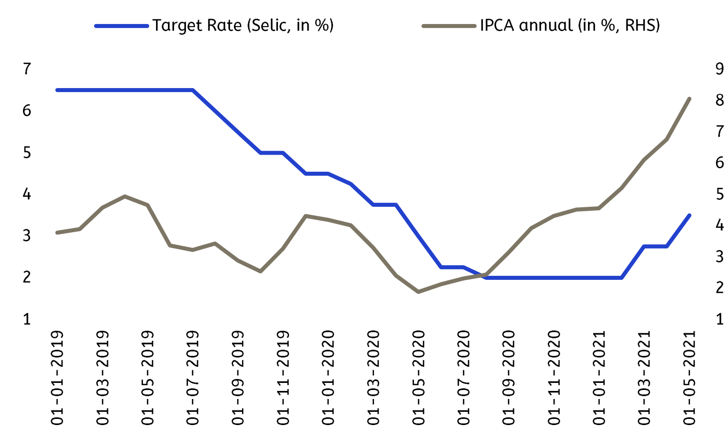
Reduction in key rates resulted in drastic decline in WALR (In bps) on personal loans and loans to MSMEs (variation: Oct'19-Mar'21)



Bank of Brazil in a bold move delivered the biggest rate hikes in a decade

Despite fiscal measures equivalent to 10% of its GDP, the highest among the G20 nations, to battle covid, Brazil's central bank found itself in a precarious position of having to choose between the upside risks to inflation and the downside risks to growth. Having chosen the latter, it sharply hiked rates by 75bps each in Mar'21 and May'21 to 3.5% and indicated another increase of the same size in Jun'21. The bank expects that the bold rise will help to put a floor under the Real, which has followed its 30% decline in CY20 with another 10% decline in CY21 and pushed the 12-month inflation to 5.2%, well above the central bank's year-end target of 3.75%. However, with the world's worst COVID-19 outbreak as on April'21 and a lagging vaccination program, Brazil and its central bank must find the balance to ensure that raising rates to curb inflation do not keep the economy from a much-needed recovery.

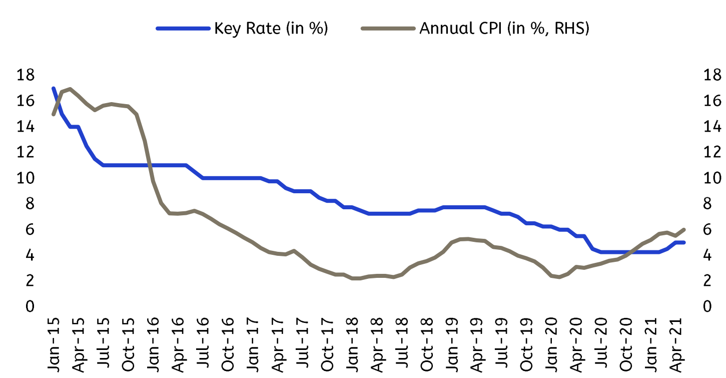
Brazil at risk of steeper rate hikes as inflationary pressures mount



Bank of Russia embarked on monetary tightening cycle to neutral range of 5-6%

Bank of Russia unexpectedly raised its key interest rate to 5% with two successive hikes of 25bps and 50bps in Mar'21 and Apr'21 respectively. It justified the sharp hikes by citing concerns of the real risk of delayed return to neutral monetary policy of 5-6%. It also published a key rate trajectory of average level at 4.8%-5.4% in CY21, suggesting the room for further rate hikes is potentially quite significant. The Bank also raised its guidance on annual inflation, the bank's main focus, in Apr'21 to 4.7%-5.2% from its Mar'21 estimate of 3.7%-4.2% and warned that price growth continued to run above forecast. On the other hand, the Bank kept its economic guidance of recovery to pre-pandemic levels before the end of CY21 unchanged.

BoR unexpectedly raised its key interest rate and warned that price growth continued to run above forecast in CY21



Source: PBoC, RBI, BoR, BoB, Bloomberg

Near Term Outlook

Near term risks to be wary of

- Less than anticipated progress with respect to the pandemic: Growing optimism that Covid-19 is in retreat in US and other advanced economies has been met with sharp contrast of continuing high case numbers in many parts of Asia, where countries such as Bangladesh, Nepal and Sri Lanka are almost out of vaccines. Further, new variants of the virus are testing the efficacy of existing vaccines and pose downside risk to the global economic recovery.
- Financial market stress: Governments and corporations amassed considerable debt in order to weather the global recession triggered by the pandemic. In the current environment of heightened debt levels, financial stress can be trigged by any number of shocks, such as by inflationary pressures that are threatening a rise in borrowing costs.
- Corporate defaults and deleveraging: A combination of support programs, such as loan guarantees and payment moratoria among others, has kept the number of corporate bankruptcies in check. As these programs are gradually withdrawn, there may be an increase in insolvency cases despite economic recovery, especially in those countries where corporate indebtedness is high and weak recoveries threaten profits.
- Policy spillovers: Significant fiscal support could lead to further over-heating of advanced economies resulting in monetary tightening. This will have significant international spillover effects, such as that of the Taper Tantrum(CY13), which was triggered by Fed's announcement to reduce its Financial Crisis(CY08) economic stimulus resulting in a collective reactionary panic across markets and a spike in US T-yields.
- Another oil price war: While strong oil prices have been benefiting oil-exporting low income countries (Chad, South Sudan), they could prompt a rise in global oil supply – in particular from US shale fields. This could result in a failure of the current OPEC+ production cut and lead to sharp increase in supply that weakens oil prices, thereby threating bankruptcy of US shale companies yet again.

Key movements to keep on your radar

- Vaccination rollouts: With the global economic recovery priced in, the market momentum is likely to be driven by vaccination progress, which will guide a more thorough economic re-opening particularly of service sectors, such as hospitality and travel and others that have been impacted by lack of vaccination and consumer cautiousness.
- Post-pandemic consumer behaviour: Recovery in consumer confidence and income unlocked sizeable pent-up demand as households spent their excess savings. The lingering question is whether the adjustments made by consumers during the pandemic will last or whether their behaviour will return to pre-pandemic trends. On the other hand, with new variants of the virus emerging, another question is whether consumers will continue to be wary of future prospects and delay the drawdown of their savings, which is still above historical levels.
- Another fiscal austerity: Never have borrowing costs in the euro-area been so disconnected from risk - Greece, a country that has been bailed out thrice since the financial crisis of '08 and considered a junk asset by all three major rating agencies, is running a negative yield on its 5-yr bond. Fresh bond issuance, supported by accommodative financial conditions, has pushed the debt-GDP ratio of Europe's most indebted countries to historical highs in CY21 – Greece at ~200%, Spain at ~120%, Italy at ~160%, and Portugal at 130%. While EU's stimulus is aiding the recovery of these countries, the question is whether it will generate sustained growth strong enough to meaningfully reduce the debt profile of these countries or result in a sovereign debt crisis once again.
- Clarity from central banks: The group of seven developed economies issued ~$7tn in debt in CY20 to fight the pandemic, most of which came to be owned by their central banks, as per Bloomberg Economics. With asset purchases continuing in CY21, some at significantly higher levels YoY, these central banks now face a challenge of balancing their huge asset piles. Adding to the problem is that governments may now rely on monetary authorities to keep borrowing costs low for longer, while investors may expect central banks to use their buying power to smooth out any volatility in market recovery. However, a strong resurgence of inflation has forced several central banks to take sharp U-turns on their easy monetary policy, thereby stretching out economic recovery. As a result, clarity on the timeline to taper is crucial, especially from Fed and ECB, whose policies tend to adversely spillover to emerging markets and developing economies.
- Market momentum: With US market valuations stretched, as measured by Robert Shiller's TR CAPE ratio, which was at 40.19 in May'21 vs 33.92 in Jan'20, and dividend yields – Robert Shiller – at 1.4%, the lowest since the dot.com bubble, corporate earnings are more important that usual for market performance in CY21. And so far, investor expectations of a swift and impressive rebound from the pandemic have been amply fulfilled. Interestingly, despite big earnings beats by the most-sought after FAANG cohort, its share-price performance has been mediocre YTD CY21. On the other hand, those who have performed poorly compared to expectations have been punished with significant falls in share prices. Similar trends have been witnessed across international markets that like US markets are at high P/Es to historical averages.
- Inflationary threats to corporate earnings: An analysis of the comments of CEOs and CFOs on earnings calls in 1QCY21 has given a clear indication of rising inflation – in US Warren Buffet stated that his company, Berkshire Hathaway, was witnessing 'very substantial inflation' and that higher prices were being accepted. In India, consumer facing companies, from auto to consumer staples, have raised prices of products to protect margins. On the other hand, commodity facing companies, from steel to coffee, are benefiting from rising prices, such as Tata Steel and CCL products in India. Investors may continue to prefer those companies that gain from rising prices or have the ability to absorb them or the pricing power to push the inflationary pressures onto consumers.

Source: S&P Capital, Fed, ECB, OECD, World Bank, Bloomberg

A Checklist for Retail Investors

Key pointers for retail investors to navigate the current market condition

- Be guided by your financial plan: A well laid out financial plan will help determine the required return and risk appetite at a portfolio level. Breaking it down to an asset level thereafter will help define appropriate allocation into various assets, such as equities, fixed income, alternative assets and liquid assets. It will also provide discipline to book profits when return goals are met, especially at richer valuations, and exit positions when risks are exceeded.
- Assess liabilities: Despite brighter prospects, the threat to recovery, due to new strains of the virus and possibility of policy slippages, is still high. Assessing liabilities to identify the hidden costs, such as those of household staff, and current and potential liabilities will help improve balance sheet strength at an individual level and help manage interest and debt coverage ratios. Re-financing existing liabilities at current lower interest rates will also help reduce cash outflow and improve disposable income or increase saving potential for unexpected requirements.
- Manage cash drag: A bane of low interest rates is allocation to cash reduces the compound effect on portfolios, especially when inflation is on the rise. An analysis of the alternatives to savings/bank accounts that have similar low-risk profiles and offer higher returns will help mange cash drag and protect purchasing power against rising inflation.
- Periodically review allocations and rebalance where necessary: With sharp rotations and steep sell-offs across asset classes portfolio allocations measured by market value may also rapidly change. It may therefore be beneficial to adopt either a range-bound or time-based portfolio rebalancing strategy to ensure that the portfolio is on track to meet the long term risk-adjusted return target.

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