MARKET COMMENTARY

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HIGHER BOND YIELDS IN LINE WITH ECONOMIC RECOVERY

Bond yields have increased dramatically in recent weeks, albeit from a very low level. However, Till Christian Budelmann, Chief Investment Officer at the private Swiss bank Bergos, does not see any grounds for departing from his optimistic economic outlook for 2021. On the contrary, he feels the rise confirms his optimism and does not see any risk for the economy from higher financing costs. Although the relative attractiveness of equities over bonds has fallen sharply compared with 2020, it is still somewhat higher than the historical average.

The increase in bond yields is causing some nervousness on the markets. Hopes of reflation combined with fears that central banks may step back from their expansive monetary policy earlier than originally expected have prompted returns on ten-year US government bonds to climb from 0.7% in the autumn of 2020 to roughly 1.6% at present. However, Till Budelmann is not concerned about the effect this trend may have on the economy: "In our opinion, the fact that bond yields are coming back from an extremely low level to a level that is still low is not an obstacle to economic recovery. In fact, it is a consequence of the recovery starting to take effect." According to Bergos CIO Budelmann, returns that are now at a slightly higher level fit much better with the strong economic upswing in the US. After all, the return on US treasuries was 1.9% before the coronavirus pandemic and as high as more than 3% in the autumn of 2018.

Optimism about improved economic performance has also been reflected on the stock markets of late. There is renewed demand for value stocks, while things have been tougher for the long-celebrated growth stocks recently. "Investors are only interested in cyclical value stocks like financial and energy stocks, however; there is less demand for defensive value stocks such as consumer staples or utilities. We are observing a clear pro-risk rotation on the markets", says Budelmann. While this rotation is currently ensuring a certain market breadth, it also increases the risk of potential setbacks, he explains.

HIGHER FINANCING COSTS WILL NOT SLOW ECONOMIC RECOVERY

Nevertheless there is no denying that rising interest rates have an effect on companies' financing costs. "If interest rates continue to rise – especially at a faster pace than expected – this will have a tangible economic impact on some industries like real estate that are sensitive to interest rates." However, Budelmann expects that the rise is more likely to be gradual and moderate. As a result, he does not foresee any excessive restrictions for the economy. Instead he forecasts that the economy will continue to recover, at a faster pace in the US than in Europe, supported by the huge fiscal stimulus on both sides of the Atlantic. In addition, personal savings have increased, and this pent-up demand is likely to be unleashed as soon as current political measures are reversed.

CENTRAL BANKS HAVE HIGHER TOLERANCE FOR INFLATION

One reason for the rise in long-term interest rates relates to expectations around inflation. Special factors such as oil prices and transportation costs are likely to drive inflation significantly in the coming months. There is also hope that the retail and gastronomy sectors will reopen from a certain date and that travel will once again be possible. "But as a general rule, modest inflation greases the wheels of the economy. It's going to take a long time until inflation without the special effects from oil and transportation accelerates to such a degree that the central banks have to intervene", says Budelmann.

In any case, he does not expect central banks to take action for the time being. The US Federal Reserve has already indicated that it will not raise interest rates for now. "Over the past ten years, central banks and analysts have consistently overestimated inflation. The central banks will therefore want to be certain that economic recovery is well under way and inflation is closing in on targets before reducing any incentives. Nowadays, central banks have a higher tolerance for inflation than in the past", explains Budelmann.

EQUITIES CAN WITHSTAND THE RISE IN BOND YIELDS

As yields increase, bonds get more attractive. But they are still slightly behind equities in terms of their appeal. For example, the price-earnings ratio (PE ratio) of the S&P 500, which relates to the expected profits for the next twelve months, is approximately 22-fold. This corresponds to a yield of 4.5% on equities, meaning that there is a gap of almost 3% compared to ten-year bonds. "Although this yield gap is considerably lower than in 2020, it is still somewhat higher than the historical average of 2% to 2.5%", says Budelmann, adding: "Assuming constant yields, interest rates in the US could climb to between 2% and 2.5% in the long term. At that level, equities would then be measured fairly relative to bonds as far as the fundamentals are concerned."

NEW CYCLE WITH A SHORTER LIFE SPAN

The Bergos CIO expects the new cycle to be noticeably shorter than the previous three cycles on average, which in the US lasted for ten, six and ten years respectively. Since the Second World War, the average interval between two recessions has been five years. Budelmann views the fact that the severe recession in the past year was followed by rapid recovery as proof of his assumption: “The US economy is likely to have bounced back to pre-COVID levels within just a few months. We also consider it very realistic that the labour market will improve much more quickly than was thought possible up to now.”

TILL CHRISTIAN BUDELMANN

As Bergos´ Chief Investment Officer, Till Christian Budelmann regularly comments on events on the international capital markets and examines them in the context of economic and political trends. Since 2004, Budelmann has been responsible for various investment strategies and sits on the bank's Investment Committee. He has been Managing Director since 2013.

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