CITĒ GESTION

Newsletter : Brace for Mean Reversion | May 2021

Key Take-Aways

- US GDP growth in the first quarter was 6.4%, much higher than expected.
- With monetary and fiscal policy in full steam, macro data is strong across the board. The US consumer, which represents 70% of the US economy, will continue to support the economy for now.
- Inflation expectations and Treasury yields have spiked. The next move will be a stabilization at lower levels. New spikes can't be excluded but for now we see 10-year Treasury yields back to 1.40% - 1.50%.
- Within equities we see a tale of two worlds: sectors impacted by the pandemic posting huge losses while the IT sector continues to grow earnings.
- In light of the huge fiscal spending plans it might be time to look at opportunities in infrastructure and sectors related to consumers.
- We do not expect big movements within major currency pairs. They have been trading in a range as major central banks are all providing liquidity at the same time.
- In commodities, stocks have outrun the underlying commodity prices. Beware of mean-reversion.
- Markets are at the crossroads of many conflicting factors, which increases complexity and volatility in financial markets – be aware over the coming weeks.

Macro, Fixed Income and Rates : Growth momentum

First quarter economic growth was as strong as expected with Q1 GDP +6.4%. The price index component rose by +4.1%, above the expected 2.6%, implying that nominal growth was higher than expected.

The main themes in the investment world are strongly supportive of growth.

Given the extremely loose monetary policy, generous fiscal stimulus, the impressive vaccine rollout and the drive to herd immunity and the re-opening of the economy, inputs for a robust recovery are clear.

There will, however, be a sober reckoning and these inputs are clear as well. At some point, fiscal stimulus will come to an end. Taxes will be raised as excessive debt obligations will need to be paid.

Even so, for now and thanks to the huge fiscal stimulus, consumer spending, which represent nearly 70% of GDP in the US, is the driver.

In the first quarter alone, auto & light truck sales were up at a 17% annualized rate. Retail sales (ex auto) rose by a stunning 29% at an annualized rate. Residential housing is up over 18% with ample room to run as there is a shortage of homes in the highest growth, lowest taxed states, and increased demand for larger homes outside city centers.

The bond market is moribund. Investors continue to migrate to spread-products in a yield hunting mode.

Government bond yields everywhere refuse to rise to higher, uncomfortable levels because central banks remain the patient, steady, and indulgent buyers.

Inflation concerns heard in the media, and from Wall Street, seem not to be shared by bond investors. Despite enduring obvious price-increases, and a high probability of increased deficits, investors have yet to embrace long term inflation expectations above 2.5% Y-o-Y for the next 10 years. (This analysis is derived using the implied probability inflation caps and floors with a strike CPI of 2.5% Y-o-Y).

This brings to mind perhaps the greatest correlation in all of finance, that long term interest rates follow long term inflation. These will both soon revert back to their long-term downward trends.

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	4 182	-0.69	0.05	5.27	5.27	11.35	20
Nasdaq	14 007	-0.53	-0.07	5.74	5.74	8.68	28
Russell 2000	2 277	-0.80	0.23	2.54	2.54	15.30	26
Euro Stoxx 50	3 978	-0.47	-0.88	1.50	1.50	11.97	16
Stoxx 600 EUR	438	-0.26	-0.32	1.87	1.87	9.68	16
FTSE 100	6 975	0.19	0.52	3.89	3.89	7.96	13
SMI	11 022	-0.52	-1.59	-0.23	-0.23	2.98	16
NIKKEI 225	28 813	-0.83	-1.29	0.00	-1.25	4.99	18
CSI 300 China	5 123	-0.79	-0.23	-0.00	1.49	-1.68	13
MSCI EM Index	1 365	-0.03	0.85	3.65	3.65	5.67	13

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	4 182	-0.69	0.05	5.27	5.27	11.35	20
UTILITIES	337	0.10	-0.46	3.53	3.53	5.54	18
ENERGY	375	-1.93	4.42	1.27	1.27	30.91	16
TELECOM	257	-1.09	2.68	7.43	7.43	15.83	20
CONS STAPLES	711	-0.35	-0.45	1.63	1.63	2.09	20
REAL ESTATE	266	0.06	0.58	7.53	7.53	16.54	49
CONS DISCRET	1 436	0.30	0.93	7.08	7.08	10.23	28
MATERIALS	521	-1.14	-0.04	5.24	5.24	14.25	19
HEALTH CARE	1 413	-0.34	-1.92	3.84	3.84	6.69	16
INFO TECH	2 462	-1.06	-1.76	5.60	5.60	7.44	25
FINANCIALS	602	-0.90	2.44	6.47	6.47	22.82	14
INDUSTRIALS	860	-0.88	0.12	3.33	3.33	14.69	21

Currency % Change	Price	1 day	5 days	MTD	QTD	YTD
DXY	91.267	0.72	0.45	-2.11	-2.11	1.48
EUR-USD	1.2032	-0.73	-0.54	2.57	2.57	-1.51
USD-JPY	109.32	0.36	1.32	-1.28	-1.28	5.55
USD-CHF	0.9130	0.48	-0.11	-3.35	-3.35	3.04
EUR-CHF	1.0986	-0.29	-0.61	-0.77	-0.77	1.58
GBP-USD	1.3816	-0.92	-0.43	0.24	0.24	1.07
EUR-GBP	0.8709	0.18	-0.07	2.27	2.27	-2.63
JP EM FX Index	56.93	-0.58	0.06	1.41	1.41	-1.71

10 yr Yield Bps Change	Price	1 day	5 days	MTD	QTD	YTD
US	1.63	-0	8	-11	-11	72
Germany	-0.20	-1	6	9	9	37
UK	0.84	-0	10	-1	-1	64
SWITZERLAND	-0.20	-2	5	8	8	35
Japan	0.10	-0	3	0	0	8
US IG Spread	97	1	-3	-1	-1	-5
US High Yield spread	238	-5	-14	-11	-11	-89
EUR High Yield spread	309	-4	-7	-14	-14	-42

Commodity % Change	Price	1 day	5 days	MTD	QTD	YTD
BBG Commo Index	89.8	-0.39	1.60	7.63	7.63	15.07
Gold Spot $/OZ	1766.9	-0.30	-0.58	3.46	3.46	-6.93
Crude Oil WTI	63.4	-2.48	1.96	7.17	7.17	30.67

Volatility	Price	1 day	5 days	MTD	QTD	YTD
VIX	19.0	1.39	1.67	-0.40	-2.06	-3.75

Source: Bloomberg 30.04.2021

Equity : a tale of two worlds

Stocks are priced for perfection in an imperfect world. Take airlines for example: average domestic US airfares rose 6% to $261 from the pandemic low, but they are still 27% below the pre-pandemic high of $361. 31mn people flew in the US in Q1, which is 27mn more than in the pandemic's worst quarter, but its still a 67% drop from the pre-pandemic number of 86mn.

The 1Q21 earnings season clearly shows the impact on financials of related industries. Boeing, for example, burnt through $3.68bn cash in the first quarter and posted a loss of $1.53 per share, worse than expected.

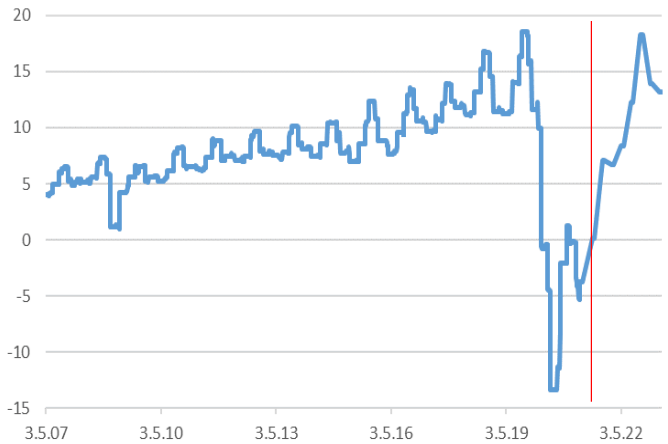
Of course equity markets are forward looking, nevertheless some sectors now seem overpriced. In the sectors of corporate America where innovation happens and the evolution towards an increasingly technology-led society is being made, the picture is quite different, however.

Apple's 1Q21 revenues grew by 54% YoY to $89.6bn in the first three months of the year. The gross margin was $38.08bn with cash and cash equivalents rising 6.8% YoY to $38.47bn. Amazon's first-quarter revenues rose by 44% YoY to $108.5bn. Net income for the period came in at $8.27bn and EPS rose by almost 40% to $14.48. Amazon's Web Services, the cloud division, posted sales 32% up to $13.5bn and the company's ads segment posted sales up 77% to $6.9bn.

About 90% of S&P 500 companies have reported and so far all sectors have beaten analysts' estimates in sales and earnings: We are witnessing one of the strongest quarters ever in the US... In Europe, the picture is only slightly less good: in the Euro Stoxx 600 index, where about 70% of companies have reported, the energy sector missed sales estimates on average and consumer staples and communications posted negative surprises in earnings. All other sectors beat estimates.

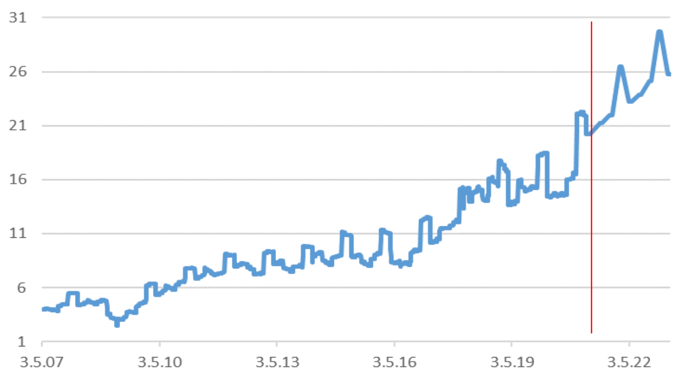
We continue to believe that with yields stabilizing after rebounding from the pandemic-lows, there are chances that higher-growth sectors such as IT will outperform again. All else being equal, the real danger for the FAANG stocks is regulation. With a quickly expanding government in the US, this risk may materialize sooner rather than later.

S&P 500 Hotels Restaurants & Leisure Industry – (expected) earnings per share



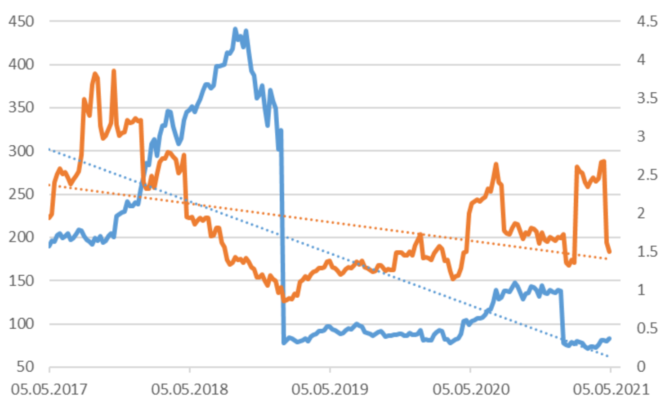
Source: Bloomberg

S&P 500 Information Technology Sector – (expected) earnings per share



Source: Bloomberg

Amazon - P/E (blue, LHS) vs. PEG (orange, RHS)



Source: Bloomberg

FX and Commodities: FX in a tight range & low volatility

The bear argument on the dollar is an isolated, single-currency argument which, in this era of central bank activism, is rendered irrelevant. .

Excessive indebtedness and demographic disruptions are long term trends expected to weigh on the U.S., with similar trends anticipated in Japan and Europe

It seems like competitive global trading networks would prohibit any of the big three currencies to depreciate, relative to the others, by any more than about 5%.

Any weakness beyond that would give the dollar tremendous trading advantages against developed nations, and at the same time would excessively punish commodity-exporting, developing nations.

EURUSD has spent 11 months in the 1.17-1.23 range with volatility down more than 2%. We expect the major F/X market to remain a low volatility trade for the time-being. Our beloved central planners, after-all, are in this together.

Commodities are much more exciting.

Copper: A hedge against inflation?

Freeport McMoRan is the dominant copper producer for the U.S market. The stock went up 400% year-on-year.

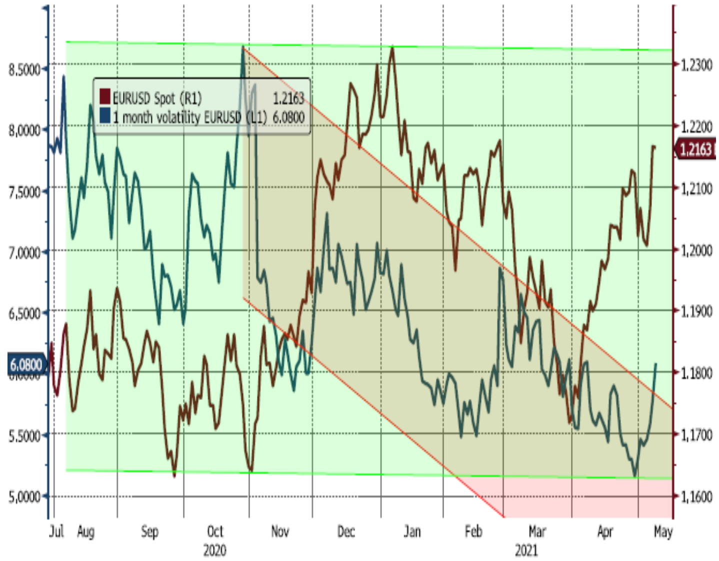
Copper over the same time frame was up 25% in 2020 and 100% year-on-year.

The three leading sectors of the economy, housing, autos and technology are all major consumer users of copper. That trend will continue.

Maybe, on a percentage-increase basis, the price of copper could catch up to Freeport but we doubt it. We would expect the shares to revert to the mean.

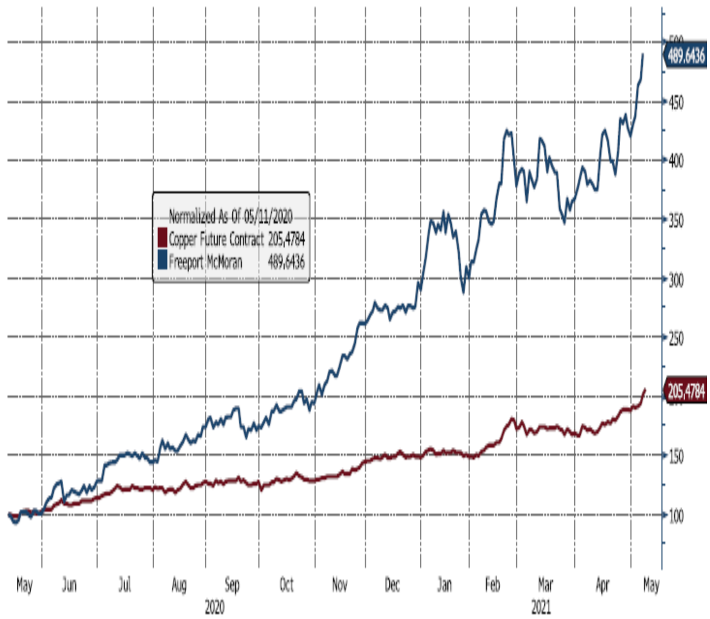
On top of it, copper and many other commodities are facing hedge fund demand as a hedge against inflation.

Gold is negatively correlated to real yields, which are negative. If they go positive, Gold will fall.



Source: Cité Gestion

Demand for commodities may extend.



Source: Cité Gestion

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