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UOB Investment Insights

Quick Note

26 February 2021

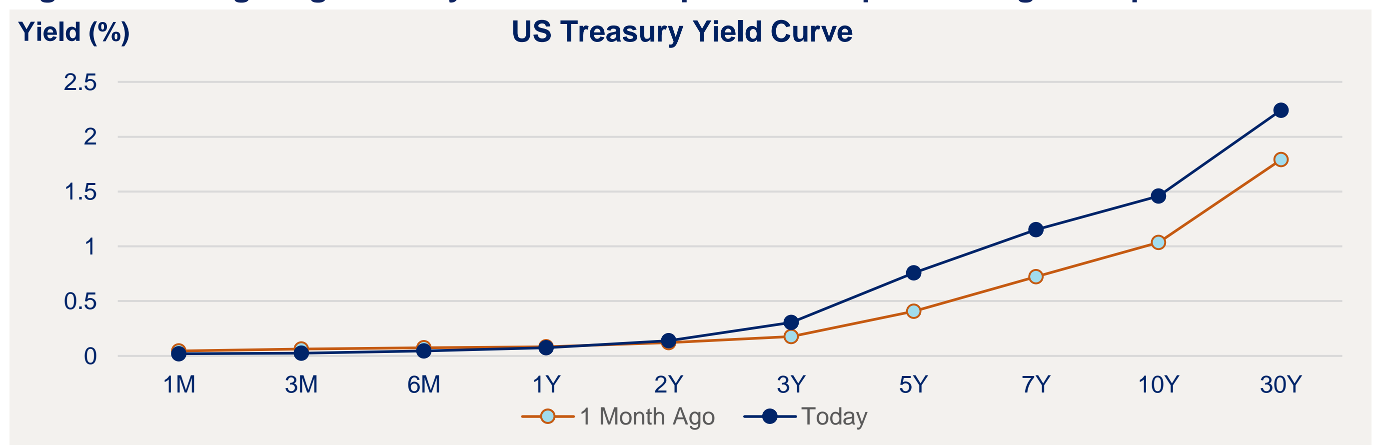
What Should Equity Investors Know About Rising Bond Yields?

- Concerns over rising inflation and central banks withdrawing liquidity has led to a sell-off in equity prices, especially in growth sectors like Technology.
- However, we do not expect central banks to reverse their loose policy stances in the near-term for fear of upsetting the still-fragile global economic recovery. Hence we remain positive on equities in general, and suggest that investors remain invested to ride through this bump.
- Investors can consider being more diversified to reduce portfolio volatility and/or to tap on specific opportunities arising from this rising yield environment, in line with your risk appetite.

Inflation jitters

- Equity markets globally have been increasingly volatile as the longer-term government bond yields continue to rise on higher inflation expectations that have been brought about by an expected global economic recovery and US President Biden's expected US$1.9 trillion stimulus package. Asian equity investors have become increasingly concerned with China's central bank withdrawing liquidity from the system in the past weeks.
- Rising bond yields are to be expected as the global economy recovers from last year's contraction. Long-term yields, such as the 10-year US Treasury yield, are being monitored as proxies for inflation expectations. Higher bond yields typically point to higher inflation expectations, which will in turn continue to push bond yields even higher.
- The recent rise in longer-term interest rates, such as the 10-year rate, negatively affects equity valuations. This has led to overall lower stock prices, especially in the growth equities space.

Figure 1: Rising longer-term yields over the past month point to higher expected inflation



Source: Bloomberg, as at 1145H Singapore time on 26 February 2021.

Figure 2: Market reactions

	Name	25 Feb 2021	26 Feb 2021
US Equities	S&P 500 Index	-2.45%	+0.07%*
	NASDAQ Composite Index	-3.52%	+0.12%*
European Equities	STOXX Europe 600 Index	-0.36%	+0.20%*
	FTSE 100 Index	-0.11%	-0.95%*
Asian Equities	Nikkei 225 Index	+1.67%	-2.39%
	Shanghai Composite	+0.59%	-1.82%
	Straits Times Index	+1.67%	-1.05%
US Government Bonds	US Generic Govt 2 Year Yield	+4.90 bps	-3.33 bps
	US Generic Govt 5 Year Yield	+21.93 bps	-6.44 bps
	US Generic Govt 10 Year Yield	+14.43 bps	-6.38 bps
Currencies	US Dollar Index Spot	-0.05%	+0.09%
	USD-JPY Cross-Rate	+0.323%	-0.20%
	EUR-USD Cross-Rate	+0.07%	-0.07%
	USD-CNY Cross-Rate	-0.03%	+0.20%

*denotes futures prices as at time of writing
Source: Bloomberg, as at 1145H Singapore time on 26 February 2021.

A policy-driven market

- Central banks like the US Federal Reserve (Fed) and the European Central Bank (ECB) have recently said that they do not see inflation as a near-term concern. Rather, a **premature withdrawal of COVID-19 support measures will be considered a bigger threat to the global economic recovery**. With the Fed shifting to average inflation targeting, i.e. allowing for inflation to exceed 2.0% for periods of time, and with Eurozone inflation still near-zero, these central banks will likely **continue to keep interest rates low** to avoid derailing the still-fragile recovery.

- A slightly different narrative is happening in China with it emerging as the first major economy to recover from COVID-19's effects and **getting back on track in terms of growth**. The People's Bank of China (PBoC) has to reduce liquidity to prevent asset bubbles from forming, and has opted to do so subtly via open-market operations (OMO) such as repo rates, while keeping its broad-stroke loan prime rates (LPRs) constant to avoid undesirable outcomes on the broader economy. With 2021 being the 100th anniversary of the founding of the Chinese Communist Party, as well as the start of the 14th Five-Year Plan, the PBoC will be **extremely cautious and sensitive** in policymaking to avoid upsetting the economy. Markets will also look to next week's **"Two Sessions" (两会)** for clearer directions on China's growth plans.

- We continue to **remain positive on equities** this year, and **slightly positive on fixed income**, as we expect the global economy to recover strongly after last year's contraction. However, the road ahead will not be smooth due to ongoing concerns over (i) COVID-19 vaccine efficacy rates, (ii) high equity valuations in specific growth sectors like Technology, and (iii) the abundance of liquidity, which has resulted in outsized market swings due to investors' fear of missing out and a subsequent bandwagon effect.

- In the near term, within equities, we remain positive **on Asia ex-Japan equities**, **particularly China**, for its strong recovery and efforts to build on its domestic growth. We also like specific sectors that will benefit from economic reopening, like **US financial equities** and **US consumer discretionary equities**. In fixed income, we continue to prefer **Asian investment grade bonds** for their better risk-return characteristics over government bonds.

- We also continue to be positive on the **longer-term growth outlook** of our **Megatrend ideas** – Sustainability, China, Global Healthcare, the US and AI & Innovation – which remain intact.

What should investors do?

- **Do not rush for the exit –** We see further upside for equities in general, hence it will be premature to exit the markets now and have to realise possible losses. Consider doing a portfolio review to determine your next steps.

- **Set aside ample cash** to increase your holding power, and consider participating in buying opportunities in specific investment ideas during such market pullbacks.

- **Use our Risk-First approach and ensure adequate diversification across assets classes and regions** to manage potential bouts of unforeseen volatility throughout the year.

- **Investors looking for longer-term sustainable returns** can buy in on market dips to add **core investments** to your portfolio. These include global multi-asset strategies, as well our **Megatrend ideas**, which will continue to drive secular growth.

- **Investors looking to tap on opportunities from rising bond yields** can consider investing in **US financial equities** – which are likely to benefit from the rising net interest margins (NIMs) resulting of higher long-term yields – and **US consumer discretionary equities**, which will benefit from higher consumption as the global economy recovers.

- Please speak to your UOB Advisor to determine the possible courses of action for you in light of these latest developments.

All data are sourced from Bloomberg unless otherwise stated.

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