

J. STERN & CO.

The Value of Long-Term Investing

Investment Insight

INTEREST RATES AND RISK ASSETS

You'll never find a rainbow if you're looking down.

Charlie Chaplin

Last month marked the one-year anniversary of the start of the new equity bull market. It also marked what will probably be a sustained rise of global bond yields. US 10-year treasury yields have risen from a trough of roughly 50 basis points at the beginning of March 2020 to a peak of approximately 175 basis points at the end of March 2021, with a substantial part of this increase taking place since the end of January 2021. Interest rate moves are driven by fundamentals and are often expected but the speed of the upward or downward moves can take investors by surprise. This time was no exception, with a varied impact on risk asset classes as shown below.

Price Moves for Global Risk Assets (Table 1)

Indices or Asset class	19th April 2020-31st March 2021	19th April 2020-26th Jan 2021	26th Jan 2021-31st March 2021
US 10Y Treasury Yield	171.2%	61.2%	68.2%
S&P 500	38.2%	33.9%	3.2%
MSCI World	39.4%	36.5%	2.1%
NYSE FANG	87.5%	96.7%	-4.7%
US Investment Grade Corporate Bonds	3.5%	7.5%	-3.8%
Global High Yield Corporate Bonds	18.7%	19.9%	-1.0%
Emerging Markets Corporate Bonds	14.2%	15.1%	-0.8%

Source: Bloomberg Finance L.P.

The data shows clearly that the recent rise in interest rates has had a greater impact on higher-quality longer-duration securities, with US investment grade bonds and the FANGs (Facebook, Amazon, Netflix and Google/Alphabet) all losing ground with the rapid rises in bond yields. Given investors' exposure to these segments of the market and the strong performance of the FANGs, it has not been surprising to see a rotation to investments that have shorter duration and greater exposure to cyclical.

Looking forward to the rest of 2021 and into 2022, we are left with a number of fundamental questions:

Are rising yields on the back of a faster than expected global economic recovery a signal of the revival of sustained inflation? Or are they just a return to normal following the massive cuts in interest rates by central banks last year and the further post-pandemic monetary and fiscal intervention? Are risk assets now discounting the full recovery of the global economy and are equities in particular expensive and vulnerable to disappointments? How will fixed income assets class be affected, in particular emerging market corporate bonds?

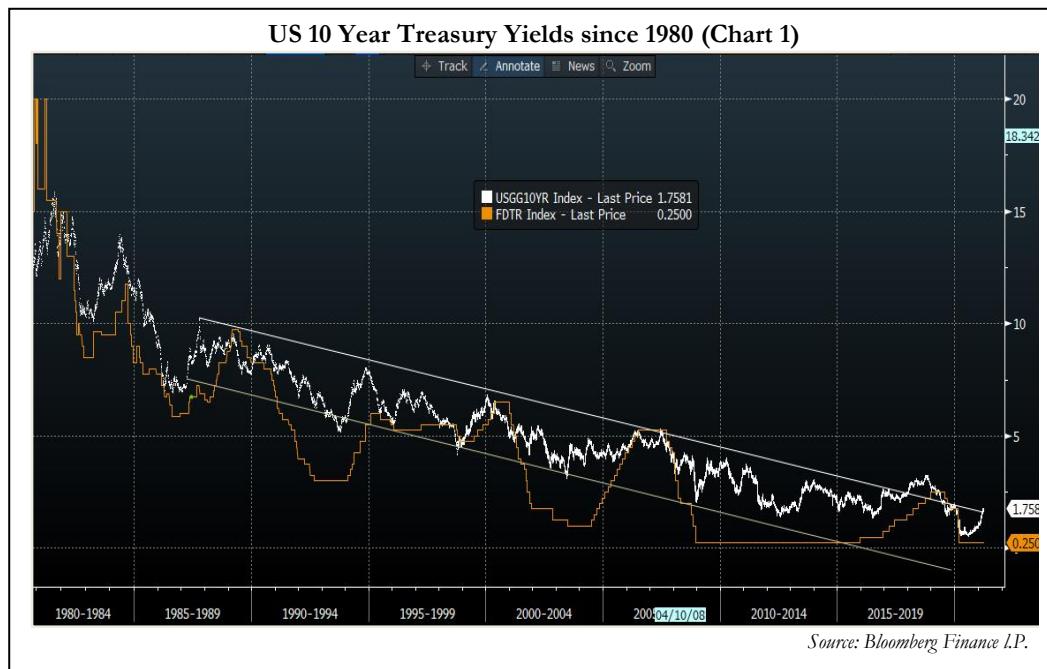
The drivers of higher bond yields are a combination of factors: strengthening prospects of much faster global economic growth facilitated in particular by the fast roll-out of the Covid vaccines in the USA and the UK, supported by accommodative central banks and substantial

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fiscal stimulus packages in many developed economies and accompanied by higher commodity and assets prices.

A chart of US treasury yields since 1980 puts the recent moves in perspective. It shows both the long-term trend in bond yields and interest rates and the more recent correction.



A bounce from the extremely low level reached last year was to be expected. However, we believe that the bulk of the short-term rise in bond yields is probably behind us as markets have discounted higher economic growth and higher inflation expectations. Money markets are already positioned for a rate rise by the US Fed as soon as next year.

While we believe a further medium to long-term rise in yields to levels similar to pre-pandemic is likely, any rise beyond those levels would require substantial policy shifts by central banks that are not currently on the agenda as they balance their worries about economic growth and employment with the credibility they need to fight inflation.

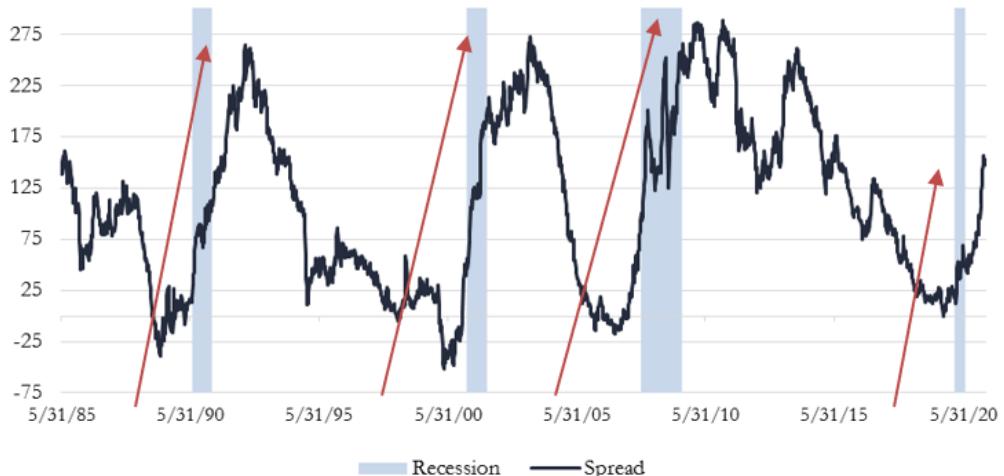
It is likely that we are witnessing a steepening of the yield curve managed by the US Fed, similar to previous post-recession recoveries. Chart 2 shows that as the Fed keeps short-term interest rates low as part of their accommodative monetary policy to support the economy as a whole, long-term bond yields adjust upwards to reflect market expectations for economic recovery and inflation going forward.

That is why we believe that the current rise in bond yields is not a sign of resurging inflation beyond the current mandates of most central banks, but rather a natural adjustment to improving fundamentals. Nevertheless, long-term bond yields are likely to rise further as a collateral effect of the “re-opening trade” and the yield curve steepening as it has in the past. As long as interest rate volatility is contained, we believe that risk assets can weather the adjustment.

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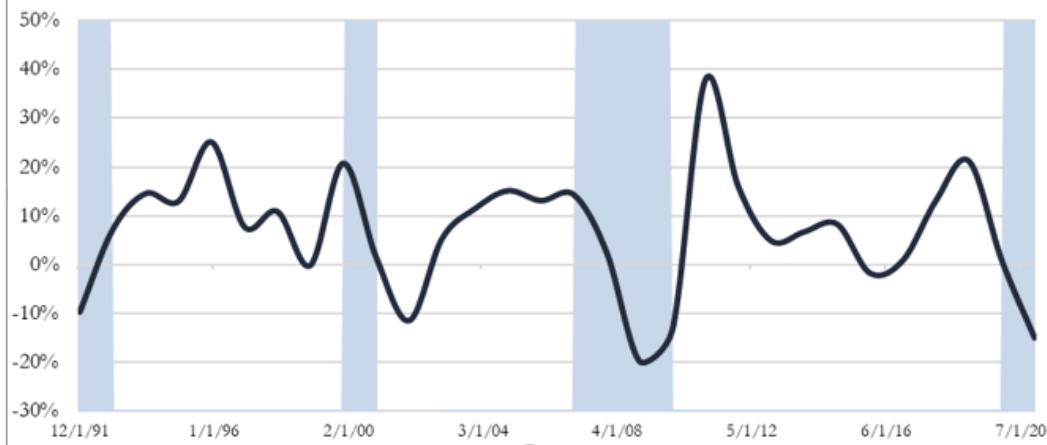
Spread between US 10-year and 2-year Treasury Yields (Chart 2)



Source: Bloomberg Finance I.P.

However, it is worth noticing that following the previous three recessions (1990-91, 2001 and 2007-2009), risk assets and in particular equities enjoyed strong performance (1991-2000, 2003-2007 and 2009-2019). Those gains were the result of robust earnings growth resulting from strong economic growth coupled with lower interest rate environments which supported higher valuations. Since 2000 digital transformation has made a major contribution to earnings growth.

Actual S&P 500 LTM EPS Growth Year on Year (Chart 3)

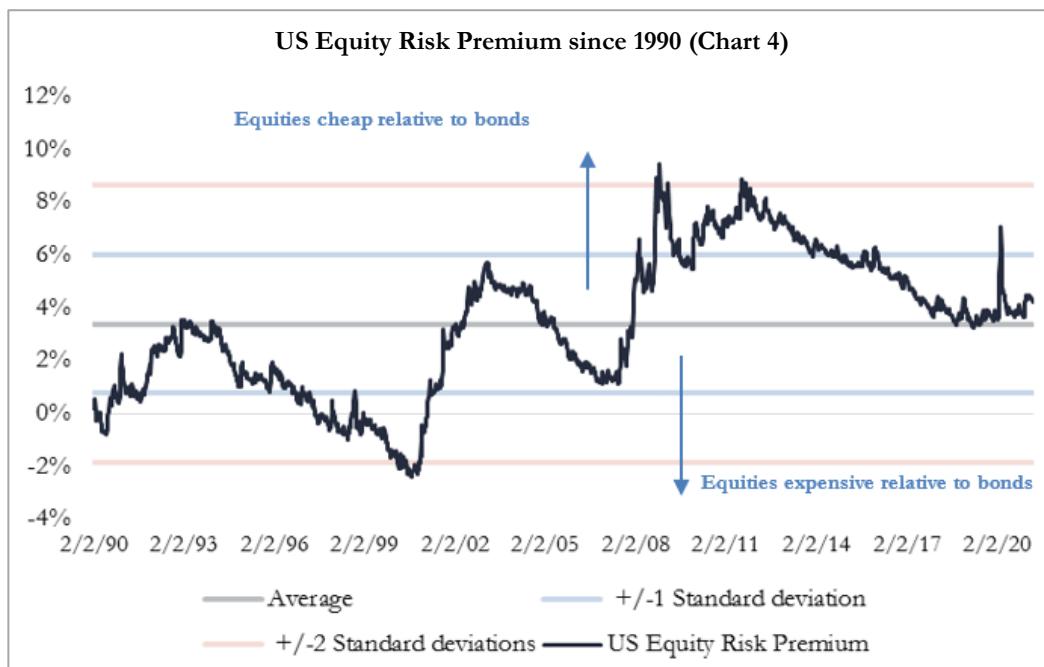


Source: Bloomberg Finance I.P.

We believe that markets are likely on the verge of another earnings cycle (Chart 3) and risk assets expansion. In addition to the ongoing secular drivers of economic growth, the expected cyclical economic recovery and expansion into 2022 and beyond is likely to be strengthened by a post-pandemic resurgence of demand for goods, services and investment and multi-year fiscal support by many governments to support economic growth and debt reduction to

offset the debt incurred to support economies during the pandemic. This environment should result in robust earnings growth and be positive for both equities and corporate debt, specifically for the latter as default rates subside.

The strong recent equity rally from the trough of March 2020 (MSCI World + 39.4%, S&P 500 +38.2%), has led to concerns about valuations. Although current average P/E multiples for major markets are at the higher end of historical ranges, a long-term perspective is again necessary. Over the long term the key driver of valuation is earnings and cash flow growth and whether companies are able to sustain or even accelerate this growth.



Source: Bloomberg Finance L.P.

A compression of the equity risk premium is not a new phenomenon (Chart 4). The current move has been driven by increasing P/E multiples for the broader market and in particular for high-quality and high-growth equities, many of which benefitted from the pandemic due to their underlying business models and resilience. Equity markets and the US in particular benefitted from the search for return through income yield and capital gains as the risk-reward provided by the fixed income market became unattractive and money flows were allocated to equities. Despite strong performance and above-average P/E multiples, the US equity risk premium is only now approaching its long-term average of 4%.

The sharp rise in bond yields over the past few months may make further significant price progression for the broader indices more difficult to achieve short-term, especially if the upward move of bond yields happens too fast. However, companies' fundamentals and their ability to deliver superior earnings growth over the long term will mean that any sell-off or lag will be an opportunity for long-term investors.

As reopening and recovery gathers pace, the interest rates and earnings that drive equity markets will also support credit markets. In March 2020 credit markets suffered from correlated declines with equities as liquidity issues led to price volatility. Despite the equally

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correlated recovery they continue to struggle with the perception that default rates might remain elevated due to the current difficulties.

We believe that a more supportive economic environment will see default rates improve. Combined with the reduction in leverage over the last couple of years (Table 2), it is likely that credit spreads may further tighten, supporting returns for the asset class. Emerging market assets are naturally linked to commodity prices and the recent price increases should provide further support.

Selected Emerging Market Bonds Leverage Ratios (Table 2)

	2018	2019	2020
Sibanye	2.5x	1.3x	0.0x
HIS	3.1x	2.8x	2.3x
Kernel	2.9x	1.9x	1.5x
Sisecam	1.1x	1.0x	0.8x
Turkcell	1.4x	1.0x	0.9x
MTN	1.6x	1.1x	0.9x
First Quantum	3.7x	4.8x	3.4x
Helios	3.6x	2.9x	3.0x
Wom	5.0x	4.0x	3.1x
Rumo	2.2x	1.8x	2.0x
Marfrig	2.1x	2.8x	1.6x
Average	2.8x	2.4x	1.9x

Source: Bloomberg Finance L.P.

Similar to equities, higher bond yields could be an issue despite the lower sensitivity to interest rate, so investors will have to manage duration exposure carefully. Managements have also taken advantage of the low rate environment to refinance existing debt and push maturity out to lock in a lower cost of capital (Table 3). Importantly, absolute debt levels have barely changed as more than 70% of new issuance has been focused on refinance. With moderate maturity profiles, still relatively attractive yields and significant levels of liquidity on the sidelines, we expect to generate compelling returns from the asset class.

Selected Emerging Market Bonds Refinancings (Table 3)

Company	Initial Bond		New Bond			
	Coupon	Duration (years)	Coupon	Duration (years)	Interest Savings	Duration Extension (years)
Millicom	6.00%	7	4.50%	10	1.50%	3
Kernel	8.75%	5	6.75%	7	2.00%	2
Helios	9.13%	5	7.00%	5	2.13%	0
IHS	9.50%	5	8.00%	8	1.50%	3

Source: Bloomberg Finance L.P.

We search for our rainbow like we have done for now many years, investing with a long-term horizon and looking out for high-quality companies with the ability to sustain earnings growth

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and cash flow. With this in mind we feel that our current investments are very well positioned to generate the expected returns for our clients.

*Jean-Yves Chereau
April 2021*

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