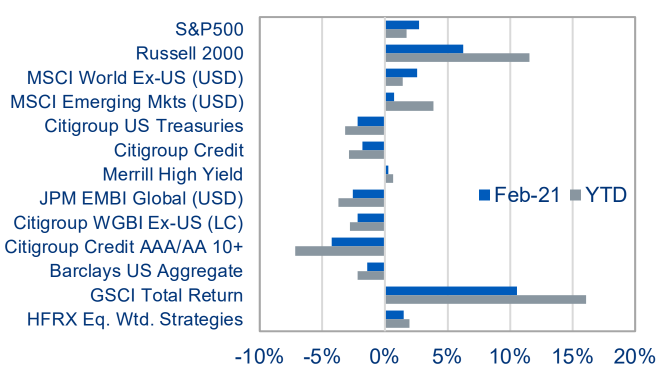
Global Market Review

Macro Summary

The prospect of reflation was the dominant market driver in February. Increased vaccine availability, large stockpiles of household savings, mounting fiscal stimulus, and easy money seem poised to unleash a spike in long pent up consumer demand. Concern that this demand spurt might hit supply constraints as firms encounter production bottlenecks and supply chain disruption fueled fears of rising inflation. This combination of forces sent global equities, commodities, and bond yields higher in February. The prospect of a cyclical economic recovery also triggered a rotation within U.S. equities from growth to value and from large to small cap stocks. Investment grade bonds, especially those at the long end of the curve, fell while high yield bonds managed a small gain. Prospects for resurgent global growth sent oil, industrial metals, and agricultural prices higher.

Performance of Major Market Indices

Sources: S&P, MSCI, FTSE Russell, Barclays, Citigroup, Bank of America Merrill Lynch, J.P. Morgan, HFR, Bloomberg.



Reflation hopes buoy equities but sink bonds.

U.S. Equities Rise with Reflation and Sector Rotation

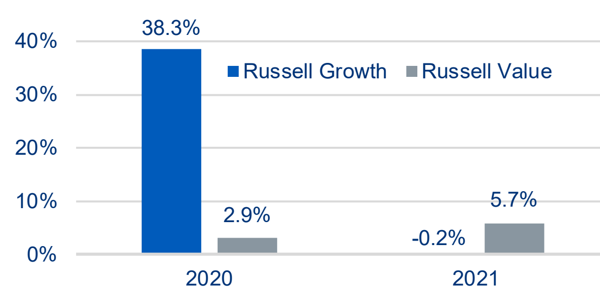
Two leading indicators of U.S. economic prospects – manufacturing and housing – suggest strong growth ahead. The ISM's report on manufacturing sector output recorded a solid gain in February, registering the highest growth since 2004 and the ninth straight month of expansion. New orders from home and abroad grew, while inventories were low, boosting production. Manufacturers encountered production bottlenecks, supply chain disruption, extended lead times, and rising input and shipping costs. Shortages were reportedly especially acute in the case of computer chips with spillover effects on auto production. Industrial metals, including steel and copper, were also in short supply and increasingly expensive to procure, raising concerns of incipient inflation.

The housing sector also showed signs of continued expansion. Spending for residential construction rose in January, the ninth month of growth.[1] Sustained increases in new residential construction typically boost demand for a wide range of products, sending money flowing throughout the economy.

Against this economic backdrop, U.S. equities rebounded strongly in February, reversing January's losses. The S&P500 gained 2.8% in February, touching a record high and bringing the gain in the first two months of the year to 1.7%. Within the U.S. equity market, there was a notable rotation from large-cap growth stocks in the tech sector to their smaller cap, value counterparts. As part of this sector rotation, small cap stocks, which had experienced large gains in January, extended their rally, rising 6.2% in February to bring their total advance in 2021 to 11.6%. Value shares, which had experienced lackluster returns in 2020 as growth stocks surged, have outpaced growth by a wide margin so far in 2021 (Exhibit 1).

Exhibit 1. Sector Rotation: Growth Passes Baton to Value

Source: Bloomberg. Cumulative percentage change.



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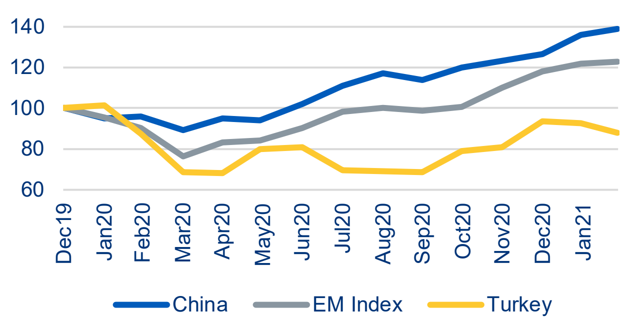
Growth Prospects Send Non-U.S. Equities Higher

As in the U.S., non-U.S. bourses in advanced economies rose in February, erasing January's losses. The MSCI World ex-U.S. index gained 2.5% in February, to bring its return so far in 2021 to 1.5%. European equities are up nearly 1% so far this year, while Japanese equities have gained about half a percent. There was also some sign of sector rotation in European equity markets, with small cap stocks outperforming large. As in the U.S., Eurozone manufacturing output has expanded solidly so far in 2021, benefiting from increased domestic and foreign demand. The strong performance in manufacturing is partially offsetting the effect of renewed lockdown measures on services, which have also suffered because of a slow rollout of vaccines. As in the U.S., the European manufacturing sector experienced shortages, shipping delays, and sharply rising input prices. Supply chain disruption was especially marked in the U.K. due to Brexit.

Exhibit 2. China Leads Emerging Markets Higher
Source: Bloomberg. Index December 31, 2019 = 100.



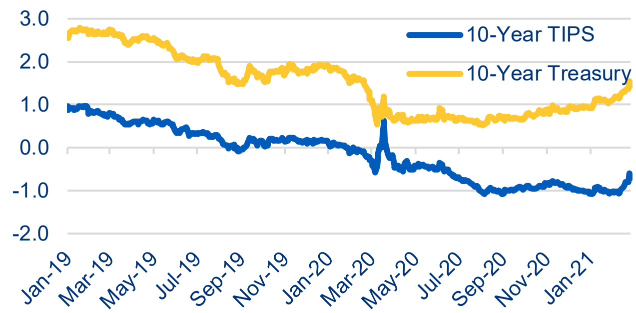
The MSCI emerging markets index rose 0.8% in February, adding to January's solid gains to bring returns so far in 2021 to 3.9%. Emerging markets have gained about 92% since the March 2020 trough, led largely by Chinese markets, which represent about 40% of the Emerging Markets index (Exhibit 2). There continues to be wide dispersion across emerging market regions and countries. Asia leads, largely reflecting China's strength, while bourses in Latin America, which have fallen 9.7% so far this year, have lagged. Some emerging markets, including, among others, Turkey, have heavy debt loads and are vulnerable to financing risks.

Bond Markets Fall as Inflation Expectations Rise

The prospect of a rapid acceleration of growth and signs of incipient inflationary pressure caused the U.S. yield curve to steepen, nominal and real yields to rise, and market-implied inflation expectations to increase (Exhibit 3). Given this dynamic, U.S. Treasuries have fallen 3.2% so far this year, with the 10+-year segment declining 10.2%. Despite recent increases, the real yield on 10-year TIPS remains negative, at about -0.8%. Yields on advanced economy sovereign bonds outside of the U.S. have also risen in 2021, as reflected in the WGBI ex-U.S. index decline of 2.8%.

U.S. investment grade bonds have fallen about 2.2% so far in 2021, with bonds at the long end of the maturity spectrum declining 10.2%. The high yield sector in contrast has managed a small gain of 0.7% so far this year, reflecting the relatively lower duration of the high yield sector and credit spread compression that helped offset the increase in underlying yields. The yield on high yield bonds remains near historic lows.

Exhibit 3. Real and Nominal Yields Increase Further
Source: Bloomberg. Yields in percent.



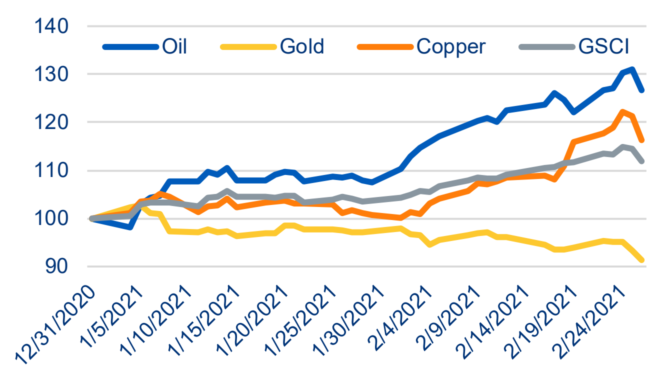
Hedge Funds Gain Despite Short Squeeze

Hedge funds rose again in February, bringing gains so far this year to 1.7%. Merger arbitrage and convertible arbitrage strategies have led other strategies so far in 2021.

Oil and Industrial Metals Soar

Commodity prices are up 16% so far in 2021, reflecting a sharp increase in oil, industrial metals, and agricultural prices. Gold prices, in contrast, have fallen from record highs last year (Exhibit 4).

Exhibit 4. Resurgent Growth Sends Commodities Higher
Source: Bloomberg. Index December 31, 2020 = 100.



Performance of Major Market Indices through 02-28-2021
Sources: MSCI, FTSE, Barclays, Citigroup, Bank of America Merrill Lynch, J.P. Morgan, S&P GSCI, HFR, Bloomberg.

	1-Month	QTD	YTD	1-Year	3-Year	5-Year
S&P500	2.8%	1.7%	1.7%	31.3%	14.1%	16.8%
Russell 2000	6.2%	11.6%	11.6%	51.0%	14.9%	17.9%
MSCI World Ex-US (USD)	2.5%	1.5%	1.5%	22.1%	4.8%	9.8%
MSCI Emerging Mkts (USD)	0.8%	3.9%	3.9%	36.0%	6.4%	15.2%
Citigroup US Treasuries	-2.2%	-3.2%	-3.2%	-0.5%	4.8%	2.5%
Citigroup Credit	-1.8%	-2.9%	-2.9%	2.9%	6.8%	5.7%
Merrill High Yield	0.3%	0.7%	0.7%	8.6%	6.2%	8.8%
JPM EMBI Global (USD)	-2.6%	-3.7%	-3.7%	1.0%	4.4%	5.6%
Citigroup WGBI Ex-US (LC)	-2.2%	-2.8%	-2.8%	-2.0%	2.5%	1.7%
Citigroup Credit AAA/AA 10+	-4.3%	-7.2%	-7.2%	-0.6%	9.4%	7.4%
Barclays US Aggregate	-1.4%	-2.2%	-2.2%	1.4%	5.3%	3.6%
GSCI Total Return	10.6%	16.0%	16.0%	8.4%	-3.5%	2.6%
HFRX Eq. Wtd. Strategies	1.2%	1.7%	1.7%	8.5%	2.4%	3.6%