XO INVESTMENTS

MONTHLY COMMENT

February 2021

MARKET REVIEW

The rise in interest rates boosts equities but implodes bonds

February posed the questions about interest rate rises and the possible return of inflation. The upward market momentum established since the summer continued. , with an increase of 30 basis points, even the Swiss 10 year bond contributed. This has had a negative impact on the global bond markets, which have fallen by 1.5% since the beginning of the year.

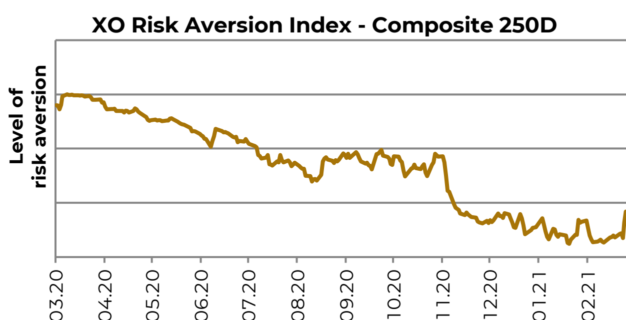
For the time being, this upward trend in interest rates is not having an impact on the equity markets. Despite a slight decline at the end of the month, they are still performing well. However, if the rise were to continue, it may eventually impact the valuation of equities.

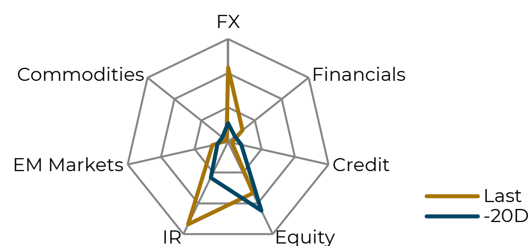
The rise in interest rates reflects inflationary fears. Not surprisingly, crude oil is on the rise giving oil stocks upward momentum

Foreign currencies appreciate against CHF, while real estate recovers January's loss with a satisfying rebound.

Our risk indicators are rising sharply on currencies and interest rates.

	Value	February	2021
Equity markets			
Switzerland (SMI)	10 522	-0.65%	-1.69%
United States (S&P500)	3 811	2.61%	1.47%
Europe (Euro Stoxx 50)	7 893	4.54%	2.58%
Japan (Nikkei)	28 966	4.71%	5.55%
China (Shanghai SE)	3 509	0.75%	1.04%
Brasil (Bovespa)	110 035	-4.37%	-7.55%
Currencies			
USD/CHF	0.910	2.18%	2.79%
EUR/CHF	1.097	1.46%	1.48%
GBP/CHF	1.266	3.70%	4.70%
EUR/USD	1.208	-0.43%	-1.19%
Other asset classes			
Swiss Real Estate		1.56%	-1.95%
Swiss Bonds		-1.38%	-1.69%
Foreign Bonds		-1.66%	-2.29%
Commodities		10.58%	16.05%
Oil	61.50	17.82%	26.75%
Gold	1 726.50	-6.78%	-8.86%
Rates / Indicators			**Δ**
10 years Swiss rate		-0.19%	0.36%
10 years US rate		1.40%	0.49%
US Unemployment		6.30%	-0.40%
US GDP		-2.40%	0.00%
US CPI		1.40%	-0.20%





TAILS : MONETARY INFLATION, FLIP SIDE : RISING COMMODITY PRICES

While most economists focus on the impacts of inflation linked to central bank injections, inflation through transport costs and commodity prices is already on the horizon.

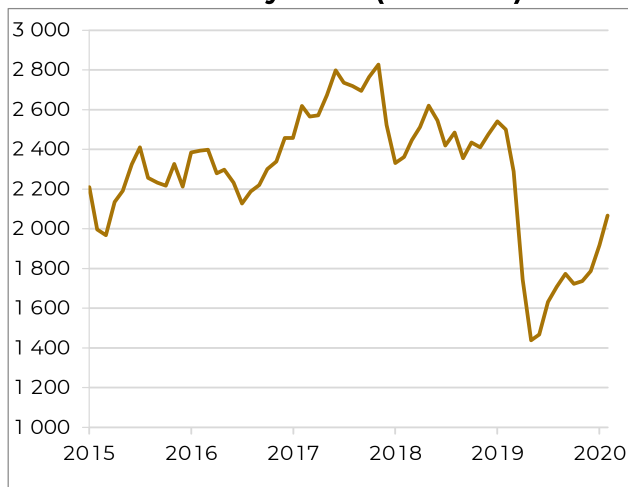
From shortages to price increases

In the spring of 2020, the health crisis brought to light the dependence of the West, and Europe in particular, on Asian production, especially Chinese production. This outsourced production of strategic components, especially electronics, has led to fears of shortages in certain sectors. The increase in the quantity of purchases of goods linked to remote working, such as laptops, is one of the reasons for these shortages, but they can affect almost all parts of our industries (aeronautics, automobile, etc.).

Upstream of these supply chains, fundamental commodities are also affected, such as the so-called rare earth metals needed in electronics or carbon emission efficient technologies,.

After the initial fall in March, all raw materials have begun a significant recovery in terms of price due to these availability problems. Large differences are noted between the different raw materials (precious metals, energy, agricultural products...) but the trend is globally positive.

Commodity Index (S&P GSCI)



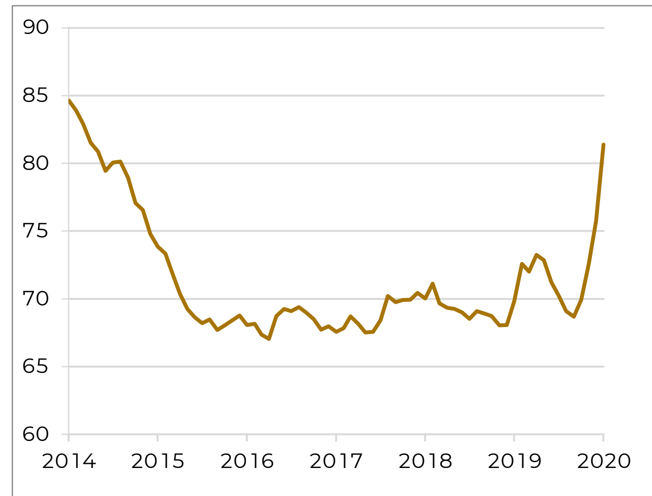
Source : Bloomberg, XO Investments SA

Increased transport costs

With supply chains under pressure for the past year, it is also not surprising to see a major increase in transport costs.

With the crisis, container prices, which had remained extremely low between 2016 and 2019, are back to their highest level in 6 years

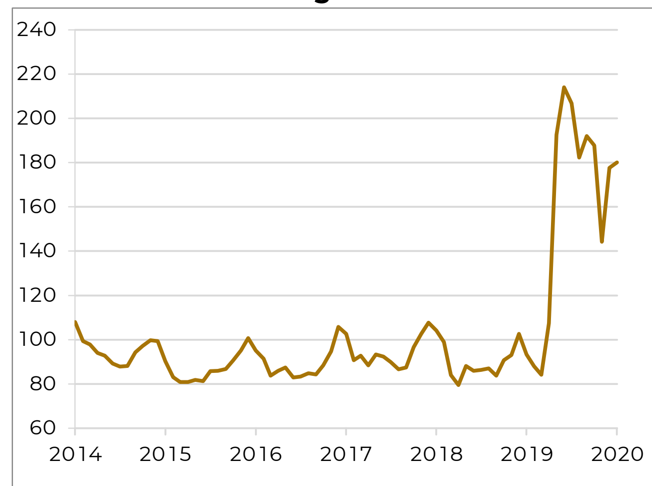
World Container Price Index



Source : CTS, Bloomberg, XO Investments SA

Air freight statistics are even more striking due to the collapse of passenger traffic, which effectively reduces the transport capacity for certain goods.

Air freight index



Source : Drewry, Bloomberg, XO Investments SA

Represented by the Drewry index combining 8 east-west routes, air freight has seen its prices double. It now costs about $5.5 per kilogram transported. This is the highest level ever observed.

Thus European countries are not only dependent on Chinese production, availability and price of raw materials, but also on the quality, speed and cost of transport. The political will to repatriate certain production to the

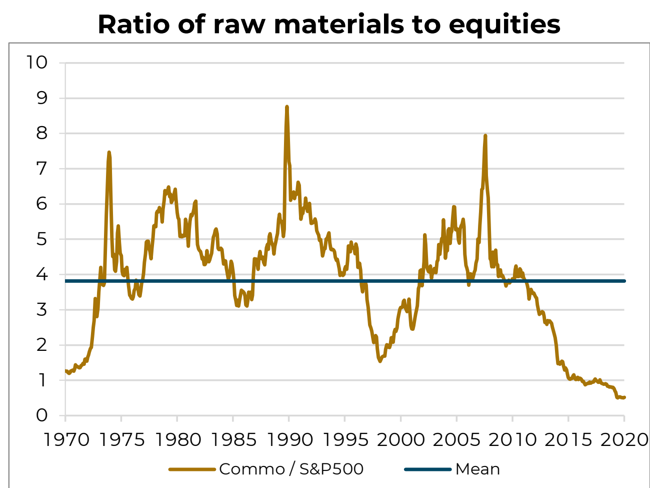
consumer countries is attempting to solve this problem. However, this political will comes up against the free trade agreements. For example, in February the European Commission refused to apply a progressive VAT rate based on the distance between the place of production and the place of consumption.

The increase in the cost of transporting goods can be seen as the second inflationary element arising from the crisis we are experiencing, the first being the increase in the price of certain raw materials. Inflation is not necessarily or only a wage phenomenon where all wages rise and allow prices to rise. Inflation can be imported via the increase in transport costs or raw materials.

The beginning of a cycle favourable to raw materials?

Raw material cycles are long, very long, as are rate cycles. One way of representing these major trends is to put commodity prices in perspective with stock prices.

Ratio of raw materials to equities



Source : Bloomberg, XO Investments SA

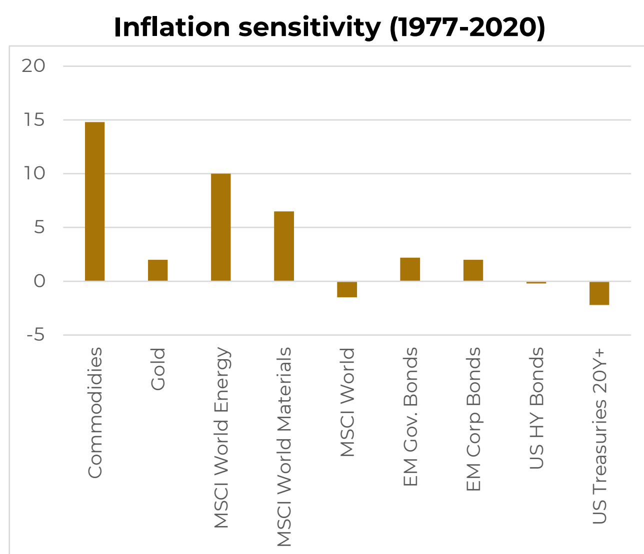
We are currently at an all-time low, comparable to the period of the internet bubble or the early 1970s before the oil shock. A low ratio that could therefore progress. This doesn't mean that stocks will fall but that the ratio may move in the opposite direction to what it has been so far. In other words, the upside potential of this ratio is important. It can be done in two ways: commodities fall less than equities or commodities rise more than equities. In historical average, to return to the long-term average, a factor of 8 is possible, i.e. a movement 8 times greater for commodities than for equities for example.

Portfolios to be adapted

At the end of the long deflationary period that we have just experienced, the hypothesis of inflation's arrival implies adjustments in portfolios. In order to represent the changes to be made we can use the inflation sensitivity of each asset class, i.e. the way in which the asset classes react to inflation.

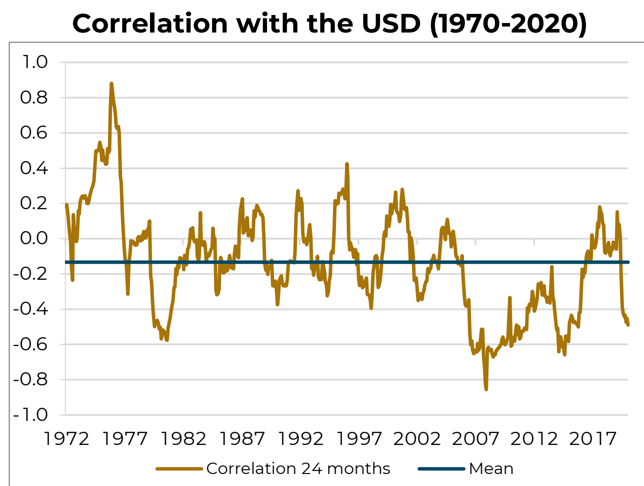
Commodities are the most inflation sensitive asset class. If central bank injections continue and inflation materialises, it is the latter that have the greatest positive sensitivity to inflation. Thus, with a sensitivity (beta) of 15, every inflation point implies on average a 15% increase in commodity prices, which is on average much better than all assets. Equities linked to commodities (oil or mining) are the stocks that benefit the most from this dynamic. Bonds are the asset class that is the least favoured during this period. However, there are major differences. Emerging bonds have a positive sensitivity to inflation while long-term government bonds are penalized in inflationary periods.

Inflation sensitivity (1977-2020)



Source : Sarasin, XO Investments SA

Correlation with the USD (1970-2020)



Source : Sarasin, XO Investments SA

In monetary terms, the correlation between the USD and commodities is negative in the long term. Since all commodities are valued in US, inflation will therefore be positive for commodities but negative for the USD. The USD is therefore the currency to be limited in a portfolio in an inflationary period.

Conclusion

The health crisis may appear in 20 years' time as the trigger for a change in monetary polarity. From a deflationary world we are probably heading towards an inflationary cycle with raw materials whose prices are rising and transport costs that are increasing. This is not without consequences on the construction of a portfolio of securities which must now adapt to this new situation since most portfolios, particularly institutional ones, do not include commodities in their strategic allocation.

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