fLAB

It´s All About Asset Allocation

October 2021, Newsletter#65

The **cascading of bad news** by the end of September was finally too much for what had been an historically resilient stock market. Global supply chain disruptions, soaring energy prices, stalled infrastructure bills, inflation fears, and looming Fed taper – finally weighed on the market. Since the Fed released at the end of the month, its latest policy statement signaling it could start scaling back its bond purchase program as early as November and begin raising rates by the end of next year, the 10-year Treasury yield and the 10yr-2yr Treasury yield curve have risen to their highest levels since June. For equity investors, **the most relevant question is "when will rising bond yields impact the stock market"?** the answer is twofold: First, for the broad market, there is some margin before the bond market derails the equity bull market, but, not nearly as much as last year. Second, the rise in bond yields is already driving leadership trends, with cyclical Value and small-caps outperforming. Bigger picture, the rotation appears to be part of a reopening 2.0 trade (with COVID cases declining, hope for vaccines for children under 12…) which should be shorter and smaller than the 1.0 version of late-2020/early-2021.

We are closely watching at three indicators for signs that bond yields are becoming problematic for the stock market:

- The yield curve: Too steep of a curve implies that inflation is getting out of control and the Fed may have to tighten quickly (150-basis point threshold has been the demarcation line between Goldilocks and too hot historically) . These days, the 10-2 yield curve is over 120 basis points, implying some cushion, but not nearly as much as there was in the early stages of reopening 1.0.
- Speed maters: With long-term interest rates being so low by historical standards, almost any relative valuation comparison favors stocks over bonds. Even so, if we look at the past 20 years, we will see that the speed of any jumps in bond yields has mattered. For the time being is not worrisome but a quick yield spike could have bearish implications.
- Correlation dropping: Recently, the rolling one-year correlation between the daily change in the S&P 500 and 10-year Treasury yield fell as low as 0.07, its lowest level since July 2007. A sustained period of negative correlation between stock prices and bond yields would imply inflation fears are more than transitory and the Fed may need to tighten policy quicker than it has previously signaled. Stock/bond correlation signals growing inflation concern.

Our current expectation is that the **interest rate advance will not prevent global equities from entering a year-end rally, especially now that the September rise of pessimism** has left global equities oversold and positioned to advance in line with seasonal tendencies.

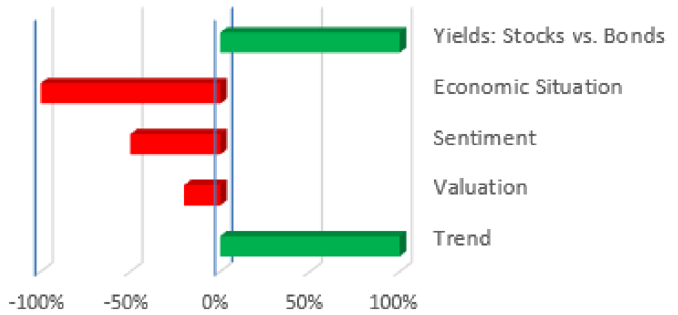
Renewed rallying with improve breadth would confirm a bullish outlook for at least the rest of the year.

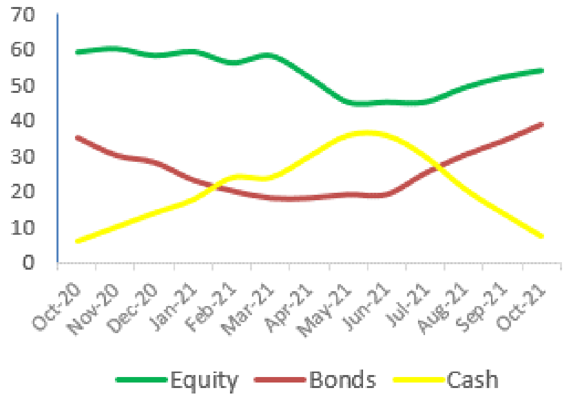
Our Global Flexible Fund, fLAB Core H-USD, has receded in September in tandem with markets, thus performing 5.37% YTD.

For October, our Asset Allocation model gives the following reading: 54% equities, 38% bonds and 8% in cash. Despite a tricky fixed income market ahead, relative strength indicators (such as Trend, Stock Earnings Yield, G7 Leading Indicator Index…) favor bonds over cash.

fLAB Core Asset Allocation Model		oct-21	Benchmark
	Stocks	54%	55%
	Bonds	38%	35%
	Cash	8%	10%

Equity vs. Bonds Relative Strenght by Betalphing 5 Indicators





red (bond & cash preference) green (equity preference)

Equity Regional Allocation vs MSCI World AC			
Europe Ex-UK & Japan	*OW*	*Emerging Mkts, UK & Pacific Ex-Japan*	*UW*
Benchmark (US 57%, Eur 13.4%, Emerg Mk 12%, Jap 7.1%, UK 4.3%, Pacific 3.3%, Can 2.9%)			

Equity World Sector Allocation			
	OW	*Consumer Staples*	*UW*

Government Bond Allocation vs Barclays Global Government Bond Index			
Europe & Japan	*OW*	*US*	*UW*
Benchmark (US 48%, Europe 25%, Japan 21%, UK 6%)			

The **S&P 500 entered its first 5% pullback** in 11 months, ending its 13th longest streak in record. Rotation amongst styles and sectors resulted in mixed returns. Japan led developed markets while China drove emerging markets lower. Global equities (MSCI ACWI in local currency terms) fell more than 3.5%, and Value outpaced Growth. This month, we have upgraded Japan to overweight, joining Europe as our geographical bets. In terms of sectors, COVID has disrupted some of the usually stable interest-rate relationships: bond proxy sectors have been less sensitive since the pandemic began, Cyclical Growth sectors have seen their correlations turn more negative (Technology is the most vulnerable) while Cyclical Value have become more positively correlated (being Financials the most). If the reopening trade gains momentum we could upgrade Financials but as a short-term trade.

In fixed income, yields on key Treasury securities took out important resistance levels. After such powerful movement, a pullback toward these breakout points would not be unexpected. We are monitoring closely the yield curve and our models, in case we have to reduce the duration of the portfolio in the coming weeks (now at 3.40 for the overall fund). We are overweight in Japanese and European government bonds at the expense of US and UK, which could suffer the most. In terms of currency, we have benefited from our real dollar exposure (18%) as the greenback has acted as a safe haven.

Our Relative Return Fund, fLAB Satellite H-USD, has withstood quite well (-0,15%) in spite of bad equity and bond markets performance, keeping a positive return of 1.95% YTD.

The compartment is invested 54% in a low-risk, low-duration diversified fixed income portfolio plus **28% in some decorrelated and tactical positions**, being the rest in cash. In a framework of higher rates , inflationary concerns and a flight-to-safety, the fund has benefited from its 20% dollar exposure (which has appreciated 1.94% against the euro), from a low duration exposure (0.87) and from its tactical bet on European Banks (2.40%), one of the top sectors this month: +4.38% (Energy has been the best by far). Global Commodities have performed very well as a whole (our Longer Dated All Commodities UCITS ETF has appreciated 4.92%) but if we look at more granular level we would find some exceptions such as Gold, which has retreated over 2.6% over that period. On the fixed income side, we would highlight the good behavior of Chinese Government Bonds (3.75% of the portfolio) not only this month but also YTD, totally uncorrelated with global bond markets. The unconstrained bias of this fund will allow us, if necessary, to position with negative duration without forgetting our 3% target volatility.

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10 year Ranking

Total Return	Consistent Return	Preservation	Expense Ratio
4	4	4	5

MORNINGSTAR

10 year Ranking

fLAB Fund SICAV Core A | ★★★★

fLAB Core Awards, June 2021

CITYWIRE GOLD

HIGHLY RATED FUND SharingAlpha

Funds people 2020 A B C

__Note : We remind you that we have launched fLAB Core & fLAB Satellite clean share classes in both EUR and USD__, applying the same management fees as the cheapest Institutional class. Please check new ISIN codes by clicking the links down here.