Reflation Trade

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We seem to be leaving behind a very difficult period that has been marked by the Covid-19 health crisis, which only started a year ago. States pulled out all the stops by implementing ultra-expansionary spending policies in order to mitigate the global economic slowdown. Also, Central Banks applied expansive monetary policies that provoked an unusual situation of very low and negative interest rates, as is the case of Europe. All this at the expense of generating more public deficits. This was an idyllic scenario for fixed income in general. But since a few months ago, this has changed, or rather, the market is starting to rule out a new interest rate scenario.

Looking at the USA rate market, the yield on the USA 10-year government bond has risen from just below 1% since the beginning of the year to almost 1.40%. Regarding Europe, the yield on the German 10-year government bond has moved from levels close to -0.60% to the current -0.30%. Thus, it could be argued that the return of inflation or the equivalent term Reflation Trade, at least in the United States, is already ruled out by the markets. On the other hand, the positive performance of TIPS (inflation-linked securities) in relation to government bonds also confirms investors' bets on an inflationary trend.

What can happen if this recovery scenario of effective vaccination that the market is discounting into occurs as expected?

Some analysts say that the actions of governments and central banks could push economies towards inflation not seen in decades. Others argue that the pandemic is only intensifying trends already seen in recent years when, especially in developed countries, price increases have been absent mainly because of weak economic and demographic growth, as well as strong technological development.

In my opinion, the developments that investors will have to be most concerned about are the rising level of indebtedness in several countries and the increase in the M2 money supply index, which measures changes in the value of all current and liquid cash assets in bank accounts. On the other hand, it is important to note that, with negative interest rates, it is cheaper to refinance debt, but, consequently, an increase in interest rates would have a negative impact on the cost of debt not only for governments, but also for companies and in particular for the most indebted ones.

In this regard, liquidity injections by central banks have stabilised credit spreads and mitigated corporate bond volatility, at least until the bond buyback programmes resume. In conclusion, we believe that we are immersed in a complex environment that requires caution, flexibility and the need to protect portfolios against possible upturns in interest rate curves.

Caution is precisely one of the basic principles of our SIGMA Short Mid-Term EUR fund, where through flexibility in our investment approach we try to preserve our investors' capital and provide them with a solution and/or alternative to holding cash in a current account or deposit. The fund is positioned at the short end of the curve and is therefore less sensitive to rate rallies while avoiding potential current market stresses.

The idea is to position the fund, in terms of risk-return, between pure money market funds and short-term fixed income funds. The fund has a much more flexible investment policy than money market funds and, at the same time, it entails a slightly more conservative management than short-term fixed income funds. 2020 was an extremely difficult year for fixed income and the fund achieved a positive return of +0.29% with a volatility of less than 1%. Although we maintain an active and flexible management of the fund's duration, due to the economic recovery and inflationary pressure, we decided at the beginning of the year to position the fund with a lower duration relative to the positioning implemented throughout 2020. On the credit side, with spreads already at pre-Covid levels and in order not to increase credit sensitivity, we have focused on incorporating shorter maturities. In terms of selection, we base ours on an exhaustive fundamental analysis of each issuer included in the portfolio and we assess the risk-return trade-off relative to the credit risk and seniority range of the issue, as well as on the basis of other issuers in the sector. At present, we continue to see a high credit quality in the fund, as a result of this positioning, the median rating of the portfolio is A-. When making decisions and analysing companies, we also focus on the study of ESG criteria, analysing the environmental, social and corporate governance impact of our investments. The SIGMA Short-Mid Term EUR is rated A by MSCI ESG RESEARCH and four out of five by Morningstar Sustainability. These are two of the most important agencies that assess the sustainable investment criteria applied to asset selection according to fund category.