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Higher interest rates revisited: What sectors might benefit?

We dealt with the rise of interest rates in last week's publication and analyzed its effect on the stock markets. In view of the further advance of yields, we have decided to focus on the topic again in this issue. In particular, US government bonds suffered relatively large losses in the past week, but emerging market bonds also registered price declines again. If we express the price development of top global bond indexes over the last few months in terms of standard deviations, most markets are at about minus two standard deviations.

That is not sufficient to warrant talk of a crash, but it would be a mistake to take it lightly. After all, the yield increase is not a matter of irrational market mood, but has a tangible background. In addition to the base effects discussed here last week, inflation expectations have been rising for some months as supply chain bottlenecks have emerged for many upstream products and a huge rebound of consumption is likely to occur as soon as the lockdowns and pandemic-related restrictions in the Western world come to an end.

Together with strong money supply growth and extremely expansionary fiscal policy, it would be almost astonishing if the inflation rate did not increase temporarily. A gradually improving labor market is also contributing to heightened inflation expectations, especially since a threat of some increase in the inflation rate by itself is not likely to cause central banks to abandon their accommodative monetary policy. On the contrary, the Federal Reserve in particular has repeatedly stated that it considers the labor market more important than fighting inflation. Now things are becoming a little complicated. For, yields normally advance on rising inflation rates because market participants expect policy interest rate increases and therefore already price them in with rising yields. However, key interest rates will not be raised in the near future, so we should regard the present yield advance as a paradox of ultra-accommodative monetary policy.

We therefore see good reason to believe most of the yield advance already lies behind us, not ahead. Nevertheless, it has undeniably left a considerable mark on the markets. There have been significant changes of favorites in many asset classes and sectors, for example. As a result of the yield increase, stocks have also declined in many emerging markets, while cyclical sectors and commodities have gained significantly. As expected, classic industrial stocks and banks have also done better in this environment than, for example, stocks in the technology sector. If the upward yield movement observed in the last few weeks were to continue unabated (which we do not expect), a sector allocation that would have worked well in past years would no longer be advisable.

To understand better what sector allocation to pursue if yields continue to advance contrary to expectations, we have performed a statistical analysis based on the 1,200 largest European stocks. We chose the last ten years as the sample period, though a longer period would not have led to significantly different results. For the sake of precision, we did not assign the 1,200 stocks to the 10 or 19 sectors at the upper end of the usual sector classification, but rather to the 146 sub-sectors at the granular industry group level.

In the next step, we calculated an elasticity value for each individual stock versus the yield on German government bonds (Bunds) with residual maturities of two and ten years. In statistical terms, we used the yield change in percentage points to explain the percentage change of the share price in the framework of a regression analysis; the coefficient of the regression is then the measure of the elasticity. However, to make the results especially robust, we checked all the yields of all stocks for outliers and capped them in advance to avoid the risk of falsely interpreting company-specific developments as fundamental correlations. Nevertheless, even after this correction, we arrived at elasticity values for some stocks that are implausibly low or high and likewise suggest that they are statistical outliers that cannot be meaningfully interpreted. Here, too, we adjusted the dataset for outliers in the elasticities by capping values upward and downward from a specific limit.

Based on this "robust" dataset, our next step was to calculate the mean values of the elasticities for all 146 industry groups and converted them into quantile ranks. You will find the result in the table on the next page. The table should be read such that sectors at the upper end (health care: misc., health care REITs, sugar, etc.) suffer on rising yields while sectors at the lower end (machinery: tools, aluminum, chemicals & synthetic fibers) benefit on rising yields.

Therefore, if the scenario for investors consists in yields continuing to rise significantly in the coming months, a sector reallocation in favor of cyclical stocks would be more than appropriate. In any case, the results convey a clear message in almost textbook style. Almost every sub-sector at the lower end of the table may be assigned to the cyclical category, while the upper end reads like a nearly complete list of defensive sectors. The results are so unambiguous they leave no room for doubt. Anyone who has a clear opinion regarding the rise of yields is making a real technical error if they do not orient their sector allocation structure accordingly. It seems nearly out of the question that our conclusions are a random result. They are statistically much too significant and economically much too logical to be taken lightly.

However, we have not limited this analysis to yields, but have also examined which sectors should be avoided or overweighted if inflation rises sharply. Superficially, one might assume that a similar result would be obtained, but that is only the case to a limited extent. Since the inflation rate does not correlate perfectly with bond yields, it would also be astonishing if there were a perfect correlation between the two elasticities. However, anyone who expects a steadily rising inflation rate in addition to sharply advancing yields should bet especially on the following sectors in view of our calculations: metal fabricating, cement, recreational vehicles, oil equipment & services, offshore drilling & services, agricultural machinery, integrated oil & gas, gas distribution, auto services, diversified materials, and food & grain products.

At this point, however, we should mention again that our main scenario does not include a continuation of sharply rising yields and inflation rates. We consider it much more likely that the inflation rate will peak in many countries during the year and should tend to decline again with a view to 2022, which will then probably also keep yields in check. Moreover, there is at least one other reason not to devise extreme scenarios regarding inflation and yield development. Proponents of the thesis that inflation rates and yields will rise all have one thing in common. They assume that the Western world will get the coronavirus pandemic more or less under control in the course of the year. Even though this also substantially corresponds to our working hypothesis, there is a residual risk that vaccination delays combined with new virus variants may call this scenario in question. Then, if not sooner, the thesis of a further significant rise of yields would no longer be tenable.

Quantile ranks of sector performance elasticities on change of yield

	Return 2-yr Bunds	Return 10-yr Bunds
Health Care: Misc.	0%	0%
Health Care REITs	0%	0%
Sugar	0%	4%
Distillers & Vintners	0%	14%
Nondur.Household Prod	0%	0%
Toys	0%	0%
Forestry	4%	55%
Footwear	4%	5%
Cosmetics	5%	0%
Elec. Eq: Other	6%	10%
Vending & Catering	6%	6%
Tobacco	7%	7%
Restaurants & Bars	8%	27%
Security Services	8%	16%
Personal Products	9%	6%
Travel & Tourism	10%	56%
Recreational Services	10%	11%
Clothing, Accessories	11%	21%
Reinsurance	12%	40%
Telecom. Services	13%	13%
Publishing	13%	18%
Food Products	14%	12%
Education Services	15%	8%
Luxury Items	15%	69%
Prop. & Casualty Ins.	16%	28%
Railroad Equipment	17%	23%
Diversified REITs	17%	10%
Consumer Svs: Misc.	18%	36%
Pharmaceuticals	19%	17%
Food Retail & Wsale	19%	19%
Health Care Services	20%	4%
Pipelines	21%	0%
Delivery Services	21%	26%
Integrated Oil & Gas	22%	59%
Medical Equipment	23%	24%
Mortgage Finance	23%	52%
Media Agencies	24%	22%
Prof.Business Support	25%	30%
Gold Mining	26%	33%
Containers & Package	26%	34%
Health Care Facility	27%	28%
Medical Supplies	28%	19%
Brewers	28%	9%
Defense	29%	25%
Industrial REITs	30%	15%
Entertainment	30%	47%
Aerospace	30%	31%
Casinos & Gambling	32%	41%
Transaction Process	32%	20%
Closed End Invest.	33%	34%
Consumer Electronics	34%	32%
Plastics	34%	39%
Gas Distribution	35%	8%
Diversified Retailers	36%	21%
Soft Drinks	36%	29%
Apparel Retailers	37%	56%
Real Estate Hold, Dev	38%	23%
Specialty Chemicals	39%	43%
Specialty Retailers	39%	54%
Retail REITs	40%	13%
Copper	41%	84%
Telecom. Equipment	41%	26%
Biotechnology	42%	37%
Consumer Digital Svs	43%	35%
Transport Services	43%	44%
Software	44%	42%
Multi-Utilities	45%	15%
Consumer Lending	45%	61%
Hhold Equip. Products	46%	67%
Oil: Crude Producers	47%	41%
Hotels & Motels	47%	47%
Residential REITs	48%	36%
Investment Services	49%	46%

	Return 2-yr Bunds	Return 10-yr Bunds
Elec. Entertainment	50%	45%
Computer Services	50%	43%
Industrial Suppliers	51%	57%
Drug Retailers	52%	39%
Radio TV Broadcasters	52%	71%
Alt. Electricity	53%	32%
Divers. Industrials	54%	60%
Elec. Eq: Control	54%	53%
Recreational Vehicles	55%	50%
Nonferrous Metals	55%	83%
Asset Mngr, Custodian	56%	64%
Full Line Insurance	57%	67%
Office REITs	58%	30%
Computer Hardware	59%	58%
Conv. Electricity	60%	17%
Marine Transportation	60%	71%
Offshore Drill & Svs	61%	82%
Chemicals: Divers.	62%	65%
Eng. & Contract Svs	63%	45%
Oil Equipment & Svs	63%	89%
Recreational Products	64%	58%
Home Imprv. Retailers	65%	74%
Automobiles	65%	76%
Plat.& Precious Metal	66%	50%
Fin. Data Providers	67%	60%
Rent & Lease:Consumer	67%	66%
Home Construction	68%	65%
Building & Plumbing	69%	49%
Div. Fin. Services	69%	63%
Real Estate Services	70%	51%
Fruit & Grain Proc.	71%	91%
Household Furnishings	71%	73%
Bldg Materials: Other	72%	76%
Machinery: Industrial	73%	48%
Construction	73%	69%
Renewable Energy Eq.	74%	78%
Banks	75%	89%
Semiconductors	76%	77%
Machinery: Const.	76%	82%
Electronic Components	77%	72%
Trucking	78%	38%
Iron & Steel	78%	87%
Elec. Eq: Gauges	79%	63%
Alternative Fuels	80%	79%
Airlines	80%	70%
Paper	81%	86%
Household Appliance	82%	80%
Machinery: Specialty	82%	88%
Metal Fabricating	83%	78%
General Mining	84%	92%
Auto Parts	84%	84%
Life Insurance	85%	91%
Diversified Materials	86%	94%
Machinery: Engines	86%	94%
Farming, Fishing	87%	73%
Waste & Disposal Svs	88%	62%
Electrical Components	89%	81%
Cement	89%	90%
Comm. Vehicles, Lease	90%	94%
Bldg: Climate Control	91%	52%
Prod. Tech. Equipment	91%	85%
Tires	92%	93%
Training, Emp. Agency	93%	94%
Comm. Vehicles, Parts	93%	93%
Railroads	94%	54%
Auto Services	95%	94%
Storage REITs	95%	75%
Medical Services	96%	80%
Oil Refining & Mkting	96%	86%
Machinery: Agri.	96%	94%
Machinery: Tools	96%	94%
Aluminum	96%	94%
Chem. & Syn. Fibers	96%	94%

Market Data

Stock marktes	As of 26.02.2021 09:15	Change versus 19.02.2021 -1 week	25.01.2021 -1 month	25.11.2020 -3 months	25.02.2020 -1 year	31.12.2020 YTD
Dow Jones	31402	-0,3%	1,4%	5,1%	16,0%	2,6%
S&P 500	3829	-2,0%	-0,7%	5,5%	22,4%	2,0%
Nasdaq	13119	-5,4%	-3,8%	8,5%	46,3%	1,8%
DAX	13727	-1,9%	0,6%	3,3%	7,3%	0,1%
MDAX	31194	-3,7%	-0,6%	7,5%	14,2%	1,3%
TecDAX	3324	-5,5%	-1,2%	9,0%	8,9%	3,5%
EuroStoxx 50	3666	-1,3%	3,2%	4,4%	2,6%	3,2%
Stoxx 50	3161	-1,4%	-0,3%	2,5%	-4,3%	1,7%
SMI (Swiss Market Index)	10659	-0,4%	-2,4%	1,6%	1,7%	-0,4%
Nikkei 225	28966	-3,5%	0,5%	10,2%	28,1%	5,5%
Brasilien BOVESPA	112256	-5,2%	-4,4%	1,9%	-1,3%	-5,7%
Russland RTS	1428	-3,0%	1,1%	9,7%	-1,3%	2,9%
Indien BSE 30	49370	-3,0%	2,1%	12,6%	22,6%	3,4%
China Shanghai Composite	3509	-5,1%	-3,2%	4,4%	16,5%	1,0%
MSCI Welt (in €)	2760	-1,7%	0,2%	4,4%	8,6%	3,7%
MSCI Emerging Markets (in €)	1384	-3,3%	-1,8%	11,2%	16,9%	8,3%
Bond markets						
Bund-Future	173,06	-112	-477	-227	-296	-458
Bobl-Future	134,22	-31	-110	-122	-92	-96
Schatz-Future	112,18	-3	-13	-16	5	-9
3 Monats Euribor	-0,54	2	2	2	-12	4
3M Euribor Future, Dec 2017	-0,52	3	5	2	-3	0
3 Monats $ Libor	0,19	1	-2	-4	-145	-5
Fed Funds Future, Dec 2017	0,08	-1	2	0	-92	0
10 year US Treasuries	1,48	15	44	61	14	56
10 year Bunds	-0,25	10	33	33	27	33
10 year JGB	0,16	6	13	14	26	14
10 year Swiss Government	-0,19	6	28	26	66	30
US Treas 10Y Performance	682,02	-1,6%	-3,7%	-5,0%	1,6%	-4,7%
Bund 10Y Performance	664,02	-0,8%	-3,0%	-3,0%	-2,5%	-3,0%
REX Performance Index	493,40	-0,3%	-1,1%	-1,2%	-1,0%	-1,2%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,26	7	24	26	19	24
IBOXX BBB, €	0,71	8	20	14	5	16
ML US High Yield	4,80	8	-7	-53	-128	-18
Convertible Bonds, Exane 25	8198	0,0%	-1,5%	1,2%	5,2%	-1,6%
Commodities						
MG Base Metal Index	418,30	5,8%	14,5%	22,2%	51,1%	17,9%
Crude oil Brent	66,07	5,0%	18,1%	35,7%	18,5%	27,3%
Gold	1760,80	-1,4%	-4,8%	-2,9%	6,4%	-7,2%
Silver	27,79	1,2%	9,4%	18,9%	52,4%	5,3%
Aluminium	2237,35	5,8%	10,7%	14,6%	32,9%	13,4%
Copper	9456,25	5,7%	18,7%	29,8%	67,0%	22,0%
Iron ore	165,02	0,6%	-2,8%	33,5%	90,3%	5,9%
Freight rates Baltic Dry Index	1700	0,1%	-3,7%	42,0%	234,6%	24,5%
Currencies						
EUR/ USD	1,2142	0,0%	-0,1%	2,1%	12,0%	-1,1%
EUR/ GBP	0,8713	0,7%	-1,8%	-2,0%	4,4%	-2,7%
EUR/ JPY	128,75	0,7%	2,1%	3,7%	7,4%	1,8%
EUR/ CHF	1,0984	1,2%	2,0%	1,4%	3,6%	1,7%
USD/ CNY	6,4617	0,1%	-0,3%	-1,8%	-7,9%	-1,0%
USD/ JPY	106,23	0,7%	2,4%	1,7%	-3,6%	2,9%
USD/ GBP	0,72	0,6%	-1,9%	-4,0%	-6,6%	-1,9%

Source: Refinitiv Datastream

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