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KAURI ASSET MANAGEMENT

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Bond Yields, What To Expect in 2021

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How much further will Bond Yields go in 2021?

Bond yields have been all the talk across financial markets in recent weeks, but will they stand in the way of the market rally?

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Monthly Portfolio Reports

Our portfolio managers take you through the main contributors and cover any changes across both the Australian and US markets.

MICHAEL SMITH
Head of Research and
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How much further will Bond Yields go in 2021?

Bond yields have been all the talk across financial markets in recent weeks, but will they stand in the way of the market rally?

Over recent months, US Treasury yields have been steadily climbing, and after hitting their highest levels in more than a year, markets are starting to become agitated by the move.

Since mid-February, we have seen a marked shift in sentiment towards high-growth stocks. This has been driven by the opportunity cost of what is effectively the risk-free rate of return across the market increasing, and in turn, drawing some investors out of the market.

However, for all the concern around the impact that rising bond yields might have, and what they tell us about future interest rate expectations, we believe the market is getting ahead of itself with its worries.

In fact, for the time being, we still believe this bull market has further potential to play out, with the growing number of stocks on 'discount' representing a great opportunity for us to take advantage of the volatility.

What does the yield curve represent?

Before we discuss our views on the matter, it's worth briefly touching on the concept of the yield curve and bond yields.

The yield curve is used as a measure of future interest rate changes based on economic activity. It depicts the interest rates or yields of bonds that have different dates of maturity, but each have equal credit quality.

Market analysts and economists look to the slope of the yield curve to gauge expectations for how interest rates might change in the future.

Where the yield curve slopes upwards, higher interest rates are anticipated across financial markets in the future. On the other side of the equation, a yield curve sloping downwards suggests that the market expects lower interest rates moving forward.

In many respects, it is considered normal for the yield curve to represent higher bond yields that steadily increase until maturity, albeit flattening out where the maturity extends to long-term durations such as 10 years.

However, what we have seen more recently is a steepening yield curve on the back of concerns that excess inflation - largely attributed to massive fiscal stimulus - will force the Federal Reserve to raise interest rates far sooner-than-expected.

The rotation from tech to value

Investors typically look at companies through a series of lenses to work out their future growth prospects.

When interest rates rise, investors begin to adjust their valuation models for companies because of something called the discount rate. This is the rate with which investors value the future profits of a company.

As such, a steepening yield curve means the discount rate investors apply to their valuations also increases. The effect of this is lower valuations as the pendulum begins to swing more towards an emphasis on near-term profits as opposed to future (uncertain) profits.

Coupled with the fact that rising bond yields provide investors with an alternative asset choice, we can apply this logic to what we have seen occur over recent weeks. Investors have rotated out of high-growth stocks that are more reliant on future earnings growth to underpin their valuations.

Instead, investors have largely rotated into value stocks, where valuations are typically driven by a greater focus on near-term profits given their maturity.

This also explains why the tech-heavy Nasdaq entered a correction recently, while the Dow Jones hit a new all-time high - a dual-incident that hasn't occurred in 20 years. At the same time, the more diverse S&P 500 has fared relatively well despite a large sell-off in certain growth names like Tesla (TSLA) and Apple (AAPL).

Why yield concerns are overblown

The first thing we should probably clarify is that rising bond yields have the potential to manifest as a problem for financial markets - even if largely sentiment-driven - except we do not believe we are near those levels yet.

Higher bond yields are ultimately a reflection that investors expect accommodative fiscal policy and stimulus to drive an improvement in the underlying strength of the economy.

Yes, here that ties in with expectations for higher inflation as well, however, bond yields have a poor history of predicting inflation. Even then, in an inflationary environment, there is still upside for corporate earnings, particularly companies not reliant on debt.

Concerns should be around disorderly inflation. Thus far, inflation isn't coming in at nor looking like approaching the levels needed to prove concerning. If anything, it is still lagging expectations.

All the while, the volatility taking place is orderly when the economy is stitching together a post-recession recovery, let alone a recovery with the velocity with which we are witnessing.

Of course there is an expectation that this growth will slow once interest rates rise. But the Federal Reserve has continued to reassure investors it does not expect to reach that stage for a long time, and that it will keep interest rates low and continue purchasing assets until it hits its lofty goals.

More broadly, there is also the point to consider that stocks, particularly tech businesses, have fared well in high-yield environments, even times where the yield curve was steepening.

Since 1998, you could count on one hand the number of meaningful periods where real bond yields and stock prices had a negative correlation, with two of those instances being brief periods surrounding the early 2000s and Great Recession.

Where there has been a negative or inverse correlation, that relationship has typically developed when the 10-year Treasury yield hones in on 4%. Outside of these isolated periods, equity prices have largely enjoyed a positive correlation with rates. Perhaps even more surprising, the CBOE volatility 'fear' index (VIX) has been the one to display a negative correlation with rates.

To provide some further context, in 45 months over the last two decades where 10-year Treasury yields have surged by more than 15 basis points, the S&P 500 has delivered a negative return just 11 times. In fact, there is as much data over that timeframe showing a monthly drop of 3% or more in the S&P 500 when yields have been trending downwards - that is, 26 out of 31 times.

The market can of course get caught up in the fear and hysteria associated with a spike in Treasury yields. This happened in 2013 in an event dubbed the 'Taper Tantrum', when the Federal Reserve signalled it would begin slowly winding back its QE program. The rest is history as they say, but we're not there yet.

What matters more to the stock market than bond yields is monetary policy. With this in mind, it is our view that an accommodative backstop is still in place and not disappearing any time soon.

A gradual-to-modest rise in bond yields is nothing bad in itself. It provides fund managers and investors the opportunity to rebalance their portfolios, plus allow stocks to find a more sustainable level of support. That's why the steepening curve has caught some off-guard and led to a readjustment of positions that have put pressure on equity prices.

In the meantime, however, the companies we are backing or looking to add amid the volatility are those with either the financial standing, scale, efficiency or innovative capabilities to drive earnings growth in any fiscal environment.

International

MICHAEL SMITH
Head of Research and
Senior Investment advisor

Performance:

Index	February Performance	2021 Performance
Dow Jones	3.2%	1.1%
NASDAQ	-0.1%	0.2%
S&P 500	2.6%	1.5%
Global Growth Portfolio	0.9%	0.30%

Top 10 Holdings:

Code	Company Name	Weighting %
PYPL	PayPal	5.96%
MSFT	Microsoft	4.93%
TSM	Taiwan Semi	4.87%
GOOGL	Alphabet	4.62%
AAPL	Apple	4.27%
V	Visa	4.22%
ISRG	Intuitive	4.09%
ADBE	Adobe	4.07%
BABA	Alibaba	3.52%
BRKB	Birkshire	3.46%

International Growth Portfolio

Last month Portfolio NAV grew by 0.9% after taking into account advisor fees, taking us back into positive territory for the new calendar year.

This result was in line with the performance of the tech-heavy Nasdaq, while the rotation into value stocks meant that the likes of the S&P 500 and Dow Jones advanced 2.6% and 3.2% respectively.

The performance of the Portfolio was also weighed down by some adverse foreign exchange movements, with the USD/AUD rate easing from 1.3084 to 1.2976. While a relatively modest move, the net impact saw approximately 1% deducted from underlying NAV of the Portfolio.

In terms of our key positions, digital payments stocks performed solidly in February, weathering the market volatility. Visa (V), PayPal (PYPL) and Square (SQ) led the way, up 9.9%, 10.9% and 6.5% respectively. In light of Square's strong performance over the last 12 months and the rotation from growth to value, we took profits on expectations the share price was likely to sink.

Another stock that delivered vast gains for us last month was Baidu (BIDU), up 20.6%. The stock has been the subject of increased interest for many weeks now after it signalled the prospect that it could deploy its technology expertise in the electric vehicle market.

Once again, with our exposure to Baidu being overweight, and extensive profits accumulated, we exited our position to ensure that we locked in our profits in case the market continued to drift lower amid tech weakness.

At the time of writing the decision to exit these holdings has proven beneficial in terms of the net effect on the Portfolio. Where we see opportunities elsewhere to add funds into new positions, and the market shows some signs of stabilising, we will be able to deploy these surplus funds accordingly.

Pleasingly, there were a limited number of Portfolio holdings weighing on NAV last month. Moreover, each of these names, in Apple (AAPL), Amazon (AMZN), Alibaba (BABA) and Pfizer (PFE), are quality firms we hold strong conviction due to their resilient fundamentals.

Realised profits totalled 6.1% of the Portfolio NAV from the end of January. Since we secured some of our outstanding earnings, unrealised profits eased slightly from the month prior, but finished at a very healthy 13.8% of closing Portfolio NAV for February.

The current market conditions are proving tricky to anticipate, particularly as we believe the sell-off arising from rising bond yields has been unwarranted. Nonetheless, as mentioned, we see this a great opportunity to pick up certain stocks on discount.

DANIEL WONG
Research Analyst

ALEX NEGROH
Research Analyst

Hub 24 - Balanced

Balanced Portfolio

The Balanced Portfolio outperformed last month thanks to a number of positions that fared exceptionally well, offsetting some minor losses elsewhere.

In total, NAV of the portfolio grew by 1.5% in February, which was ahead of the 1% gain in the ASX 200.

After a period of subdued movement for a month or so, pharmaceutical business Race Oncology (RAC) had a stellar month, soaring over 100%. The move followed the company's half-year results and has since continued into March as the momentum trade plays out.

We believe the share price of RAC still has a lot of room to move north given the company's long-term prospects in developing a cancer-fighting drug called Bisantrene, which has shown early promise. Nonetheless, despite our optimism, if we see a correction unfolding across the ASX, we may look to close out our position as we look to move away from extreme high-growth assets.

Another major winner was Sealink Travel Group (SLK), a relatively lesser-known name in the land and marine tourism space that operates transport services. Shares in the company surged around 32% for the month, with the business unveiling its revenue quadrupled and its NPAT more than doubled in the December half.

After a slow start, our investment in Tribeca Global Natural Resources (TGF) is starting to reap dividends as the stock received a re-rating. Shares leapt 25% as the divergence between the stock price and underlying Net Tangible Assets (NTA) narrowed, in what was a nod to the thesis behind our rationale for backing the stock.

As tech stocks began to face turbulence there was some weakness among names like Xero (XRO), Afterpay (APT) and Laybuy (LBY).

In the case of Xero, the downtrend has been in place since its highs across December and January. Aggressive profit taking has been a headwind for the stock, however, the underlying business remains solid with a growing user base and increasing revenue, while the stock is now sitting at a solid support level.

Meanwhile, some of the air has come out of the buy-now pay-later segment, with APT off 11%, and Laybuy down 4%. We are happy to continue holding these stocks as we believe the sector is still a 'hot' theme. Extra volatility across tech means we will be reducing exposure where risk levels rise, but we view concerns around the broader rally as merely a near-term hiccup.

Performance:

Index	*February Performance*	*2021 Performance*
ASX 200	1.0%	1.3%
ALLORDS	1.0%	1.3%
Balanced Portfolio	1.5%	0.8%

Top 10 Holdings:

Code	*Company Name*	*Weighting %*
HM1	Hearts & Minds	5.4%
MQGPC	Mac Notes	5.1%
KKC	KKR Credit	4.6%
NABPD	NAB Note	3.4%
WBCPJ	WBC Note	3.4%
WBCPJ	WBC Note	3.4%
BHP	BHP Group	3.0%
CBA	Comm Bank	3.0%
FANG	Fang ETF	2.8%
RAC	Race Onc	2.7%

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Research Analyst

DANIEL WONG
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Hub 24 - Growth

Growth Portfolio

Unlike the Balanced Portfolio, our flagship Growth Portfolio trailed the benchmark ASX 200 index in February, rising 0.5% for the month compared with a 1% gain for the broader market.

The fundamental reason for the underperformance and lag against the index is due to the increased allocation of funds in higher-volatility growth stocks.

In times where the market is conducive to a risk-on appetite, the Growth Portfolio typically outperforms, however, when a risk averse attitude takes hold, high-growth stocks are often first to be sold down.

With this in mind, two of the key drags on the performance of the portfolio were Afterpay (APT) and Redbubble (RBL).

Although Afterpay delivered strong results in its half-yearly earnings update, and also raised capital at a significant premium via convertible notes, the stock has been caught up amid weaker sentiment in the US towards tech stocks as bond yields rise.

Meanwhile, Redbubble shed 23.7% given a similar rotation away from high-growth stocks towards value plays. In our view, the company is still in a solid position, although we may look to exit our exposure here given the macro sentiment and the chance to take profits after an extremely strong run post last year's market crash.

We were also disappointed with the performance of NRW Holdings (NWH) following its earnings report. The company seems to be pricing themselves into jobs, sacrificing margins to bolster revenue.

As this gave us reason to be concerned about the company's outlook, we closed our position in NWH for a healthy profit. In its place we may look to add Alliance Aviation Services (AQS), offering exposure to a similar sector but with far better performance in recent months.

Two strong names for the portfolio were Lynas (LYC) and Sezzle (SZL). Shares in Lynas jumped around 25% due to continued strength in the lithium and rare earths space. Sezzle defied weakness in the BNPL sector to deliver a great month, although this has since come back.

The rotation out of high-growth stocks is something we will monitor closely. Not only do we wish to reduce excessive risk exposure, but we also wish to identify opportunities we think can rebound strongly once the market calibrates its expectations for interest rates.

Performance:

Index	*February Performance*	*2021 Performance*
ASX 200	1.0%	1.3%
ALLORDS	1.0%	1.3%
Growth Portfolio	0.5%	1.5%

Top 10 Holdings:

Code	*Company Name*	*Weighting %*
MQGPC	Mac Hybrid	5.1%
HM1	H & Minds	5.0%
RIO	Rio Tinto	3.8%
FANG	Fang ETF	3.7%
EVN	Evolution Mining	3.7%
LYC	Lynas	3.5%
CBAPE	CBA Hybrid	3.3%
APT	Afterpay	3.0%
XRO	Xero	2.9%
FMG	Fortescue	2.7%

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