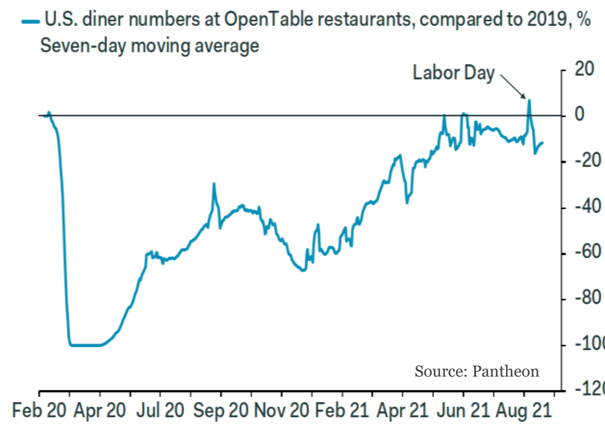
MARKET OUTLOOK

2021/October

A BENIGN ENVIRONMENT FOR ECONOMIC GROWTH

I would like to start our analysis on a positive note. First, at least within developed markets (DM), the situation around COVID seems to be under control. The US is close to reaching immunity, as the Delta variant and the vaccination rollout have both proceeded at a high pace. In Europe, except for the UK, the Delta variant has spread less compared to the US but the vaccination campaign has been very successful, which means herd immunity should not be too far, with slight differences across nations. Asia and more generally emerging markets (EM) are lagging, although there are exceptions such as China and India.

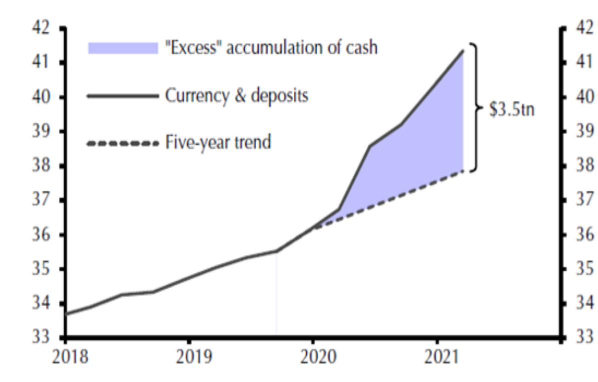


Therefore, life in DM seems to be back to normal, or almost entirely. Moreover, even in the case of a new, more contagious variants emerging, we see a limited probability for governments to reimpose harsh lockdowns as these have proven to be highly costly in both economic and social terms.

What this means is that in the U.S. those sectors more affected by the spread of the virus are now back to, or close to, pre-pandemic levels and all of this is supporting the confidence of both consumers and businesses. The situation across the Atlantic is not much different, although consumer confidence has rebounded more strongly compared to the US and of late business survey indicators have been negatively affected by the current energy crisis.

Bearing the above in mind, it should not be a surprise that developed market GDPs are recovering from their 2020 lows, supported by the extraordinary monetary and fiscal measures put in place by world governments and central banks; in this respect, the IMF forecasts GDP growth in 2021 and 2022 to be 7% and 4.9% respectively for the US and 4.6% and 4.3% respectively for the Eurozone.

Beyond the short-term, it seems the economy has all the necessary ingredients to experience a prolonged period of above-average demand growth. First, households especially in the US are full of cash to dispose of. Some of the financial aid has been spent already, but it is estimated that residual excess savings amount to 7.5% of DM GDP – quite a significant number. Secondly, corporates have also plenty of cash to dispose of, as they have taken advantage of very low interest rates to issue long-term debt, have achieved resilient profits, and reduced investment spending due to the pandemic. Cash balances among firms in DM are estimated at 4% of GDP. The expectation (or hope) is that such cash will not be used solely for share buybacks, but rather to renovate assets that are now obsolete, resulting in higher productivity. However, there is no prolonged period of above-average growth without healthy balance sheets. Fortunately, the financial health of the private sector in developed market economies is in good shape. Households have lowered their debt burdens, and in some cases have used the latest government aids to pay down mortgages or credit card bills. The same is true for the financial system, where balance sheets are reassuring. However, banks seem to have neither leveraged on



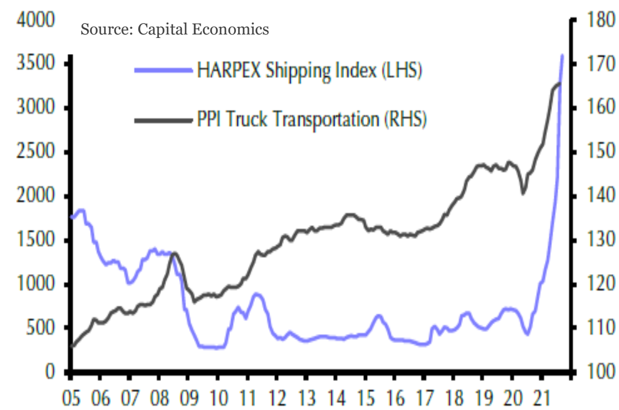
Sources: Refinitiv, Capital Economics

such improvements nor on the increase in liquidity provided by the massive quantitative easing measures of our era. We hope the current environment, made of rising consumer and business confidence along with government support will encourage banks to open the taps. Fourth, central banks remain supportive of the economy, with nominal rates being close to all-time lows. In a scenario where inflation rises only moderately, currently the consensus expected outcome, central banks will refrain from raising interest rates boldly. Finally, and just as importantly, there seems to be a general agreement that government borrowing without limits has no consequences, other than being positive for economic growth. While this is clearly debatable, the short-term effect is that government spending is increasing everywhere and fiscal austerity, for both economic and political reasons, is a union of words nowhere to be found in today's political agendas, although in some countries fiscal deficits are in fact expected to recede slightly, albeit from absurd levels.

RISKS HAVE NOT DISAPPEARED, RATHER THE OPPOSITE

There are a series of concerns, or risks, that one must keep in mind in the current environment. The number one is obviously inflation; not inflation per se, but inflation spiraling out of control. While a moderate rise in inflation is expected and would be beneficial to both economic growth and debt levels, unexpected and uncontrolled spikes would be detrimental to the currently benign environment and would most likely prompt authorities to act, leading most likely to negative effects for economic growth.

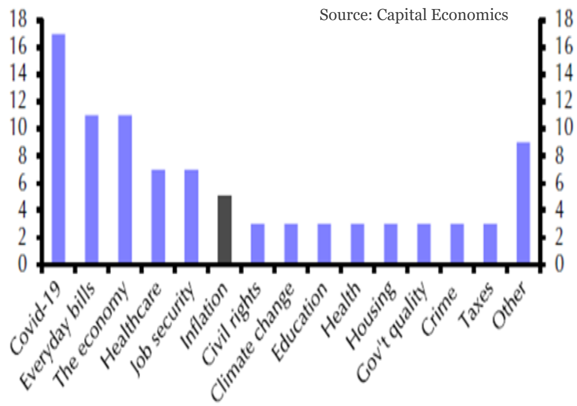
Forecasting inflation is terribly difficult, and beyond the scope of this commentary, but we would like to distinguish between what we believe are more transitory factors compared to more resilient items. The rise in both used and new cars prices look to be a transitory phenomenon for two reasons; on the one hand, current bottlenecks around the shortage of semiconductors and other raw materials will abate in time, although it may last more than initially envisaged (expectations for a return to normality are pointing at mid-2022). Secondly, assuming wages don't experience massive inflation, there is a natural limit the price of a car can reach, as it is not considered by society as a store of value.



Transportation costs, which affect almost 50% of the items within the CPI basket, are soaring. Capacity constraints and staff shortage are the main reasons behind this phenomenon. We do believe that in this case too such effects are only transitory and the latest news regarding President Biden securing pledges from both private sector heavyweights such as UPS and FedEx, and The International Longshore and Warehouse Union to extend their working hours, confirms our view.

Energy prices, which account for approx. 10% of the CPI basket, but clearly feed into the cost of most of the items in the inflation basket, have also experienced a spectacular ascent. A combination of rising demand from China, where the supply of coal is in deficit, extreme weather events in the western hemisphere, and low inventory levels have created a mismatch between supply and demand. We think suppliers will increase output, thus curbing the recent price increase. At these prices, it is probable that both OPEC and U.S. shale producers will most likely pump more oil into the market, while President Putin is taking advantage of the natural gas shortage in Europe to have his Nordstream pipeline approved.

On the other hand, we see housing prices as stickier and, given its importance in the overall economy, representing a higher risk compared to the previous items. Real interest rates close to zero, looser covenants, and the government free cash disbursement have supported such constant appreciation of prices. Because we don't expect most of these factors to change soon, and given the high valuations of financial assets, we see further upside for real estate prices going forward.



Over the past year, the Federal Reserve (FED) has often described the current rise in inflation as transitory. But when does inflation shift from being transitory to permanent? In our view, this occurs when inflation expectations start to rise faster than what authorities have communicated, and what recent CPI data would suggest. We are currently living in very dangerous times because, given how tight the labor market is, any request of wage increase would need to be matched by the respective employer. It is like walking on the edge of a cliff; you are not falling yet, but all you need is a little push…

Despite all we have said until now, it seems inflation expectations have stabilized, although at very elevated levels compared to what we are used to. According to recent data, the growth of private wages and salaries is increasing at a constant rate and in line with the long-term trend, confirming the US population does not see inflation as a possible threat. But inflation is a self-fulfilling prophecy; once it gets started, then it will not stop overnight.

Should inflation start to rise out of control, there are three ways authorities could bring it back down; central banks raising interest rates, reducing their balance sheets, or governments embarking in a period of fiscal austerity. The latter two options would probably be of little effect due to a timing mismatch between a short-term problem (inflation) and longer-term solutions (reducing central banks' balance sheets raises long-term interest rates and increasing taxes or cutting government spending takes months to implement). Thus, we are left with raising interest rates, but given today's debt levels and based on the experience of 2018, when the economy slowed down markedly after rates were increased to 2.5%, it is likely that simply starting to raise them would be enough to slow the economy.

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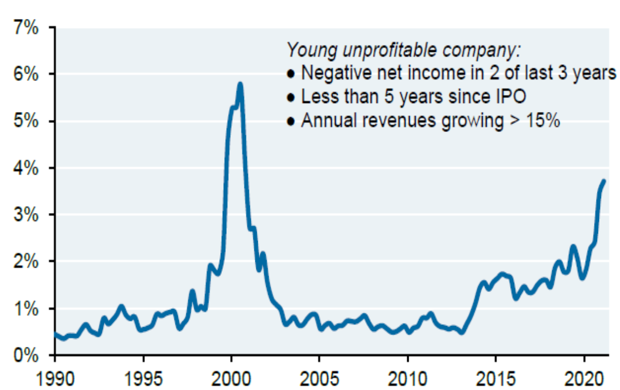
Over the longer-term, there are a few more risks that necessitate our attention. We believe China remains an economy with huge potential, but the events of 2021 have dented our confidence and increased the risks over the medium-term. To achieve common prosperity, as they call it, one action taken was to cool the real estate market, where Evergrande seems to be bearing the biggest burden, together with some of its creditors and investors. If the Chinese government succeeds in making the middle class richer, the growth potential of the economy is virtually unmatched. However, the shift from a supply-driven economy to a consumption-driven one may take months, if not years to materialize. More importantly, the real estate sector represents more than 30% of the Chinese GDP, and it is strongly connected with other sectors such as infrastructure and manufacturing, hence a slowdown in house prices increases the risk of hard landing. The good news is, some of the stimuli injected during the pandemic have been withdrawn already, as China emerged from the woods sooner than the rest of world; this allows the authorities to provide support during potential glitches while transitioning towards a new economy.



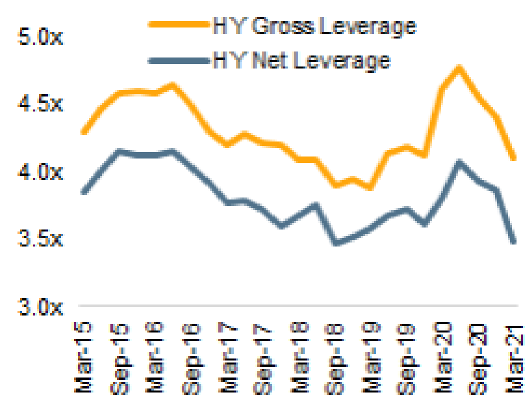
Market Cap of Young Unprofitable Companies – Source: JPM

Finally, let's conclude with an evergreen; the unknown risks related to the action undertaken during the past ten years by central banks. The massive expansion of balance sheets and the zero or negative interest rate policies have undoubtedly supported economic growth, but they have also created several imbalances. First, in some cases government debt burdens are back to levels seen during World War II although lately we haven't fought any major wars and are not looking to fight one in the near term. Secondly, we are in a situation where central banks are literally financing the full government deficits and, in some cases, even corporates. This is not unprecedented, but when it happened it was labelled as the darkest of all evils, and the effects of it unfolding could be unprecedented. Thirdly, equity markets are starting to show clear characteristics that often in the past have anticipated some sort of price adjustments, to use a euphemism. These are risks that may materialize over the longer-term, but investors should never forget they exist as they will challenge our economic and financial landscape considerably.

FIXED INCOME: DURATION RISK MATERIALIZING

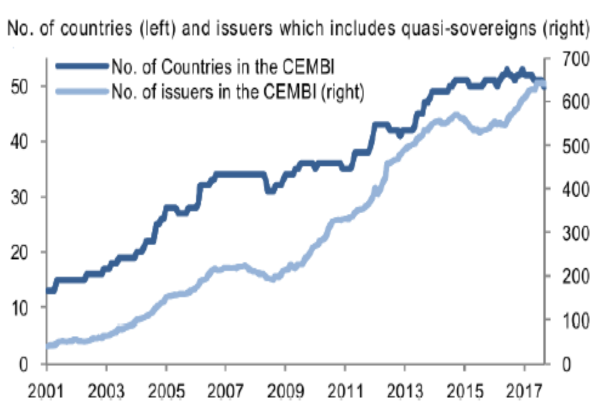
The FED has maintained its policy on hold in September but confirmed the tapering process will most likely start very soon and last until mid-2022, when the emergency asset purchases program is estimated to terminate. The committee has also anticipated the first official rate hike estimate in 2022, even if President Powell has been signaling caution and graduality about the future path of rates. In the meantime, inflation estimates have been raised both for 2021 and 2022. A slightly hawkish meeting in a nutshell. Outside of the U.S., other central banks are turning on the hawkish side, for example the Bank of Norway and the Bank of England.

Long term government rates have barely moved during most part of the summer period but recently spiked after the FED meeting, with the Treasury 10yr-yield currently hovering around 1.60%. The sovereign curve steepness, as measured by the difference between 10yr and 2yr rates, has increased accordingly towards the current level of circa 120 basis points. Some disappointing macroeconomic data (see September U.S. payrolls) and the spread of the Delta variant played a role in keeping rates low during the bulk of the third quarter, while the debt ceiling debate and supply bottlenecks fueled inflation fears, determining some volatility as of late. The German 10yr Bund has behaved in a similar if not even more volatile pattern and is currently around -0.15%. Some upward pressure from the inflation data front, combined with an announced slower future pace of purchases from the European Central Bank, all contributed to this volatility. At this stage, taking into consideration buoyant economic forecasts, mounting inflation fears and the still low level of long-term rates, duration exposure clearly remains a risk.



Source: FactSet, CreditSights

The corporate investment grade sector was heavily impacted by the recent rates spike on both sides of the Atlantic Sea and closed the third quarter with a roughly flat performance, eroding previous gains. Valuations are stretched and very close to historical lows while absolute yields are not compelling either. On top of this, the asset class bears a remarkable embedded duration risk (around 8 years in the U.S.).



Source: Vontobel

On a different note, U.S. high yield defaults are expected to finish the year at 4%, well below the historical average of 5.2%, and are concentrated in one sector, namely energy. U.S. high yield credit metrics are pointing to the right direction as well. The asset class posted a nice performance recently, both in the U.S. and Europe. Valuations are stretched on an absolute basis but offer value in relative terms, especially when taking into consideration (callable) short term bonds and the BB-rated bucket.

Emerging corporate debt displays improving fundamentals in terms of credit metrics and relatively cheaper valuations. The historical risk/reward proposition is compelling while performance has been positive year to date. Last but not the least, the asset class is growing swiftly in terms of size, diversification, and liquidity.

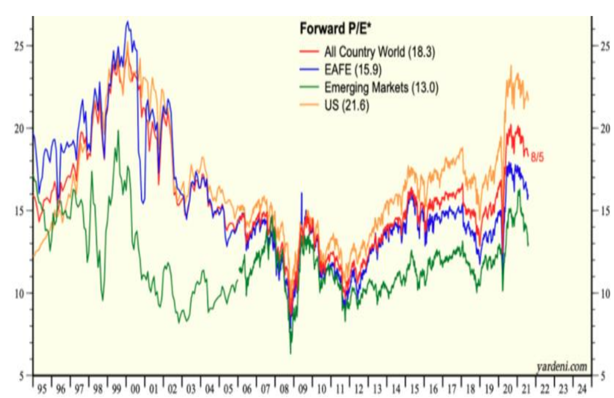
To sum up, the fixed income asset class is expensive in terms of absolute valuations, and yields offered are not attractive either. At this stage, duration exposure remains the major risk for several reasons such as inflation risks and the projected future fiscal stimuli, to name a few. In relative terms, pockets of value still exist in some niches of the riskier buckets of the fixed income space, namely short-term high yield and emerging corporate debt.

EQUITIES: STELLAR EARNINGS OFFSET FEARS

The summer saw some reversal of the "reflation trade", a strong uptrend by economically sensitive stocks that kicked off with the vaccine announcement last November. Several factors weighed on equity prices, such as concerns that earnings, valuations, and GDP growth are at or near peak levels, a possible lasting inflation, the acknowledgement that the FED will begin to taper its asset purchase program, and expectations that interest rates will be raised sooner than expected. The supply chain's shortage and energy crisis also added pressure to equity markets.

The positive news is that company earnings have been impressive by several measures, especially among cyclicals, and the key driver of S&P 500 returns this year. In Q2, 87% of the companies have beaten on both earnings per share and revenue growth and the 3Q has also started with stellar results above expectations. We know the influence of the base effect and that earnings must slow from here. However, companies have successfully managed costs through the crisis period and have been able to raise prices, pushing higher costs onto the end consumer, protecting their margins.

During the first half of October, markets rebounded on the back of positive news such as Russia offering to pump more gas in Europe in order to stabilize the energy crisis, the U.S. Senate agreeing to lift the U.S. debt ceiling until December and, ironically, a weaker than expected labor market report, which nourished the hope that the FED would delay quantitative or monetary tightening; all backed by a great start to the earnings season. Currently, earnings growth (45.3%) is beating expectations (27.5%), and analysts' forecasts continue to improve. Earnings are also supportive in Europe, with the Eurostoxx600 third quarter earnings expected to increase 45.6% from Q3 2020, on the back of an economic normalization. Excluding the energy sector, earnings are still expected to increase 31.3%.



With a forward P/E of 21.6, S&P 500 valuations remain stretched and above the last 5-y average (18.6 forward P/E). In Europe, despite equities have rallied YTD, rising earnings and the higher exposure of the index towards cyclical stocks decreased current valuations (MSCI Europe forward P/E from 17.1 to 15.4). Swiss stocks, on the other hand, are very expensive and lately have been hit by both the increase in long-term interest rates and regulatory risks in the all-important Chinese market (luxury stocks). Finally, EM equities have been relatively poor performers and therefore offer interesting valuations. Many EM already experienced tighter monetary policies and have been affected by a strong USD, as well as restrictions imposed by Chinese authorities. For China specifically, there's still uncertainty about the amount, timing, and substance of further policy actions: issues surrounding data privacy and regulations on monopolistic and anticompetitive behaviour continue to cloud the near-term outlook. But we think that, following the downdraft in prices, the margin of safety provided among many Chinese blue chips could compensate investors for the added risks.

In terms of relative valuations, the equity risk premium, calculated as the earnings yield of equities less the real yields of government bonds, is back to favouring stocks compared to bonds, on a global scale. In terms of regions, a simple (non-inflation adjusted) measure of dividend yield minus government nominal yield shows a positive yield gap for the Eurozone, the UK, and Japan. The latter looks appealing following the announcement of a massive Abenomics-style stimulus package

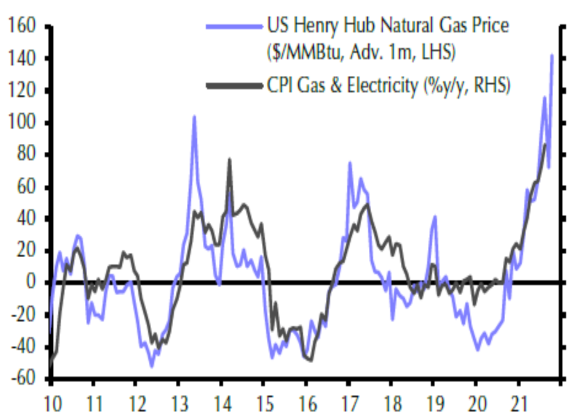
worth around 30 trillion yen ($269 billion) by the end of the year. The program includes aggressive monetary policy, fiscal consolidation, and growth strategies.

Lastly, it is worth mentioning the surge in option volumes, especially within the U.S. equity markets, which acts as support for prices but also highlights important risks. Option volumes recently exceeded stock market volumes for the first time ever and margin debt to finance stock purchases is approaching $ 1 trillion, fast-tracking its way to becoming a "primary" asset class. Contemporary trading platforms, such as Robinhood are bringing millions of new players into the options trading "game", supporting the markets, but also adding risks of snowballing corrections. Easy leverage at current low rates is adding fuel to the fire.

In conclusion, equity markets still offer relative value, but with the tapering taking place, it is now key to select companies that can continue to deliver earnings above expectations and protect margins through pricing power or more efficient processes. As inflationary pressures increase across supply chains, only a gradual tapering from the FED will be crucial to avoid strong market reactions. In terms of sectors, financials should benefit from rising yields, while the valuations of both real estate and materials are attractive. Themes such as cybersecurity, clean energy, and the blockchain remain very interesting investment possibilities for the future.

COMMODITIES AND CURRENCIES: LOOKING PAST SUPPLY BOTTLENECKS

Talking about commodities in general makes little sense at this stage; some are experiencing supply-side bottlenecks or an unexpected rise in demand (see energy and some industrial metals) while others, such as gold and silver, seem to have lost their inflation-protection role, in favor of newer assets such as cryptocurrencies. As we have explained earlier, we believe



Source: Capital Economics

energy prices will likely stabilize, to say the least, due to the expectation of a supply surge from both OPEC and shale producers. Industrial metals prices could also stabilize albeit at elevated levels, thanks to opposing forces; on the one hand, China's possible hard landing could reduce demand while on the other, global fiscal stimuli should increase it. Supply bottlenecks should abate over the medium term, putting further downward pressure on prices. Finally, a word on gold; we acknowledge digital assets are the new, hot topic. Because cryptocurrencies pay no cash flows, we have not yet found a proper way to estimate their fair value, except from the "network" effect many enthusiasts of the assets refer to. The same is true for gold; as it pays no cash flows, its real purpose serves only as a means to store value. What sets them apart is the fact that the yellow metal has been around for thousands of years, while cryptocurrencies are young. With this, we are by no means saying that cryptocurrencies are a simple temporary frenzy, but we would be cautious in calling the end of gold's role in portfolios.

A *fil rouge* that accompanies all commodities (and digital assets) is the faith in the U.S. dollar. The recent appreciation of the relevant index (DXY, the USD vs. a trade-weighted basket of currencies) was the result of the FED acknowledging inflation risks are more elevated than initially thought, therefore anticipating the timing of both its asset tapering as well as its first rate hike. Hence, the rise in the USD is driven by a monetary phenomenon, short-term by definition. Looking further ahead, the risk of inflation rising uncontrolled and above current expectations poses a risk to the USD; the effect of inflation differentials rising markedly among economies is usually negative for the currency where inflation is rising the most.

Therefore, we cannot rule out we could find ourselves at the cusp of a prolonged period of dollar depreciation, which could support both commodities and digital assets (absent any new regulations) going forward. Once again, differentiating outside of a single currency becomes very important.

OUR STANCE

Liquidity: Overweight ▲	**Bonds**: Underweight ▼	**Equities**: Neutral ◄	**Alternatives**:Underweight ▼	**Commodities**: Overweight ▲

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