Perspectives

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IN SHORT

- Inflation concerns have picked up again as price pressures mount. Talks regarding tapering continue to intensify.
- Yields have surged globally following the more hawkish tone of central banks and questions regarding the transitory nature of inflation.
- Equity markets have witnessed volatility and come under pressure at the end of the month after a strong start, but we still see an additional bounce in performance towards the end of the year.

Inflation, no time to die

The list of risks for investors continues to grow, but inflation and tapering remained clearly on top in September. Price pressures continue to build as energy prices soar, including gas and fuel demand in Europe, supply bottlenecks don't appear to be resolved, inventories are depleting, and pent-up demand continues to be released as the economy reopens. Business leaders are increasingly talking about rising price pressures. This is intensifying discussions about tapering, and central banks have taken note that these pressures may last longer than initially expected. The Fed has indicated that "a moderation in the pace of asset purchases may soon be warranted," which could be announced in November. The DOTS has shown a potential first rate hike as early as late 2022. Similarly, the Bank of England raised its year-end inflation forecast to 4%, and hinted that it may raise its policy rate next year. Norges Bank became the first European central bank to raise its main rate. We do not think this will be a real problem and will derail the recovery. The adjustments will be gradual and anticipated by the markets.

Yields have jumped globally and are back to where they were in June, with the 10-year gilt hitting a two-year high after the more hawkish tone of the BoE. We expect yields to continue to rise as monetary policy normalization continues, the recovery unfolds and inflation pressures remain unresolved. We still believe inflation to be transitory, but it is likely to remain anchored at a higher level before declining and stabilizing.

Despite signs of slowing, the economic recovery remains on track. We are probably past the peak of growth, but while decelerating, we think it will remain at a high level. Manufacturing activity remains strong and the service sector, which suffered from delta-related concerns over the summer, still has room to catch up and take over growth. Fiscal support continues to be ample with the bipartisan $1 trillion infrastructure package and the $3.5 trillion budget plan that focuses on "soft" infrastructure currently under discussion in the House of Representatives after being approved last month in the Senate. The need for an increase in the public debt limit is currently being discussed in Congress, but the U.S. Treasury has taken steps to provide the necessary funding in the interim. In Europe, countries continue to receive their first tranches of money from the €750 billion European Recovery Fund. There is still plenty of liquidity and pent-up demand to deploy, and strong consumer demand and spending should continue to support the recovery.

The spread of the delta variant seems to have stabilized worldwide and hospitalizations have remained under control so far. Covid risks appear to have receded behind concerns of inflation, tapering, or central bank monetary policy mistakes. Chinese regulatory headlines have given way to fears that Evergrande, China's second-largest property developer by revenue, could collapse and create a systemic risk. We do not believe this is a major risk and that it will become a new Lehman Brothers, as financial exposure is limited and Chinese authorities will ensure that contagion remains low.

Equity markets have experienced increased volatility in recent weeks, but we remain optimistic. We expect strong economic growth despite a deceleration, with strong support from central banks and government spending. Valuations remain at high levels, but we believe earnings growth will continue to support the market in the coming months.

Asset class details

Equities

Fears of continued high inflation, tapering talks and Evergrande's debt dilemma have led to increased volatility in recent weeks, with the VIX again exceeding 20. Major equity indices declined in September, with the exception of Japanese stocks. Value sectors are again leading the charts, with the energy sector far outperforming and benefiting from rising energy prices, while financials are barely in positive territory but have outperformed the market. Quality stocks, which made a comeback over the summer, suffered and lagged the market.

The economic backdrop remains positive however, as vaccination campaigns in develop markets should avoid further stringent measures and the accommodative stance on fiscal and monetary matters should be maintained.

The positive economic surprises have slowed, highlighting that we may be past the peak of growth and concerns about stagflation are starting to make headlines. However, we believe that despite the slowdown in economic growth, it will remain at a high and sustained level, supporting risky assets. Earnings estimates for 2021 and 2022 remain high and are being steadily revised upward. Valuations are elevated and the above-mentioned risks could weigh on the markets, but strong earnings growth should continue to drive the market higher as revenues and margins improve globally.

Against this backdrop, we have maintained a bullish bias but have reduced our overweight on equities in our portfolios, maintaining a preference for cyclical stocks. Sustained high growth and lower valuations should favour sectors such as financials and energy. A select portion of growth sectors show strong earnings resilience and can help diversify the equity basket. We are paying attention to the Chinese market where the regulatory crackdown and the Evergrande story have weighed on the market and could lead to attractive entry points.

Fixed Income

Inflation and tapering have driven markets again in September. Yields have surged globally with the U.S. 10-year Treasury yields rebounded over 1.50%, the 10-year UK gilt reaching a two-year high of 1% and the 10-year Bund back to its June level at -20 bps. Central banks meetings were at the forefront, and showed a more hawkish tone. The Fed indicated that it may be soon reducing their asset purchases; the Bank of England increased their inflation forecasts to 4% by year-end and hinted they could start raise rates next year; the Norges Bank became the first European central bank to raise its main rate. However, the ECB maintain an accommodative approach talking only about recalibrating its quantitative easing policy rather than tapering.

We believe yields will likely continue to trend higher, but that the increase will be gradual and remain capped as investors weigh growth concerns, monetary policy will remain accommodative, and forward guidance will be cautious so as not to catch the market off guard. We do not expect a Fed rate hike until late 2022 or early 2023, and the ECB is expected to normalize policy later, at an even slower pace, to continue supporting its banking sector and peripheral countries.

In this context, we remain cautious on duration as we see more upside risk. We favour credit risk, as default levels have declined and spread levels have offset the risk taken. The longer duration of IG indices and tight spread levels leave less room to compensate potential losses from rising rates. Following the Evergrande headlines, corporate spreads have widened slightly but held up relatively well and selective high yield opportunities may present themselves.

We remain positive on emerging hard currency corporate debt, as the carry level remains attractive compared to developed markets, we see additional room for spread convergence, and corporate balance sheets are strong. However, selection remains key in this area.

Currencies

Inflation fears and a more hawkish Fed has led to dollar strength which reached 1.15 against the Euro, a level not seen since last year. We do not expect additional upside, as strong growth and risk taking should eventually detract from further strengthening but we monitor this level. The broad range trading witnessed over the last months should continue against major currencies. EM and commodity-linked currency may benefit from such environment.

Commodities

World oil demand will be back to pre-pandemic level by year-end and production cuts are still in place and properly managed to maintain a sustainable price recovery. Most of the rebound has probably already taken place as supply remains plentiful, but continued strong growth should keep a floor on oil prices.

Gold has retreated from last year's highs and has suffered from expectations of higher inflation and real rates, but the reopening of emerging economies and increased central bank reserves could lead to higher physical demand. We expect a wide trading range in the near term.

Alternatives

Alternatives continue to provide diversification and de-correlation opportunities. We believe that real assets can also help provide income in a world where interest rates will remain lower for longer.

Asset Classes	Negative	Neutral	Positive
Equities			● ○
Fixed Income		●	
Equities			
US		●	
Europe			●
Japan			●
Asia ex Japan			●
Emerging Markets		●	
Asia		●	
Latam		●	
Europe		●	
Fixed Income			
Sovereign US	○ ●		
Sovereign EUR	● ○		
IG US		●	
IG EUR		●	
HY US		●	
HY EUR		●	
EM Hard Ccy		●	
EM Local Ccy		●	
Commodities			
Oil		●	
Gold		●	
Base Metals		●	

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