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Asset Management

BAROMETER OF FINANCIAL MARKETS SEPTEMBER INVESTMENT OUTLOOK
September 2021

Barometer: Dealing with Delta

While the spread of the new Delta Covid variant has unsettled the global economy, stimulus and vaccination programmes should prevent a sharp slowdown in growth.

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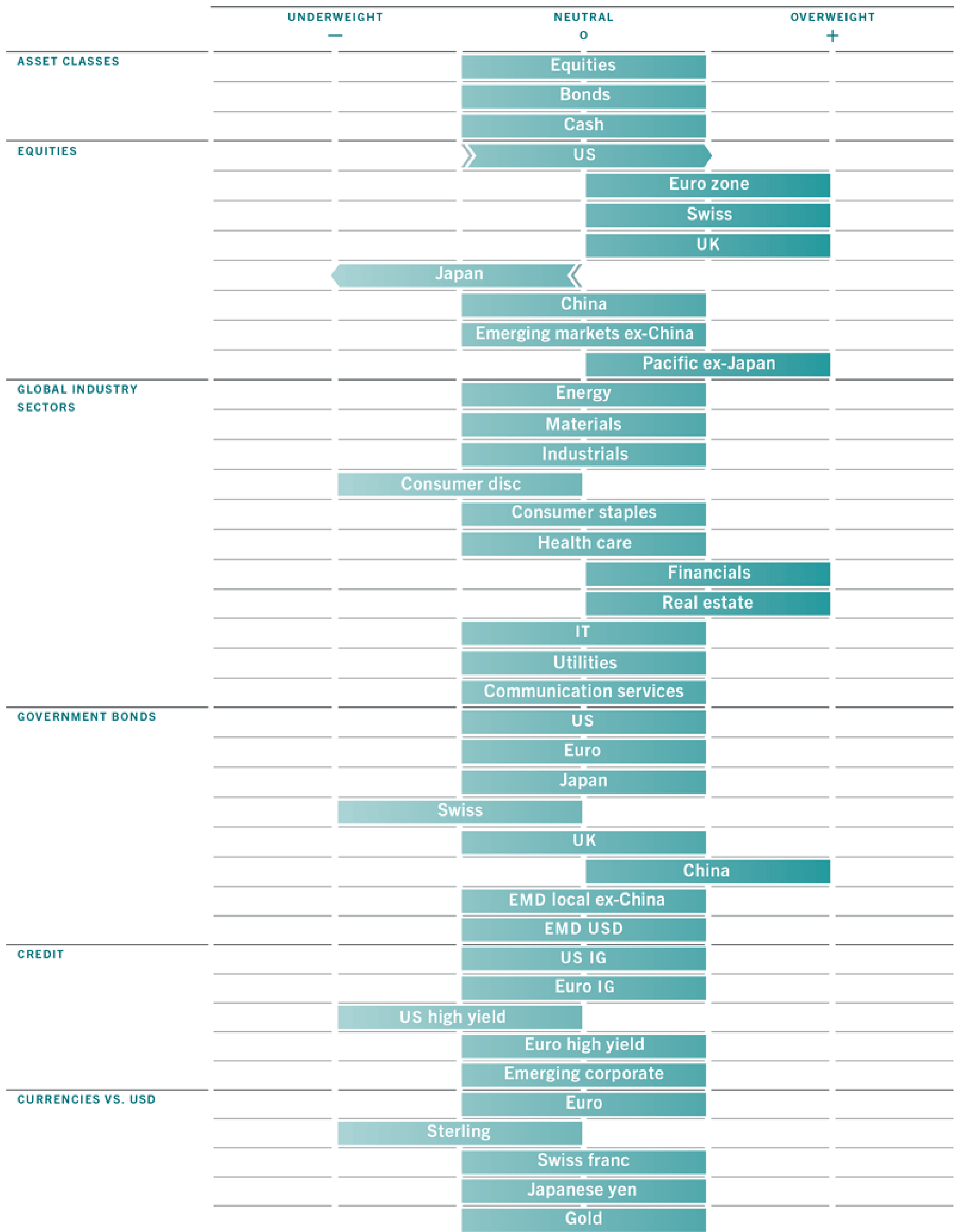
Asset allocation: stimulus and vaccine offer enduring support

Economic growth has clearly slowed in recent months thanks in large part to the spread of the particularly infectious Delta variant of Covid. Still, with monetary stimulus in plentiful supply and vaccination rates holding firm, this dip could prove to be temporary.

Whether inflation will be transient is not so clear, however. So far, much of the increase in inflation results from distortions caused by changing consumer behaviour – a narrow group of items such as used cars and holiday accommodation accounts for most of the price increases seen in recent months – and base effects. A concern, though, is that price pressures are starting to seep into other areas, like services.

Fig. 1 - Monthly asset allocation grid
September 2021



Source: Pictet Asset Management

Making matters more complicated, policymakers aren't giving particularly clear signals.

The heated inflation debate taking place within the US Federal Reserve's ranks has spilled out into the open, and investors are still waiting for an indication of when the central bank will start to wind down its USD120 billion monthly asset purchase programme or how long the process might take.

There are other risks for investors to consider.

While developed economies have started to get a grip on the pandemic, signs that outbreaks are possible despite mass vaccination programmes stand as a warning for what might happen this winter in the US and Europe. Meanwhile, regions that had previously been largely unaffected by Covid – like Southeast Asia – are bearing the brunt of the current wave.

An additional worry is China. Covid-driven lockdowns, a tightening of credit supply earlier this year and Beijing's regulatory and market reforms have all dampened growth and raised uncertainty for the business community. A big puzzle facing the Chinese government is why households are spending so little and how to get them spending more. Taking all this into account, we have chosen to reduce exposure to some cyclical stocks (Japan) but maintain our overall neutral stance on all major asset classes.

Our **business cycle** analysis offers up a mixed picture. We are now less positive on the UK, Switzerland and Europe outside of the euro zone. However, we believe that weakness in the US is likely to be transitory, driven by a resurgence of the virus, which will merely postpone the pickup in consumption rather than undermine the underlying strength of the recovery.

In light of weakness in US consumption and construction we have lowered our GDP growth forecast for this year to 6.5 per cent from 7 per cent, but continue to expect a robust expansion of some 5.3 per cent for 2022.

The euro zone, meanwhile, has offered positive surprises. The leading indicator is very strong. Online indicators show that mobility is back above pre-pandemic levels, which suggests that Europeans have learned to live with Covid.

Fig. 2 - Peaky: P/Es shifting lower
MSCI All Country World Index trailing 12m EPS vs trailing P/E ratio

Source: Refinitiv Datastream, MSCI, IBES Pictet Asset Management. Data from 01.01.2018 to 23.08.2021.

Our **liquidity indicators** show that Chinese credit growth peaked last autumn and then started to contract four months ago. This means that even though the People's Bank of China's recently cut its bank reserve requirement ratio, the lagged effects from prior tightening will linger for the rest of the year.

That said, global liquidity conditions in the coming months will be primarily determined by the pace of monetary tightening in the US. The major risk is that the US tightens too much too soon. For now, though, liquidity conditions worldwide remain supportive for riskier asset classes, with central banks still more generous than they were in the months following the global financial crisis a decade ago, while private liquidity creation in the form of loans remains at about its long run average.

Our **valuation indicators** show that even though global bonds have become expensive, particularly US Treasuries and euro zone bonds, equities are more expensive still.

If liquidity conditions turn negative - in other words, if the rate of money supply expansion falls below the nominal rate of GDP growth - then global stocks' price to earnings ratios will come under pressure. That's especially true because P/E ratios are very high for this stage of the cycle relative to earnings growth (see Fig. 2) – our models suggest these ratios will contract 5 to 10 per cent by the year end.

Our **technical indicators** show that equity sentiment remains neutral across all regions, while strong short-term trends support bonds. By contrast, a sharp loss of momentum is weighing on commodities.

Separately, investor risk appetite has pulled back from euphoric levels in mid-May across asset classes.

02

Equities regions and sectors: time to reduce Japan

The recent slowdown in GDP growth has already had an effect on economically-sensitive stocks. As Fig. 3 shows, cyclical stocks have lagged their defensive counterparts in recent months as economic data are no longer surpassing analysts' forecasts by a wide margin. Because we expect this trend to continue, we have reduced our holdings of some cyclical stocks, primarily by downgrading Japan.

Japan’s economy is in any case facing the biggest challenge yet of the pandemic as a renewed surge in Covid infections and a stubbornly slow vaccination rate weigh on business activity and consumer confidence.

What is more, the Bank of Japan is struggling to stimulate the economy in the face of sluggish private credit creation, which hit its weakest level in nine years.

Our leading indicator has contracted for three months in a row and the outlook remains bleak as Japan appears particularly vulnerable to a slowdown in China and a decline in external demand.

For these reasons, we have downgraded Japanese equities to underweight.

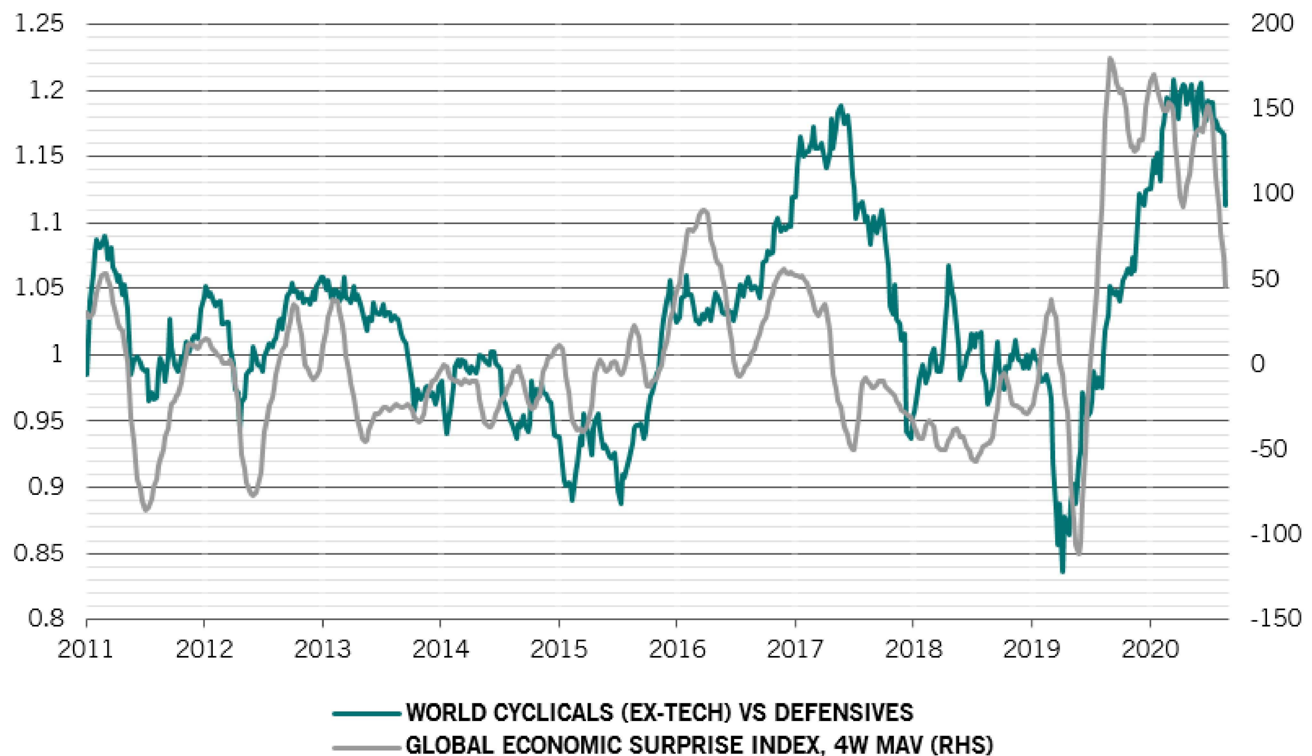
In contrast, we are becoming more optimistic on prospects for US stocks. While the US remains the most equity market on our valuation scorecard, we see a number of encouraging signs that prompt us to upgrade our stance to neutral from underweight.

The US economy is growing comfortably above its long-term trend, with close to 10 per cent nominal GDP growth projected for this year and next. At the same time, the rate of increase in new Covid infections appears to have peaked. Monetary policy, meanwhile, remains supportive as the Fed appears reluctant to rush into scaling back its stimulus and bank lending standards are at their loosest on record.

US companies are also reporting strong earnings: our model shows US firms are enjoying the strongest momentum in analyst profit forecasts upgrades compared to firms based in other developed and emerging countries.[1]

Our neutral stance in the US along with an overweight position in Swiss equities, allow our portfolio to hold a greater number of quality stocks, which tend to perform well during this particular phase of a bull market cycle.

Fig. 3 - Cyclicals underperform defensive sectors as economic prospects weaken
World cyclicals (ex-tech) vs defensives compared to global economic surprise index



Source: Refinitiv, MSCI, CITI, Pictet Asset Management. Data covering period 30.12.2011 and 20.08.2021

We also like euro zone stocks.

Real time indicators of services activity are stabilising at a high pre-pandemic level while the region's retail sales have also recovered above their pre-Covid trend.

Our model also shows strong upward earnings revisions among European companies, many of which are value stocks, as economies reopen. That includes financials, which should also capitalise on rising bond yields, and real estate.

We remain neutral in China. Our leading indicators continue to decelerate, with consumption weighed down by local lockdowns and travel restrictions in response to the pickup in Covid infections. A cut in reserve requirements for domestic banks failed to arrest a contraction in credit creation, which we expect to bottom in September.

However, we expect retail spending to resume growth in the coming months once the impact of the recent Covid wave wanes.

In the long term and relative to other stocks, Chinese are attractively valued according to our model. (As recently as February this year, Chinese equities were, on several measures, as expensive as US stocks). However, on traditional earnings-based measures, the current valuation discount of MSCI China, at 30 per cent to global equities, is not yet at crisis levels – in 2014-2015, the gap widened to as much as 45 per cent.

[1] Measured as net upgrades to +12m EPS estimates as a % of total estimates, 3m average. Source: Refinitiv Datastream, Pictet Asset Management, IBES.

03

Fixed income and currencies: Chinese bonds a bright spot

Concerns about slowing growth and a resurgence in Covid infections have spurred a strong rally in global bonds, despite their unattractive valuations. This sent the real yield – which strips out inflation – to a record -1.17 per cent in the US at one point in August.

At the same time, the volume of negative-yielding bonds has risen to a six-month high above USD16 trillion.

The rally has since cooled off as expectations grew that the Fed would prepare the ground for policy normalisation and global economic slowdown worries subsided.

At a time when income-generating assets are in short supply, Chinese bonds continue to offer attractive opportunities, in our view. It is an asset class with low volatility and deepening liquidity and one which also offers attractive yields of 2.9 per cent.

A recent shift in the monetary policy stance of the PBOC also supports the country's fixed income market. Faced with a slowdown in the world's second largest economy, the central bank stands ready to ease monetary policy further after a 100 basis point cut in bank reserve requirement ratios in July. This sits in contrast to the Fed, which is planning to scale back its monetary stimulus.

Our technical model also shows positive trends in the asset class.

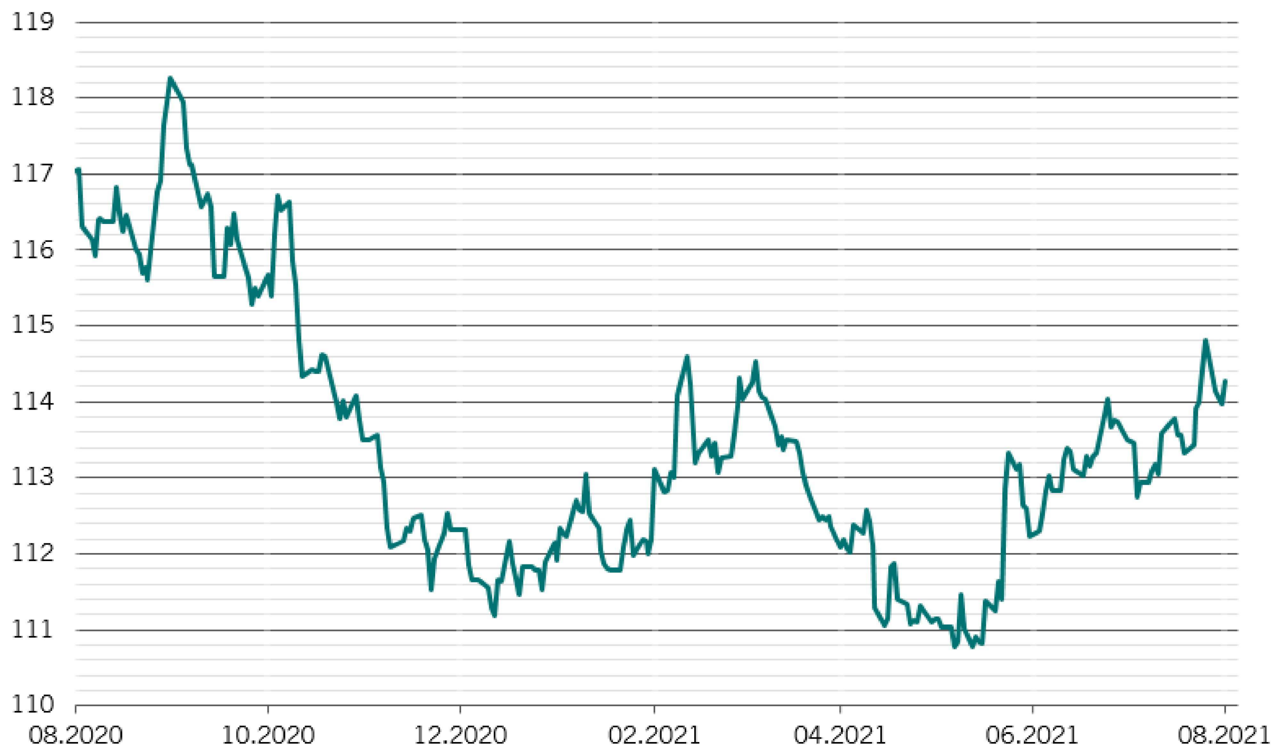
Separately, we maintain our neutral stance on US Treasuries. US yields appear too low at current levels of 1.30 per cent, 40 basis points below what our models suggest as a long-term fair value.

However, we don’t foresee a disruptive rise in yields.

We believe the current bout of rising inflationary pressure is largely due to distortions in supply chains and demand for Covid-sensitive items such as used cars, which add as much as 2.5 percentage points to the headline reading.

Excluding these effects, core inflation remains benign at 1.6 per cent.

Fig. 4 - Dollar run done?
Trade weighted US dollar index



Source: Refinitiv, Pictet Asset Management. Data covering period 26.08.2020 and 26.08.2021

We are also neutral in all other major government and corporate bond markets, apart from Swiss bonds and US high yield, in which we are underweight.

In the currency markets, the US dollar, supported by strong US growth, rose to a 10-month high after hitting a bottom a couple of months ago. Looking ahead, however, we don't expect the greenback to see a repeat of its recent surge, which is why we maintain our neutral positioning across all major currencies. The exception is sterling, in which we are underweight.

The Bank of England, which has already slowed down the pace of bond purchase, has now started setting out plans to gradually tighten monetary policy. This, in our view, points effectively to double tightening which could have negative effects on the still fragile economy.

We expect the UK to be the first among developed economies to have an inverted yield curve in this economic cycle – usually a warning sign for the economy.

04
Global markets overview:

Global markets: record-setting stocks

Global equity markets finished the summer on a strong note, having gained 2.7 per cent in August in local currency terms. Both Europe's STOXX 600 and US's S&P 500 scaled record highs during the month. Investors welcomed comments from Fed Chairman Jerome Powell who signalled that, while the US central bank was moving closer to reducing monetary stimulus, it was in no rush to do so and was planning to move slowly.

Cyclical sectors broadly underperformed more defensive industries as momentum in global economic growth slowed a notch. The spread of Covid's Delta variant prompted lockdowns in New Zealand and Vietnam, and raised the spectre of further restrictions elsewhere in the world. Materials was the only sector to finish the month in the red (albeit marginally), while top gainers including utilities and healthcare (up 4.0 and 2.8 per cent, respectively).

Performance across emerging markets was mixed, with developing countries taking both top and bottom places for returns globally (in local currency terms). India, Mexico and Russia powered ahead, while South Africa, Korea, Brazil and China finished firmly in the red. China in particular was hit by concerns over regulatory crackdowns on its tech firms. Under the latest rules, Chinese children will only be allowed to play games for three hours a week, with gaming companies required to enforce this by verifying users' real identities.

Fig. 5 - Bottoming
US 10Y TIPS yield, %

Source: Refinitiv, Pictet Asset Management. Data covering period 23.08.2019 and 25.08.2021

Global bonds were down 0.3 per cent at the end of what proved to be quite a volatile month as investors looked for clues on future central bank policy and tried to gauge whether inflationary pressures would prove transient or long lasting.

US Treasuries finished the month marginally lower, giving up earlier gains after Powell's comments. US inflation-linked bonds, or TIPS, also saw prices move lower and yields higher towards the end of the month, as investors took profits on strong recent performance (see Fig. 5.).

In Europe, meanwhile, losses were a bit steeper in the face of increased price pressures – including German inflation hitting a 13-year peak.

Corporate bonds on both sides of the Atlantic fared a bit better than their sovereign counterparts, cheered by strong earnings news.

Elsewhere, oil prices dropped 4.5 per cent, reflecting expectations of lower demand from Asia. Industrial commodities also lost ground, given waning growth momentum, a weak set of macro data from China and continued strength in the US dollar.

The dollar is just off its highest levels versus a basket of currencies since last November. Its gains were most pronounced versus sterling and Swiss franc. Despite

some signs of moderation, activity in the world's largest economy remains strong, well above trend levels.

05

In brief

BAROMETER SEPTEMBER 2021

Asset allocation

We retain our neutral stance on the main asset classes amid signs that a recent economic slowdown will only be temporary.

Equities regions and sectors

We downgrade Japan to underweight and upgrade the US to neutral.

Fixed income and currencies

We like Chinese bonds which offer attractive yields, low volatility and deepening liquidity.

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