NEWSLETTER

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"Eyeing rate hikes like hawks"

Global equities continued their upward march, reaching new heights, while volatility remained moderate. The markets were driven by upgrades in company earnings forecasts while investors ignored the resurgence that was occurring in Covid-19 cases worldwide, mainly in the UK and Asia. The US Federal Reserve shifted its tone, raising its inflation projections. Its hawks (the most conservative members) brought forth their forecast date for initial rate hikes to 2023. On the fiscal front, Biden obtained the support of senators from both parties for his infrastructure plan. Meanwhile, the G7 reached an agreement on a global minimum corporate tax rate of 15%.

Market trends

Global equities set records, gaining 1.3% in June. US equities outperformed (S&P 500 +2.3%), driven by a rally in techs stocks (Nasdaq +5.5%), while emerging equities underperformed (MSCI EM +0.2%), as China continued to drag down emerging markets. The yield curve flattened due to rising short-term rates (US 2Y +11bps to 0.25%), which were driven, in turn, by monetary policy expectations, and to falling long-term rates (US 10Y -13bps to 1.47%, US 30Y -20bps to 2.09%). Credit outperformed duration on the month. The dollar rose steeply (DXY +2.9%, EUR/USD -3.1% to 1.1849). And gold suffered its worst loss since 2016 (-7.2%), while oil (+10.8% by WTI) hit a high since 2018.

In Switzerland, the LPP pension fund indices (indices de la prévoyance professionnelle) were positive in June by +1.8% for the LPP25+ and by +2.2% for the LPP40+, bringing their year-to-date performances to 4.2% and 7.5%, respectively.

Market performance as of 30 June 2021

STOCKS MARKETS	LEVEL 30.06.2021	CHANGE SINCE 31.05.2021	CHANGE SINCE 31.12.2020
Index			
MSCI World	720.0	1.32%	12.30%
USA			
Dow Jones Ind	34502.5	0.02%	13.79%
S&P 500	4297.5	2.33%	15.25%
Nasdaq Comp	14504.0	5.55%	12.92%
Europe			
Euro Stoxx 50	452.8	1.50%	15.15%
SPI (Switzerland)	15347.1	4.62%	15.15%
CAC 40 (France)	6507.8	1.15%	18.91%
DAX (Germany)	15531.0	0.71%	13.21%
FTSE 100 (UK)	7037.5	0.40%	10.87%
Japan + Emerging			
Nikkei 225	28791.5	-0.11%	5.59%
CSI 300 (China)	5224.0	-1.53%	0.93%
MOEX Index (Russia)	3841.9	3.43%	18.95%
S&P BSE Sensex (India)	52482.7	1.29%	10.59%
Ibovespa (Brazil)	126801.7	0.46%	6.54%

BONDS & ALTERNATIVES MARKETS	LEVEL 30.06.2021	CHANGE SINCE 31.05.2021	CHANGE SINCE 31.12.2020
Rates			
Germany 10 y	-0.21	-2 Bps	36 Bps
France 10 y	0.13	-4 Bps	46 Bps
Italy 10 y	0.82	-9 Bps	28 Bps
US 10 y	1.47	-13 Bps	55 Bps
Debt			
Investment Grade US	341.50	1.05%	-0.54%
Investment Grade Europe	265.17	0.41%	-0.39%
High Yield US	2422.60	1.34%	3.62%
High Yield Europe	435.14	0.61%	3.56%
Emerging Debt	924.35	0.89%	-1.00%
Currencies			
EUR/USD	1.19	-3.02%	-2.93%
EUR/CHF	1.10	-0.20%	1.45%
USD/CHF	0.93	2.90%	4.50%
Commodities			
Crude Oil (WTI)	73.47	10.78%	51.42%
Gold	1770.11	-7.17%	-6.76%

Economic highlights

Pandemic situation

Currently identified in about 100 countries, the Delta variant is an increasingly serious concern in Europe. Better known as the "Indian" variant, in reference to the country in which it was discovered, it is estimated to be 40% to 60% more contagious than the British variant, which, in turn, was more contagious than the legacy Covid-19 variant.

In the UK, more than 95% of new cases are of the Delta variant. This percentage is 60% in Australia, 45% in the UK, 30% in Germany, and 20% in Switzerland. The reproduction rate is rising, and experts agree that this variant will dominate the global pandemic landscape by August. **In countries where vaccinations are far along, the rebound in case numbers has not been followed by a meaningful increase in hospitalisations and deaths, as was the case previously.** In the UK, for example, the lethality rate, which measures the ratio between deaths and confirmed cases, has fallen to 2.6%.

The figures show that vaccination works and is effective against the new variants. According to studies by the UK Health Security Agency, vaccines used in the UK offer almost 80% protection against symptomatic forms. The poorest countries, particularly in Africa and South America, have thus far administered relatively few doses. In developed countries, the challenge facing the authorities is in persuading unvaccinated sceptics. So, we are far from reaching the global herd immunity that is necessary for eradicating the pandemic.

Economic environment

The employment variable is being closely watched, as that is what is driving US monetary policy. The latest figures for June were for 850,000 non-farm job creations after two relatively disappointing months. **The job climate is neither too hot or too cold, which is how the markets like it. The catching-up phase has been perceptible since the start of the year, but employment is down by almost 7 million units compared to the pre-crisis trend.** The recent increase in wages, to 3.6% year-on-year, could stoke fears of a resurgence in inflation that is more sustained than temporary. This is something to keep an eye on, especially the low-wage component. In contrast, the low 61.6% participation rates suggests that many persons have not resumed gainful employment. The phasing out of government allocations between July and September will lift one obstacle to getting people back to work.

PMI business surveys revealed a growing divergence in growth prospects between developed and emerging economies. The composite index held steady at 59.3 in developed economies while declining to 50.9 in emerging economies, a low since June 2019. The Chinese economic slowdown shows up clearly in the latest Caixin statistics, which are nearing their equilibrium points of 51.3 in manufacturing and 50.3 in services. **Chinese activity is being slowed by curtailed lending to the economy** that Chinese officials are using to limit financial risk, as well as **tougher regulations covering technological platforms** (Didi, the Chinese "Uber", found this out to its displeasure, just after its IPO). We also take note of the lessening pricing pressure in goods and services after their early-year run-up.

US PMI and ISM surveys are at high levels but have pulled back from their peaks, which suggests that growth may have peaked during the second quarter. In the euro zone, the economic recovery is continuing more robustly, with the PMI composite rising from 57.1 to 59.5, a high since June 2006. Moreover, new orders rose further, as did employment. As we noted in previous comments, these results are being driven mainly by services, which hit 58.3 in late June, up from just 49.6 at the end of the first quarter.

In Switzerland, the KOF Economic Barometer corrected slightly from 143.8 to 133.4. The upward trend continues in manufacturing, albeit at a slower pace, while retailing and catering & hotels are still sluggish. **The mixed bag of statistics from one sector to another suggests that the Swiss economy is now on its way to a more moderate normalisation.**

Vaccination plans have helped reopen economies, which has meant higher commodities prices and bottlenecks in production, logistics and labour shortages in some sectors, and therefore inflationary pressures in the US. Inflation rose to 5.0% year-on-year, and to 3.8% without the more volatile components of energy and food. In Europe, inflationary pressures remained weak at 2.0%, half of which was due to the increase in higher energyprices. In Switzerland, inflation is negligible at 0.6% year-on-year. **Various stimulus policies, including direct cash handouts to US households that have boosted consumer spending, will result in different monetary policies.**

Monetary policies

In the US, the FOMC's decision to put tapering discussions on its agenda (which would reduce its current monthly 120 billion dollars in asset purchases), along with the increase in the number of FOMC members expecting a rate hike in 2023 were interpreted by investors as a signal of future tightening in Fed monetary policy. Of the 18 participants, 13 see at least one hike by 2023, up from seven in March, and only five now see no rate hikes until 2024. The Fed's hawks (who advocate a less accommodative policy) carried the day, and the markets now forecast between two and three rate hikes by the end of 2023.

So, the Fed reassured the markets that it will not allow inflation get out of hand under its new inflation averaging monetary policy framework. Even so, inflation is a burning issue. While the Fed's "transitory" inflation scenario seems to have taken hold and been accepted on the bond markets, the question now is what the new average rate will be after normalisation, which is likely sometime in 2022. This is the challenge now facing central banks and investors. The uncertainties of macroeconomic data make it impossible (for now) to answer this question.

We would rule out the possibility of a "hard" tapering, as occurred in 2013 under Bernanke. Central banks are now better at preparing the markets for a reduction in monetary support. We see a window between Jackson Hole and the November FOMC meeting for announcing a reduction in asset purchases, which could then occur in 2022 (with a 10 billion euro monthly reduction bringing the monthly amount from 120 billion to zero), followed by an initial rate hike in early 2023.

On the issue of whether inflation is temporary or long-lasting, we agree with the Fed – that it is temporary. The expansion in the money supply has accelerated further since the pandemic began, but this alone does not prove the scenario of strong inflation to come, as two components are missing for a more rapid dissemination of money into the economy – the demand for loans and the increase in real wages are still sluggish (when excluding direct government payments to individuals). **At this stage, the most likely scenario is that inflation will "land" between 2.0% and 2.5% in the next cycle, one notch above its average of the past 10 years.** Growth in the economy and the inflation cycle have clearly peaked.

On the political front

The markets cheered the common ground reached on the infrastructure investment plan, although the stated amount of 1,000 billion dollars is below the previously announced 2,300 billion. While this is a major step forward, the agreement did not bring discussions to an end. The progressive wing of the Democratic party wants to link the agreement with the "family infrastructure" plan, the fight against global warming and tax revenue. The Republicans, even this bare-bones agreement looks overdone, and some of them would rather not hand a victory to Joe Biden.

Has the G7 opened the door to the G20 to accept a minimum tax rate on multinational companies' earnings? According to the G7, the "largest and most profitable" companies must pay taxes on a portion of their earnings in countries where they do business and not just where they repatriate those earnings. But what, exactly, are the "largest and most profitable" companies and which digital taxes imposed unilaterally will be offset by cuts elsewhere? Lots of questions have been left hanging. In the event of an agreement, the new international standard would come into force in 2022. Tax Justice Network has estimated that a 15% rate could generate up to 275 billion dollars in annual new receipts for governments. So the stakes are high. **The Swiss Confederation and its cantons are readying potential offsets to maintain their attractiveness for multinational companies.**

Investment decisions

At mid-year, the Investment Committee confirmed its current allocation grids while weighing the opportunities and risks, and signed off on the portfolios' positioning. On the whole, the environment continues to favour risk-taking in the portfolios as long as excessive concentrations are avoided. **Corporate risk is overweighted compared to neutral weighs, while bonds and interest-rate risk is underweighted.**

In equities we are sticking to our diversification between regions and between defensive, tech and more cyclical sectors, as we seek to exploit the current context as much as possible via a balanced mix between beneficiaries of the recovery and long-term structural winners. **Among regions, Europe is a good candidate for diversification and the quest for performance, as seen in its results so far this year. Large-scale vaccination is furthering the adoption of reopening plans and the acceleration of economic activity in services. Earnings forecasts continue to be upgraded, and domestic themes remain attractive.** We also continue to overweight convertibles (7.5%), in which the primary market has recovered some very attractive momentum and which demonstrated their value in 2020.

In the bond universe our preference is clearly for corporate bonds. With business activity expected to be high in 2021 and in 2022, defaults are likely to remain low and valuations, high. We are invested in a mix between high-quality companies and higher-yielding issues, particularly in China. Meanwhile, the riskiest segments (like CCC) no longer offer enough excess returns to offset the risk incurred.

Cat bonds, which are generally issued by insurance companies to transfer some of the risks they incurred from exceptional natural events offer attractive diversification in an environment of low interest rates, along with attractive yields. The reason for this is that these assets' prices are independent of the economic situation and are loosely correlated to those of other assets, such as equities and traditional bonds.

Overall, we remain cautious on the long end of the curve, which is likely to continue rising, albeit at a slower pace than early in the year.

Our conviction is neutral on gold as it remains correlated to fluctuations in the US dollar (gold rises when the dollar falls) **and real interest rates, which are not normalised** (gold falls when real rates rise). The investment thesis is still valid, as monetary policies are still accommodative and governments are still running stimulus programmes.

In the current environment, we recommend exposing portfolios to global listed real estate. Our investment thesis is based on a positive correlation between the performances of global listed real estate and the rise in long-term inflation expectations. This is driven by the updating of leases that often contain fixed or inflation-linked increases, for example in apartment and commercial leases. The sector has reacted rather well to higher interest rates, with limited price increases over 12-month time horizons.

Compared to sectors that have stalled in the face of inflation expectations, international listed real estate has an interesting profile, as seen in its year-ot-date showing (+16.8% by the FTSE EPRA Nareit of developed countries, in dollars). Meanwhile, the relative lag accumulated over the past five years vs. to the major indices points to some upside potential in the event that investors react to higher inflation by modifying their sector allocations.

In currencies, our strategy consists of investing in equities in their listing currencies and to hedge currency risk in bonds, with the exception of the yuan for Chinese domestic bonds. We also invest in alternative or asymmetric strategies such as convertibles. **Balanced profiles are thus exposed between 60% and 70% to the accounting currency.**

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