NEWSLETTER

Sébastien Gyger, Chief Investment Officer

“From great to good”

The focus remains on the Delta variant, with infection rates having risen in the US and in some parts of Asia, where restrictions have been put back in. The US economy expanded at an annualised rate of 6.5% in the second quarter and would have been even stronger without another inventory squeeze and supply bottleneck. Worldwide, business surveys remained firmly expansionist in July but do show that economic activity has peaked. According to news from the latest FOMC meetings, Fed officials are coming up on the point when they may begin to withdraw support to the US economy, although much progress remains to be achieved. The ECB, meanwhile, has adopted a symmetric 2% inflation target in place of its previous target of keeping inflation below, but close to 2%.

Market trends

Global equities gained +0.7% in July, with the United States and Europe outperforming (S&P 500 +2.4%, Nasdaq +1.2%, and Stoxx 600 +2.1%). Emerging markets (MSCI EM -6.7% and MSCI EM Asia -8.1%) took a hit from a regulatory crackdown in China (CSI 300 -7.4%, Hang Seng -9.6%). Despite higher inflation, US yields fell significantly (US 10Y -25bps to 1.22%), due to economic growth fears driven by the Delta variant and the solid anchoring of inflation expectations. The US dollar was almost unchanged (DXY -0.1%, EUR/USD +0.2% to 1.1870). Meanwhile, oil was up slightly (WTI +0.7%) after OPEC at last reached a compromise on a gradual increase oil supply. Global listed real estate (+3.9%) and gold (+2.4%) were last month’s two winners.

In Switzerland, the LPP pension fund indices (indices de la prévoyance professionnelle) improved in July by +0.9% for the LPP25+ and by +0.8% for the LPP40+, bringing their year-to-date performances to 5.2% and 8.5%, respectively.

Market performance as of 31 July 2021

STOCKS MARKETS	LEVEL 30.07.2021	CHANGE SINCE 30.06.2021	CHANGE SINCE 31.12.2020
Index			
MSCI World	724.2	0.69%	13.08%
USA			
Dow Jones Ind	34935.5	1.34%	15.31%
S&P 500	4395.3	2.38%	17.99%
Nasdaq Comp	14672.7	1.19%	14.26%
Europe			
Euro Stoxx 50	461.7	2.06%	17.52%
SPI (Switzerland)	15578.3	1.51%	16.88%
CAC 40 (France)	6612.8	1.63%	20.85%
DAX (Germany)	15544.4	0.09%	13.31%
FTSE 100 (UK)	7032.3	0.07%	10.95%
Japan + Emerging			
Nikkei 225	27283.6	-5.23%	0.07%
CSI 300 (China)	4811.2	-7.37%	-6.51%
MOEX Index (Russia)	3771.6	-0.37%	18.52%
S&P BSE Sensex (India)	52586.8	0.36%	10.99%
Ibovespa (Brazil)	121800.8	-3.94%	2.34%

BONDS & ALTERNATIVES MARKETS	LEVEL 30.07.2021	CHANGE SINCE 30.06.2021	CHANGE SINCE 31.12.2020
Rates			
Germany 10 y	-0.46	-25 Bps	11 Bps
France 10 y	-0.11	-23 Bps	23 Bps
Italy 10 y	0.62	-20 Bps	8 Bps
US 10 y	1.22	-25 Bps	31 Bps
Debt			
Investment Grade US	344.94	1.01%	0.46%
Investment Grade Europe	268.19	1.14%	0.75%
High Yield US	2431.83	0.38%	4.01%
High Yield Europe	437.19	0.47%	4.05%
Emerging Debt	929.36	0.54%	-0.46%
Currencies			
EUR/USD	1.19	0.10%	-2.83%
EUR/CHF	1.07	-2.02%	-0.60%
USD/CHF	0.91	-2.06%	2.34%
Commodities			
Crude Oil (WTI)	73.95	0.65%	52.41%
Gold	1814.19	2.49%	-4.43%

Economic highlights

Pandemic situation

The Delta variant continues to raise concerns because of its rapid transmission rate and its greater contagiousness. Within 30 days, it rose from a 30% of new cases in Switzerland in early July to 100% in early August. It is spreading just as rapidly in Europe, the United Kingdom and in the US.

In countries where vaccinations are well along, the rebound in infections has not resulted in a significant increase in hospitalisations and deaths, as was the case previously. According to research by the UK's public health agency, vaccines used there offer almost 80% protection against symptomatic forms and, moreover, an Israeli study found that they are 93% effective in preventing serious cases. The mortality rate (i.e., the relationship between the number of deaths and number of cases) is now "just" in a range of 1.5% to 2.5% in large economies, compared to 15% in the UK and 11% in Europe at the peak of the first wave.

In contrast, new cases are turning back up in US states that are below average in vaccinations. Florida is the epicentre the current surge in Covid, suggesting that the next wave will be due to non-vaccinated persons and public agencies' defying public health recommendations**. While new pockets of Covid may slow the pace of reopenings locally, they are very unlikely to reverse this positive momentum.**

Economic environment

US inflation is still a hot topic. Prices are spiking for a small number of items, such as second-hand cars, and this is impacting consumer prices. The US CPI came to 5.4% in July at an annualised pace (4.3% ex energy and food). This was its fifth consecutive month above the 2% target, but the smallest monthly gain since March (at 0.5%). Over the past five years, the average US CPI is now at the Federal Reserve's 2% target. Moreover, we are seeing inflation spreading increasingly into services, which, like inflation in rent, will replace the more temporary items.

Accordingly, measures of year-on-year inflation are likely to remain in ranges well above those corresponding to the Fed's long-term target, while it is true that temporary impacts will recede and inflation may well have peaked.

At its latest meeting, the FOMC acknowledged that higher prices could actually be less temporary than expected and therefore lead to monetary policy that is less accommodative than currently. We expect the announcement of reduced asset purchases to happen between the Jackson Hole central banker meeting in August and the FOMC meeting in November. It could then be implemented in early 2022 (with the pace being reduced by 10 billion dollars each month, starting from 120 billion and ended up at zero), followed by an initial rate hike in early 2023. This scenario is backed by the significant improvement in the employment picture. July figures are indeed encouraging, with a steep drop in unemployment, to 5.4% vs. 5.9% in June, and 943,000 non-farm jobs were created (keep in mind that the June figure was revised upward to 938,000 jobs created vs. an initial estimate of 850,000).

Like the Fed, the ECB modified its inflation target. Under Christine Lagarde, the European Central Bank has set a new 2% symmetric inflation target with some leeway for temporary overshooting. This is a major shift from Bundesbank monetary doctrine and is meant to give the institution more manoeuvring room in hitting its target. Not since 2003 has euro zone core inflation exceeded 2%. The ECB may leave its rates unchanged until 2024. Prior to the ECB, the Swiss National Bank had pushed back the prospect of a coming interest rate hike. **We will have to get used to "lower for longer" in asset allocation decisions regarding Europe and Japan.**

As we have seen, various stimulus policies, including direct assistance to US households boosting consumer spending, have resulted in different monetary policies. While the US is talking about reducing its purchasing plans in order to lay the ground for an initial rate hike, Europe wants to stick to a highly accommodative bias, whereas 50% of emerging market central banks have already raised their rates, including in Brazil and Russia.

We have also seen that the ECB will address the issue of climate change in setting its monetary policy. What does climate change have to do with monetary policy? Well, the European Central Bank is explicitly acknowledging that climate change could destabilise economic activity and price discovery. Flooding, spiking food prices, constraints on labour mobility and inequalities are some flagrant examples. The ECB therefore plans to change its balance sheet management and its guarantee rules in order to avoid heavy-CO_2-emitting companies that are not in phase with European Union objectives. With this in mind, **the latest report from the Intergovernmental Panel on Climate Change (IPCC) calls for a rapid and fundamental transition in response to the climate emergency. This will be impossible without decisive action from political bodies and massive private investments in transitioning towards a low-carbon economy.**

In aggregate growth, July purchasing manager (PMI) surveys tend to confirm that the peak in global growth was hit in the second quarter and that the pace then slowed. In late July, the global PMI came to 55.7, down by 2.8 points since the end of May. **The PMI declined in 60% of countries in a sign of moderation after the previous records.** We also note that the outlook is better in developed economies (with a PMI at 57.5) than in developing ones (at 52.0), due to the gap in rolling out vaccines and slower growth in China.

On the corporate front, results are unheard of, just like the period we just went through. S&P 500 companies turned in their highest year-on-year growth rate, at 24.7% (by way of comparison, the average rate is 4.5% over the past five years and 3.4% over the last 10), and earnings were 17.1% above (already very high) forecasts. These unusually high growth rates are being driven by a combination of companies' ability to adapt to Covid and a less demanding basis of comparison than one year earlier.

That being said, earnings growth will probably be far more difficult to achieve in 2022, as companies will be facing slower economic growth, higher wages, higher interest rates and, probably, higher corporate taxation. In short, the recovery will continue but at a significantly slower pace. **We are therefore moving "from great to good" in the growth-inflation-monetary policy mix.**

The China story

China's tougher line on regulation is raising fears. After the debacle of Didi Chuxing (the Chinese "Uber" of mobility), investigations into the cybersecurity of applications, enhanced surveillance of IPOs, and record fines imposed on e-commerce groups for abuse of dominant positions, the Chinese regulator has now cracked down on the private tutoring sector. The severity of these measures (the USD 100 billion sector has lost 95% of its market value) is commensurate with the industry's importance for China's social fabric, as the fees charged were becoming an obstacle to social mobility and common prosperity. The party is thus reminding those who may have forgotten that, in China, the collective welfare takes precedence over individual ambition.

These heavy-handed regulatory interventions are less shocking in China than in the West. Resident managers take a relatively constructive view, as these measures are a belated response to the lack of regulatory framework in innovation. They aim to reduce wealth inequalities and are likely to encourage the movement of talents into industries that the party deems of higher value and in areas that are key to its population's vital interests. However, many foreign investors fear that China will become "uninvestable", now that Beijing has undermined the legitimacy of its "variable interest entity" structures, i.e., foreign-listed Chinese companies and that the party is willing to sacrifice outright an entire swath of its domestic economy. As a result of this regulatory squeeze, Chinese companies will now have a much harder time raising capital abroad, particularly in the US. **Some caution in allocations in China therefore makes sense, pending better news on regulation and a future easing in monetary policy.**

Investment decisions

Globally, the environment continues to favour risk-taking in portfolios while avoiding excess concentrations. 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 most as possible via a balanced mix between beneficiaries of the recovery and long-term structural winners. **Among the winners, Europe is a good candidate for diversification and for seeking outperformance.**

In the bond universe, our preference is clearly for corporate bonds. We are invested in a mix between high-quality companies and high-yielding issues. **We are, on the whole, cautious on the long section of the curve, which could rise, albeit at a slower pace than early this year.**

For diversification purposes, we brought cat bonds into the portfolio during the month, as they offer attractive diversification in an environment of low interest rates and attractive yields. We continue to overweight convertibles, in which the market has shifted back to a highly attractive pace of primary issues and which in 2020 showed how valuable they were. **Our conviction is neutral on gold, as it remains linked to fluctuations in the US dollar and real interest rates, which have not returned to normal.** We are sticking to our long-term investment thesis, as monetary policies are still accommodative and governments' stimulus plans are still active. In the current environment, **we finally recommend exposing portfolios to global listed real estate.** Our investment thesis is based on the positive relationship between global listed real estate and the increase in long-term inflation expectations. The sector is also reacting well to higher interest rates and it is lagging behind the most popular sectors.

Sébastien Gyger
Chief Investment Officer
+41 22 316 02 00
sebastien.gyger@parisbertrand.com
parisbertrand.com

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