NEWSLETTER

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“Covid: living with rather than after”

Several economic indicators pointed to more moderate growth, just as Covid-19 infections were increasing and high inflation (5.4% year-on-year in July and June) was undermining consumer confidence. Equity markets nonetheless remained on an upward trajectory, driven by second-quarter company results. At Jackson Hole, Powell, the Fed chairman, warned against the risks of premature tightening and stressed that additional headway was necessary to achieve the goal of full employment. The House of Representatives continues to negotiate a fiscal package worth USD 3.5 billion, and an infrastructure bill has already been approved by the Senate. The hasty retreat of US personnel from Afghanistan could have geopolitical and humanitarian repercussions but has not had any market impact.

Market trends

Global equities rose further in August, by +2.5% (in USD), hitting new highs, driven ahead by the US (S&P 500 +3.0%) and tech stocks (Nasdaq +4.1%). Japan (+3.0%), emerging markets (+2.6%) and Europe (+2.2%) rode the other markets upward. Bond yields rose only slightly, by 9 basis points to 1.31% in the case of 10-year US bonds and by basis points in Germany, in anticipation of Fed tapering. The US dollar remained strong (DXY +0.5%, EUR/USD -0.5% to 1.1809). Meanwhile, oil pulled back by USD 5.4 per barrel (WTI -7.3% to USD 68.5), as investors priced in the outlook for additional OPEC+ production and the restarting of US output after Hurricane Ida.

In Switzerland, the LPP pension fund indices (indices de la prévoyance professionnelle) continued to improve in August, by +0.6% for the LPP25+ and by +1.1% for the LPP40+, bringing their year-to-date performances to 5.8% and 9.6%, respectively.

Market performance as of 31 August 2021

STOCKS MARKETS	LEVEL 31.08.2021	CHANGE SINCE 30.07.2021	CHANGE SINCE 31.12.2020
Index			
MSCI World	741.3	2.50%	15.91%
USA			
Dow Jones Ind	35360.7	1.50%	17.04%
S&P 500	4522.7	3.04%	21.58%
Nasdaq Comp	15259.2	4.08%	18.92%
Europe			
Euro Stoxx 50	470.9	2.18%	20.08%
SPI (Switzerland)	15947.7	2.37%	19.66%
CAC 40 (France)	6680.2	1.02%	22.08%
DAX (Germany)	15835.1	1.87%	15.43%
FTSE 100 (UK)	7119.7	2.05%	13.23%
Japan + Emerging			
Nikkei 225	28089.5	3.00%	3.07%
CSI 300 (China)	4805.6	0.11%	-6.41%
MOEX Index (Russia)	3919.0	3.91%	23.15%
S&P BSE Sensex (India)	57552.4	9.47%	21.50%
Ibovespa (Brazil)	118781.0	-2.48%	-0.20%

BONDS & ALTERNATIVES MARKETS	LEVEL 31.08.2021	CHANGE SINCE 30.07.2021	CHANGE SINCE 31.12.2020
Rates			
Germany 10 y	-0.38	8 Bps	19 Bps
France 10 y	-0.03	8 Bps	31 Bps
Italy 10 y	0.71	9 Bps	17 Bps
US 10 y	1.31	9 Bps	40 Bps
Debt			
Investment Grade US	345.28	0.10%	0.56%
Investment Grade Europe	267.10	-0.41%	0.34%
High Yield US	2444.32	0.51%	4.55%
High Yield Europe	438.35	0.26%	4.32%
Emerging Debt	937.83	0.91%	0.44%
Currencies			
EUR/USD	1.18	-0.51%	-3.33%
EUR/CHF	1.08	0.56%	-0.04%
USD/CHF	0.92	1.02%	3.38%
Commodities			
Crude Oil (WTI)	68.50	-7.37%	41.18%
Gold	1813.62	-0.03%	-4.46%

Economic highlights

Pandemic situation

The **US is still one of the countries with the highest rate of new Covid-19 cases, due mainly to a resurgence in southern states that are lagging behind in** vaccinations. Florida, Louisiana and Mississippi, for example, have hit higher case numbers than at any other point during the pandemic. To date, only 53% of Americans are fully vaccinated. An identical percentage have been vaccinated in Switzerland. This is still too little, when keeping in mind that **in countries where vaccinations are well under way, the rebound in case numbers has not been followed by a significant increase in deaths, as was the case previously.** US health authorities expect new Covid cases to peak on the national level in September. This is already the case in Europe, which has plateaued since July and where the vaccination rate is higher (at 59%).

Keep in mind that the higher the vaccination rate, the more manageable the situation is from a healthcare point of view, the less restrictive lockdowns are, and the better economic agents fare. In Asia, for example, the vaccination rate is still insufficient in several countries (albeit while rising fast), and that is forcing governments to continue to use lockdowns in managing the Delta variant. **As a result, Japan's long-standing public health restrictions are causing persistent economic problems.**

Health passports and paid tests are controversial but are becoming the rule in Switzerland and the rest of Europe, as there is little political will for returning to large-scale lockdowns. Rather, hopes are that a fourth wave can be headed off by higher numbers of vaccinations. In fact, some developed countries are already rolling out a third dose, as the concentration of antibodies diminishes over time. **In short, we are learning to live in a world with Covid, rather than in a world after Covid.**

Economic environment

Global economic activity slowed on the whole in August, hitting a seven-month low, with a deceleration in both manufacturing and services. The scenario that we sketched out is happening, i.e., that economic momentum peaked in the second quarter. The growing risk posed by the Delta variant, combined with supply-chain disruptions and resource shortages (which are hindering production and sending up costs) have slowed the recovery worldwide. According to the latest purchasing manager surveys, the global PMI composite fell by 3.1 points to 52.6 – the steepest drop in the indicator since April 2020, to a low since January.

Europe has moved out in front, thanks to a higher vaccination rate, staggered reopenings, and pent-up consumer demand. While the euro zone's PMI composite fell by 1.9 point to 59.0, it is one of the world's strongest, led by Germany and Italy.

In the US, the slowdown in economic growth is showing up in figures such as the Markit manufacturing PMI, which fell by 2.3 points to 61.1, while the service index was down by 4.8 point to 55.1. **The latest jobs report is also consistent with a recovery that is going through some obstacles.** The US economy created just 235,000 private-sector non-farm jobs in August, far below forecasts and down from 800,000 job in July, which came on top of June's 770,000 figure. The leisure and hotel sectors were undermined by new restrictions. **US consumer confidence has fallen to a 10-year low, according to the** University of Michigan survey, at 70.3 for the second consecutive month. This release came on top of lower retail sales in July. Consumer spending is slowing and may continue to do so in the coming months. One obvious reason for this is that the resurgence in Covid cases is keeping some consumers out of public spaces. A second reason is that it was clearly premature to believe that consumers would quickly spend their stimulus checks. **Despite these declines, our analyses suggest that a recession is not an imminent risk.**

"Bad news is good news" for the markets, as job weakness gives the Federal Reserve more flexibility in adjusting the tapering outlook for its asset purchases. **That being said, we do not believe that prospects for tapering have been thrown into question within the FOMC.**

In China, retail sales were a big disappointment, rising only 8.5% vs. 2020. In August, the services PMIs slipped below 50 points, to 47,5, while the manufacturing PMI fell to 50.1, just above the expansion/contraction demarcation line. Covid restrictions, flooding-related disruptions, and a regulatory crackdown undermined economic activity and consumer confidence.

In Switzerland, too, recent data call into question the optimism of the beginning of the year. For example, the KOF economic barometer has slowed down over the past two months, and the SECO weekly index points to a slowdown in the third quarter. This is due to delivery delays in industry and a shortage of skilled labour.

Major central bankers were meeting at Jackson Hole

We had stressed that various stimulus policies, including direct aid to US households (something that boosted consumer spending) are resulting in various monetary policies. The US is laying the ground for a tapering of its purchase programme before enacting an initial rate hike. Europe wants to stick to a highly accommodating bias, whereas half of central banks in emerging market economies have already raised their rates, Brazil and Russia in particular.

Late in the month, the markets were hanging on the words of the main central bankers at their annual Jackson Hole symposium. This was especially the case of Powell, the Fed chairman, regarding the timing and the pace of the slowdown in asset purchases (which are currently at USD 120 billion each month). Seen against the backdrop of the most alarmist expectations, Powell's speech turned out to be a non-event, as the Fed declined to shift course. Powell confirmed the 2020 change in strategy to average inflation targeting, stressed the improvement in macroeconomic conditions, reiterated his conviction on the transitory nature of inflation, and confirmed that the Fed is targeting full employment. Recent comments by several Fed members nonetheless buttress our expectation of a tapering announcement by yearend, in September or November, that would fall within a range of USD 10 to 15 billion per month (before arriving at neutrality no later than the end of 2022 in terms of asset purchases), thus opening the door to an initial rate hike in early 2023. Investors already priced in this strategy, as 10-year Treasury bond yields held at about 1.3%.

Could expectations of US monetary policy tightening be premature? While very moderate, the tapering expected in Fed asset purchases coincides with the resurgence in Covid-19 cases, slower economic activity, and the likely withdrawal of fiscal stimulus. Tapering is therefore raising many issues. **We would point out that this is the Fed's fourth attempt at tapering in the past 13 years and that all previous attempts have resulted in signs of weaker economic activity.** Will the same thing happen this time, and is the Fed jumping the gun? We won't have the answer for several more quarters. At this point, our analysis suggests that growth has maxed out, and that inflation is certainly peaking before our eyes. The post-Covid cruising speed of this pair of indicators is not known, but it will steer the path of Fed monetary policy. Remember, for example, that the Fed first raised its key rate in December 2015 and then waited a full year before putting in a second increase, in December 2016. **Anyone expecting interest rates to move rapidly back to normal are in for a disappointment.**

Reassured by a European economy that will surpass its pre-Covid-19 level this year, the European Central Bank has decided to rein in its Pandemic Emergency Purchase Programme (PEPP). The Governing Council felt that favourable financing conditions could be maintained at a slightly slower pace of net purchases beginning in the fourth quarter (currently EUR 80 billion per month). The markets' attention will now turn to the December meeting and what the ECB will have to say on its policy for 2022 and beyond and, especially, on continuing its "regular" asset purchase programme. Preserving favourable financial conditions is a matter of consistency and credibility for the ECB, which has just committed to an "especially forceful or persistent" monetary stance as long as policy rates remain close to their lower bound.

Investment decisions

On the whole, investors are still risk-on while avoiding excessive concentrations. **Keep in mind, however, that the slower growth trajectory is having consequences for investor preferences.** In mid-cycle, equity gains tend to level off, although asset allocations continue to favour equities over bonds. Leadership gradually shifts from towards small to large caps and from value towards growth stocks. On this latter point, we would note that growth stocks have already taken a comfortable lead in comparison to previous cycles.

In equities, we therefore reiterate our diversification between regions and between defensive, tech sectors and cyclical stocks. We are trying to make the most of the current environment through a proper balance between long-term structural winners and beneficiaries of the recovery. **Of the various regions, Europe is a good candidate for diversification and the quest for performance.**

In the bond universe, we have a clear preference for corporate bonds. We are invested in a mix of high-quality companies and higher-yield issues. **We remain cautious on the whole on the long section of the curve, which is likely to move up, albeit at a pace slower than early this year.**

In our diversification assets, we remain exposed to convertible bonds for their asymmetric profile, Chinese bonds and cat bonds for their yields and diversification qualities, to precious metals for as long as real rates are negative, and to Swiss and international real-estate.

Beginning next month, you will find our publications on the "Insight Page" managed by Rothschild & Co Bank, following the merger of our two entities. This includes a monthly market summary which you can read in English and French. We thank you for the interest you have shown in this investment newsletter.

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