

Slower, steadier growth



« One of Aesop's Fables tells of a race between a fast hare and a slow but relentless tortoise. Readers are supposed to be surprised when the tortoise manages to defeat the hare, coining the phrase 'slow and steady wins the race'. **After an economic recovery that took forecasters by surprise for its sheer velocity**, growth rates are normalizing, and positive economic surprises are occurring less frequently. This is not something we perceive negatively, rather, we believe that **the economy is adopting a more sustainable pace** and we remain upbeat about the macroeconomic outlook for the latter half of the year. »

Fredrik Skoglund *Chief Investment Officer, BIL*

In the short-term, supply chain bottlenecks are preventing economies from reaching their full potential, but we believe this will only serve to push demand into Q4 of this year and 2022, thereby prolonging the cycle. Bottlenecks aside, key growth drivers are still in place:

- **Vaccination rates continue to rise.** 5.3 billion doses have now been administered globally, while one jab (Pfizer-BioNTech) has graduated from being authorized for emergency use to having full FDA approval. The proliferation of vaccines seems to have been effective in reducing hospitalization rates and fatalities.
- **The fiscal stimulus train remains on track.** In the US, a \$1 trillion infrastructure package has been approved by the Senate and will be subject to a vote in the House before September 27th. In Europe, August saw initial disbursements of the pan-European recovery fund. Eligible countries have received pre-financing representing somewhere around 10-13% of their entitlement and this should soon start percolating through to the real economy. Looking east, China has said it will

cut the reserve requirement ratio for banks and accelerate fiscal spending.

- **Monetary policy remains supportive for now, but investors and central bankers alike are aware that current measures cannot go on indefinitely** or inflation could spiral out of control. Eurozone CPI rose 3% in August, while the latest US reading came in at 5.4% (for July).

Given this situation, tapering is now trending. The Bank of Korea became the first major Asian central bank to raise its key rate (by 25 basis points to 0.75%), while the central scenario laid out in the Federal Reserve minutes is now a slower taper beginning this year. After hawkish comments from select ECB governors, the European sovereign yield curve bear steepened and investors now look to the next policy meeting on September 9th for more clues.

A taper without a tantrum?

At the height of the 2020 crisis, central banks adopted a 'whatever it takes' stance, resulting in a topsy-turvy world where there are negative yields

on over \$15 trillion worth of global debt. Some worry that central banks are so far down the rabbit hole that it will be difficult to get back out. However, we do believe that the Fed is capable of executing a tantrum-less taper. Firstly, the Fed has been very transparent, priming markets for a gradual reduction in asset purchases. Secondly, at the Jackson Hole symposium, the Fed calmed markets by confirming the absence of a mechanical link between the timing of tapering and that of an eventual increase in the target range for the federal funds rate. Thirdly, US GDP is almost back to its 10-year pre-Covid average on the back of unprecedented monetary and fiscal stimulus: it took at least 5 years for the economy to get back to its pre-2008 trend in 2013 when the last taper tantrum occurred. And lastly, the Fed's Reverse Repo Facility (RRP) and Standing Repo Facility (SRF) facilities should also help dampen any liquidity impact.

Equities

Risk assets continue to flourish, even if growth is coming off the boil, and in August, the S&P 500 tied a bow on its seventh straight month in

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the green—its longest winning streak since 2017. Some are prophesizing about peaks (earnings, growth, etc.), but we believe that equities remain supported by ample liquidity, a still-strong macro backdrop and fiscal and monetary stimulus. Further, another stellar earnings season in Q2 bodes well for revisions moving forward. Sector-wise, we continue to favour cyclicals such as Consumer Discretionary, Materials, Energy and Financials, the latter providing a hedge against rising rates.

From a regional perspective, we are overweight the US, Europe and China. US firms eked out a record number of positive surprises in the Q2 earnings season, while forthcoming fiscal stimulus will be supportive for employment, growth and equities. Even if consumer confidence has taken a hit recently, an acceleration in shipments (1% in July after 0.6% in June) suggests that business investment in equipment could offset an anticipated slowdown in consumer spending and keep the economy on a solid growth path in the third quarter. **In the US, we maintain a value tilt, believing that as the Fed begins to taper, rates may grind upwards lending support to value stocks.**

Europe's Q2 earnings season was also better than expected and so far the Delta variant has had a limited impact on sentiment. **Europe is typically a key beneficiary of rising inflation and interest rate expectations given its value characteristics.**

Current valuation levels render China even more interesting, especially when weighed against the longer-term growth opportunities presented by the region, which also offers a stable earnings environment. While recent PMIs disappointed, we believe this was largely due to temporary factors such as flooding and new restrictions on movement to curb the Delta variant. Of course, the current regulatory overhang presents some risk and we cannot rule out further policy action. Regulating big tech and 'the new economy' is a global theme that is also being pursued in the US and Europe. The difference is that Beijing's communication style has deviated from what international investors are accustomed to but we believe that the ensuing pockets of volatility offer opportunities.

Fixed Income

We are reluctant on this asset class, anticipating a gradual rise in yields, hand in hand with continued macro strength. We expect the US 10Y yield to rise further, albeit modestly in comparison with its journey thus far, and European rates are likely to move in sympathy.

We give preference to investment grade corporates (though spreads are tight and excess returns must be generated through selectivity and carry) and high-yield paper (the universe of choice for investors hunting for yield, where distressed debt levels are low and where upgrades now outnumber downgrades by the most in the

last 10 years (3x) in both Europe and the US.) In the emerging market debt sphere, we continue to prefer corporates as they offer a more effective buffer against rising real yields while flows are stickier.

Commodities

An environment of policy normalization and higher rates makes us cautious on gold. We remain positive on oil. Despite the anticipated OPEC+ decision to increase its daily output by 400k barrels per day, oil futures are nudging higher. The recovery in oil demand is expected to continue over the coming months and **investors are closely watching oil prices after Storm Ida knocked out at least 94% of offshore oil and gas production in the Gulf of Mexico.**

Summary

In light of our base case scenario that sees a combination of slower but continued growth, the commencement of Fed tapering, and stickier inflation, longer-term rates should gradually move higher. However, we do not believe that higher borrowing costs risk choking off growth. With the Fed unlikely to hike rates for some time, we think the yield curve can steepen from here, which is in line with our recommended overweight on cyclical asset classes and value.

Investment Strategy

31/08/2021

Global Allocation		Equities		Fixed income	
Equities	▼	US	▼	Government Bonds - Developed	▼
Bonds	▼	Eurozone	▼	Emerging Market Debt	▼
Gold	▼	China	▼	Corporate - Investment Grade	▼
Oil	▼	Japan	▼	Corporate - High Yield	▼
USD	▼	Emerging Markets Ex-China	▼		

Stance: Indicates whether we are positive ▼, neutral ▼ or reluctant ▼ on the asset class

Change: Indicates the change in our exposure since the previous month's asset allocation committee: ▲ positive, ▼ negative or () neutral