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The tide is turning on monetary policy

> « September marked a clear shift in the tone of global monetary policy, with key central banks now openly contemplating tightening as they observe robust growth and stickier inflation. We believe that markets are able to digest a gradual, well-communicated tightening campaign and we remain overweight on risk assets, with our portfolios positioned to benefit from progressively higher rates. »

Lieven De Witte *Head of Fixed Income Strategy, BIL*

Although the pace of growth may have peaked, it looks set to remain elevated into the latter half of the year and through 2022. For now, the expansion has hit a soft patch and three of the world's most powerful central bankers – Lagarde, Powell and Bailey – have all indicated that they believe the root cause lies on the side of supply, not demand. Bottlenecks and other supply tensions have persisted for longer than anticipated, putting upward pressure on prices and weighing on sentiment – just like a heavy shopping bag, the longer companies carry these concerns, the heavier they feel. While problematic in the short-term, we believe these disruptions will ultimately serve to push demand further into the future, thereby prolonging the cycle.

A slower flow of monetary support

As it stands, monetary policy is ultra-accommodative. Given that the global economy is now safely out of the depths of its nadir, and the fact that powerful fiscal stimulus is forthcoming, central banks are looking to rein in support. However, markets are somewhat addicted to "accommodative" policy and the detox needs to be handled with care; in 2013 when Ben Bernanke noted that the pace of bond buying might start to wind down "in the next few meetings", those five little words wreaked havoc on bond markets causing 10-year Treasury yields to almost double in a short space of time.

At its September meeting, the Fed communicated that the FOMC now broadly supports a "gradual" tapering of its bond-buying programme, which could begin as early as November, with the intention of ending purchases around the second half of next year. The refreshed dot-plot (which displays the opinions of the 18 FOMC members) showed that the committee is evenly split on the prospects of a rate hike in 2022, and an additional increase has been pencilled in for 2023. All this was conveyed without causing any major market turmoil.

The market was less prepared for the message that came out of the Bank of England's September Monetary Policy Committee and a mini taper tantrum on Gilts ensued. Elsewhere, Norway became the first G10 country to hike rates, while rates were also lifted in Brazil, Hungary, Paraguay and Pakistan.

The ECB stands out as being decidedly more dovish. At its September meeting, it announced a slower pace of purchases under the Pandemic Emergency Purchase Programme (an envelope that set aside EUR 1.85 trillion for purchasing private and public sector securities at the height of the health crisis), stating that favourable financing conditions can be maintained if purchases run at a moderately lower pace than the monthly pace of EUR 80 billion registered in the previous two quarters. The PEPP programme is expected to end in March 2022, but the Asset Purchase Programme (APP) will continue at least throughout 2023 and a rate hike is not expected before 2024.

For now, the market is still clutching on to the mantra that inflation will prove transitory. If price pressures prove to be more persistent, eventually central banks could be compelled to tighten policy quicker than intended. This will largely depend on whether congestion in global

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supply chains eases up and is a risk that we are monitoring.

Investment Strategy

We still carry an overweight on equities, believing that stellar earnings form a solid foundation for this asset class, even as economic growth simmers from a boil. Policy tightening and higher rates make sector and style decisions evermore crucial while rendering the broad fixed income universe relatively unattractive.

In terms of our regional allocation, we brought our exposure to Chinese equities down to **neutral**. International investors are exhibiting caution with regard to Chinese assets given the ongoing regulatory overhang as China attempts to reduce the economy's reliance on its real estate sector and foster inclusive growth. The long-term benefits of such a shift are obvious, but in the short term, the policy push could create some casualties, for example the ongoing Evergrande saga. The Government has a lot of unused ammunition that it could use to bolster the economy, but as of yet, Beijing's response is unclear. This leaves us with a lower degree of conviction than we have for other markets at this time, but we stand ready to re-adjust our positioning if clarity on China's policy outlook is restored.

With the proceeds of this sale, we increased our **overweight** on **European equities**. Through a macro lens, Europe is faring well; consumer activity has returned to pre-pandemic levels, despite Delta, while industrial momentum remained strong through summer. The disbursement of the >EUR 800 bn pan-EU recovery fund should keep economic momentum intact. From a market perspective, Europe is typically a key beneficiary of rising inflation and interest rate expectations because of its value characteristics, while relatively dovish policies from the ECB should keep risk assets in the bloc supported.

We maintain our positive stance on US equities. US equity markets are digesting the Fed's hawkish posturing at the September FOMC, perceiving that the Fed will be tapering for the right reasons, with indications of a reacceleration in macro data. The Q2 earnings season brought the highest number of positive surprises on record and the strong results are pushing expectations for Q3 higher. Fiscal stimulus will be supportive for consumption, employment, growth and equities.

Style-wise, rising rates mean we favour Value stocks, while in terms of sectors we like Consumer Discretionary, Financials, Materials and Energy.

In the fixed income world, the hunt for yield continues. Our preference is still for investment grade bonds and developed market high yield. We are underweight on Govies and prefer to take credit risk rather than duration risk.

An environment of policy normalisation, higher rates and a stronger US dollar makes us reluctant on gold. We are positive on oil with growing confidence in the economic recovery triggering a demand surge, pushing prices higher. The recovery in oil demand is expected to continue over the coming months and despite the OPEC+ decision to increase its daily output by 400k barrels per day, the course of oil future prices has not slowed.

Conclusion

Loose monetary policy has served its purpose, helping economies recover from the pandemic-induced downturn. Indeed, the US officially exited recession in April 2020, making it the shortest recession on record. Deep down, markets know that central banks cannot inject trillions of out-of-thin-air dollars into the financial system indefinitely, especially with outsized fiscal support in the pipeline. As such, it is likely that a gradual withdrawal of support can be staged without derailing risk assets and we maintain our equity overweight, focusing on those regions and sectors that we believe are poised to benefit from higher rates.

Investment Strategy

27/09/2021

Global Allocation	+	N	-	
Equities	●			
Bonds			●	
Gold			●	
Oil	●			
USD		●		

Equities	+	N	-	
US	●			
Eurozone	●			▲
China		●		▼
Japan		●		
Emerging Markets Ex-China			●	

Fixed income	+	N	-	
Government Bonds - Developed			●	
Emerging Market Debt			●	
Corporate - Investment Grade	●			
Corporate - High Yield	●			

Stance: Indicates whether we are positive (+), neutral (N) or reluctant (-) on the asset class.
Change: Indicates the change in our exposure since the previous month's asset allocation committee: increase, decrease or no change.

As economic conditions are subject to change, the information and opinions presented in this outlook are current only as of September 27th, 2021. This publication is based on data available to the public and upon information that is considered as reliable. Even if particular attention has been paid to its content, no guarantee, warranty or representation is given to the accuracy or completeness thereof. Banque Internationale à Luxembourg cannot be held liable or responsible with respect to the information expressed herein. This document has been prepared only for information purposes and does not constitute an offer or invitation to make investments. It is up to investors themselves to consider whether the information contained herein is appropriate to their needs and objectives or to seek advice before making an investment decision based upon this information. Banque Internationale à Luxembourg accepts no liability whatsoever for any investment decisions of whatever nature by the user of this publication, which are in any way based on this publication, nor for any loss or damage arising from any use of this publication or its content. This publication, prepared by Banque Internationale à Luxembourg (BIL), may not be copied or duplicated in any form whatsoever or redistributed without the prior written consent of BIL 69, route d'Esch ı L-2953 Luxembourg ı RCS Luxembourg B-6307 ı Tel. +352 4590 6699 ı www.bil.com.