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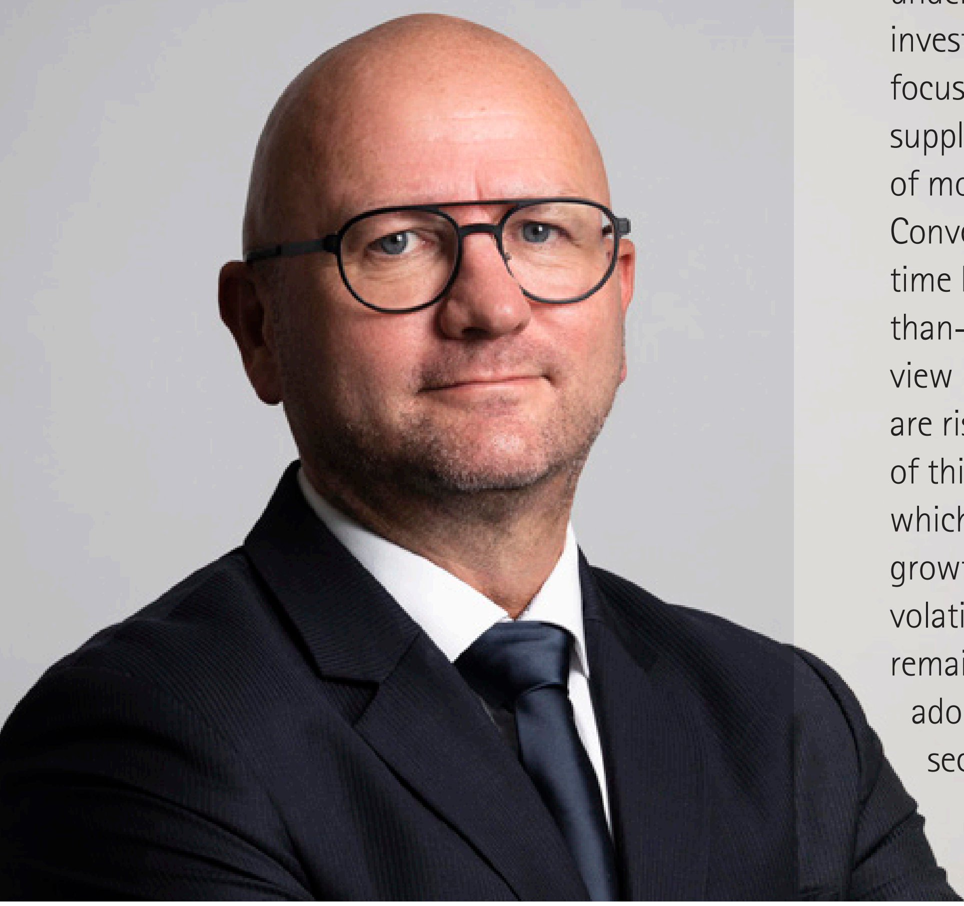
Contrasting views of the world



« Bond and equity markets paint contrasting pictures. The fixed income world has undergone aggressive repricing with investors taking a bleak view of the world, focusing on stickier inflation, persistent supply-side issues and imminent tightening of monetary policy by central banks. Conversely, stocks are again close to all-time highs as companies report stronger-than-expected profits for the summer. Our view lies somewhere in the middle: risks are rising, but the sky is not falling. In light of this, we remain overweight on equities, which are still supported by above-trend growth. However, we acknowledge that volatility could pick up throughout the remainder of the year and so we have adopted a more defensive stance via our sectoral allocation. »

Lars Naur Mogeltoft *Head of Equity Strategy*

The Macro Landscape

The transition to the autumn season brought heightened volatility to economic data with supply-side issues persisting and price pressures mounting. Ultimately, we believe that strong demand will be delayed (and not derailed) until kinks in the global supply chain are ironed out, thereby prolonging the cycle into 2022.

However, in the meantime, corporates face a bitter cocktail of bottlenecks, labour shortages and higher input and logistic costs. These factors have yet to meaningfully impact margins, and in order to prevent this from happening, companies are beginning to pass higher costs onto consumers. Inflation has been above 5% for four consecutive months in the US and sits at a 13-year high of 3.4% in the euro zone. The idea of supportive monetary policy is still afloat, but every surprise inflation reading is a new rock in the boat, with central banks aware that inflation expectations could quite easily become embedded. If this were to play out, it would likely put upward pressure on wages, and what might have been a transitory inflation episode (in light of post-pandemic dislocations) could become more permanent. However, central banks are in a catch-22 situation: if they act too aggressively they risk choking off growth and destabilising financial markets in age of debt piling.

Fixed Income

Already, markets are betting that central banks will be forced to act sooner than intended. This is most prevalent in the UK, where a rate hike by the Bank of England is priced in for November. Markets are also giving 50/50 odds that the Fed will raise rates as soon as July 2022, and expect the same in Europe as soon as 2023. While we believe that these expectations are too aggressive, ultimately rates – and yields – are on a gradual upward trend. This makes us broadly reluctant on fixed income and duration. Where we do hold bonds, we give preference to investment grade corporates, in particular financials. Companies are well funded and flows are strong with plenty of money chasing yield. However, credit is priced for perfection and has little room to rally further; excess returns must be generated through selectivity and carry.
We are also positive on high-yield bonds, with leverage ratios now at pre-pandemic levels and upgrades outnumbering downgrades in both the US and Europe. We note that spreads on European high yield have opened while remaining rangebound in the US: with a higher energy sector allocation, US high yield is benefitting from high oil prices. In the emerging market debt space, we prefer hard currency corporates, which have a better volatility and duration profile. Corporates are more resilient against a rise in real yields.

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Equities

While the factors supporting risk assets still intact, they are gradually being watered down: absolute growth numbers remain strong but the positive surprise element has fizzled out; earnings revisions are still positive but the trend is bending downwards; interest rates are still at historical lows but hikes are no longer a distant prospect; and monetary policy is still dovish but key central banks are clearly on a tightening campaign. The slow dilution of equity market drivers could spark volatility, especially while supply-side issues remain unresolved. As such, we have applied a barbell strategy in our sectoral allocation, playing both cyclicals (energy, materials and financials) that typically thrive in an inflationary environment and defensives (healthcare). The latter is less exposed to headwinds from inflation, elevated input costs, labour shortages and supply chain issues.

Consumer discretionary was brought to underweight in the US, and neutral in Europe. The reasoning behind this is that in the US, most of the reopening trades have already played out and revisions have turned negative, while direct fiscal support to households is being pared back. In the euro zone, the upward trend in retail sales remains quite firm and broad-based across categories, particularly services, and consumer sentiment is above pre-crisis level.

On the other hand, the industrials sector was brought to underweight in Europe, and neutral in the US. Bottlenecks and inflation pressures have proved more persistent than originally thought and, while the US economy seems to be coping (e.g. durable goods orders and shipments remain strong), European industry appears to be tanking despite healthy demand. A key driver of the decline is the auto sector and car manufacturers have said that they expect bottlenecks to persist into next year.

On that note, regionally speaking, we prefer the US, which is faring better in terms of both earnings and macro momentum, while the news that corporate tax hikes are unlikely to be part of Biden's infrastructure bills is another positive. The US is also attractive from a flight-to-safety perspective on any potential risk-off sentiment (there are more quality stocks in the US that tend to perform well in such periods). We are also maintaining our overweight to Europe: although lagging behind the US on macro data and earnings, the higher interest rate and inflation environment benefits the more value-oriented nature of the European market, while on the monetary side the ECB is decidedly more dovish than other major central banks.

Sector Preferences

NEGATIVE
Consumer Staples
Industrials (Europe)
Consumer Discretionary

NEUTRAL
Utilities
Industrials (US)
Consumer Discretionary (Europe)
IT
Real Estate
Communication Services

POSITIVE
Financials
Materials
Energy
Healthcare

Alternatives

An environment of policy normalisation, higher rates and a stronger US dollar makes us reluctant on gold. We are positive on oil, with the recent output increases from OPEC+ failing to satiate the global demand surge for the time being. In the currency space, we moved from neutral to positive on the Swiss franc. Switzerland has shown strong supply-side resiliency during the COVID-19 recovery, and the Swiss franc has historically appreciated in an inflationary environment coupled with muted growth.

Conclusion

Looking at equity and bond markets presents two very different pictures of the world. The future according to the bond market is drawn in charcoals – grey and gloomy – with market participants believing that higher rates are needed to limit feedback loops in inflation, ultimately hurting growth. However, equity markets would suggest that economic vibrancy persists, despite the increasingly challenging operating environment. Albeit, if support for risk assets was once obvious, vivid and bold like an oil painting, it is now more faded like a watercolour. Taking both pictures into account, we remain cautiously overweight on equities with a more balanced palette of defensive and cyclicals in our portfolios.

Investment Strategy

26/10/2021

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.

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