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Investment Policy

Q4 2021 | September 2021

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Key points

Jackson Hole and central banks

Investors kept a close eye on the traditional annual central bank symposium at **Jackson Hole** in late August, on the lookout for anything that might provide some clarity as to future monetary policy, particularly the US Federal Reserve's.

In the end, announcements at the event delivered **no real surprises**. Although Fed Chair Jay Powell acknowledged that inflation was quickening faster than expected, he reiterated the Fed's belief that this was a temporary phenomenon. Similarly, while admitting that the economic recovery was proving more buoyant than anticipated, Powell qualified this good news by pointing out that, depending on the course of the pandemic, it could not be taken for granted that the economy would be able to fully reopen. That being the case, those factors that might have prompted early monetary tightening – namely more growth and higher inflation – can for the time being be set aside. Nevertheless, **tapering** of asset purchases (from their current level of $120bn a month) is likely to be announced by the end of the year. Rate hikes do not appear to be on the cards: the first is unlikely to materialise before early 2023.

The lack of any real market reaction indicates this message had been correctly priced in: the Fed has maintained its accommodative bias, which is conducive to investor risk appetite.

Raising its growth and inflation forecasts in September relative to those issued in June, the **ECB** decided to slow the pace of asset purchases (from €80bn to c. €65bn a month) under its Pandemic Emergency Purchase Programme (PEPP), still slated to end in March 2022. Its more traditional Asset Purchase Programme (APP) will continue to run and could be adjusted as needed.

Although at this stage these changes feel more like tweaks, and **financial conditions** remain highly accommodative, we are seeing a first step towards central banks beating a retreat. While the process will be gradual, it does point to the end of the pandemic-related state of emergency. That, in reality, is good news…

Scenario and conclusions

- Cyclical economic growth has peaked
- **In China, the CPC is tightening its grip**
- **Inflationary pressures** persist
- US **tapering** by the end of the year

→ **Equities**: "neutral" with protective puts – progress expected to be bumpier

→ **Bonds**: preference for carry (high-yield segment; USD emerging sovereign debt and Chinese sovereign debt in RMB)

→ **Currencies**: unchanged

→ **Cash**: unchanged

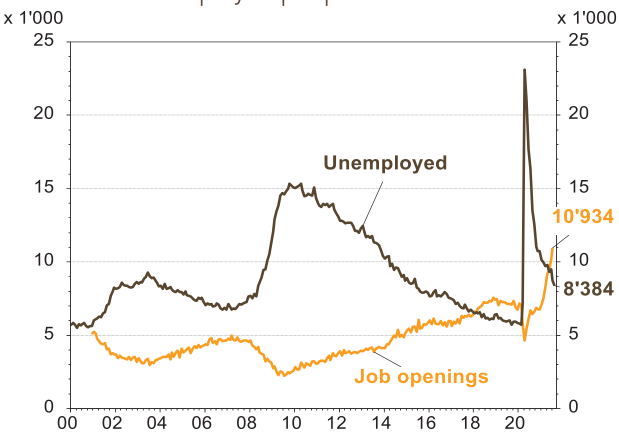
	UW (-)		N (=)		OW (+)
Asset allocation					
Equities			■		
Sovereign bonds	■				
Credit		■			
Alternative investments				■	
Cash				■	
Equities					
US			■		
Europe			■		
Switzerland				■	
Japan		■			
Emerging markets			■		
Bonds					
Sovereign	■				
Corporate investment grade	■				
High-yield corporate					■
Emerging market sovereign (USD)				■	
Emerging market sovereign (local)				■	

Economy: *is there a real risk of stagflation?*

*"**Equality and prosperity** not only can but must go hand in hand"*: while one might be forgiven for thinking this statement comes from the Communist Party of China, it is in fact an opinion expressed by Heather Boushey, a member of the White House Council of Economic Advisers. Her view is in line with the thinking of both Nobel economics laureate Professor Joseph Stiglitz and US Treasury Secretary Janet Yellen, and in any event far removed from the liberalism of the Chicago School, which had, until recently, been predominant. The starting point is that the market alone cannot solve all problems and, in the absence of proper guardrails, major mishaps are both too frequent and too dangerous. In particular, political considerations aside, widening **inequalities** act as a brake on economic growth as well as a source of social and political unrest. While the Biden administration's stimulus plans aim to reduce inequalities, some obstacles remain. Indeed, while the infrastructure package worth over a trillion dollars ("Build Back Better") has successfully negotiated its tricky passage through the Senate, the real turning point will come with the $3.5trn "human infrastructure" (health and education) package still under discussion in Congress. Getting the measures approved will inevitably mean rebalancing the remuneration and/or taxation of two key factors of production: labour and capital.

Shorter term, the latest statistical releases have been disappointing in terms of both confidence among economic agents (consumers and businesses) and economic activity (retail sales). **Q3 GDP** could slow after very buoyant growth in Q1 (6.3% QoQ annualised) and Q2 (6.6% QoQ annualised). However, with the labour **market** continuing to improve, we are confident on activity in the final quarter of the year. With the phasing-out of extra unemployment benefits, which have meant some people have been paid more to stay at home than they would have earned by working, there is more of an incentive to go back to work. And since there are more vacancies (10.9m) than unemployed people to fill them (8.4m), the unemployment rate should continue to come down quite quickly (**Chart 1**). Another 5.3m jobs need to be created to get back to pre-pandemic levels.

Chart 1 | United States: more job openings than unemployed people to fill them!



Source: Refinitiv Datastream, 14.09.2021

The temporary dip in economic activity has been accompanied by **inflationary pressures** (with year-on-year price inflation coming in at 5.3% in August), raising fears of the risk of **stagflation** (low growth and high inflation) (**Chart 2**). Indeed, if wage growth were to fail to at least keep pace with rising prices, the loss of household purchasing power would seriously dent consumption, thus jeopardising the continuation of the cycle. While we are not there yet, uncertainty is growing.

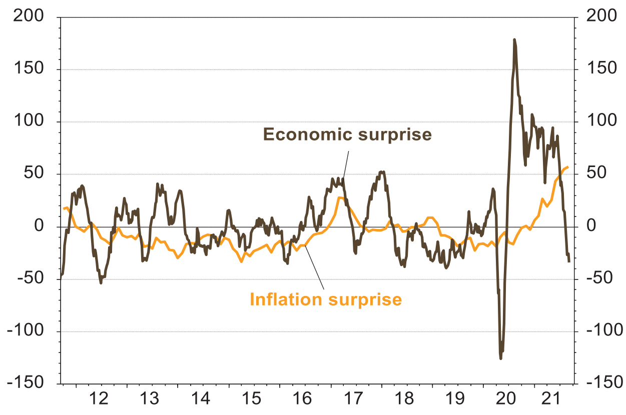
The recovery in the **eurozone** has been gathering pace. It quickened in Q2, with GDP growth coming in at 9.2% QoQ annualised, resulting in GDP recovering to almost its end 2019 level. In August, retail sales were 5% higher than their February 2020 levels and industrial production was not far behind. European countries have begun to receive their first allocations of funding from the "Next Generation EU" fund, which will help support economic activity. Although still trailing some way behind the US and Chinese cycles, pricing pressure is also evident in

Financial markets

*) To 21.09.2021	Performance			Valuation			Earnings growth			
Equity markets	Price (local currency)	Quarter Q3*)	Since 31 Dec 2020	12-month P/EPS	Dividend yield	Price/ net assets	12-month EPS	2021 EPS	2022 EPS	2023 EPS
United States	4 240.97	1.37%	15.60%	22.02	1.8%	5.1	14%	46%	8%	10%
Europe	454.12	0.28%	13.80%	16.33	2.5%	2.2	17%	57%	9%	8%
Japan	2 100.17	8.10%	16.00%	15.05	1.8%	1.4	19%	39%	8%	8%
Switzerland	11 766.42	-1.50%	9.90%	18.54	2.5%	3.3	9%	11%	9%	8%
United Kingdom	3 986.90	-0.69%	8.50%	12.52	3.6%	1.9	16%	81%	5%	3%
Emerging Markets (USD)	1 258.23	-8.47%	-2.56%	13.18	2.5%	2.1	16%	54%	8%	8%
World (USD)	3 046.20	0.96%	13.20%	19.57	2.1%	3.4	15%	47%	8%	9%

Source: Datastream, IBES consensus

Chart 2 | G10: inflation has surprised to the upside, growth to the downside!



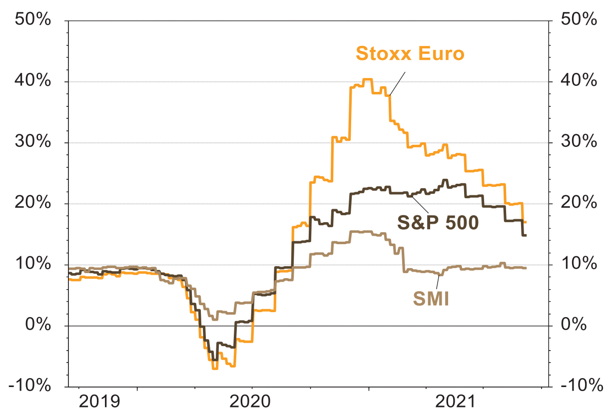
Source: Refinitiv Datastream, 14.09.2021

the eurozone (with year-on-year consumer price inflation up to a ten-year high of 3%). Furthermore, trade union demands for higher wages (with the German public sector union, for example, pushing for a 6% pay rise) could, if the trend catches on more widely, add fuel to this spiral.

While some excesses of capitalism are political hot topics that are stirring up debate even in liberal economies, recent decisions by the **Chinese government** have come as no great surprise. To ensure "shared prosperity" – its raison d'être – the CPC has announced restrictions on (private) education, curbs on the holding of personal data by digital businesses and higher taxes on the wealthiest citizens. Time will tell whether these measures stifle innovation and new business creation. This is a risk, but it is the price that has to be paid to maintain control over the economy and society – and, indeed, the price of "communist capitalism" more generally. Moreover, to counter the current slowdown, the PBoC (China's central bank) has lowered the mandatory reserve requirement ratio for banks to stimulate a recovery in credit. Other measures to revive economic activity could also be forthcoming, particularly if a potential default by Evergrande, China's leading real estate developer, were to spill over into the rest of the sector. In the meantime, the upturn in global trade (with exports up 25.6% YoY and imports up 33.1% YoY in August) is reassuring.

After contracting slightly in Q1, the **Swiss economy** posted solid GDP growth of 1.8% QoQ (7.7% YoY) in Q2. With many restrictions lifted, private consumption bounced back strongly (up 4.1% QoQ), mainly driven by continued public spending (up 5.5% QoQ) to combat the pandemic (vaccines, testing, etc.). It should be noted in passing that sports events in the form of the Tokyo Olympics and the UEFA European Football Championship contributed 0.2% of growth, with both organisations headquartered in Switzerland. The "hole" dug by the pandemic is on the way to being filled: quarterly growth pushed GDP up to just 0.5% shy of its pre-pandemic (Q4 2019) level. Available data for Q3 suggests that growth will remain robust before dropping off, as one would expect, in Q4. As elsewhere in the world, prices are rising (up 0.9% YoY) but do not constitute a cause for lasting concern for the economy, still less for the SNB.

Chart 3 | Equities: expected 12-month EPS growth (IBES consensus)



Source: Refinitiv Datastream, 14.09.2021

10-year sovereign bonds	Level at 21.09.2021	Change Q3*) (bps)	Change since 31 Dec 2020 (bps)
USD yields – United States	1.31%	-14	40
EUR yields – Germany	-0.32%	-7	26
JPY yields – Japan	0.05%	-1	2
CHF yields – Switzerland	-0.23%	1	32
GBP yields – United Kingdom	0.80%	5	56
Emerging markets (USD)	3.97%	2	40
Emerging markets (local currency)	6.34%	9	31
Commodities	**Price**	**Quarter Q3*)**	**Since 31 Dec 2020**
Gold (USD/oz)	1 764.60	0.0%	-7.0%
Brent (USD/bl)	73.45	-1.4%	41.0%

FX	Level at 21.09.2021	Change Q3*)	Change since 31 Dec 2020
EUR vs. CHF	1.0882	-0.73%	0.61%
EUR vs. USD	1.1736	-1.07%	-4.40%
EUR vs. JPY	128.4064	-2.44%	1.65%
EUR vs. NOK	10.2245	0.19%	-2.40%
GBP vs. EUR	1.1715	0.56%	5.89%
GBP vs. USD	1.3670	-1.05%	0.00%
USD vs. CHF	0.9281	0.41%	4.99%
USD vs. CAD	1.2817	3.50%	0.60%
AUD vs. USD	0.7254	-3.38%	-6.00%

Source: Datastream

Monetary preferences

Rank 1	Rank 2	Rank 3
Appreciation expected	Stabilisation	Depreciation expected
USD	**GBP | JPY | GOLD | NOK**	**CHF | EUR**
▪ **USD**: benefits from monetary policy divergence	▪ **GBP**: attractive valuation and expected economic recovery (vaccination) ▪ **JPY**: attractively valued and a safe haven currency ▪ **GOLD**: a currency hedge and a diversifying asset ▪ **NOK**: stabilised now that oil prices have picked up	▪ **CHF**: high valuation; penalised by risk appetite ▪ **EUR**: penalised by a late restart and a more accommodative ECB

Investment conclusions

The rate at which **equity indices** are climbing has slowed compared with the first half of the year. The main driver of gains – namely earnings growth momentum, which has recovered strongly – has, as one would expect, begun to slow. Furthermore, the change of direction by the main central banks, although gradual and still in the future at this point, will mop up the excess **liquidity** that has helped stimulate investor risk appetite.

The environment is thus deteriorating and the asset class's risk/reward profile is suffering as a result. However, financial conditions remain highly accommodative and corporate earnings are set to continue to grow, albeit at a more moderate pace (**Chart 3**).

That being the case, we are keeping our allocation to equity risk unchanged (neutral) but taking advantage of current low **volatility** to buy **protection** (put options) to make allowance for this increased level of risk.

In **bonds**, we continue to steer clear of duration risk (long maturities in sovereign and investment-grade corporate debt); our preference instead is for credit risk, including in the high-yield segment, as well as hybrids and "rising stars" (bonds whose ratings were downgraded early in the pandemic but whose fundamentals have rapidly improved such that they can be expected to return to their previous status). Local currency Chinese sovereign debt continues to offer attractive surplus returns.

While **gold**, taken on its own, offers limited appeal (due to rising yields and US dollar appreciation), it is the only asset that can provide both protection and diversification in a multi-asset portfolio. Moreover, structured products can take advantage of its volatility – particularly high for a defensive asset – to generate attractive returns.

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