

Market Compass

September 2021



MARKET OUTLOOK

- Toppish data, rising Covid worries and China's regulatory clampdown are weighing on the outlook.
- Yet the recovery will not run off the rails and policy makers will tread cautiously in removing accommodation.
- Low real yields and solid expansion still leave risky assets with legs, while rates will creep higher only sluggishly.
- We maintain a prudent pro-risk bias, but acknowledge a higher risk of setbacks in the more mature phase of the cycle.

Edited by
**MACRO & MARKET
RESEARCH TEAM**



A team of 13 analysts based in Paris, Cologne, Trieste, Milan and Prague runs qualitative and quantitative analysis on macroeconomic and financial issues.

The team translates macro and quant views into investment ideas that feed into the investment process.

US

- ! Employment growth slowed, but jobs opening remain at record high
- ! Covid fears are dampening consumer sentiment
- ! Inflation remains high but signs of cooling appear
- + Tapering to start in Q4, but no rate rise in sight

UK

- + 2021 GDP growth likely to reach around 7%
- BoE send rather hawkish message
- PMIs started to roll over

EUROZONE

- + 70% vaccination mark reached, renewed lockdown unlikely
- + Key indicators stay at elevated levels
- + ECB likely to maintain dovish stance
- Persisting bottlenecks in manufacturing and (temporarily) high inflation

CHINA

- China suffers from a Covid-19 outbreak...
- Beijing stepped up regulatory tightening measures
- Latest dataset was weak, more policy support expected

EMERGING MARKETS

- ! Growth recovery is stalling in Asia but LatAm activity is gaining traction
- Central banks continue to tighten monetary policy. Inflationary pressures are picking up in LatAm, Central and Eastern Union
- ! Vaccination rollout finally accelerates. Asia has been hit by the virus resurgence while tensions declined in LatAm

- + Positive
- Negative
- ! Topics to watch

DIRECTION OF TRAVEL

- Reduce overweight (OW) in Equities preferring Euro Area (EA) to the US
- Emerging Markets: neutral in Equity
- OW credit, but slightly underweight (UW) High Yield relative to Investment Grade (IG)
- UW in Core bonds due to inflation risk
- To protect from inflation risk: OW in Cash

Equities

- Equities continue to climb despite resurgent Covid cases, US monetary policy normalization and a toppish macro momentum.
- Support is coming from declining real yields accompanied by increasing earnings and dividend estimates.
- We maintain a cautious OW position on equities, with a preference for EMU vs US. Neutral on EMs.

Bonds

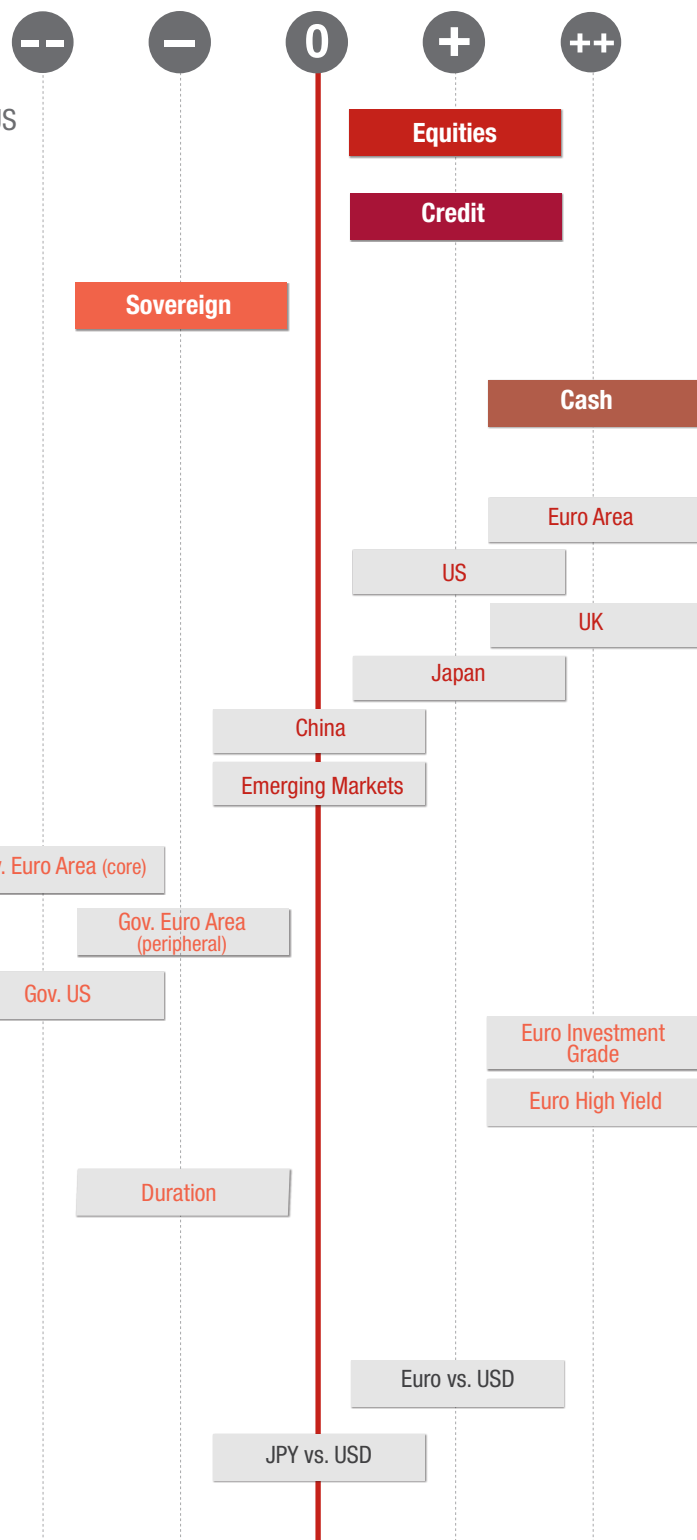
- Peaking macro indicators and concerns about the expected next Covid wave are likely to slow the forecast yield increase.
- EA non-core sovereign bond spreads to remain stable amid ongoing ECB support in the short term. Further on, ECB taper concerns to trigger a moderate spread widening.

Duration

- Moderate short duration recommended.

Currencies

- The USD may benefit near term from a looming Fed tapering and Covid worries.
- Yet with the global recovery tempered, but not derailed, the anticyclical USD is ultimately headed for some renewed weakness.
- A steadily dovish ECB stance will keep the EA rebound from translating into a strong EUR bounce.



TOPICS TO WATCH!

- Correction of crowded position in risk assets
- Inflation spike, commodities boom and vax advance trigger taper concerns and faster yield rise
- Political tensions US/China (Taiwan), tighter regulation on tech
- Mutations challenging vaccine effectiveness, new shutdowns

Probability:	Impact:

Probability: High Low

Impact: High Low

SPECIAL FOCUS

A difficult path to normality

Cyclical indicators have peaked and the Covid delta variant poured cold water on hopes of a quick return to normal. China extended its clampdown on tech companies. Yet global equity markets have advanced further, while Credit markets extended their resilience.

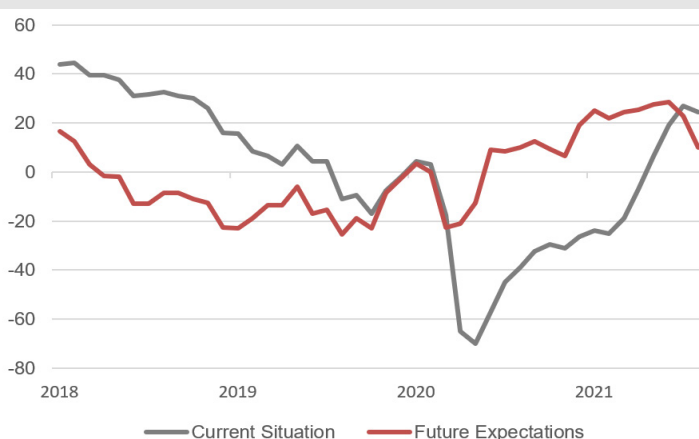
While resurgent Covid worries will retard the global recovery, they will unlikely derail it. Most people in most advanced economies are vaccinated, so governments will not risk a fallback into harmful lockdowns. Booster shots are increasingly rolled out to vulnerable groups, addressing fading protection.

Meanwhile, policy support will be withdrawn only very gradually. The Fed plans to start tapering its QE programme in Q4, but Chair Powell also stressed in his Jackson Hole intervention that the bar for raising rates will be much higher. The ECB may even delay any tapering decision of its PEPP programme into next year.

Toppish growth indicators and the more mature phase of the cycle may well herald higher volatility and more frequent setbacks among risky assets. But with the global expansion still strong, we retain a pro-risk bias. Corporate earnings are still reassuring and falling real yields underpin equity valuations. While credit spreads are already tight, a persistent search for yield, easing default rates and ongoing ECB support are boding well. However, we are more cautious about the riskier HY segments - especially in the US amid looming Fed tapering and a pick-up in M&A activity.

Core yields are heading mildly higher on above potential growth and lingering US inflation worries. A sharp increase in yields may also prove self-defeating given the fragility of the recovery, debt sustainability concerns and potential larger impacts on risk sentiment. We thus prefer only a moderately short position in fixed income duration.

Euro area business sentiment (SENTIX index)



Source: Datastream as at September, 2021.

GLOSSARY

TAPERING and FED FUND RATE: no mechanical relationship

Chair Powell is keen to reassure that the beginning of the tapering does not have any mechanical relationship with the increase of the Fed funds rate. Slowing down purchases of medium/long term bonds ease pressures on the long end of the yield curve and it is probably no longer needed at this stage of the recovery, but would keep monetary policy accommodative, as the Fed funds rate remains at zero. Raising it, on the contrary, would result in a tightening of financial condition as it would likely reverberate to the whole curve.

TAPERING

Tapering is the reduction of the rate at which a central bank accumulates new assets on its balance sheet under a policy of QE. Tapering is the first step in the process of either winding down—or completely withdrawing from—a monetary stimulus program that has already been executed.

FED FUND RATE

The federal funds rate is the interest rate that banks charge each other to borrow or lend excess reserves overnight. Law requires that banks must have a minimum reserve level in proportion to their deposits. This reserve requirement is held at a Federal Reserve Bank.



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