

# Market Compass

## October 2021



### MARKET OUTLOOK

- The approaching end of the monetary stimulus and supply chains disruption are keeping markets nervous.
- Yet the success of vaccination and the still substantial policy support (especially in Europe) should prevent the worst.
- Bond yields are increasing and real yields will start adjusting to the incoming tapering. But the move will remain contained.
- We maintain a very prudent pro-risk bias, as equity returns - while decreasing - are still higher than bonds.

#### 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

- + Despite the recent volatile figures, job recovery remains strong
- + No immediate rise in policy rate despite forthcoming tapering
- Persistently high inflation risks harming consumption
- ! Fiscal policy uncertainty increases as debt ceiling discussion is stuck

#### UK

- BoE signals again rather hawkish policy
- Core CPI inflation rose to 3.1% yoy
- UK-EU dispute over Northern Ireland heats up

#### EUROZONE

- + PMIs show that growth, while slowing down, remains solid
- + ECB signals a cautious withdrawal of support
- + NGEU funds will start flow into the economy soon
- Commodities and supply chains are pushing inflation to the highest level in a decade

#### CHINA

- + Covid-19 outbreaks more limited
- China faces production stops due to power outages
- Evergrande and the real estate sector remain a worry
- ! Latest dataset again weak, but more policy support expected

#### EMERGING MARKETS

- Chinese slowdown spurs concerns on the EM economic recovery
- Central banks continue to tighten monetary policy. Inflationary pressures are picking up in LatAm, Central and Eastern Union
- ! EM assets have been temporary pressure with rising US yields

- + Positive
- Negative
- ! Topics to watch

## DIRECTION OF TRAVEL

- Trim further the equity overweight (OW), preferring Euro Area and Japan to the US
- Reduce OW credit, with relative underweight (UW) of High Yield versus Inv. Grade
- Maintain the core bonds UW due to inflation risk and incoming tapering
- OW on hard currency EM debt
- OW cash to protect from inflation

### Equities

- Equities will probably remain volatile but we maintain our constructive view and barbell sector recommendation, made of Value and secure sectors (ex-Tech).
- Cautious OW on equities; prefer EMU vs US. Neutral on EMs. We expect a lower earnings growth vs consensus, but still see a TR of at least 6% in 12 months.

### Bonds

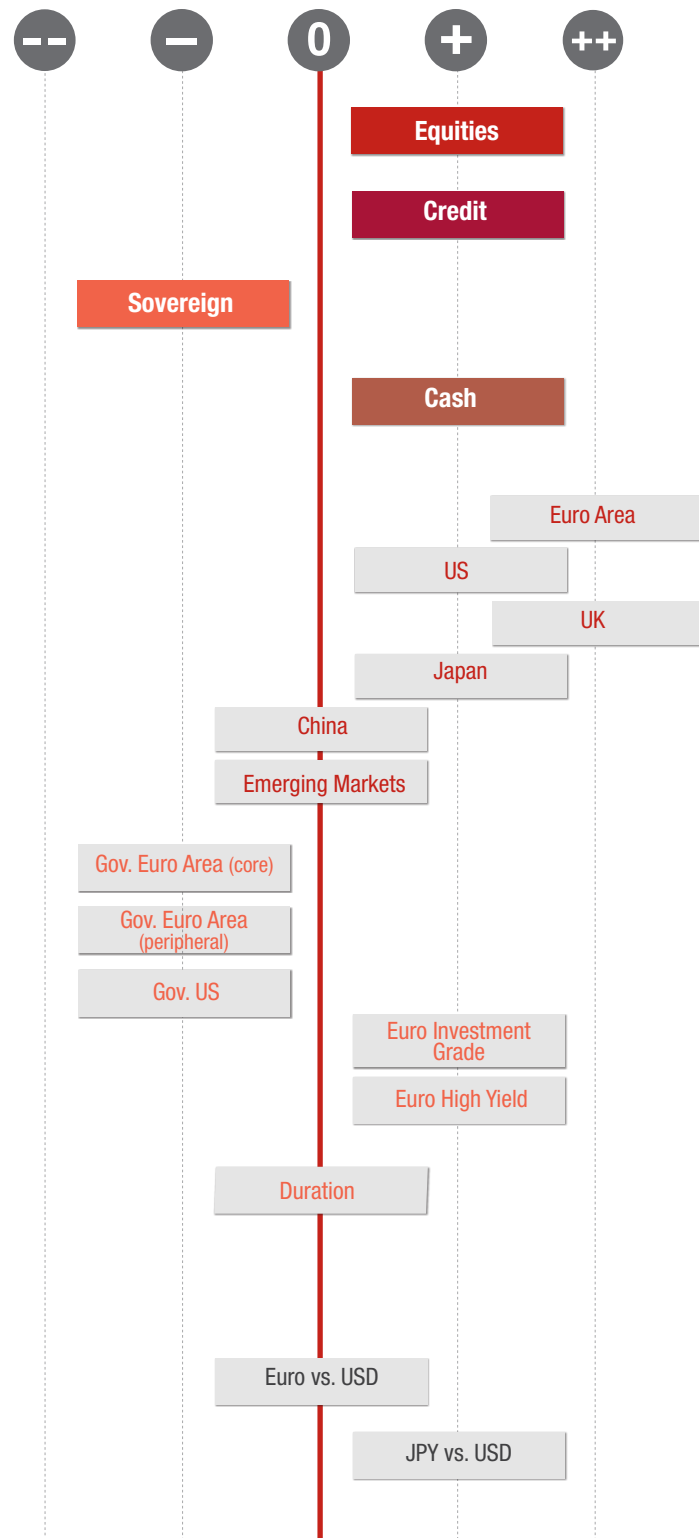
- Less dovish central banks to trigger a further increase in core yields. High level of debt and concerns about US debt ceiling to limit upward movement.
- Euro Area non-core sovereign bond spreads to remain on a low level amid ongoing ECB bond purchases.

### Duration

- Moderate short duration, almost closer to neutral, recommended.

### Currencies

- The global recovery still bears headwinds for the countercyclical USD. Yet support from the Fed is mounting, thanks to an earlier and faster rate lift-off (now in our books for end-2022).
- Rising US yields weigh on the JPY, but more attractive real yields and capital inflows are brightening the mid-term picture.



## TOPICS TO WATCH!

- Debt ceiling dispute triggers US government shutdown and default worries
- Inflation spike, commodities boom and vax advance trigger taper concerns and faster yield rise
- Evergrande default triggers wider contagion on global credit markets and Chinese economy
- Mutations challenging vaccine effectiveness, new shutdowns

Probability:	Impact:

Probability: High Low  
Impact: High Low

## SPECIAL FOCUS

### Off crutches

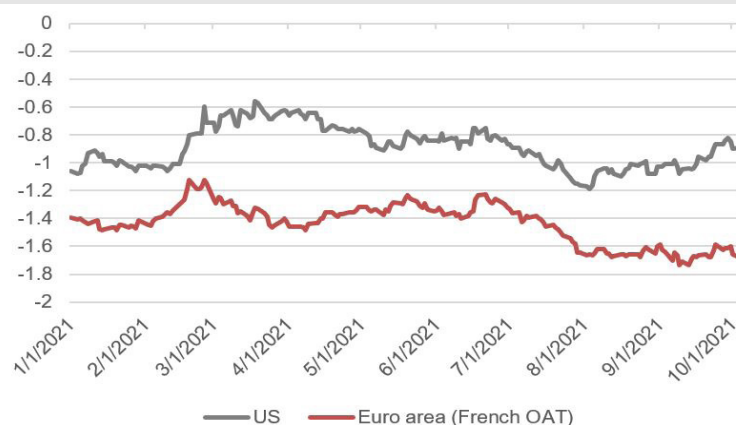
The global economy has enjoyed massive policy support over the past eighteen months. It is time to take the crutches off. The fiscal impulse is turning negative, not least in the US, and central banks are about to taper bond purchases. This has been well telegraphed, but persistently high inflation creates new policy uncertainties, making the markets more volatile. As supply issues dominate both US employment and inflation, monetary policy efficacy is in doubt.

During the summer, the global economy has hit a speed bump, due to the Delta variant and supply chain issues; we expect growth to find a floor in H2, as the fourth Covid wave recedes, and China cautiously eases policy. But supply constraints are proving sticky, and commodity prices surging. The latter is a tangible threat to consumer demand, whose strength will be much needed as the western fiscal impulse recedes, particularly in the US.

Bond yields are recovering from the summer slump. We see more upside but expect self-correcting mechanisms to contain the move. We hold an underweight in Govies, and keep duration slightly short for for now Credit is offering a decent low-volatility carry still, but are now more selective. The three major tailwinds for equities (profit growth, central bank stimulus and fiscal impulse) are flattening out. So will the returns. But we still find equities cheap vs. bonds (also due to low real rates) and go back to a stronger Value bias.

In terms of risks, we do not see Evergrande as the root of a systemic crisis. The Chinese government will be keen to avoid a crash. The US debt ceiling is another major risk, though eventually Democrats have the nuclear option of including the debt ceiling increase in the reconciliation bill. The fiscal and social package (\$3.5tn intended) may be shaved off in the process, which will only emphasise the negative fiscal impulse. Finally, Fed tapering. This has been very well telegraphed, which should limit the market impact. However, we see both upside inflation risks and communication challenges remain.

10 Year Real Rate



Source: Datastream as at October, 2021.

## GLOSSARY

### DEBT CEILING

The debt ceiling is the maximum amount of money that the United States can borrow cumulatively by issuing bonds, also known as the «debt limit» or «statutory debt limit». If US government national debt levels bump up against the ceiling, the Treasury Department must resort to other «extraordinary» measures to pay government obligations and expenditures until the ceiling is raised again. The debt ceiling has been raised or suspended numerous times over the years to avoid the worst-case scenario, which would be a default on U.S. government debt.



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