CBH | Asset Management

Quarterly Insight

Autumn 2021

Creativity within Excellence

Composition abstraite - Félix AUBLET
1961 - Huile sur toile

Index

Asset Allocation

		Neutral	Underweight		Overweight	Change
CASH	**$**	**5%**		**10%**		
	€			**15%**		
Cash	$	5%			10%	
Cash	€				15%	1%
CORE BONDS	**$**	**50%**		**28%**		
	€			**23%**		
Government 1-5Y	$	15%	5%			
	€		0%			
Government 5-10Y	$	10%	5%			
	€		5%			
Investment Grade 1-5Y	$	15%		15%		-2%
	€			15%		-3%
Investment Grade 5-10Y	$	10%	3%			
	€		3%			
SATELLITE BONDS		**0%**		**10%**		
High Yield 1 - 5 years					4%	
EM Hard currency					4%	
EM Local currency				0%		
Senior loans				0%		
Convertible					2%	
EQUITIES		**40%**		**41%**		
North America		17%		17%		
Europe		8%		8%		
Asia Pacific & Japan		4%	3%			
China		2%			4%	1%
Emerging Markets		3%		3%		
Global		6%		6%		
OTHERS		**5%**		**11%**		
Gold		2%			3%	
Other investments		3%			8%	1%

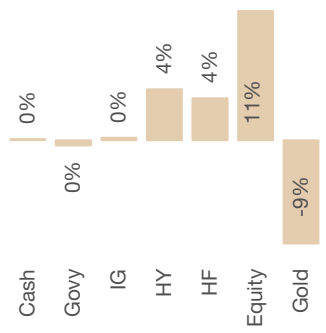
Asset Commentary

After a strong performance year to date, risk market sentiment seems to be seized by rising uncertainties, in particular higher long yields, the Fed taper, inflationary supply chain snarls, Chinese government interventionism and Washington political wrangling. These negatives somewhat obfuscate the well supported economic recovery that is taking place globally, which will continue well into next year given the stimulus packages to be laid out in the world's largest economic ensembles. As this normalization is affecting the US treasury curve for the second time this year, we pare down our allocation to Investment Grade bonds, as they lack carry protection against a future curve steepening. The sharp deterioration in sentiment on Chinese equities fuelled by government's actions featured prominently last quarter and we see this as an opportunity to moderately increase our exposure to the world's second largest economy.

Economic background

After a strong start to the year, the global economy hit a soft patch in the early summer. This was as much a consequence of fears around the Covid delta variant as a reflection of the multiple supply chain breakdowns that caused scarcity effects for components in a number of industries. That said, the global recovery is now in full swing with demand rising across the board, creating in turn a whole new set of challenges – notably on supply chains and price integrity.

Market performances (in %)



As central bank discuss the end of their Covid era support mechanisms, government stimulus programs are set to take over. China, which to date had been modest on the matter will likely have to deploy support mechanisms to mitigate the demise of the country's largest property developer. These initiatives should in effect carry the current economic recovery well into 2022.

Cash

Despite Central Bank talks around the tapering of purchase programs, we are still some way away from seeing the first increase in rates from either the Fed or even more so the ECB.

Fixed Income

After a summer of technical flattening, government bond curves have resumed their steepening trends. Given the scale of the economic re-opening, we struggle to see any meaningful catalysts for lower long rates and maintain our underweight in government bonds. The current tight credit spread environment offers little protection against rising long yields. We thus reduce further our duration exposure by dialing down our allocation to the Investment Grade credit segment. Our favored Fixed Income segments continue to be High Yield, Emerging Debt and for investors with the right risk profile, subordinated debt. In our view, High Yield and subordinated debt should benefit from rising credit ratings coming on the back of the overall improvement in credit quality, itself supported by the economic recovery. Emerging market debt also benefits from better carry following the rise in yields affecting the China high yield segment after Evergrande.

Equities

Risk markets have been marked by some nervousness of late as multiple factors have held back sentiment. In addition, the strong performance of equity markets year to date implies a potential lack of technical support until the year end as investors will want to preserve their returns. That said, the economic recovery is vigorous enough to support a decent third quarter results season with shareholder returns likely to increase. We raise slightly our allocation to Chinese equities, considering the pull back in valuations year to date and the prospect of positive government action to support the real estate sector going forward.

Others

We maintain our current overweight on Gold, seeing limited potential downside at current levels. We also increase slightly our exposure to alternative investments, considering the tailwinds currently experienced in the private equity and private debt segments.

Past performance is not a reliable indicator of future performance and should not be solely relied upon.

Macroeconomic Scenario

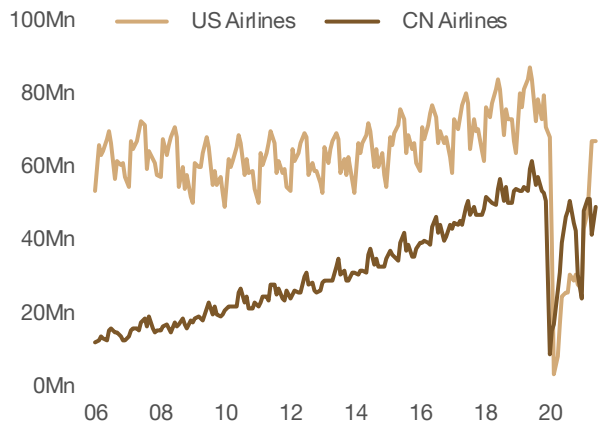
The economic recovery has been strong since the start to the year but far from homogenous or indeed linear. The stop and go created by the various lockdowns of 2020-21 have engineered what could be best described as an accordion recovery where scarcity effects in some areas – chips being the most talked about - have met a full on restoration of demand, leading to higher prices for a number of items and longer delivery times. This has also affected the availability of skilled labour in a number of economic sectors, leading to logistical issues of significant proportions. Following an historical vaccination effort, the Covid pandemic seems to gradually morph into a background noise for a lot of countries. Conversely, the resetting of supply chains will be key to return to smoother economic growth patterns and a more homogenous economic recovery. This in turn should set the scene for improved macroeconomic conditions for the year-end and a continuation of expansionary conditions into 2022.

After the summer soft patch

The strong economic recovery of the spring was followed by a softer patch. Whilst this was essentially caused by uncertainties around the emergence of the Covid delta variant, other factors were at work. The sudden and brutal rise in demand that took place in the spring as Covid restrictions were lifted resulted in significant scarcity effects across a number of sectors and jurisdictions. The resulting rise in prices and reduced availability of components caused delays and in many ways tempered the initial enthusiasm that previously presided over the reopening of the larger economies.

Despite this, companies still managed to deliver a set of second quarter results that came on top of already ambitious consensus numbers. Guidance in a few cyclical and chip dependent sectors was pared down. Yet the economic growth momentum remains sustained in the US, Europe and China as swathes of the economy are reopening – including air travel – with constraints as shown in the chart below.

Airline passenger numbers in the US and China



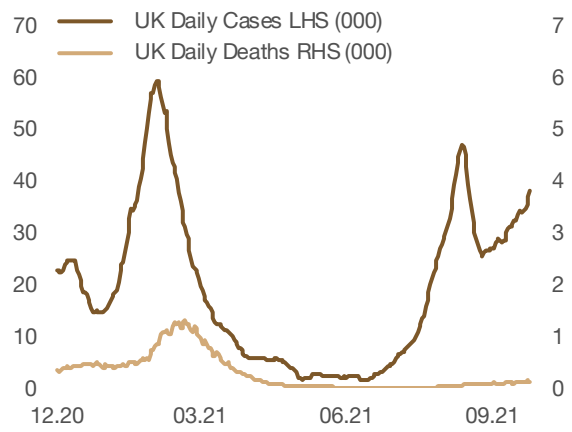
Air transport and civil aerospace have been at the deep end of the Covid crisis and the recent return of air travel, albeit with testing constraints has lifted a heavy shroud on the last part of the economic activity that had not restarted. As demand returns in earnest to all areas of the global economy, we expect shortages to remain an issue in the short term but ebb off next year. That said, it will not prevent the global economy to enjoy healthy growth in the last quarter of the year, spilling over into 2022.

As an illustration, consensus for global growth stands at 5.9% for this year and 4.5% for 2022. Barring the emergence of a vaccine resistant Covid variant, we see little rationale for disputing the consensus numbers at this stage. In addition, next year should see the subsiding of the worst part of the restart scarcity effects that the global economy is currently experiencing.

Covid has faded into a background noise

As we go to print, Covid is fading into a background noise in the jurisdictions that have implemented vaccinations strongly. Data from the UK shows that vaccinations have indeed managed to break the link between cases and hospitalizations/deaths. Interestingly, for the first time since the onset of the pandemic, cases in the UK are now going down despite the lifting of movement restrictions.

UK Covid Cases and related deaths



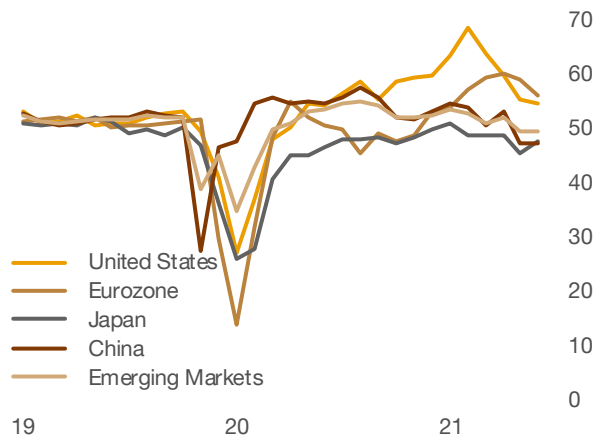
This is likely good news for the US, Europe and China, which have both caught up on their programs. This bodes well for the jurisdictions that have a smaller proportion of vaccinated individuals amongst their population ahead of the Northern hemisphere winter.

The lifting of restrictions in many jurisdictions set on a sense of a return to reality. This contributed in many ways to the Covid headlines moving down from the front page into the background. Now the emergence of a vaccine resistant variant remains a key potential risk but even a supposedly tougher delta variant did not succeed in derailing the economic recovery. To this end, research into a catch all variants vaccine is moving forward. In addition, clinical studies have started on a delta variant targeted booster shot.

The road to the year end

As shown in the chart below, PMIs have eased off in the early summer. Given the scale of the disruption caused by the various Covid lockdowns, a cooling off in economic activity after the sharp rise that started the year is hardly a surprise. This does not mean however that we have reached 'peak growth' but rather something that is closer in nature to what could be called peak recovery. We would still expect PMIs to come at healthy levels in the months to come.

The summer soft patch through PMI numbers



Where does that leave us for the year end in terms of the main economic forecasts for the various economic ensembles?

United States: after the summer soft patch that was as much linked to fears around the delta variant as shortages, we expect the US to continue to exhibit healthy growth. Goods and energy inflation are two potential headwinds that could curtail growth to slightly below 6%.

China: despite a number of negative factors linked inter alia to the government intervention, the demise of Evergrande and power shortages, China growth should tick towards the consensus of 8.5% this year. This is due to the overwhelming pull on the Chinese manufacturing sector from the rise in demand in other jurisdictions.

Eurozone: the area is gradually catching up after its disastrous start in the vaccination campaign. Still, the rising costs of living from energy and raw materials inflation are likely to curtail momentum in Q4. After having missed the start to the year and despite a very good summer, we struggle to see a GDP growth number of more than 4% for the year.

India: after the dreadful episode of Covid in the late spring, the country is in full recovery mode. We expect the infrastructure government targeted stimulus to take effect. Growth this year should be well supported and should come close to the consensus number of 9.3% for this year and 7% for the next.

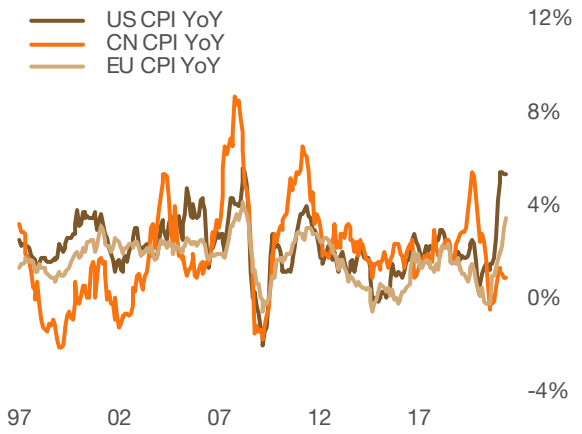
South East Asia: the zone will continue to benefit from the demand recovery in other jurisdictions as a (i) provider of raw materials and (ii) manufacturing solutions. These countries are in the last phase of the sanitary Covid crisis and at the start of the economic recovery phase. In addition, their manufacturing base offers solutions to various global shortages. As a result, they should experience a growth catch up in 2022.

Latam : Mexico continues to be the place to be in the region as the country benefits from the rise in the oil price as well as from the strong economic recovery of its northern neighbor. Brazil will likely start to be affected by a rise in negative sentiment ahead of the elections to be held next year.

Demand shock, supply chains, inflation and shortages

The global economy has been under an historical demand shock for the best part of one year. The reopening of large economies by sections has in fact created scarcity effects in various corners. These in turn have triggered inflation rises for certain goods and services that flared up in the May and June inflation numbers.

US CPI – Inflation seems to have reached a plateau

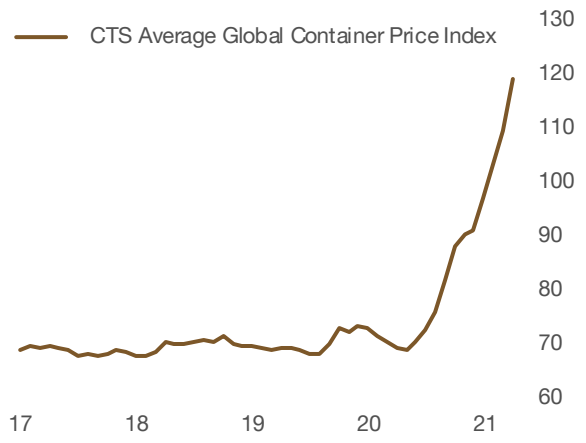


In line with the Fed's view, we continue to see the rising inflationary undercurrents as transitory, arguing also that the length of the transition was never clarified by the Central Bank. It is clear to us that the resilience of inflation on a sector by sector basis is a direct function of the complexity of said sector in terms of components and associated supply chains.

The scale of the supply chain disruptions that have affected the global economy are clearly evidenced by the rising cost of container space. A 40 foot container that moving from China to the US costs now cUSD20k vs cUSD2k before the onset of the Covid pandemic. After spiking in the first quarter, container shipping costs have plateaued slightly and in our view could start coming down in the coming months as capacity is gradually released and demand patterns return to normal.

In our previous edition, we used the price of lumber to demonstrate how these effects can be temporary on short cycle raw materials. The recent action around iron ore prices is another tale of a normalization led correction. After having touched an historical high at USD240/t, the ubiquitous commodity declined back to USD100/t over the summer.

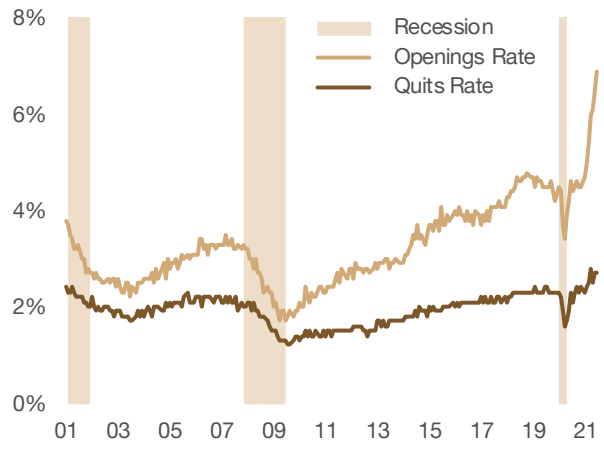
Container space at a premium



Given their complexity, microchips are likely to experience a longer period of supply chain tensions. That said, the CEO of AMD, one of the leading producers, indicated that the current shortage in chips and components should subside in the course of next year.

Labour skill shortages are altogether more worrying and could take longer to solve than material ones. As the chart below shows, 2021 is poised to become the year of the great resignation. About 55% of Americans that are employed have indicated that they are likely to look for a new job in the next twelve months. The number jumps to 77% in the GenZ and millennial segment of the population and is equally high for the tranche of the population making less than USD30k per year. This phenomenon comes from the large number of employees that have re-evaluated their priorities during the lockdowns of 2020-21.

2021: the great resignation



The recent shortage of staff in a number of sectors: in particular manufacturing, long haulage, education, arts and entertainment, tourism or hospitality is another source of temporary inflation generated through scarcity. It is likely to prove also transitory but will also take longer to cure given that in most cases, a re-training of the workforce will be necessary to close the demand gap.

The Fed pivot: mastery at Jackson Hole

Expectations around a potential taper tantrum in the search of potential negative catalysts were found wanting. At Jackson Hole, the Fed managed to negotiate a difficult crossroad by de-coupling the timing of the upcoming bond purchases tapering from the interest rate rise. This now provides the Fed with a range of options to exit the exceptional support mechanisms extended at the height of the covid crisis.

We expect the Fed to reduce its monthly purchases before the year end and stop them altogether in the late summer of next year. We anticipate a reduction in purchases of USD10-20bn a month.

All other things being equal, we expect the Fed to carry out its first rate increase in 2023. Given the size of the debt pile in the US, we however doubt that the quantum will be 25bp but actually think that smaller increments may be favoured – at least in the early stages of the interest rate cycle.

Support to move from Central Banks to governments

As Central Banks spell out the exit roadmap, support will have to come from individual governments. The US and the Eurozone stand out in that regard.

The new US administration is particularly profligate with a USD1.9trn program signed into law in March this year. The aim is to smooth the US economy's exit from the Covid lockdowns with help targeted at low and middle income citizens. The US administration is following this up with a USD6trn envelope targeted at new investments in education, transportation and green infrastructure. This is

partly funded by tax increases on incomes of USD400 000 a year and more and additional corporate taxation. Nevertheless, this is will likely result in a USD1.8trn budget deficit in 2022 despite the strong bounce of the US economy.

This ambition to run the largest budget deficit in peacetime will likely be checked along the way given the small majority that the US president's party has in the Senate. Initial political wrangling on the politically charged US debt ceiling and on the first part of the US administration spending package are two examples. We believe that the US administration will manage to get the majority of its program, through even if this means finding last minute compromises with the Republicans. This in itself should help fuel US economic growth well into next year.

Across the Atlantic, the EU has put together a EUR800bn stimulus package in addition to the EUR1.2trn to be deployed into the multi annual financial framework 2021-27. The so called NextGenerationEU program is targeted at research and innovation as well as the deployment of environmentally friendly infrastructure.

The initiative is significant not only for future European growth but also because this is a jointly funded effort – the first of its kind. As we go to print, the identity of the next German chancellor is unknown but the probabilities are rising in favour of a so called 'traffic light' coalition involving the SPD, the greens and the liberals from the FDP. Such an outcome would likely be positive for an extension of the existing EU support programs and other EU wide initiatives such as the banking union.

As opposed to what happened after the Great Financial Crisis of 2007-09, China seems reluctant to extend stimulus into its economy. We believe that this will change as the government now needs to address the fallout from the demise of property developer Evergrande. Recent power shortages coming on the back of stricter environmental rules mean that a clear point of focus is likely to be low CO2 power generation and improved transmission and distribution for infrastructure spending.

What is going on in China?

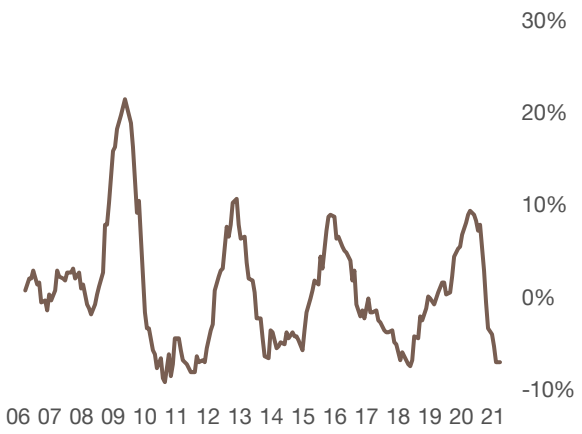
This brings us to the rather heavy handed actions undertaken by the Chinese government in the wake of the Jack Ma sortie at the end of last year. In a bout of control frenzy, the Chinese government took a number of decisions to curtail the power and influence of the country's tech giants. As the government rolls out its common prosperity agenda, the intention to separate the roles of the state and the corporate world is made clear.

This re-regulation, as painful as it is now in terms of negative sentiment for Chinese assets in the short term will likely cause a rise in innovation over the medium term. In addition, the crackdown on anti-competitive practices will also cause the emergence of new companies and processes. This was the case after the latest government crackdown on tech in 2018.

The Chinese government behavior on corporate failures is also changing as evidenced by the contrasted treatment of Huarong and Evergrande. Inferring from what happened in these two cases, it seems that if a company is government owned and essential to the Chinese economy, then the government will bail it out – albeit reluctantly. If that is not the case, then the government will take care of the social impact – in the case of Evergrande suppliers and clients – with brutal consequences for the finance providers.

As other issues linked to the defense and energy agendas become more prominent, we expect the intensity of government action towards the tech sector to be dialed down. The latest factory numbers from China have started showing the impact of the power shortages – a topic that needs addressing more urgently than video games consumption.

The China credit impulse



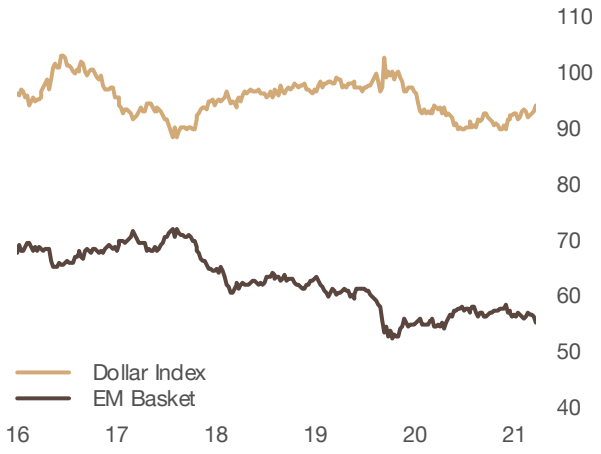
As the chart shows above, the China credit impulse is now closer to the levels prevailing in 2019. This means that economic activity is more likely to decline than increase in the short term.

We believe that this is not going to be the case as the government will have to mitigate the effect of Evergrande's demise on the construction sector and the overall economy through credit expansion and stimulus.

The dollar underpinning looks strong

The strength of the economy and the proximity of the Fed tapering have buoyed the dollar this year. As the US economy continues to expand and the Fed moves into the early stage of a tightening cycle, we expect the dollar to continue to appreciate over the next few quarters at a greater rate compared to consensus. .

The dollar continues to strengthen



We caution none the less that the expansionary program of the Biden administration will result in a rise in US treasury bonds supply i.e. dollars. In the absence of the Fed technical underpinning, this will likely weigh negatively on the US treasury curve and longer term against the dollar. We do not expect this to have significant effects until the late spring of next year.

Austerity temptation

We could not help to notice that as life slowly finds a semblance of normality, the temptation to turn off the expansionary taps is rising in a number of jurisdictions. This is clearly not the case in the US where at least in the short term, the government is pulling all the stops with the help and support of a still accommodative Fed. This is possibly more of an issue in China where the government seems reluctant to resort to stimulus measures this time around.

This is the case in the UK however where the government has decided on an increase in National Insurance contributions, the end of the pension triple lock and the end of the Universal Credit scheme. Additional comments from the Bank of England governor are pointing at a potential increase in rates this year. Seeing a comeback of government and monetary austerity in a country that was amongst the first to lift restrictions is cause for concern given how damaging such political choices proved to be in the aftermath of the great financial crisis.

Another concern further in the future is the potential loss of Congress in the mid-term elections to the Republican Party who would no doubt put spanners in the works to slow US government spending. The recent tussle over the US debt ceiling where the usual postponement decision was taken - and the attitude of senator Manchin (D) suggest that the expansionary policies of the US government have a ‘best before date’ - around November 2022. This could lead to a far less benign economic backdrop from 2023 onwards, at least in the US.

Our 2021 economic scenario in brief

US GDP growth 6%

The breakneck pace of vaccinations and the historically large stimulus package is closing the US output gap fast despite headwinds in the form of higher energy costs.

US CPI 3%

Inflationary pressures have materialized as activity normalizes. We expect inflation readings to start easing after the high readings witnessed in Q3.

US Fed Funds rate 0.25%

The Fed continues to be very accommodative without committing to specific bond yield targeting. The decoupling of taper from interest rates suggests that we are not close to the first increase.

US 10-year yield 1.8%

After the technical flattening that caused 10y treasuries to close on to 1.2%, the Fed tapering combined to the rise in US treasury supply will likely lift up long rates.

China GDP growth 8%

The only large economy that grew in 2020 continues on its expansion path into 2021, helped by the re-opening of the larger economies.

Eurozone growth 3.5%

In our view, consensus on growth is still too optimistic on the Eurozone, even at the revised down 4.2% consensus rate.

Eurozone CPI 2%

We raise our inflation target for the Eurozone, taking into account the rise in energy that has materialized in the recent weeks.

EUR Refinancing Rate 0bp

The ECB has left the refinancing rate untouched at the worst of the crisis. The likely course of action is thus to continue using quantitative easing and other tools to support the economic recovery.

German 10-year yield 0%

We expect the Bund to remain closely correlated with the US treasuries at least until the Fed starts to de-couple from the ECB on support measures.

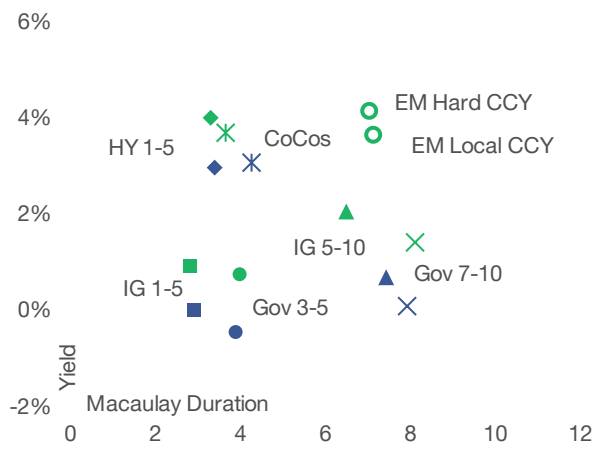
Fixed Income

Within fixed income, we continue to favor high-yield, subordinated debt instruments and emerging market debt. Cross over credits still offer value and have been a significant carry provider so far this year. Lagging positive rating actions are yet to provide an additional catalyst for performance in this segment – this will be coming over the next few months as the recovery takes hold. We stay away from duration risk, seeing the curve retracement from this summer as a technical anomaly caused by position buy backs from short sellers in a US treasury market that is far less liquid than what is typically assumed by market participants. We continue to see pressure developing towards a US treasury and Bund curves steepening. This is also the reason why we are underweight investment grade, seeing the available carry as insufficient protection against rising long yields.

The Fixed Income value map

Considering the volatility prevailing in other risk markets, credit spreads in the high yield segment have held up rather well but have none the less widened out. Within high yield and subordinated debt, we are back to levels last seen at the end of May. This is potentially an opportunity to add risk in a segment that is yet to experience its strongest catalyst: rating upgrades.

The Fixed Income value map – EUR in blue – USD in green



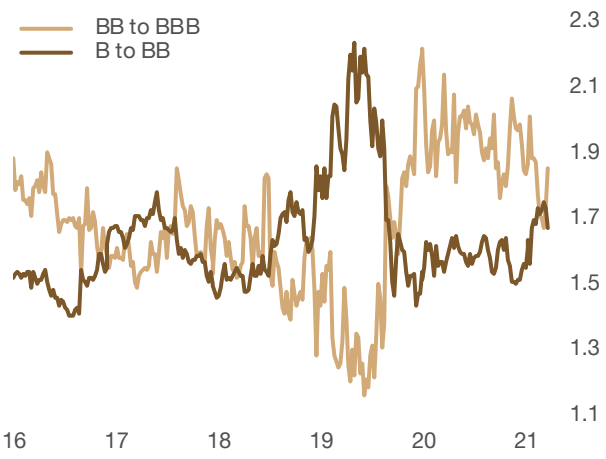
The chart above plots the different sub-indices within fixed income showing average yield to maturity vs duration. For Additional Tier One (contingent convertible bonds) yield vs duration to call.

BBs : from fallen angels to rising stars

The strong performance of the high yield segment year to date has been curtailed in recent weeks by a slight widening in spreads. This was insufficient however to offset a year of decent carry that was further supported by a rise in demand for yield. As the chart below continues to show, there is still a decent gap between BB rated issues and the BBB segment.

This is naturally borne out by central banks activity. The combination of reduced purchases by central banks, and more importantly, the proximity of positive rating actions will add momentum to the cross over credit trade.

BB spreads closing in but still cheap

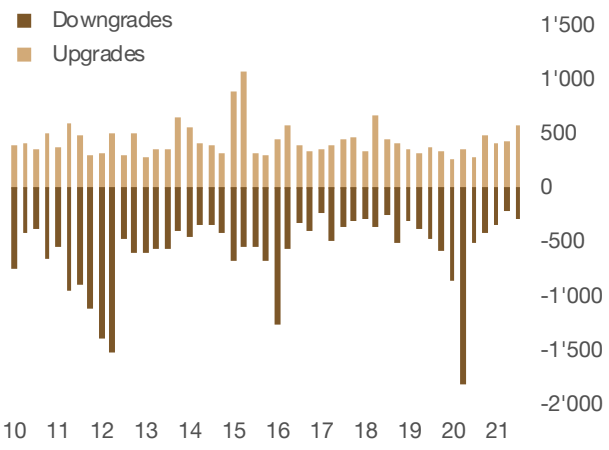


Indeed, rating agencies have now turned a corner. Under the weight of the economic recovery, positive rating actions are outpacing negative ones for three consecutive quarters. This is an important positive catalyst for the high yield segment.

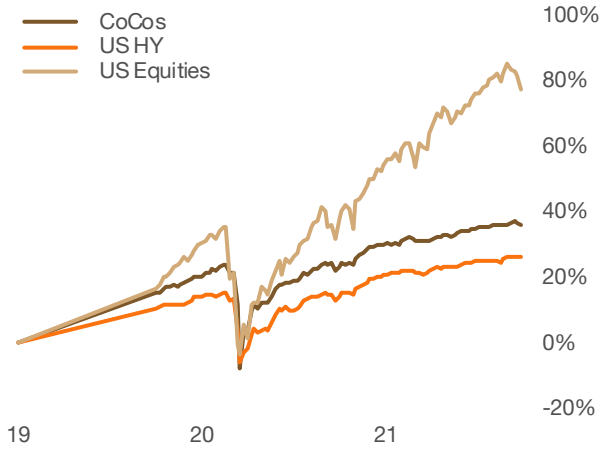
We underline however that rating agencies typically demonstrate a high degree of inertia in their upgrading moves.

The good news is that the market will anticipate some of these movements and credit spreads will likely be ratcheting tighter as soon as anticipations towards the upgrade of a particular issuer builds up. In our view, this is about to benefit the entire high yield segment.

Rating agencies – slowly but surely upgrading



AT1 performance



The wave of default that the market was anticipating to take shape is still not materializing. The main reason is the continuous level of support that governments have provided to their economies even after lockdowns were lifted.

This is not to say that defaults will not rise as economies have to learn again to function with less help but this will continue to be mitigated by government intervention in sectors that have been hit the most and the longest.

Duration : an uncertain place to be

We continue to be wary of duration risk, in particular after the strong volatility that affected the long end of government curves during the summer. The return of the recovery trade in September has caused the various government curves to steepen to levels close to the wides attained in March.

This affects our reasoning on the investment grade sub fixed income asset class too. We find that it offers too little carry protection – in particular for the bonds that have been recently issued - to mitigate the risks associated with both the rise in long rates and a potential widening of IG spreads linked to reduced central bank purchasing activity.

Subordinated debt remains well anchored

This year's star of fixed income will continue to shine until at least the end of the year. Banks have been spared the worst of the crisis with sovereign states shouldering the burden. The sector is exhibiting strong CET1 ratios after this year's provisions release.

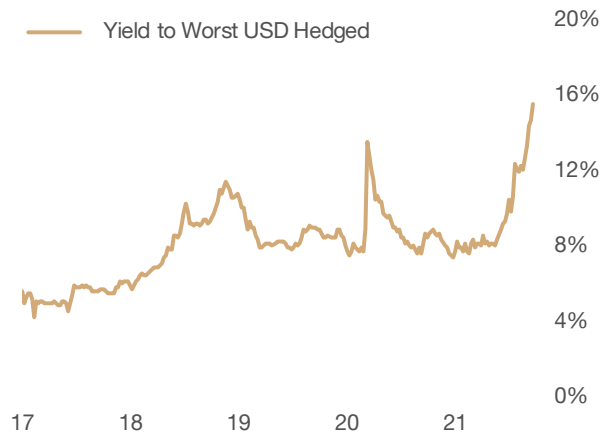
True, banks will have to reward shareholders in the coming quarters but their profitability will also likely benefit from a steeper yield curve.

We continue to look at the factors that could lead to question our thesis on the matter – supply being the key one. As far as we can judge, a wave of AT1 calls is to materialize in 2024-25, which leaves about two years of relatively clear skies for the asset class – idiosyncratic risk notwithstanding.

EM debt – Evergrande opens up yields

Emerging market debt has been negatively affected by the fallout from Evergrande – depending on the China exposure of each index. China high yield had borne the brunt of the shock with indices comprising more than 50% of bonds linked to the property sector. The segment now trades at a yield to maturity of 15%, which implies a default rate of 25-35% depending on the chosen loss given default. This is excessive in our view given our anticipation that the government will have to intervene should contagion spread in the real estate sector.

China : now this is High Yield!



China investment grade: although spreads have widened slightly, we see a high likelihood of government stimulus taking shape thus supporting spreads.

China high yield: this is a high risk proposition given the weight of property in the indices. As we discussed above, we judge the implied default probability excessive in this segment.

Asian issuers ex China: outside of China, we see Asian issuers benefitting from the economic recovery momentum in manufacturing and a better price deck in raw materials.

Latam: we continue to favor Mexican issuers over Brazilian ones where spreads do not compensate for rising political risks.

Russia : spreads on Russian issuers are becoming too tight in regards to the potential political risks that may affect sentiment on the jurisdiction, even if those seem to have taken a back seat at the moment.

Turkey : spreads on the sovereign and corporates have moved wider in recent weeks, only to retrace slightly. We do not feel that bondholders are yet compensated for the risks associated with what remains a fluid economic situation.

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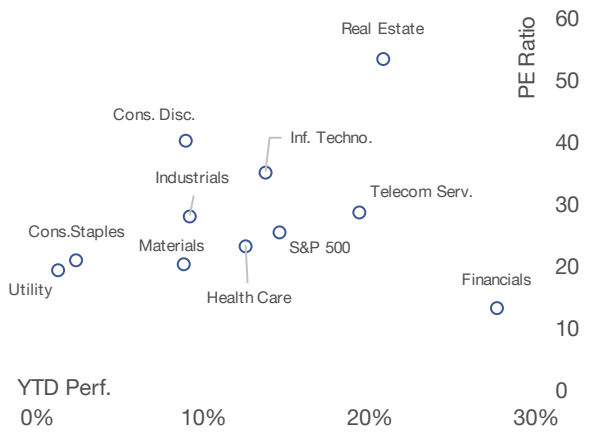
Equities

Despite a fairly poor July and September, equities have held up well over the quarter. A few items have affected sentiment such as the Fed taper, the Chinese government's heavy interventionism, the rise in energy prices of inflation data. We contend that the amount of growth to come from the Covid recovery and the associated stimulus programs will continue to support the brick and mortar names. In the meantime, valuations in US tech remain stretched. Chinese equities by contrast are well offered, a reflection of the negative sentiment surrounding the government's heavy handed actions during the summer in screen time regulation as well as the destruction of the private tuition sector. We continue to see value in Chinese equities given the key position of the country in key growth themes. Emerging market equities, which have generally underperformed the US also offer appreciation potential.

The value map in US Equities

At this point in the year, US equities dominate asset performance, having returned c20% year to date. Fears around the Fed tapering, high valuations and inflations have for the time being not made an impact. This is also because fundamentals have held up well. Companies have delivered a strong set of second quarter results and there are reasons to believe that the third quarter should be positive even if slightly less spectacular.

The US Equities value map – ex energy



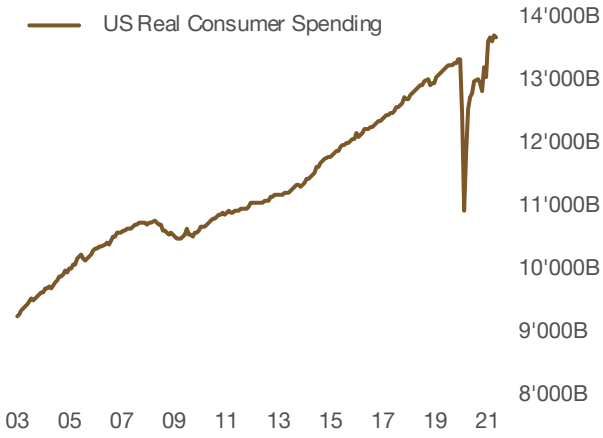
Given the strong performance of the energy sector by contrast to what happened in 2020, we have excluded it from our chart. US energy names have enjoyed an average 42% return year to date, making it the stars of the recovery trade.

US Equities: an agitated summer

Following a stellar end of Spring, the US Equity market went into sell the news mode as a strong results season came about. By mid-July, it felt like the economic recovery of 2021 never happened as fears around the delta variant sent recovery stocks back to their end of March levels. Tech on the other hand continued to grow, albeit at a slower pace. Despite a strong month of August, the return to the office did little to assuage a multiplicity of fears, that affected sentiment negatively overall.

As we enter the fourth quarter, the picture is less clear. The economic recovery is real and despite signs of inflation in certain sectors and shortages that will affect activity, consumers are now free to move and raise their spending. As shown in the chart below, this is blatantly the case, even if we seem to reach a plateau. This should be positive for equity risk across the board.

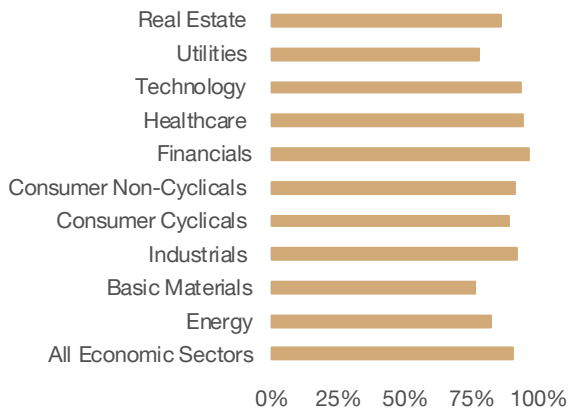
US Personal consumption SAAR



On the other hand, performance to date is strong and it seems a number of market participants are willing to lock it in through hedging or selling arrangements at the first whiff of a selloff. We have been there before this year in March and also in early May, each time to move to new highs.

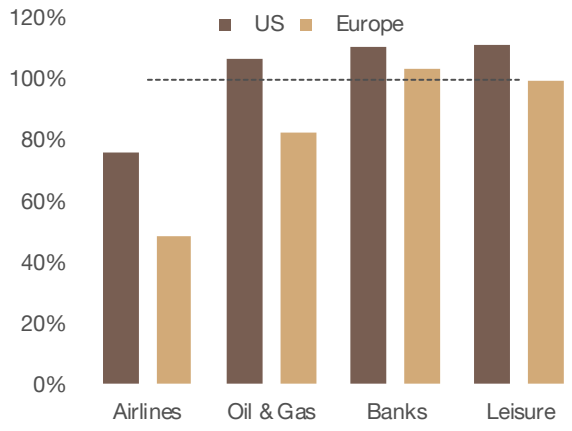
Between these two elements, we go towards the former with our constructive stance on US equities likely to be validated by what should be a strong third quarter results season – clearly not as strong as what we saw in the second quarter but strong non the less against an easy set of comparables. We also expect a number of results announcement to be accompanied by a rise in shareholder returns - notably in the energy and financial sectors.

Second quarter results – delivery against expectations



The US tech complex continues to power ahead even when doubts surface over the strength of the US recovery and despite a now steeper yield curve. The terms 'duration stock' has now made an exit, which we hope will be definite. We are not holding our breath however. Lastly, following this quarter's agitation, the reflation trade has been somewhat dented and looking at certain individual stocks, one could wonder that we are truly out of lockdown, able to travel again even with constraints.

Reflation trade – nearly there

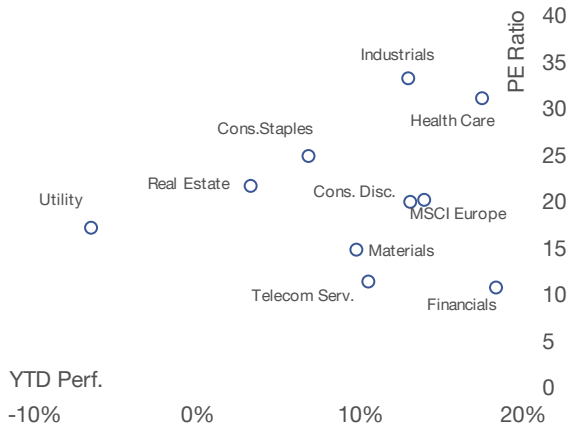


As market participants' realisation increases that we are moving towards a return to more normal economic conditions, we believe that the reflation trade could be again a source of performance within equity markets. The air pocket experienced by these sectors in the middle of the last quarter indeed prove to be an opportunity. Despite the valuation recovery, some sectors still lag and trade at a discount.

Europe : a nice catch up to validate

European equities managed to maintain some sort of momentum vs the US after a strong start to the year. That said, the old continent's shares suffered in the summer from investors' disaffection for recovery stocks. The rally has resumed but sentiment seems ever slightly more fragile than in the US.

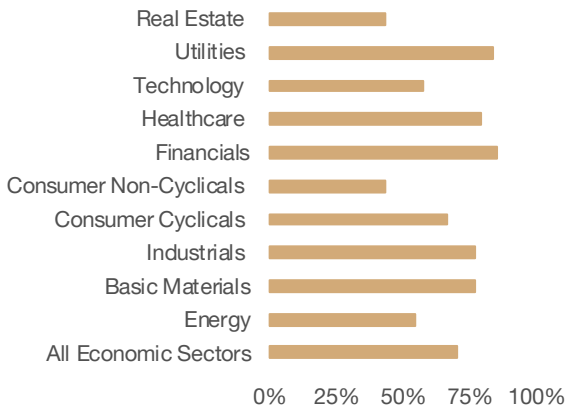
European equities value map



We have little doubt that European companies will do as well as their US counterparts on the earnings front even if the lack of microchips has started to hurt production into key sectors such as car manufacturing. That said, higher value add and high margins sectors such as civil aerospace have not been functioning for the last year and are just starting their recovery. This is an area where Europe has a competitive advantage and this should offset some of the negatives around chips availability and raw material inflation.

By contrast, European financials are likely to continue to lag their US counterparts given that the ECB is likely to keep maintaining an accommodative interest rate policy for longer than the Fed. After all, the ECB has not raised rates since July 2011 with a 0% rate in place since March 2016.

European equities – results summary for Q2/H1



The discount that we observed in our previous editions between the valuation recovery for US stocks vs European ones is still stubbornly there. Comparisons in the oil majors segment are particularly telling with US names trading at a c10% discount to their pre-covid levels against c20% for a similar European company.

At this stage, we continue to consider European equities more of a recovery play than an innovation/growth play. For such a theme, the US and the Chinese equity space offer a larger variety of investment options.

China : negative sentiment trumps fundamentals

In our last edition, we flagged an improvement in investor sentiment towards Chinese equities. To the surprise of many, including us, the Chinese government announced a series of measures that spooked investors already brought to attention by the fall from grace of Ali Baba's Jack Ma. In a short few weeks the Chinese leadership announced in the main :

- A regulation of advertisement channels so that competitors cannot block advertisement from another competitor

- Restrictions on in game money spending and restrictions on screen time for minors

- A ban on private tuition, which led to a considerable loss of value for stocks that were tied to private education in China

- An authorization regime for companies wanting to get a US listing with the aim to get more companies listed in Shanghai rather than the US

- A centralized database for consumer credit to dent the competitive advantage that tech player's may draw from their data treasure troves

China tech in the doldrums

By showing who's boss and regulating with fierce alacrity, the Chinese government dented sentiment on Chinese issuers significantly, particularly in the tech sector. This led to a huge valuation gap between the US tech sector and that of China as shown below.

This sentiment deterioration then affected the remainder of Chinese stocks with the final negative coming in the form of Evergrande's demise. All in, Chinese shares are now trading close to their mid 2020 level. For tech, the picture is worse with Chinese tech names trading at levels close to year end 2018.

We do not believe that is quite right. Of course, government intervention and financial markets do not mix well when things are going right. Nevertheless, the fundamentals of the Chinese economy remain strong and despite the personal spat between Mr Ma and the leadership, tech groups are poised to continue growing in China over the next years. We think that in that instance, taking the long term view looks like the right approach.

EM ex China : new hunting grounds

Emerging market equities seem to have been overlooked of late despite benefitting from the same tailwinds as the rest of the world. India is a case in point with a market now up 24% year to date despite one of the worst bout of Covid witnessed this year. Similarly, Vietnam is up nearly 22%. We believe that there is more to come as these jurisdictions reach the next economic development stages.

This is not to mention commodity based issuers in emerging market that are benefitting from scarcity effects in certain metals or energy commodities. These markets have to date only partially benefitted from the global recovery in valuations.

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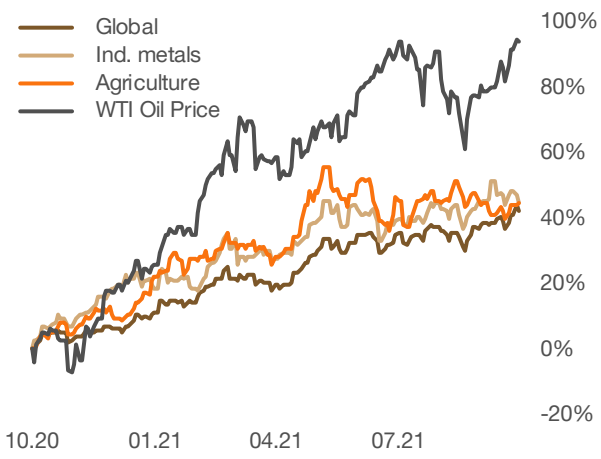
Commodities

Energy linked commodities have performed strongly, benefitting from scarcity effects ahead of the Northern Hemisphere winter. We see the barrel set to stay above the USD70p.b. level in the short term but pressure is building up on the supply side. Metals are having a more difficult time as the supply scarcity can quickly turn into oversupply as demonstrated by what happened to iron ore and copper to a lesser degree. Gold is not having a great time of late but we still see the 1750 price level as a good point of entry. Higher government yields amid the current economic recovery are likely to dampen momentum for the yellow metal.

Oil & Gas – very much in demand now

The strong restart of demand for energy has pushed the price of oil above USD80p.b. as Opec+ remains cautious on supply increases. Short term, prices should continue to benefit from the continuation and extension of the economic recovery with demand for plastics raw materials and jet fuel to rise. In the meantime, we expect Opec+ to hold the line, and stick to the already agreed 400k per day output increase in its October meeting. According to the cartel's Joint Technical Committee, there is still a 1.1m bpd deficit expected for this year.

Commodity price panorama



Whilst oil is poised to enjoy a few months of high prices, there are several factors that could dampen future price rises. In particular :

- Increase in shale oil production in the US. Despite the recent increases, we are still 7% below the pre covid production levels.

- Additional conventional production could also be deployed considering that the number of rigs operating in the US is 40% less than what it was pre-Covid.

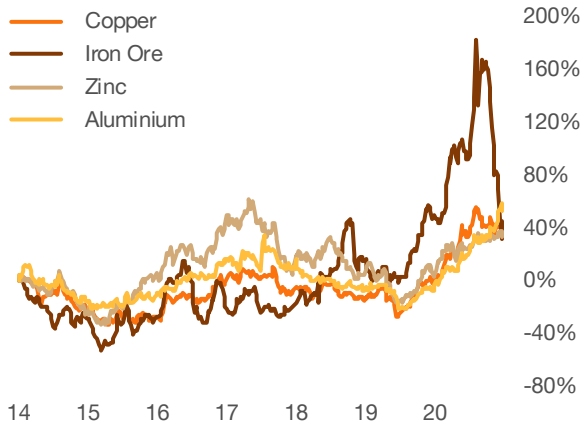
- Recent news flow around a potential US/Iran nuclear deal shows that the relationship is tentatively thawing. Even if the negotiations are slow and complex, indications by the Iran new leadership that it wants a deal create a long term overhang over the oil price.

Gas prices have increased gradually this year, following the rise in the oil price. The increase has intensified lately as power supply from wind turbines has declined, forcing gas power plants to increase production. This is aggravated by tension on Liquefied Natural Gas supply that is absorbed by China and technical interruptions in Norway and Russian pipelines. If price volatility is here to stay, we none the less believe that prices should normalize once technical supply constraints have been lifted.

Base Metals : transitory price increases

Industrial metals have enjoyed a strong start to the year but the boon times did not last. Once production started increasing and hoarding behaviors diminished – partly following the intervention from the Chinese government, prices quickly came back to earth. Iron ore is a case in point. After a historical increase in price in the second quarter, iron ore went back to cUSD100 per ton in matter of weeks once supply chains in the steel industry came to some semblance of normality. We believe that Copper and Aluminium prices are bound to follow a similar pattern in the coming months.

Iron ore goes back to earth



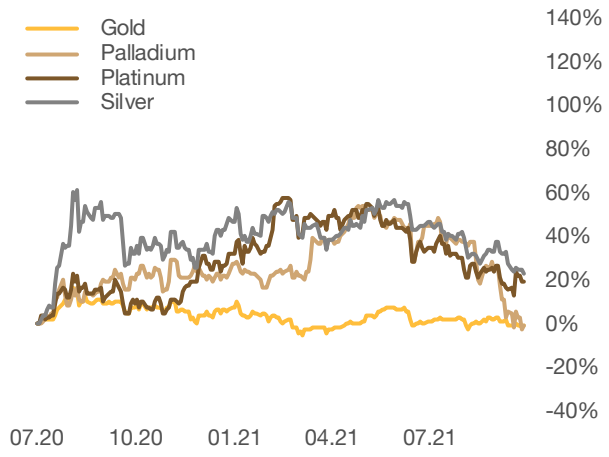
The outlook for base metals in the coming months is mixed despite the support coming from higher demand. Up the chain, the global microchip shortage constrains car

manufacturing, which is a large user of base metals. Elsewhere, the likely slowdown in property construction in China from the Evergrande fallout is also a negative demand driver. Echoing our previous write ups on the topic, mining companies have been well advised not to raise production significantly purely based on the wild price increases that came about in the second quarter of this year.

Gold : the second half of 2021 is a struggle

The yellow metal has spent the last quarter hovering between USD1730 and USD1830, failing each time to break out and set a trend. Indications that inflation levels are plateauing, the rise in long yields and the strength of the dollar are diminishing the attractiveness of gold.

Precious metals : supply chain hurts



That said, gold remain the only true hedge for investors worried about elevated inflation. Current levels are close to the year's lows – in fact, gold prices have not spent a great deal of time below USD1750 over the last two years. We thus see current levels as a good point of entry.

Palladium and platinum prices have come down following the decline in car production, currently negatively affected by the global chip shortage. Microprocessor industry leaders have indicated that they expect the current shortage to subside in mid-2022, which should set a recovery for both car production and its associated feeding metals.

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Currencies Market Expectations

Major Currencies

		Q4-21	Q1-22	Q2-22	Q3-22	Q4-22
EURUSD	1.16	1.16	1.17	1.17	1.17	1.17
EURCHF	1.08	1.09	1.10	1.11	1.12	1.12
EURGBP	0.86	0.85	0.85	0.85	0.85	0.85
EURJPY	130	129.0	131.0	131.0	131.0	129.0
EURNOK	10.17	10.00	9.95	9.90	9.85	9.77
USDCAD	1.28	1.25	1.25	1.24	1.23	1.22
USDCHF	0.94	0.93	0.94	0.94	0.94	0.94
USDJPY	112	111.0	112.0	112.0	112.0	112.0
USDCNY	6.47	6.47	6.46	6.44	6.47	6.40
GBPUSD	1.34	1.38	1.39	1.40	1.40	1.41
NZDUSD	0.69	0.70	0.71	0.72	0.73	0.73
AUDUSD	0.72	0.74	0.74	0.75	0.76	0.77

Other Currencies

		Q4-21	Q1-22	Q2-22	Q3-22	Q4-22
USDMXN	20.6	20.2	20.3	20.5	20.4	20.4
USDBRL	5.43	5.3	5.3	5.3	5.5	5.4
USDARS	98.7	106.5	120.5	135.0	142.5	150.2
USDTRY	8.92	9.1	9.3	9.5	9.5	9.9
USDILS	3.22	3.2	3.2	3.2	3.2	3.2
USDHKD	7.79	7.8	7.8	7.8	7.8	7.8
USDINR	74.2	74.0	74.0	74.0	74.0	74.3
USDRUB	72.9	72.0	71.5	72.0	71.5	70.0
USDPLN	3.99	3.9	3.9	3.9	3.9	3.8

The table above provides an overview of market forecasts for major currencies. It is composed of dozens of individual forecast providers and delivers a consensus forecast. These consensus forecasts represent a median number and all forecasts evaluated correspond to calendar quarter-end dates.

Future forecasts do not guarantee future performance and should only be used for indicative purposes.

Market Performances

	Name	QTD *	YTD**	2020	2019	2018	2017	2016
Cash	Dollar 3m Total Return	0.0%	0.1%	1.0%	2.5%	2.4%	1.1%	0.6%
	Euro 3m Total Return	-0.2%	-0.5%	-0.5%	-0.4%	-0.4%	-0.4%	-0.2%
Government bonds	US 3-5	-0.2%	-1.2%	6.2%	5.3%	1.5%	1.0%	1.3%
	Eurozone 3-5	-0.1%	-0.6%	1.3%	1.9%	0.1%	0.1%	1.5%
	US 7-10	-0.3%	-3.6%	10.0%	8.5%	0.9%	2.6%	0.8%
	Eurozone 7-10	0.0%	-2.1%	4.5%	6.7%	1.4%	1.3%	3.5%
Corporate bonds IG	USD Corp 1-5	0.0%	0.1%	5.4%	7.0%	1.0%	2.6%	2.9%
	EUR Corp 1-5	0.1%	0.3%	1.1%	2.8%	-0.5%	1.2%	2.6%
	USD Corp 5-10	-0.1%	-1.2%	9.7%	14.3%	-1.7%	5.6%	5.6%
	EUR Corp 7-10	0.1%	-1.0%	4.4%	10.9%	-2.4%	4.2%	7.0%
Corporate bonds HY	USD Corp 1-5	0.7%	4.3%	5.8%	13.9%	-1.8%	7.0%	16.5%
	EUR Corp 1-5	0.7%	3.8%	2.3%	11.3%	-3.8%	6.9%	9.1%
	USD Corp 5-10	0.3%	3.6%	-2.0%	9.1%	-1.9%	7.6%	7.3%
	EUR Corp 5-10	0.8%	3.0%	2.8%	13.2%	-4.4%	8.0%	10.8%
EM bonds (in $)	Hard currency	-0.5%	-1.1%	6.5%	13.1%	-2.5%	8.2%	9.9%
	Local currency	-0.9%	-1.8%	5.3%	9.5%	-3.4%	14.3%	5.9%
	Chinese Yuan	2.3%	5.9%	9.3%	2.8%	3.0%	5.0%	-4.7%
Others	S&P Leverage Loan Index	1.0%	4.4%	3.1%	8.6%	0.4%	4.1%	10.2%
	Global Convertible	-1%	5%	26%	18.2%	-1.2%	7.2%	4.6%
Equities	North America	1%	15%	19%	29%	-6%	19%	9%
	Europe	0%	13%	-5%	22%	-13%	7%	0%
	Japan	7%	16%	7%	16%	-17%	18%	-3%
	Asia Pacific	-4%	0%	17%	16%	-16%	29%	2%
	Developed Markets	1%	13%	14%	25%	-10%	20%	5%
	China	-12%	-13%	23%	38%	-21%	32%	-7%
	Latin America	-15%	-9%	-16%	14%	-9%	21%	28%
	Emerging Markets	-8%	-2%	16%	15%	-17%	34%	9%
Other investments	HFRX Alternative	0%	4%	7%	9%	-7%	6%	3%
	VIX	47%	2%	65%	-46%	130%	-21%	-23%
	G7 Currency Volatility	2%	-13%	23%	-34%	21%	-36%	22%
	DJ Global Commodity	5%	28%	-4%	5%	-13%	1%	11%
	Gold	-3%	-9%	25%	18%	-2%	14%	8%
	Industrial metals	4%	23%	16%	5%	-21%	28%	20%
	Agriculture index	-1%	19%	16%	0%	-13%	-12%	2%
	WTI Oil	2%	54%	-21%	34%	-25%	12%	45%
Currencies (vs. $)	Dollar Index	2%	5%	-7%	0%	4%	-10%	4%
	EM Currency Index	-4%	-5%	-6%	-1%	-11%	6%	0%
	Euro	-2%	-5%	9%	-2%	-4%	14%	-3%
	British Pounds	-3%	-2%	3%	4%	-6%	10%	-16%
	Swiss Francs	-1%	-5%	9%	1%	-1%	5%	-2%
	Japanese Yen	-1%	-8%	5%	1%	3%	4%	3%
	Chinese Yuan	0%	1%	7%	-1%	-5%	7%	-6%

* Quarter to date
** Year to date

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