Newsletter : Autumn consolidation | October 2021

Key Take-Aways

- The Chinese debt crisis, heightened by an excessively leveraged property market, will result in the first Chinese recession in a generation. This is a significant threat for investors.
- The U.S. Economy is decelerating at an accelerating pace. It will be difficult to achieve its pre-pandemic growth trajectory.
- Supply chain disruptive price increases will create significant reduction in demand.
- Without wage growth, current inflation is and will continue to be destructive to demand. Demand-shock is going to blow up a lot more than just GDP growth given the current socioeconomic backdrop.
- Powell suggested the conditions for “tapering” of the bond purchases program have been “all but met”. The market is convinced it is only a matter of time before bond purchase are reduced.
- The bond market is correct to be concerned. Yet, it remains a haven.
- The U.S. equity market is correct to re-price lower. Funding costs are rising, Washington is dysfunctional, and it is vastly over-valued.
- From a valuation point of view, Europe and Japan look more attractive than the US. A rotation back into value is happening for now.
- The incredible acceleration of digital transformation in technology is staggering. Investors must understand the magnitude of this development.
- Funding costs in the bond market are rising. Interest rates are at their highs for the month and quarter. Even though it should, the recent trading range will be lucky to hold.
- The short end of the yield-curve looks relatively more attractive now. The 5-year Treasury yields have risen to 1%. Meanwhile, corporate spreads remains very tight.
- Are cryptos the new gold? We are not sure. But they may have earned a place in asset allocation.

Review : September 2021

And suddenly the party is over... in September, major equity indices corrected sharply. Among the worst performers were the SMI and the Nasdaq, falling 6.19% and 5.14% respectively. Emerging Markets also suffered with the MSCI EM Index ending the month down 4.39%. Notable outliers were the Nikkei and the CSI 300 China index which rose by 4.85% and 1.26%, respectively.

At the end of the third quarter 2021, however, the Chinese CSI 200 Index remains the worst performer, losing close to 7% since the beginning of the year.

Sectorwise, there was just one place to be: energy was the only sector to perform positively, adding almost 10% in September. All other sectors posted negative returns. Materials were the weakest, ending the month down 6.78%, followed by utilites and real estate. Financials had the second-best performance, losing only 1.66% over the period.

The month was marked by a sharp rise in the US Dollar and Treasury yields.

The US Dollar rose by almost 2% vs. the EUR and the CHF. It also appreciated against all other major currencies. EM currencies suffered particularly from the strong dollar and fell on average 2.79%, as measured by the JP Morgan EM FX Index.

Core government bond yields rose across the board. The US 10-year Treasury yield added 21bps, the German 10-year Bund yield increased by 18bps and the UK 10-year Gilt ended the month 31 bps higher.

Surprisingly, corporate spreads remained very tight, at least in the US where they managed to fall by another 5 (IG) to 8 bp (HY). In Japan and Europe, however, spreads widened by a small amount.

Finally, the commodity-index rose on the back of rising energy-prices. The Bloomberg Commodity Index rose 4.62% in September. Crude Oil jumped more than 10%. Gold suffered from a strong dollar and rising yields and ended the month 3% down.

In this environment, equity volatility as measured by the VIX Index rose by 7.54%.

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	4 324	-0.81	-2.81	-4.39	0.62	15.12	20
Nasdaq	14 474	-0.26	-3.84	-5.14	-0.20	12.31	27
Russell 2000	2 217	-0.35	-1.84	-2.48	-4.03	12.28	25
Euro Stoxx 50	4 048	-0.79	-3.50	-3.53	-0.40	13.95	15
Stoxx 600 EUR	455	-0.05	-2.71	-3.41	0.44	13.98	15
FTSE 100	7 086	-0.31	0.11	-0.47	0.70	9.69	12
SMI	11 642	0.12	-2.48	-6.19	-2.51	8.77	17
NIKKEI 225	29 453	-0.31	-0.63	4.85	2.30	7.32	17
CSI 300 China	4 866	0.67	0.27	1.26	-6.85	-6.62	13
MSCI EM Index	1 251	-0.76	-1.67	-4.39	-8.97	-3.10	12

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	4 324	-0.81	-2.81	-4.39	0.62	15.12	20
UTILITIES	325	-0.74	-2.03	-6.34	1.02	1.82	18
ENERGY	398	-0.85	3.89	9.93	-2.24	39.18	13
TELECOM	269	-0.07	-2.51	-6.26	1.75	21.21	19
CONS STAPLES	718	-1.35	-2.20	-4.00	-0.47	3.14	19
REAL ESTATE	279	-1.23	-4.04	-6.29	0.62	22.48	44
CONS DISCRET	1 433	-1.25	-2.51	-2.40	0.07	10.00	26
MATERIALS	500	-0.89	-1.93	-6.78	-3.26	9.75	16
HEALTH CARE	1 495	-0.53	-3.28	-4.98	1.80	12.94	16
INFO TECH	2 629	-0.49	-4.47	-5.64	1.32	14.73	24
FINANCIALS	627	-1.30	-0.99	-1.66	2.63	27.78	14
INDUSTRIALS	834	-1.30	-2.10	-5.44	-3.76	11.22	19

Currency % Change	Price	1 day	5 days	MTD	QTD	YTD
DXY	94.301	-0.04	1.31	1.81	2.02	4.85
EUR-USD	1.1577	-0.18	-1.38	-1.96	-2.37	-5.23
USD-JPY	111.45	-0.46	1.00	1.28	0.31	7.36
USD-CHF	0.9339	-0.04	1.05	2.01	0.95	5.21
EUR-CHF	1.0812	-0.25	-0.39	0.04	-1.45	-0.00
GBP-USD	1.3457	0.22	-1.92	-2.17	-2.70	-1.56
EUR-GBP	0.8603	-0.40	0.55	0.21	0.36	-3.88
JP EM FX Index	55.31	0.05	-1.49	-2.79	-3.39	-4.51

10 yr Yield Bps Change	Price	1 day	5 days	MTD	QTD	YTD
US	1.52	-0	8	21	-0	60
Germany	-0.20	1	6	18	1	37
UK	1.02	3	12	31	3	83
SWITZERLAND	-0.16	0	2	16	0	39
Japan	0.07	-1	3	5	0	5
US IG Spread	90	0	-4	-5	3	-12
US High Yield spread	246	-5	-7	-8	18	-81
EUR High Yield spread	327	2	15	7	19	-24

Commodity % Change	Price	1 day	5 days	MTD	QTD	YTD
BBG Commo Index	100.4	0.83	2.23	4.62	6.22	28.66
Gold Spot $/OZ	1759.7	1.93	0.97	-2.97	-0.59	-7.31
Crude Oil WTI	75.7	1.11	3.01	10.45	1.11	55.94

Volatility	Price	1 day	5 days	MTD	QTD	YTD
VIX	24.0	1.46	5.39	7.54	51.74	1.27

Source: Bloomberg 30.09.2021

Macro, Fixed Income and Rates : Transitory Inflation?

The Fed, the Economy and Interest Rates…It has been an amazing month. The attempts to analyze the economy after the remarkable pandemic gyrations are challenging. Forecasts from the smartest analysts exhibit a high degree of strategic dispersion. Volatility is on the rise. It is clear to discerning observers though, that the state of the economy is finally beginning to become more visible.

Regarding the economy the primary concern involves the rising cost of money and how much of it the Fed is willing to provide to the post pandemic economy.

It seems patently obvious, that if the Fed raises rates, or reduces stimulus, they will be forced to re-initiate stimulus as markets reprice lower. The Fed's forecast is for slower growth and lower inflation ahead. That's the risk. It's really about household disposable incomes. Our main consideration in this regard is that economic conditions are deteriorating rapidly because inflation rose too early in the economic expansion and ate into real incomes.

That is the result of enormous government stimulus measures, introduced to fight the pandemic, distorting the economy beyond any known historical context

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, September 2021

Percent

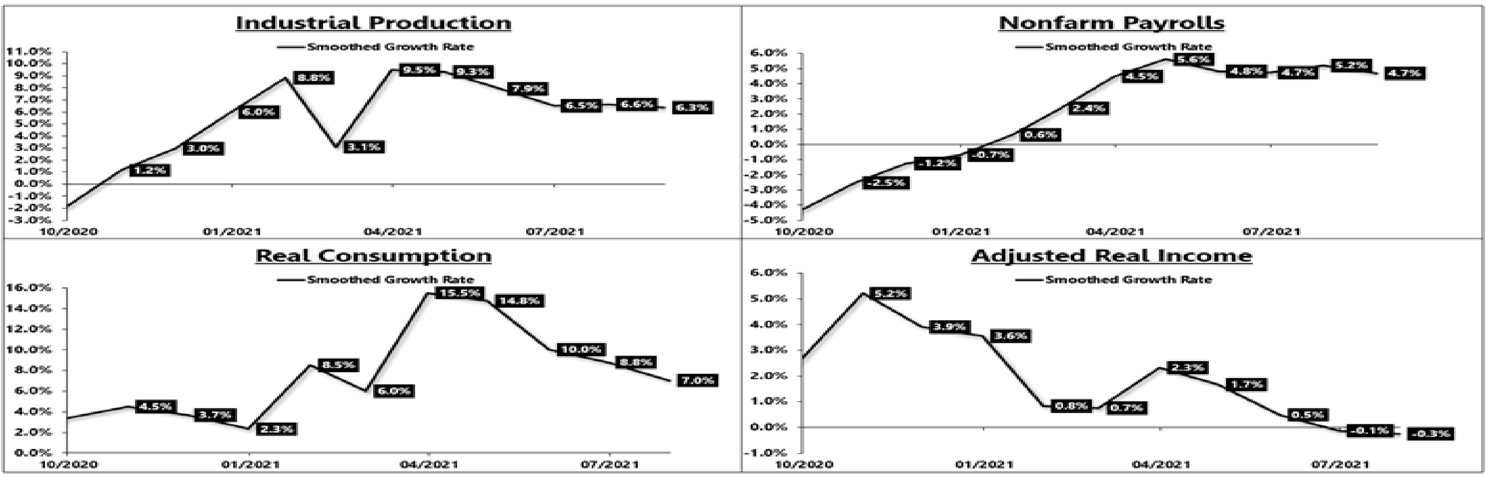
Variable	Median[1]					Central Tendency[2]					Range[3]				
	2021	2022	2023	2024	Longer run	2021	2022	2023	2024	Longer run	2021	2022	2023	2024	Longer run
Change in real GDP	5.9	3.8	2.5	2.0	1.8	5.8–6.0	3.4–4.5	2.2–2.5	2.0–2.2	1.8–2.0	5.5–6.3	3.1–4.9	1.8–3.0	1.8–2.5	1.6–2.2
June projection	7.0	3.3	2.4		1.8	6.8–7.3	2.8–3.8	2.0–2.5		1.8–2.0	6.3–7.8	2.6–4.2	1.7–2.7		1.6–2.2
Unemployment rate	4.8	3.8	3.5	3.5	4.0	4.6–4.8	3.6–4.0	3.3–3.7	3.3–3.6	3.8–4.3	4.5–5.1	3.0–4.0	2.8–4.0	3.0–4.0	3.5–4.5
June projection	4.5	3.8	3.5		4.0	4.4–4.8	3.5–4.0	3.2–3.8		3.8–4.3	4.2–5.0	3.2–4.2	3.0–3.9		3.5–4.5
PCE inflation	4.2	2.2	2.2	2.1	2.0	4.0–4.3	2.0–2.5	2.0–2.3	2.0–2.2	2.0	3.4–4.4	1.7–3.0	1.9–2.4	2.0–2.3	2.0
June projection	3.4	2.1	2.2		2.0	3.1–3.5	1.9–2.3	2.0–2.2		2.0	3.0–3.9	1.6–2.5	1.9–2.3		2.0
Core PCE inflation[4]	3.7	2.3	2.2	2.1		3.6–3.8	2.0–2.5	2.0–2.3	2.0–2.2		3.5–4.2	1.9–2.8	2.0–2.3	2.0–2.4	
June projection	3.0	2.1	2.1			2.9–3.1	1.9–2.3	2.0–2.2			2.7–3.3	1.7–2.5	2.0–2.3		
Memo: Projected appropriate policy path															
Federal funds rate	0.1	0.3	1.0	1.8	2.5	0.1	0.1–0.4	0.4–1.1	0.9–2.1	2.3–2.5	0.1	0.1–0.6	0.1–1.6	0.6–2.6	2.0–3.0
June projection	0.1	0.1	0.6		2.5	0.1	0.1–0.4	0.1–1.1		2.3–2.5	0.1	0.1–0.6	0.1–1.6		2.0–3.0

At his latest and recent press conference, Chairman Powell said that conditions were "all but met" for the Federal Reserve to start tapering the size of asset purchases. He also, said that given the current conditions it may be appropriate to begin the tapering process soon and conclude sometime around the middle of next year. Assuming the Federal Reserve starts the process of tapering in December, that leaves a roughly 6-10 month tapering window for the Federal Reserve to scale down asset purchases from $120 billion per month. The question is… are current conditions static? We think probably not.

It is obvious that current FOMC projections are more hawkish based-on the stubbornly sticky inflation measurements in September relative to June. The bond market responded to this acknowledgment by shifting short-term interest rates significantly higher. 5-year treasury yields have risen from 35bps from 0.65% to 1.00%. 30y rates have broken their recent trading range. After just printing its post-pandemic low at 93bps. There are mixed messages here.

Real economic growth is empirically declining, yet the inflation figures are extremely worrisome. The rate of industrial production growth and real consumption both peaked in March while non-farm payrolls growth changed direction in April - outlined by the four major coincident indicators below.

Macro, Fixed Income and Rates : Transitory Inflation?



The spread between long-term rates and short-term rates peaked un-coincidentally in March as the rate of industrial production, employment and consumption all found local peaks. When the economy is in a growth rate cycle downturn, risks are elevated, and volatility is generally higher. Tightening monetary policy into slowing economic growth brings an added layer of risk to the table. The next several months are a high-risk window for asset markets.

Transitory inflation? Until this month, the Federal Reserve's message on inflation had been consistent: This year's price surge was famously deemed 'transitory', and inflation measures, we have been told, would soon return to the central bank's previous 2% target.

Powell, and a growing number of Fed officials, are turning less sanguine. Last September, long before the supply bottlenecks emerged, the median forecast by Fed officials was for core inflation (which excludes food and energy) in 2022 of 1.8%. Since then they have nudged that up, and in the forecasts released Wednesday they see core inflation next year at 2.3%.

While current-year forecasts get pushed around a lot by temporary factors such as a jump in the prices of food and energy, the "Next-year forecast" reflects where inflation is expected to settle once temporary factors recede. The message from the Fed is that "transitory" is lasting longer than expected. The latest reading in PPI made a new high of +8.3% CPI is running at 5.3%. This might explain why the Fed is accelerating plans to raise interest rates.

The Fed is now buying $120 billion a month in bonds and wants that to fall to zero before it starts to raise rates. The Fed signaled recently it would likely start tapering those bond purchases in November, which means the process would be over by mid-2022, clearing the way for a rate increase. Half of Fed officials think rates will start rising by late next year. Just last March, a majority of officials didn't see that happening until 2024.

What changed? It isn't because the economic outlook is stronger. In fact, officials now see slower growth and higher unemployment than they did in March. Chairman Jerome Powell explained that some officials simply wanted more confidence that an expected recovery would materialize. But inflation risks clearly play a part. The U.S. inflation rate reached a 13-year high recently, triggering a debate about whether the country is entering an inflationary period similar to the 1970s.

A future +2.3% inflation rate isn't a big deal. Indeed, it would conform pretty closely to the Fed's new goal of letting inflation run above 2% for a while to compensate for the many years it ran below 2%. Yet if officials are wrong, which they are at the moment, inflation will be well-above their forecasts.

Equity : expensive and not buying the recovery story

In the equity space we firmly believe that technology remains the best place to be. Technological advancement is extremely deflationary.

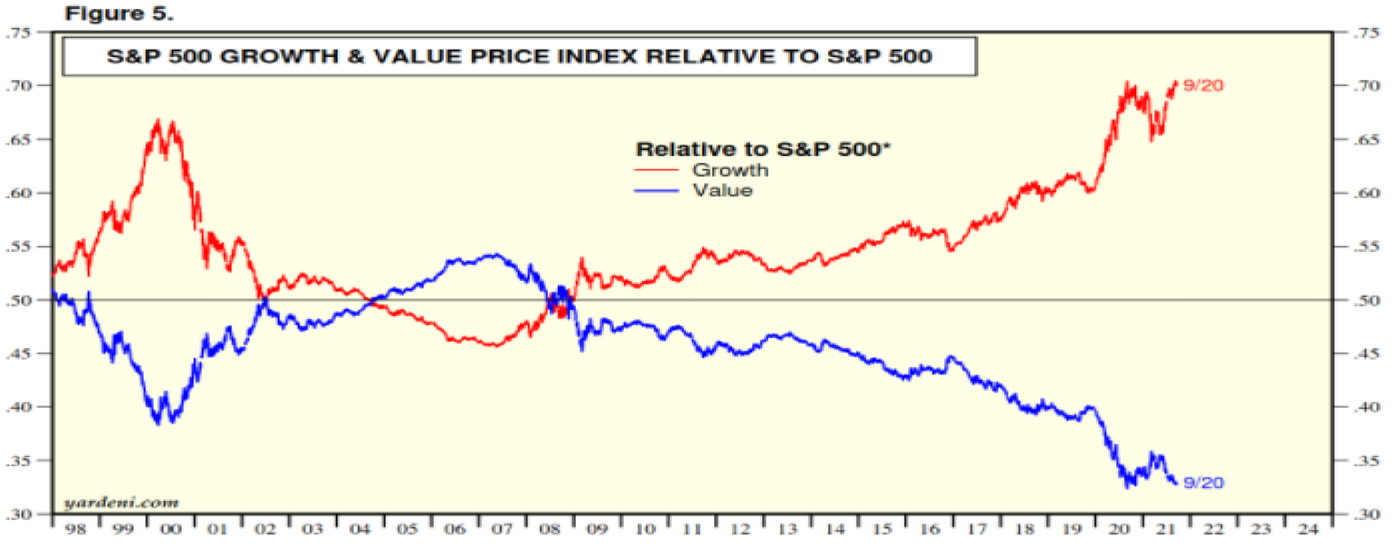
The Big Cap tech Titans: Apple, Microsoft, Alphabet, Amazon, and Facebook thrived through the pandemic. Their latest earnings reports indicate they are still doing so. The five companies generated a combined $332bn in revenue in Q2, that's up 36% from a year earlier. Profits at all five companies were better than expected. Their products are being used more than ever. They have the best business models on the planet.

They are by far the largest companies in the U.S. market by a wide margin, and they offer perhaps the best way to invest in the global economy's most important trends: digital transformation and cloud computing, and the future of communication, entertainment, commerce. and work.

What they have in common is that as platform owners they don't own the supply, they aggregate it. That supply must compete for an audience at the expense of the supplier. That is what gives them power. Amazon sell 500 million products (Walmart still has less than 5 percent of that number) and each one of Amazon's products are vying for your attention, with teams trying to optimize their products to stay on top. Google now indexes more than 130 trillion individual web pages. YouTube doesn't create the vast majority of its content, it hosts it. It offers a place to aggregate it and therefore all of the cost is in the content providers' hands. Walmart has to collect, store, and market each of its products, Amazon does none of that. That is why Amazon is valued almost three times as high as Walmart, once the most valuable company in the world. Apple is now valued higher than the 30 firms in Germany's DAX index. It's also not so far off all 40 companies in France's CAC index. At the start of the 21st century 41 of the world's top 100 most valuable companies were based in Europe. Today that number has fallen to 15. Some of Europe's losses are down to the rise of China. Yet US companies have managed to maintain and grow their share. What's the reason behind this? It's the rise of the Big Cap Tech Titans.

But equities, as a whole, look overvalued nevertheless. And the fact that value is underperforming growth by so much tells us that investors do not embrace the recovery story.

Growth vs Value



* Rising (falling) line indicates that the index is outperforming (underperforming) the S&P 500.
Source: Standard & Poor's and Haver Analytics.

Source: Arbor Research

FX and Commodities: US Dollar in a tight range

Back in June, the Euro was trading close to $1.20. The risk sentiment at the time was nothing like the one these days: Decelerating economies in China and Europe, supply-disruptive price increases, energy crisis, an emerging market debt crisis and Powell's hawkish shift.

In aggregate, developments in the last month increase the odds of a developing stagflation scenario. Higher inflation and rising bond yields have historically always been a deadly combination for risk assets. The Dollar's rise is attributed to a steady migration, if not outright flight, to safety in the U.S.

In the developed world, the Japanese yen and the Swiss franc regarded as regional safety plays, have seen weakness to the US dollar. They, and their regional trading partners are more vulnerable to higher energy prices and stagflation. The same is true for the regional and largest trading partners to the U.S. The Mexican peso and the Canadian dollar are also both weaker against USD.

In the developing world, a strengthening dollar is reducing the appeal of emerging market carry trades, which handed investors their biggest monthly loss in 18 months. An index that measures return from borrowing in dollars and investing the funds in eight high-yielding currencies, such as the Turkish lira, Brazilian real and Indonesian rupiah, lost 3.3% in September; the most since March 2020.

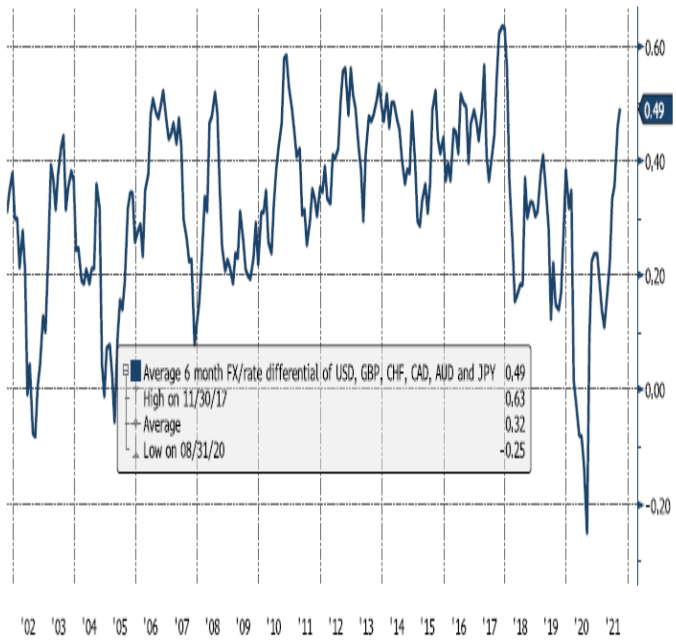
As for Gold... We heard a noted crypto enthusiast (and very large and aggressive hedge fund crypto investor) said this week: "Bitcoin has effectively replaced gold."

We are not convinced that this is entirely true. All the gold in the world which has been mined can fit into an Olympic-sized swimming pool. The largest central and commercial banks in the world control most of it. If investors want to get some assets out of the financial system, buying gold does not necessarily satisfy that desire. Buying gold as a tangible asset is a reasonable consideration, but it is lost on no one that the dollar value invested in crypto has risen to over $1.6t. Furthermore, the ability to engage in any meaningfully sized transaction with gold appears to be getting more problematic. However, with Crypto it appears to be getting easier.

The US Dollar breaking the top of recent range

Source: Bloomberg

FX and rates correlation back to normal



Source: Bloomberg

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