Prime Partners

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MARKET INSIGHT

OCTOBER 2021

CITYWIRE SWITZERLAND TOP 50 INDEPENDENT ASSET MANAGERS 2021

Market Analysis

October 2021

Volatility back on the agenda for investors

> “The question of the Fed’s tapering of asset purchases received a positive answer in September”
>
> **FRANÇOIS SAVARY,** CHIEF INVESTMENT OFFICER, PRIME PARTNERS

One month seems indistinguishable from the next on the financial markets, at least as regards the increasingly important role that Chinese news is playing for international investors.

This was illustrated in September by the saga of the Chinese property developer Evergrande’s possible default, which fuelled a sharp – but for the time being temporary – upswing in stock market volatility. While questions regarding Evergrande’s interest payments have yet to be fully resolved, it is likely that we will not be faced with global systemic risk and that the Chinese government will take the necessary steps to restructure the company as “smoothly” as possible.

At a broader level for the global economy, the Evergrande affair is detrimental to the economic outlook because it risks slowing down Chinese business activity, which still depends heavily on events in the real estate sector, and fuelling a mismatch between the economic cycles in the various regions of the world that will last throughout the coming quarters.

Consequently, although we are of the opinion that global growth in 2022 ought to return to normal at satisfactory levels compared with recent history, this forecast does carry a downside risk. All the more so as energy prices have soared and, more generally, inflation could undermine consumer purchasing power in the short term.

Nevertheless, the recent decision of the US Federal Reserve, validating our scenario of a cautious, gradual approach to the tapering of financial asset purchases, has come at an opportune moment to avoid further unsettling investors. After all, investors have had their fingers burnt by uncertainties about China, the Biden administration’s difficulties in getting its stimulus packages passed, persistent supply-side constraints threatening supply chains, and leading indicators showing increasingly clear signs that we are hitting a plateau after several quarters of sharp recovery.

Given the circumstances, it may seem surprising to see interest rates rising significantly in the wake of the Fed’s reassuring decisions. Perhaps we should interpret it as meaning that investors have concluded that the Fed will not want to risk rocking the boat by changing monetary policy too abruptly. Others prefer to see it as the logical reassessment of medium-term inflationary risk, after months of denial over the summer.

Events in China and the greater likelihood of economic cycles getting out of step as a result tend to bear out our central scenario on inflation.

We are convinced that the strong pressures of the last few months are temporary, although we also believe that we will see larger price rises than those of recent years over a three- to five-year horizon.

The fact that the latest COVID-19 developments are quite reassuring further supports our short-term inflation expectations, as the “bottleneck” phenomena affecting certain goods should gradually disappear.

Overall, the past few weeks have not brought certainty as to the future of the world economy; therefore, it makes sense that investors would continue to have differing growth and inflation forecasts.

In a situation where nobody has the advantage of clear signals that would tip the balance one way or the other, it is not unreasonable that volatility has returned to centre stage – albeit temporarily as it happens – after August’s strong stock market performance.

This stock market consolidation is a development we welcome. Admittedly, the performance of our allocations has suffered as a result, but at least we have been proved correct in the choice we reaffirmed last month not to buy stocks at any price.

We continue to take the view that the coming months should help to clarify matters on the economic front, and that 2022 should be satisfactory in terms of growth. In addition, the reduction of certain distorting factors should help inflation to return to normal. In such an environment, we still think that equities have moderate upside potential that makes them attractive compared with other more vulnerable assets, including government bonds. Without being overweight equities, our investment policy still gives them significant preference over fixed-income assets; this is further reinforced by our exposure to convertible bonds.

Despite the recent rise, long yields have not reached levels commensurate with the economic fundamentals that we foresee for the medium term.

Considering the increase in yields that we expect for three and twelve months, we remain underweight in our bond component.

Although we do not consider government bonds and investment grade corporate debt attractive, we maintain positions in high-yield debt, never losing sight of the fact that overall portfolio duration must be defensive.

Last month we reported on our choice to maintain a buy-on-weakness strategy for equities.

We did not make such an adjustment despite the downturn in the indices in recent weeks. Stock market consolidation has so far been very limited, but it is not necessarily over. This is shown by certain important issues, such as the vote on US stimulus packages and the issue of the US debt ceiling, both of which represent uncertainties likely to fuel volatility in the immediate future.

Likewise, Europe is still our largest regional exposure when it comes to equity allocation; it should benefit from being less expensive relative to the US, and its more cyclical sectors should perform better over the next few months.

In this regard, we should note the recent good run for financial stocks, in line with our expectations, following the rise in bond yields in recent weeks.

Aside from energy, the commodities segment has been disappointing for the past few months, and this has only been exacerbated by developments in China. We are still of the view that confirmation of a sustained recovery in 2022 and an increase in inflationary trends in the medium term should support this segment of the market.

Given that 2021 has been notable for at times violent sector rotation, we are maintaining a diversified approach; in other words, despite their underperformance over the past few months, cyclical sectors should not be sold at any price, especially in an environment where ten-year yields are set to rise further before the end of the year. Our target for the US ten-year yield is 1.70% -1.75% by 31 December.

In keeping with our expectations, the US dollar has continued to tread water against the euro in recent weeks. We are banking on this trend continuing over the coming months (margins 1.16-1.22). Longer term, we feel it is still possible that the 1.25 zone will be tested again, especially since the result of the German elections rules out the risk of a rapid return to budgetary orthodoxy, which had proved so damaging for the euro throughout the last decade.

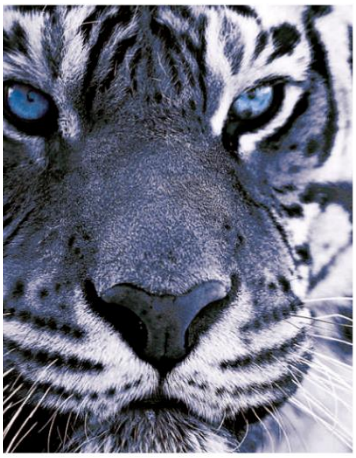
In conclusion, after vexing observers throughout the summer, the question of the Fed's tapering of asset purchases had a positive outcome in September. We are delighted that clarity on the process defined by Jerome Powell and his colleagues has dispelled all uncertainties on this issue.

On the other hand, there still remain hard questions about how the economic cycle will evolve. Quite justifiably, the numerous developments in China continue to have an impact on investor sentiment.

Furthermore, major deadlines on the other side of the Atlantic raise concerns, which should be resolved in the coming weeks, although it is impossible to determine whether their outcome will necessarily be positive.

In such a context, we do not want to rush into equities, although we maintain a buy-on-weakness stance for the medium term.

Geneva, 28 September 2021



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