JULY 2021

# MONTHLY INVESTMENT OUTLOOK

UBP

Union Bancaire Privée

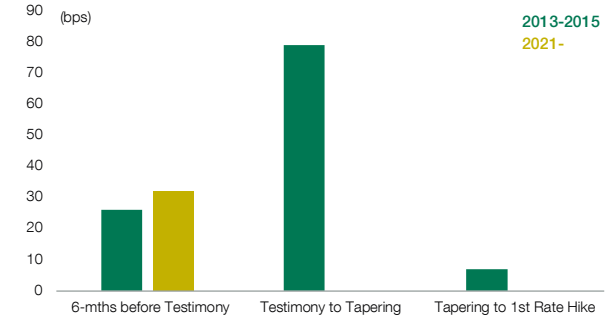
MONTHLY INVESTMENT OUTLOOK

# CONTINUING TO PIVOT ALONGSIDE THE FEDERAL RESERVE

- Global equity markets closed at the half year point higher, while global bonds fell as the Federal Reserve began to signal a pivot change – by potentially slowing the pace of its bond buying, i.e. 'tapering' – in its post-pandemic policy regime.
- August may reveal the next step in this policy shift as the central bankers' meeting in Jackson Hole, Wyoming, offers the Fed an opportunity to outline details for the next stage in the Federal Reserve's policy framework.
- In the 2013 'tapering' following the 2008-09 Global Financial Crisis, higher Treasury yields and wider spreads emerged even before the Fed began to signal its intended shift in policy. Once the tightening policy was made public at a Congressional testimony, yields continued to rise and spreads carried on widening.
- This should signal caution for bond investors in the months ahead. As a result, we seek opportunities to continue our rotation within fixed income, in particular seeking to add to positions in US senior loans.
- Equity investors did, however, not face the same drawdowns. After the Congressional testimony in 2013, equity markets rose nearly 13% before tapering began in December, suggesting less cause for concern among equity investors.
- Looking more deeply, however, and about 40% of the returns during the policy change in 2013 came from rising PEs. With price-earnings ratios still above the 20x level – only seen in the early-2000s tech bubble and during the global pandemic – we are skeptical that rising PEs can once again drive investors' returns looking ahead.
- Entering earnings season in July, the earnings tailwind for investors remains robust, with expectations for 2Q21 performance still below actually reported 1Q21 earnings despite progressive upgrades during the quarter.
- To benefit more fully from this, we have begun shifting our focus towards not only quality earnings growth prospects but also attractive valuations, allowing durable valuation floors to minimise the adverse effect that declines in P/Es have on visible earnings growth prospects.
- In the US, 'Big Tech' now offers just such a durable valuation floor to match its quality earnings stream. In Europe, Swiss equities provide a quality-biased exposure for investors relative to the more cyclically-focused exposure found in continental Europe.

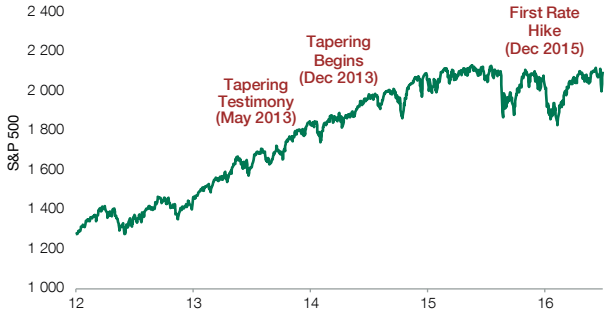
**Higher yields and wider spreads preceded the start of tapering in 2013**

Change in Baa rating bonds




Sources: Moody's, Federal Reserve Board, Bloomberg Finance L.P. and UBP

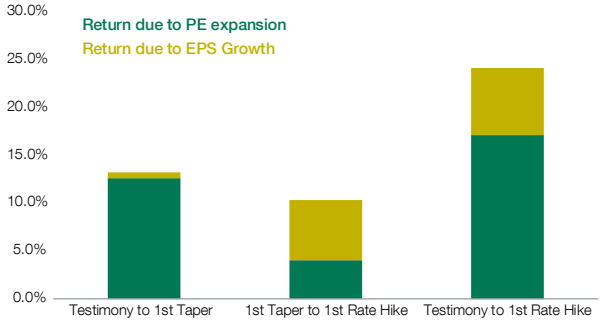
**Tapering presented few headwinds to equities in 2013**




Sources: Standard & Poors, Federal Reserve Board, Bloomberg Finance L.P. and UBP

**Investors cannot rely on PE expansion in the upcoming tapering, focus on quality earnings**

Contribution to S&P 500 return




Sources: Standard & Poors, Federal Reserve Board, Bloomberg Finance L.P. and UBP
* May 2013 – Congressional Testimony;
Dec 2013 – Tapering Begins; Dec 2015 – 1st rate hike

GLOBAL TACTICAL ASSET ALLOCATION

# EARNINGS ARE KEY TO DRIVING EQUITIES HIGHER

## Global economy / Asset allocation

- Global growth continues to recover but looks uneven across regions; Europe should benefit from reopening services while momentum fades in the US and China.
- Inflation should remain high in H2-21, though a decline is not expected before 2022; US fiscal policy fuels upside inflation risks favouring strong growth and full employment.
- The monetary regime is about to change as the Fed is expected to communicate a reduction in purchases next year and several central banks seek a more neutral policy.
- We maintain our pro-risk stance going into the Q2 corporate reporting season. Equity markets should be supported by another strong earnings season, as corporate profits seem set to continue to recover from the pandemic shock.

## Fixed income

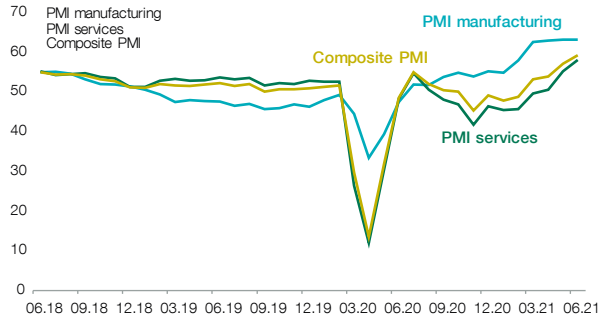
- With two rate hikes now possible as soon as 2023 instead of 2024, more uncertainty was added to the market. Treasury yields initially traded higher after these developments, notably the front-end of the yield curve, but quickly reversed course on the long-end, with the 10-year again trading below 1.5%. However, increased levels of Treasury supply and concerns over Fed tapering could push rates still higher starting in August.
- Since valuations are very tight across most fixed income asset classes, we expect coupon yields to carry the day during the second half of the year. We continue to rely on security selection to drive alpha generation and avoid long-duration debt which could be affected by a slight increase in yields.

## Equities/ Alternatives

- The upcoming Q2 earnings season is likely to prompt another wave of upgrades to consensus estimates, while PE compression should remain contained. Still, with the economic cycle maturing, investors should progressively move towards stocks with high-quality earnings streams.
- Hedge funds are particularly valuable in generating alpha in markets with rising volatility. We are seeking to re-enter the field in the second half, after having exited some of our holdings last year in favour of directional equities.

### Rebuilding confidence in the eurozone

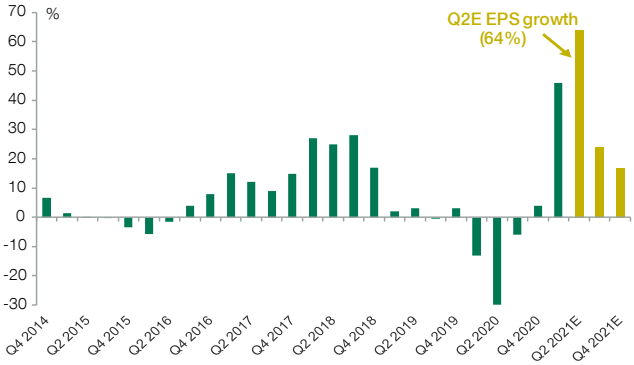
Eurozone: business confidence




Source: Markit

### S&P 500 Q2 EPS to surprise on the upside despite high consensus growth rate

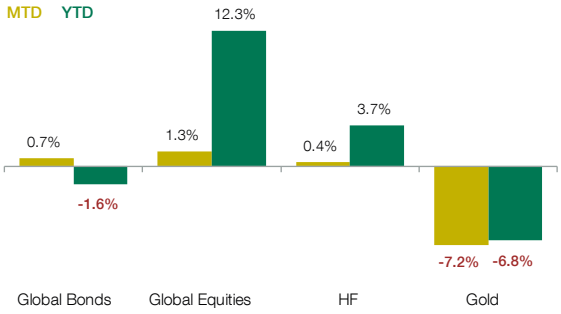
S&P 500: actual and estimated earnings growth rates (analysis' consensus)




Sources: Refinitiv, MSCI and UBP

### Flat markets in June except Gold

Major Asset Classes Performance




Performance is as end of June 2021
Sources: Refinitiv, UBP

UBP ECONOMIC OUTLOOK

# EUROPEAN RECOVERY TO TAKE OFF

## Key points

- Europe ready to lead Q3 growth, while momentum should fade in the US and China. New variants may fuel downside risks to activity and emerging countries are still lagging the recovery.
- High inflation likely to remain in H2-21 due to strong oil prices and high demand. A global decline is expected in 2022, but strong labour and public support could fuel upside risks in the US.
- More infrastructure spending should benefit US and Europe, while monetary policy should gradually be withdrawn to reduce its aggressive support.

## Eurozone to benefit from reopening sectors

- After accelerated vaccination and reopening services, activity should rebound in Q3, and the 2021 scenario has been revised up from 4.2% to 4.7%.
- Higher consumption should lead the recovery thanks to strong demand, accumulated savings and still active support to labor. Services should regain pace while manufacturing still faces supply disruption, notably the auto industry.
- The EU Recovery Fund is set to begin deployment in H2-21 and will support further recovery and transition via public spending in infrastructure and new technologies.

## US strong underlying growth but fading momentum

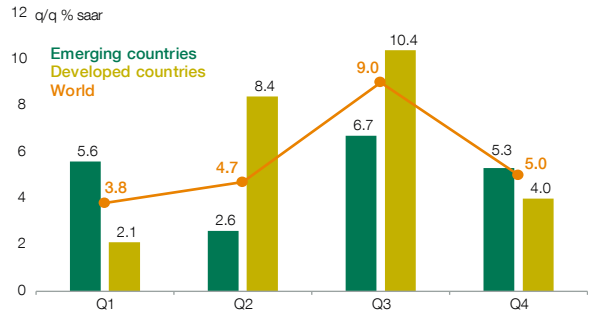
- Q2 growth should be close to an annualized 10% thanks to direct support to consumers but Q3 growth should come in a 7-9 % range; more infrastructure and social spending should support 2022 growth, but measures subject to debate in Congress in the summer.
- After direct support ended, markets became more volatile, and momentum faded. Rising inflation, uncertainties on labour and weakening housing reduced economic surprises after a strong global rebound.

## Chinese growth facing constraints

- After Q1, growth peaked on the back of fading base effects, while a tight monetary policy and tough regulation on specific sectors weighted down on momentum.
- Credit and housing are under focus to avoid overheating and favour deleveraging; this has limited the rebound in consumption despite being a favorite sector for long-term policy.

### Strong Q3 recovery in sight in developed countries

World growth in 2021




Source: JP Morgan, UBP

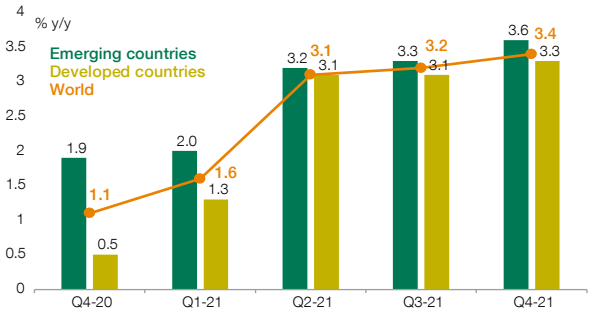
### Strong growth expected in developed countries in 2021

| GDP y/y % | 2020 | 2021 | 2022 |
|---|---|---|---|
| **WORLD** - *MER* | -3.6 | 5.7 | 4.2 |
| *- on PPP basis** | *-2.9* | *5.9* | *4.4* |
| **USA** | -3.5 | 7.2 | 4.5 |
| **Japan** | -4.9 | 2.5 | 1.8 |
| **Eurozone** | -6.6 | 4.7 | 4.5 |
| **United Kingdom** | -10.1 | 6.7 | 5.2 |
| **Switzerland** | -3.0 | 3.5 | 3.0 |
| **Brazil** | -4.1 | 4.5 | 2.1 |
| **Russia** | -3.0 | 3.5 | 2.6 |
| **India** | -7.5 | 9.0 | 6.0 |
| **China** | 2.3 | 8.6 | 5.5 |
| **Developed countries** | -5.0 | 5.6 | 4.1 |
| **Emerging countries** | -1.7 | 6.1 | 4.6 |

Source: UBP - Economic & Thematic Research
MER: market exchange rates; PPP: purchasing power parity

### World inflation to stay high in H2-21

World inflation




Sources: JP Morgan, UBP

# MAJOR SHIFT IN MONETARY REGIME AHEAD

- Monetary policy will progressively shift from an ultra-accommodative stance to one that is more neutral. Several central banks will adapt their strategy to a new growth and inflation environment and have stated their willingness to taper or adjust key rates.
- After aggressive support to activity, several banks have already changed their communication (Canada, New Zealand, Korea, Norway) and a few have adjusted their rates (Hungary, Czech Rep. after Russia and Brazil).

## Fed: tapering ahead, but still debate around timing

- At its last meeting, Fed governors were more comfortable with the economic scenario and agreed to talk about tapering; they also advanced expectations of the first policy rates adjustments to 2023.
- Tapering should be explicitly debated at the next meetings and labour and inflation data should lead the agenda of official change in the Fed's strategy.
- Under our current scenario, tapering is expected to be mentioned during the Jackson Hole meeting in August and presented at the FOMC meetings in September and October. It should begin in Q1-22, while the first adjustments in policy rates are expected by Q2-23.

## The ECB: still dovish but no consensus

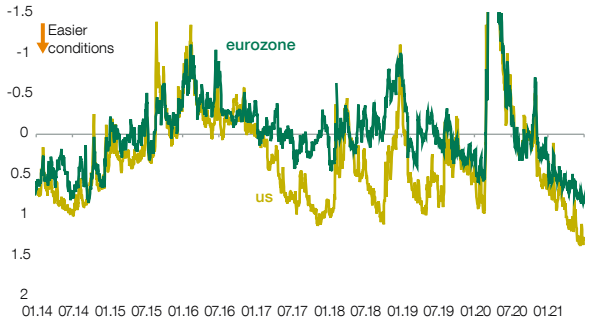
- The ECB maintained its "high" level of monthly asset purchases (EUR 80 bn) but there was no consensus on reducing these in the future, even if the economy were to improve.
- Discussion on tapering was viewed as "too early and premature", but the PEPP is scheduled to end in Q1-22. As inflation looks set to fall back below 2% in 2022, purchases could continue via traditional programmes (APP) with ongoing liquidity injections (TLTRO).
- The ECB's new strategy should adopt a flexible symmetric 2% inflation target and include QE as a regular tool.

## Varying speed of adjustments expected in emerging

- The Chinese central bank adopted a tight policy in Q1 to force deleveraging; a partial easing is expected later.
- In Latin America, rises in key rates are forecast for the next quarters as inflation has rebounded, while in other Asian countries central banks should leave key rates unchanged.

### Financial conditions at highly accommodative levels in both US and eurozone

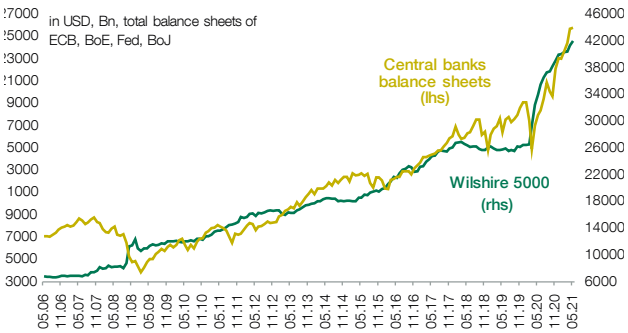
US and eurozone financials conditions indices




Sources: Bloomberg Finance L.P.

### Central banks' balance sheet expansion was supportive for risky assets

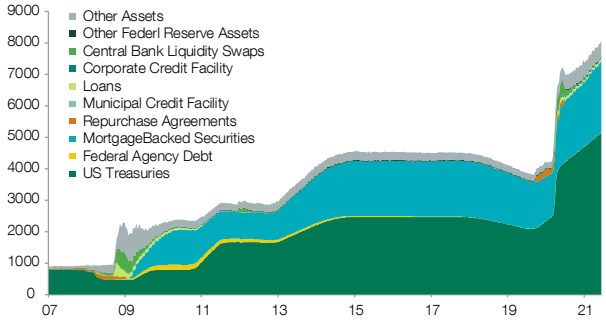
Central banks balance sheets and stock market




Sources: National central banks, Bloomberg Finance L.P., Wilshire index

### US Fed balance sheet has dramatically expanded during the pandemic

Fed balance sheet: assets, in USD billion




Sources: Fed, Bloomberg Finance L.P.

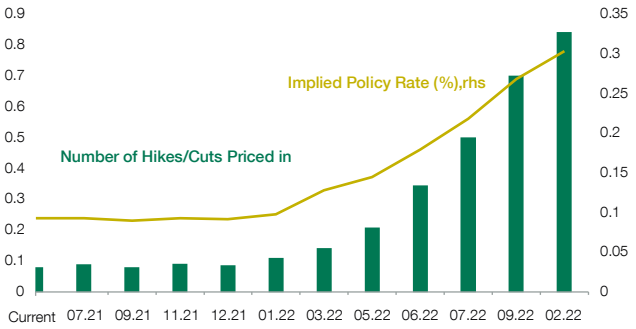
GLOBAL BONDS

# CONSTRUCTIVE ON CREDIT BUT CAUTIOUS ON LONG-DURATION DEBT

- Rising inflation has remained the focus of investor concern as economies reopen and stimulus remains fully active. In addition, the recent Federal Open Market Committee meeting was more hawkish than expected, pulling forward the Fed's time frame for rate hikes.
- Two rate hikes are now possible as soon as 2023 instead of 2024 as previously thought. Treasury yields initially traded higher after these developments, notably the front-end of the yield curve, but quickly reversed course on the long-end, with the 10-year again trading below 1.5%. However, increased levels of Treasury supply and concerns over Fed tapering could push rates higher.
- Despite these worries, the fixed income market is still skewed towards risk-taking, with investors continuing their search for yield. They expect inflation to be transitory and remain comfortable with fiscal and monetary support measures, progress on vaccine distribution, and economic growth.
- As a result, we remain highly constructive on leveraged finance asset classes. Commodity prices, which have more than recovered to reach new highs, continue to propel the reopening economy, especially industrial sectors. In addition, the superior trade-off between carry and duration provided by the leveraged loan index is a key reason for our positive view.
- We are more cautious on emerging market (EM) debt, especially corporate debt due to geopolitical tensions, higher US rates and inflation. Sovereign spreads continued to trade in a narrow range but have widened slightly.
- In Europe we remain constructive on European bank hybrid securities which we consider as having an attractive risk-return profile with premium yields. Strong balance sheet fundamentals, the high beta to growth, and still-conservative capital management should keep the bid from bond investors strong.
- That said, since valuations are especially tight across most fixed income asset classes, we expect coupon yields to carry the day during the second half of the year. We continue to rely on security selection to drive alpha generation and avoid long-duration debt which could be affected by a slight increase in yields.

### The market repriced the timing of rate increases

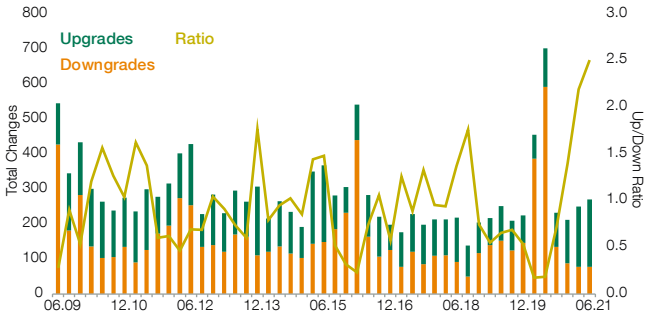
Implied Overnight Rate & Number of Hikes/Cuts




Sources: Thomson Financial, UBP

### Companies are improving fundamentals by refinancing debt at historically low rates

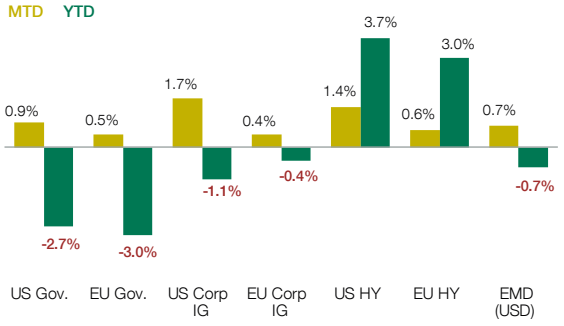
US High Yield - Credit Ratings Trends




Sources: EPFR, BoA ML, UBP

### Bonds continued to come back in June

Fixed Income Performance




Performance is as end of June 2021
Sources: Refinitiv, UBP

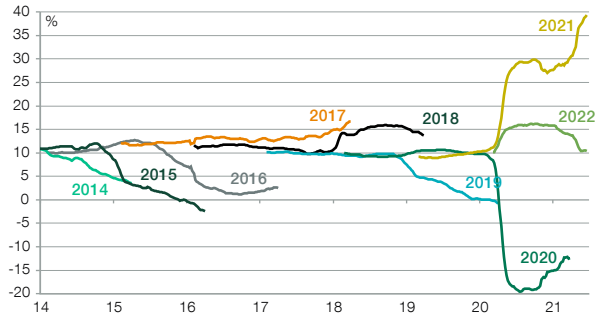
GLOBAL EQUITIES

# ALL ABOUT EARNINGS

- Despite the slightly less accommodative message from the Fed and the spread of the Delta variant, equities once again posted positive performances in June.
- Earnings revision ratios unsurprisingly moderated over the last month after having reached historically high levels; the US continued to display the best earnings momentum among the major regions.
- EPS projections continued to drift higher for most markets, with 2021 EPS growth estimates for global equities moving up nearly 40%.
- Globally, materials, financials, industrials, energy and technology continued to show the strongest revisions while defensive sectors were broadly flat.
- In the US, the expected EPS growth rate for Q2 has risen by 10pp to 64% since the start of the quarter thanks to higher estimates for all cyclical sectors. Despite this strong increase, current Q2 EPS estimates remain 9% below Q1 actual EPS, which adds to evidence that we should again see some positive surprises during the coming reporting season and further upgrades to consensus estimates.
- Reducing inflation fears and the ongoing Fed buying should put a lid on bond yields and therefore contain PE compression, allowing earnings to move markets higher.
- With the economic cycle set to mature in many parts of the world, investors should increasingly focus on stocks with high earnings quality.
- These stocks would probably outperform if, as was the case in 2013, any tapering announcement leads to a rise in volatility.
- Swiss equities clearly fit these criteria of earnings quality, as witnessed by the remarkable stability of their return on equity (ROE) over the last year, and do not look expensive relative to global equities.
- Moreover, with the reopening phase of recovery for Europe nearing an end, governments will move their support efforts from wide-ranging stimulus to more targeted measures, notably via the EU Recovery Fund. Investors should increasingly focus on earnings beneficiaries from this next stage of fiscal spending.

### Expected earnings growth rate for global equities rose again to reach nearly 40%

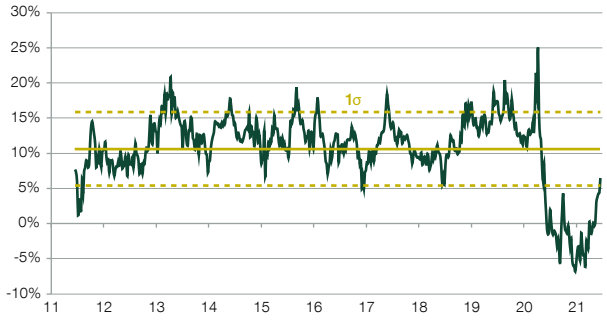
Consensus EPS growth expectations for global equities




Sources: Refinitiv, UBP

### Swiss equities still look relatively cheap

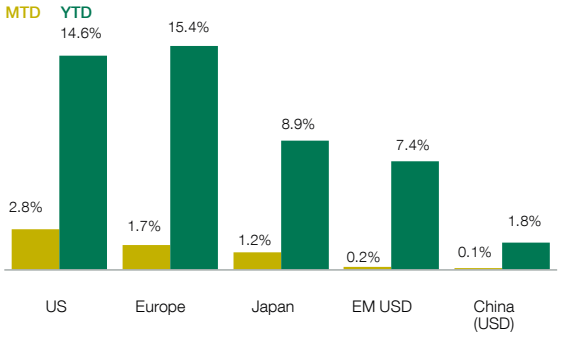
Swiss equities relative to Global equities
PB relative less ROA relative




Sources: Refinitiv, UBP

### US equities outperformed in June

Equities Performance




Performance is as end of June 2021
Sources: Refinitiv, UBP

RECENT CHANGES

# REDUCING CHINA DOWN TO NEUTRAL

- Since November of last year, we gradually added cyclical exposure alongside long-term transformational growth themes in the equity space to benefit from the global economic and corporate earnings recovery.
- This month, we reduced our Chinese equity exposure from overweight to neutral. While we stay constructive in the long-run on Chinese equities, the economic cycle in China is more advanced than other regions of the world. Chinese equities were hurt by the first-in, first-out effect and in the short term, regulatory risks remain significant.
- In the fixed income space, we added carry through US senior loans where yields are still attractive, and valuations are cheap compared to other segments of the fixed income market.
- With put options having expired in June, we opted not to renew the protection as we entered the Q2 corporate earnings reporting season. US earnings are expected to grow 64% in Q2 which will act to support equity markets in the short term.
- With the US economic cycle set to transition into a 'mini-cycle' in the coming months, equity volatility and drawdowns should increase. A proactive and dynamic risk management approach therefore becomes increasingly key to navigating the final stages of the recovery phase. As a result, we will probably add back protection for our portfolios later in the year.

### US earnings are expected to grow 64%

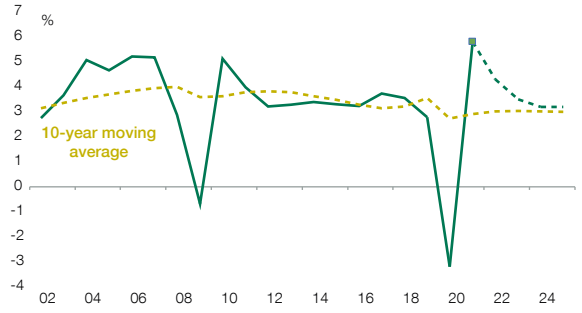
S&P 500 - consensus EPS growth (y/y, %)

| Sectors | Earnings weight (2021E) | Q2 21 | 21 | 22 |
|---|---|---|---|---|
| Consumer discretionary | 10% | 241 | 74 | 33 |
| Consumer staples | 8% | 9 | 7 | 8 |
| Energy | 0% | 223 | 977 | 27 |
| Financials | 17% | 99 | 46 | -1 |
| Healthcare | 19% | 11 | 15 | 6 |
| Industrials | 5% | 547 | 84 | 37 |
| Materials | 3% | 111 | 63 | 3 |
| Real estate | 1% | 24 | 14 | 6 |
| Technology | 23% | 30 | 26 | 12 |
| Communication services | 11% | 40 | 26 | 13 |
| Utilities | 4% | 1 | 2 | 8 |
| S&P 500 | 100% | 64 | 36 | 12 |

Sources: Refinitiv, UBP

### Growth is likely to peak in the coming months

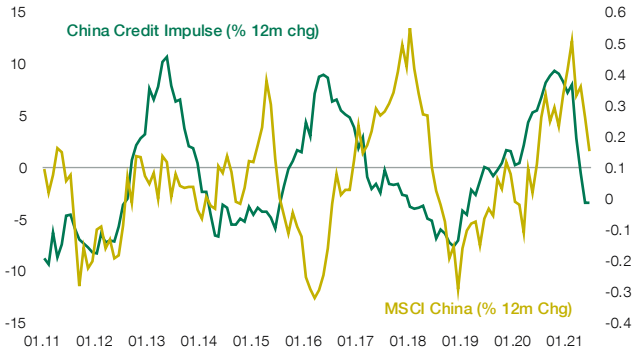
World GDP growth




Sources: Refintiv, UBP

### Credit impulse does not bode well for Chinese equities

China credit impulse vs Chinese equity




Sources: Bloomberg Finance LP, UBP

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**Union Bancaire Privée, UBP SA | Head Office**
Rue du Rhône 96-98 | P.O. Box 1320 | 1211 Geneva 1 | Switzerland
ubp@ubp.com | www.ubp.com