NOVEMBER 2021

MONTHLY INVESTMENT OUTLOOK

UBP

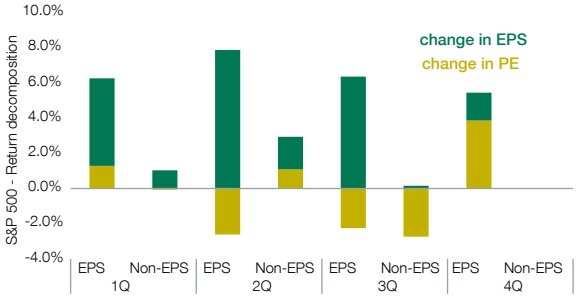
Union Bancaire Privée

MONTHLY INVESTMENT OUTLOOK

REBUILDING USD AND DURATION EXPOSURE GOING INTO YEAR-END

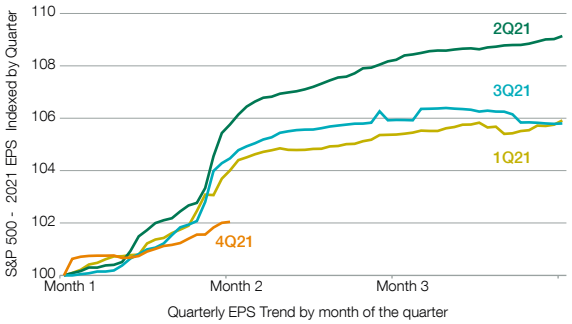
- Global equities resumed their rally in October following their September pause as global bonds saw interest rate headwinds return with both US Treasury and German Bund yields hitting levels not seen since early 2019.
- The global economy has seen growth headwinds emerge – via energy and China – while inflationary pressures look likely to persist deeper into 2022 than previously expected. As a result, risk is rising on both fronts entering the new year as policymakers seek to strike a delicate balance to keep the post-pandemic growth trajectory on track.
- While earnings season has buoyed US equities, the October rally has been largely due to rising PE multiples rather than the robust upgrades to earning expectations seen in previous reporting periods.
- Indeed, earnings upgrades in October have been modest as expected compared to the historic earnings beats delivered over the summer.
- Consequently, while we expect the remainder of earnings season in early-November to remain a tailwind for markets, investors should be cautious about the sustainability of further PE expansion driven returns looking into the new year. We therefore expect our quality earnings bias to remain prudent looking ahead.
- As US Treasuries make progress towards our year-end target of 1.7-2.0%, opportunities are beginning to emerge to reintroduce duration into portfolios. A move above 1.7% would present the first opportunity to build longer duration positions over the course of the coming months.
- Indeed, with the previous mini-cycle phases of the global economy having resulted in localized credit events looking back to the 1990s, longer duration US Treasury positions should begin to restore some cushion within portfolios.
- With US 2-year yields also rising, we now expect USD strength going into 2022 in particular against the EUR. As a response to this, with the prospect of a move towards 1.10, we have reduced EUR exposure across portfolios in favour of the USD.
- Overall, having weathered the seasonally weak September and benefitted from the October rally, investors should now pivot focus to begin building more asymmetric exposure as the moderate returns, but elevated volatility that typically characterise mini-cycle phases become more pronounced entering 2022.

US earnings season rally has been PE driven rather than earnings driven



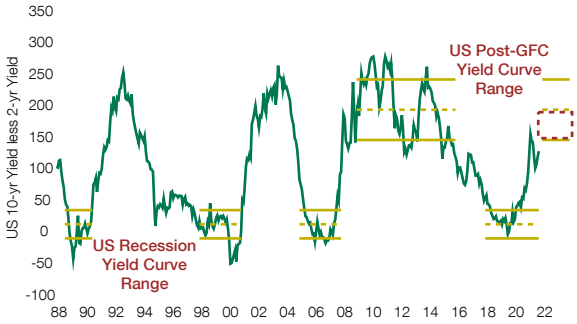
Sources: Standard & Poor's, Bloomberg Finance L.P. and UBP

As expected, the current earnings season lags previous quarters in upgrade momentum



Sources: Standard & Poor's, Bloomberg Finance L.P. and UBP

Looking to add duration as the US yield curve steepens



Sources: Bloomberg Finance L.P. and UBP

GLOBAL TACTICAL ASSET ALLOCATION

ADDING RESILIENCE INTO PORTFOLIOS

Global economy / Asset allocation

- Facing energy and inflation shocks, global activity is expected to moderate in the coming quarters.
- Downside risks to growth have grown due to lower visibility, the global energy shock leading to disruption in industry and slower growth in China raising the prospect of potential policy errors.
- Governments in Europe have adopted measures to mitigate the impact of higher energy prices, while US policymakers are still debating next year's budget.
- As a result, we are seeking to add resilience into portfolios after a year of strong performance in equity markets. USD and longer duration government bonds should provide some cushion against a market correction going forward.
- Proactive risk management is valuable to allow us to stay invested in key long-term themes without being concerned about near-term volatility and drawdowns.

Fixed income

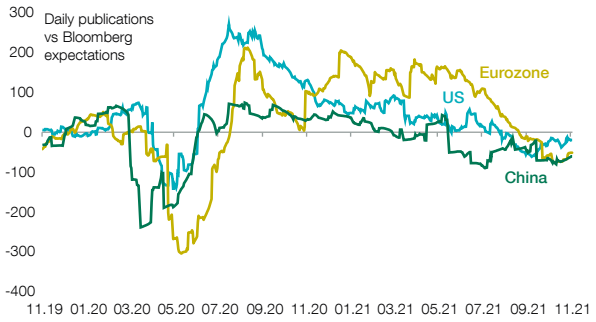
- Given that inflation is set to remain elevated for longer than expected and as central banks progressively remove their support, bond yields are expected to rise further in the next quarters.
- With the prospect of US 10y Treasuries back in a 1.7%-2% range in the next months, we will look for opportunities to reintroduce duration when US 10-yields exceed 1.7% while moderating credit risk exposure looking ahead.

Equities/ Alternatives

- Q3 earnings beats and rather reassuring guidance have supported global equities. Despite more muted earnings momentum and less accommodative policies going forward, the outlook for equities remain positive, albeit with a likelihood of higher volatility and more moderate returns heading into 2022.
- Hedge funds are particularly valuable in generating alpha in markets with rising volatility. We are looking to re-enter the field after having exited some of our holdings last year in favour of directional equities.

Activity has lost momentum in all main regions

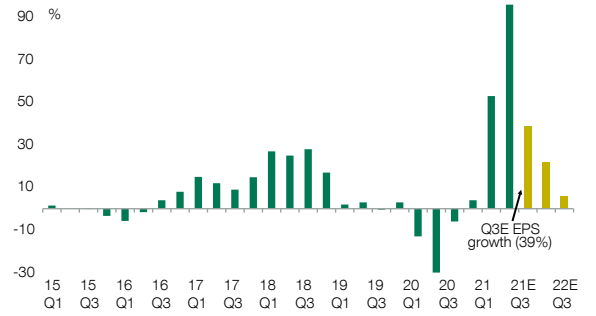
Surprise index – dailyl



Source: Citigroup Global Markets

Earnings growth has peaked but will remain positive in coming quarters

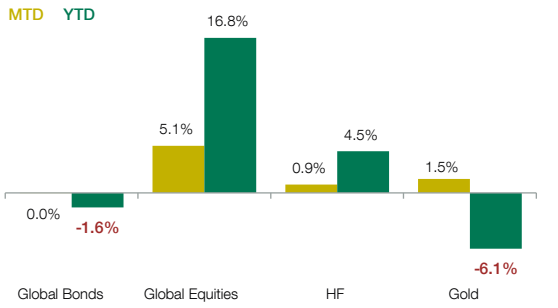
S&P 500: actual and estimated earnings growth rates (analysts' consensus)



Sources: Refinitiv, MSCI and UBP

Equities delivered positive performance

Major Assset Classes Performance



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

UBP ECONOMIC OUTLOOK

PROSPECTS OF SLOWER GROWTH AND HIGH INFLATION

Key points

- Global expansion should continue but at moderate pace; the 2022 outlook has been revised down for US, China and eurozone with renewed headwinds.
- Inflation should remain high due to the combined impact of high energy prices and bottlenecks in industry. A significant decline in inflation is only expected from Q3-22.
- Budgetary policy should continue to be supportive, while monetary policy will end quantitative easing in 2022; some central banks are preparing to tighten key rates.

US growth on moderate pace

- Consumption drove the rebound in H1-21 but has moderated in Q3 facing declining purchasing power, partly compensated by saving. As bottlenecks remain in industry, moderate growth is expected in the coming quarters.
- While more infrastructure spending is expected, political negotiations remain tough on renewed support to consumers. The debated USD 1.5 tr plan looks less ambitious, with a more limited rise in taxes, than the initial projection of USD 3.5 tr.

China facing tough regulation, but limited policy supports

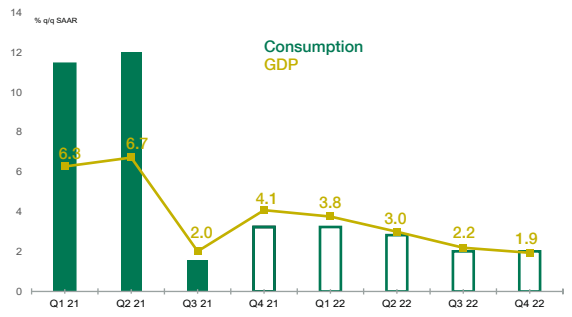
- The 2022 outlook has been revised down to 5% as regulation weighs on various sectors. The external sector should benefit from foreign demand, while momentum on domestic sectors should slow further over next quarters.
- No new policy support has been launched to compensate for the drag on activity. Monetary policy has offered limited liquidity injections, while prospects of easing in rates, or in banks' reserve ratios, are fading in the short run.

Energy shock to weigh down on activity in Europe

- After sustained growth in Q2 and Q3, activity should moderate in the next quarters due to higher energy prices and negative impact on consumption. Eurozone governments have launched measures to mitigate the rise in energy costs on some industries and for those on low incomes.
- Next year, activity should benefit from the New Generation EU and Recovery Fund; governments will spend further as limits on public debt and deficit have been postponed to 2023 and Maastricht criteria are under review.

US growth on moderate trend

US GDP 2021-2022 scenario



Sources: BEA, UBP

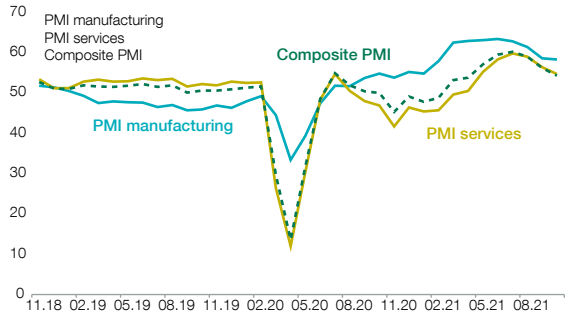
2022 growth trend to slow after strong recovery in 2021

GDP y/y %	2020	2021	2022
WORLD - *MER*	-3.6	5.4	3.9
*- on PPP basis**	*-2.9*	*5.6*	*4.0*
USA	-3.4	5.8	3.6
Japan	-4.7	2.5	2.2
Eurozone	-6.3	5.0	4.0
United Kingdom	-9.7	7.0	4.7
Switzerland	-2.5	3.5	3.0
Brazil	-4.1	5.4	2.0
Russia	-3.0	4.0	2.6
India	-8.2	9.0	6.0
China	2.3	8.2	5.0
Developed countries	-4.8	5.1	3.6
Emerging countries	-1.7	6.0	4.4

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

Eurozone: a still fragile confidence in services

Eurozone: business confidence



Source: Markit

STAGFLATION FEARS

Energy shock to redistribute growth and inflation

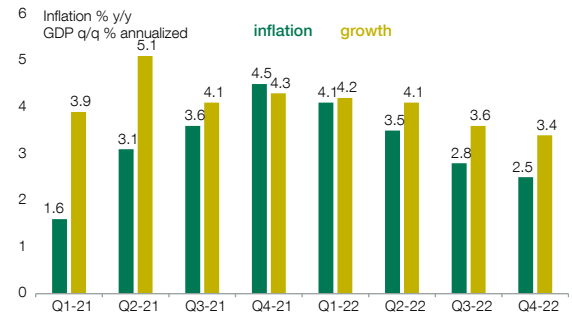
- Global growth is slowing down, and inflation is climbing due to the energy shock. At the same time, central banks are removing their stimulus and the prospect of rate hikes is increasing. Fears of stagflation have increased pointing to a "mediocre" growth trend and persistent high inflation risk.
- In 2022, the world economy should grow by around 4% after the strong recovery in 2021 of close to 6%. Economies should continue to rely on domestic demand, but the inflation and energy shock will interfere with current trend, accelerating the slowdown and fuelling upside risks to inflation.
- The growth cycle remains fragile as it faces a falling long-term trend in potential growth. Drags come from an aging population and limited skills among the workforce seeking to shift into new industries. The energy shock, leading to a decline in consumers' purchasing power and investment downgrades could therefore end the cycle prematurely.
- Inflation has rebounded sharply due to the combination of higher energy prices, stronger demand, and rising production and transport costs. In our scenario, inflation should peak in Q4-21 but is set to remain high in H1-22 as industry bottlenecks and increases in some services (transport and rent) fuel the pressures. So, a significant decline in inflation is postponed to Q3-22.

Calibrating economic policy to fight the spectre of stagflation

- To avoid stagflation, governments must focus on public-sector investments, boosting productivity, and on fine-tuning monetary policy. Budget deficits will remain high, but unlike in the 1970s, governments should direct public investment and spending into new technologies and infrastructure to address climate issues and extend the current growth cycle.
- Monetary authorities will have to finesse liquidity management and asset purchases to limit pressures on nominal interest rates and calibrate rate hikes carefully to avoid rising real interest rates.
- Any error in policy could derail the cycle and the economic policy needs to be more flexible across economic regions than it was when exiting from past crises. This should avoid any stagflation scenario and the cycle should only turn to moderate growth with high inflation.

Slower growth versus higher inflation in the next quarters

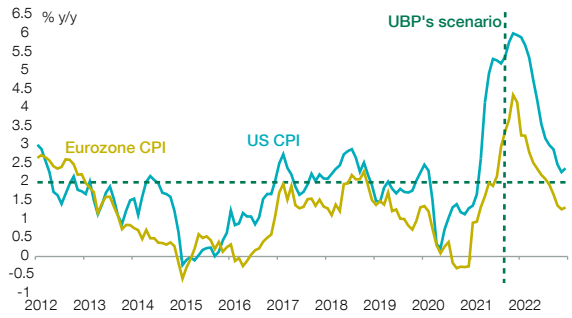
World growth & inflation



Sources: JP Morgan, UBP

The 2021-22 inflation wave in the US and eurozone

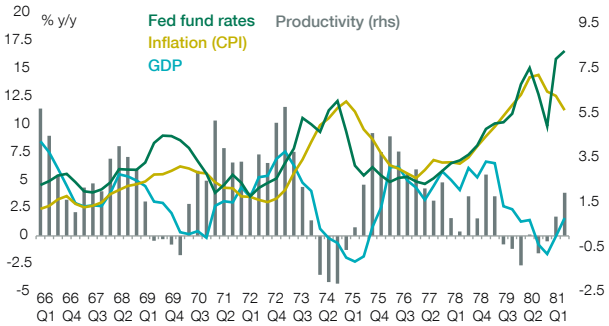
Inflation scenario



Sources: BLS, Eurostat, UBP

The US in the 1970s: from booming growth to booming inflation

US 1966-1981: Growth, inflation and Fed fund rates



Sources: Fed, BEA

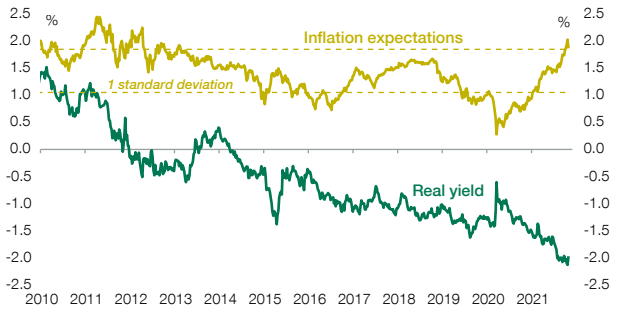
GLOBAL BONDS

OPPORTUNITIES TO REBUILD LONG DURATION POSITIONS

- The strong rise in energy and raw material prices coupled with firmer global demand have continued to push inflation upwards. Central banks now see the "transitory" inflation surge lasting longer than previously expected. These pressures have been priced in by bond markets, through rising yields and mostly by the strong rise in breakeven inflation rates in the US and the eurozone.
- The Fed has turned slightly more hawkish and has prepared markets for a reduction in its assets purchases in Q4; despite more flexible inflation target, the growth and labour outlook appears sufficient for the Fed to justify a reduction in liquidity injections and some Fed governors have pushed forward their expectations for the first of the rate hikes expected in 2022.
- The ECB looks confident in its inflation scenario, reiterating expectations of a significant easing in 2022. However, as bottlenecks in industry are expected to last longer, there is a lack of consensus among governors on the duration of asset purchases.
- As investors increasingly fear central banks will have to tighten policy faster due to inflationary pressures, front-end rates increased strongly while more concerns about the long-term growth outlook have still limited the rise in long bond yields.
- Long bond yields could enter a highly volatile period and face more upside pressures in the coming months. We expect US 10-year Treasuries to enter a 1.7%-2% range and the German Bunds 10-year to come closer to 0% in the coming quarters. This would create opportunities to rebuild longer duration positions.
- Credit spreads remain at particularly low levels, reflecting limited default rates thanks to the supportive economic environment. However, in a context of more volatility and rising bond yields, these low spreads offer limited protection, and the risk reward looks less attractive going forward. This should support a progressively more cautious stance on credit in the coming months.
- The repricing of the Fed interest rate hikes has been a boon for the USD but triggered outflows from emerging bonds. Prospects of higher Fed funds rates, rising long bond yields and ongoing credit concerns in emerging markets, particularly in China, have reduced the attractiveness of emerging bonds. We therefore remain selective on emerging corporate bonds and cautious on emerging bonds given the more favourable USD outlook.

Strong rises in US and German breakeven on inflation fears

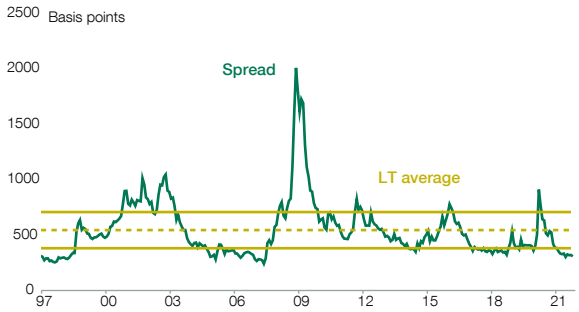
Germany inflation expectations and real yield based on 10-year TIPS



Sources: Refinitiv, UBP

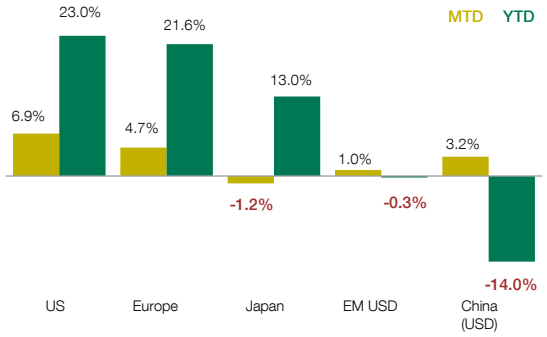
Spreads on US high yield appear tight in the current environment

US High-Yield OAS spreads



Sources: BoA ML, UBP

Fixed Income Performance



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

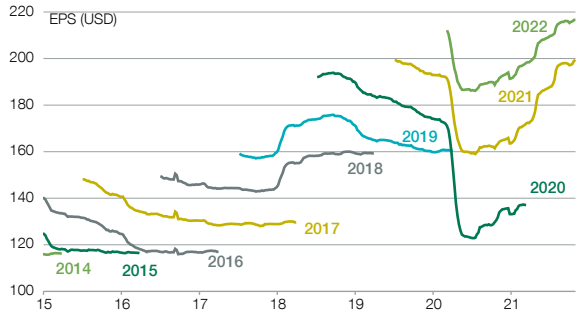
GLOBAL EQUITIES

RESILIENT CORPORATE MARGINS

- Helped by a reassuring start to reporting season, equities rebounded from their losses witnessed in September. Solid corporate results have indeed alleviated concerns that the slowing global economy combined with input price inflation and supply chain issues would prove to be a serious headwind to profits.
- This has been the case for specific sectors and stocks, but in aggregate margins have been resilient. With sales going up nicely, companies benefited from strong operating leverage and lots of them have been able to absorb higher costs by raising prices or via efficiency gains.
- While guidance and comments around margins have been mixed with many companies citing bottlenecks and rising costs, including labour, this did not really come as a surprise to investors. On the outlook for these supply chain issues, the range of views was wide, with some saying the problem will get better in H1 2022, and others saying it may take longer. Importantly, the tone around demand remained positive.
- In the US, strong earnings pushed the S&P 500 Q3 EPS growth rate to 39% (vs 29% on October 1st). However, contrary to the prior reporting seasons, estimates for the following quarter have not increased, but stayed flat in aggregate at 22%. While they continued to rise for the commodity-related sectors and financials, they edged lower for the two consumer sectors and more meaningfully for industrials.
- Earnings also came in well above expectations in Europe. As in the US, the market did not really reward companies that surprised to the upside (while heavily penalising those that missed) but this is similar to what has been seen in recent seasons.
- The bottom-up consensus EPS estimate for next year was little changed over the last month with an expected rise of about 8% in all major regions. Following the latest reassuring earnings releases and given the still solid growth outlook, analysts may need to upgrade their forecasts for 2022. Moreover, the new tax plan in the US appears to pose less of a risk to profits than feared.
- The outlook for equities therefore remain positive, but given the inevitable slowdown in GDP growth, less supportive monetary policies and still elevated valuations, investors should continue to be overweight stocks which offer strong cash flow streams with above average visibility.

More muted earnings upgrades

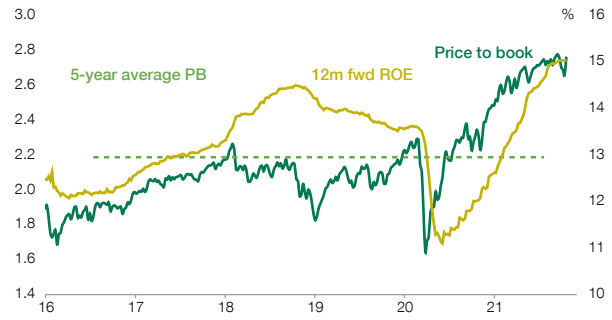
Consensus estimates for S&P 500 EPS by calendar year



Sources: Refinitiv, UBP

Corporate profitability should remain notably high

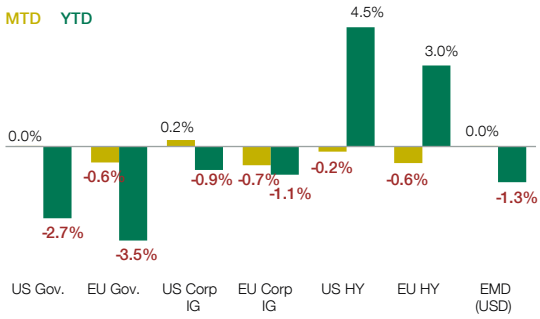
Global equities – Price to book & return on equities (ROE)



Sources: Refinitiv, UBP

Equity markets pulled back during the month

Equities Performance



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

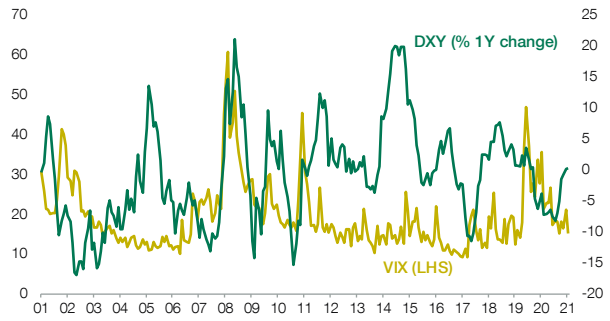
RECENT CHANGES

INCREASING LONG DURATION GOVERNMENT BONDS AND USD

- As expected, global equity markets rebounded strongly from their September correction on the back of a reassuring corporate reporting season so far with strong earnings and resilient margins.
- While we stay positive on global economic growth at this stage, headwinds started to emerge with global energy disruptions, slower growth in China and rising risk of potential policy errors.
- As a result, although we maintain our overweight in equities, we seek to build resilience into portfolios by increasing long duration government bonds and USD as a first step.
- With US 10-year rates approaching 1.70-2.0%, the safe-haven status of government bonds should again provide some cushion against any downside in markets.
- In equity space, we continue to favour companies with high quality earnings streams and more visibility, which should outperform in a "Mini-cycle" environment.
- Previously, we rotated some of our equity holdings into banks and energy sector, which usually outperform in an environment of elevated inflation and rising interest rates.
- With increasing equity volatility and drawdowns, a proactive and dynamic risk management approach remains key going forward. We maintain some asymmetry with structured products in Europe, protecting us from downside risk while allowing us to participate on the upside.

USD tends to strengthen in times of high market stress

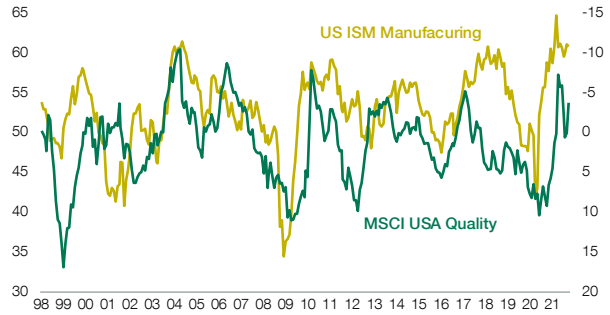
USD vs Volatility



Sources: Refintiv, Datastream, UBP

Quality stocks usually outperform during an economic downturn

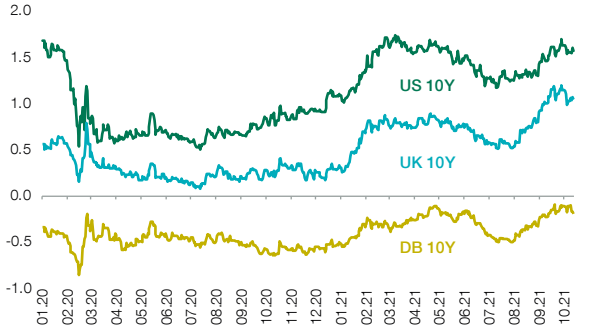
MSCI US Quality vs ISM



Sources: Refintiv, Datastream, UBP

10-year interest rates recovered from pandemic lows

10-year rates



Sources: Refintiv, UBP

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