DECEMBER 2021/
JANUARY 2022

MONTHLY INVESTMENT OUTLOOK

UBP

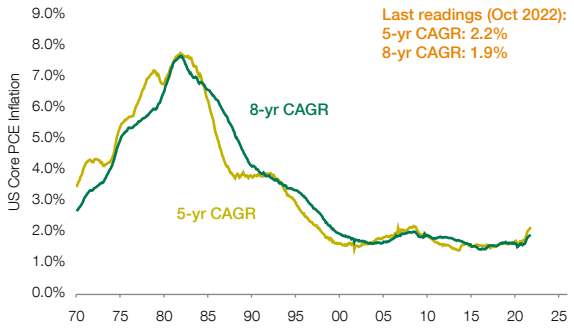
UNION BANCAIRE PRIVÉE

MONTHLY INVESTMENT OUTLOOK

PREPARING FOR AN INFLECTION IN MONETARY POLICIES LOOKING AHEAD

- Volatility returned to both equity and bond markets in November and December as equities exited earnings season and markets began to prepare for a change in Fed policies looking ahead.
- These pivots come amidst a renewed acceleration in new case counts around the world as the latest variant, dubbed Omicron has begun to overtake the Delta variant as the dominant strain in countries around the world.
- While the humanitarian burden remains high, the economic effect appears more modest as mobility in South Africa, where Omicron was first identified, and in the US, UK and through many EMs remains near pandemic era highs suggesting limited impact on activity.
- At the same time, historically high inflation matched with unemployment nearing historical lows in the US suggests a pivot in the Fed policy lies ahead.
- While the slowing of its bond buying programme has been well telegraphed, a consensus is growing that a rate hiking cycle will begin in 2022. We expect two rate hikes in 2022. Historically, these cycles have lasted one - two years and since 1980, seen Fed Funds rate increases of 200-400 bps.
- For bond investors, Fed rate hiking cycles have proved challenging with 2-year yields rising in each of the nine rate hiking cycles while 10-year yields rose in eight of the nine rate hiking cycles since the 1970s. With credit spreads widening in three of the four rate hiking cycles since 2000, credit may offer little respite for bond investors.
- Since the early 1970s, equity holders have fared comparatively well, with US equities rising, albeit in some cases modestly, in seven of the nine rate hiking cycles. Since the turn of the century, equity investors did even better, with all four rate hiking cycles delivering consistently positive returns, averaging nearly 7%.
- With these two risks on the horizon – uncertainty surrounding the newest variant of the virus combined with the start of a Fed tapering / rate hike in the year to come, directional fixed income looks set to deliver increasingly unattractive risk-reward profiles in 2022.
- Instead, we see increasing opportunities in alternative strategies including long-short credit and, in equities, high alpha strategies including long-short equities to both manage risk while at the same time seeking positive inflation adjusted returns looking ahead.

Inflation and unemployment trends signal a Fed policy pivot ahead in 2022



Sources: Bureau of Economic Analysis, Bloomberg Finance L.P. and UBP
*comments from select Fed Presidents suggest Average Inflation Targeting over 5-8 year horizon

Fed tightening cycles have been challenging for bond investors going back to the 1970...

Fed Policy Cycle	Months	Fed funds chg (bps)	US 2-yr Yld chg (bps)	US 10-yr Yld chg (bps)	Moodys Baa Spread chg (bps)
1972-74	27.4	950	na	148.0	(66.0)
1976-80	40.6	1,525	921.9	563.0	(41.0)
1983-84	16.3	325	313.3	249.9	(115.9)
1987-89	23.3	375	286.7	175.8	(75.8)
1994-95	13.1	300	264.0	155.9	(35.9)
1999-00	17.3	175	50.1	12.9	49.1
2004-06	28.4	425	350.9	116.5	(65.5)
2014-16*	21.3	351	40.1	(74.1)	132.1
2017-18*	22.4	214	122.8	29.4	19.6
Average	**23.3**	**515.6**	**293.7**	**153.0**	**(22.1)**
ex-1970s	**20.3**	**309.3**	**204.0**	**95.2**	**(13.2)**

Sources: Moody's, Federal Reserve Bank of Atlanta, University of Chicago, Bloomberg Finance L.P. and UBP
*using the Wu-Xia Shadow Rate to incorporate the impact of QE

...but US equities saw positive returns in 7 to 9 Fed tightening cycles since the 1970s

Fed Policy Cycle	Change in S&P 500	Change in PE	Change in EPS
1972-74	(18.1%)	(43.4%)	44.6%
1976-80	0.0%	(35.1%)	54.1%
1983-84	1.4%	(10.7%)	22.0%
1987-89	(1.0%)	(36.2%)	55.2%
1994-95	1.2%	(13.0%)	16.3%
1999-00	9.8%	2.9%	6.7%
2004-06	10.9%	(19.4%)	37.6%
2014-16*	0.5%	(0.5%)	1.0%
2017-18*	6.1%	(15.5%)	25.5%
Pre-99 Ave	**(3.3%)**	**(27.7%)**	**38.5%**
Post-99 Ave	**6.8%**	**(8.1%)**	**17.7%**

Sources: Standard & Poor's, Bloomberg Finance L.P. and UBP
*using the Wu-Xia Shadow Federal Funds Rate to incorporate the impact of QE

GLOBAL TACTICAL ASSET ALLOCATION

QUALITY EARNINGS ARE KEY

Global economy / Asset allocation

- Renewed downside risks weigh on activity at year end, due to rising infection rates in several European countries and the new Omicron variant spreading from South Africa.
- Europe is relatively more exposed to Q4 downside risks among major economies, due to renewed lockdown and restrictions in some countries, rising Omicron cases in addition to existing constraints on industry.
- Central banks were ready to shift their policy towards a tighter stance, but developing risks could postpone or soften their decisions.
- While we stay constructive going into the new year, visibility is reduced meaning volatility should increase going forward.
- As a result, we reinforced quality growth exposure in our equity allocation. Companies with high quality earnings are particularly valuable when uncertainties are high.
- We are seeking to rotate some directional equity exposure into long-short equity hedge funds with proven alpha generation capability. In the fixed income space, credit arbitrage hedge funds can shelter investors from rising interest rates and widening spreads.

Fixed income

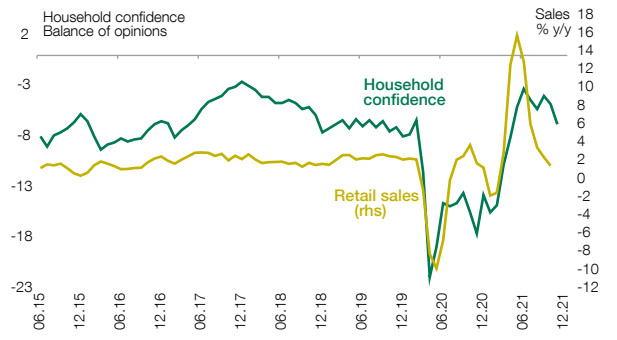
- Government bond yields (10y) have declined over the month on fears the Delta and Omicron variants will stop global expansion, while the Fed turned more hawkish.
- Our base case scenario still favours higher government bond yields over the medium term as growth should remain in place. But expecting higher volatility in bonds, and given tight credit spreads, investors should pivot in favour of hedge funds within fixed income to enhance returns and capture opportunities via various credit strategies.

Equities/ Alternatives

- Earnings will continue to grow next year, but at a much more modest pace and with less visibility in the cyclical areas of the market. We have therefore added Growth and quality names in our portfolios.
- Hedge funds are particularly valuable in generating alpha in markets with rising volatility. Selected long-short hedge fund strategies present useful asymmetric exposure for equity investors. Fixed income investors could also find shelter in an environment of rising interest rates

Eurozone is facing renewed restrictions and risks related to virus

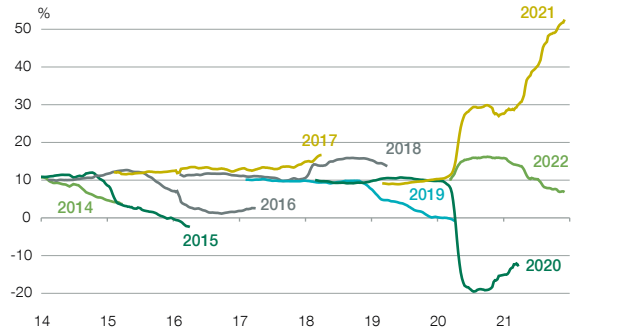
Eurozone:household confidence & retail sales



Sources: Eurostat, ECB

2022 earnings growth set to slow down substantially

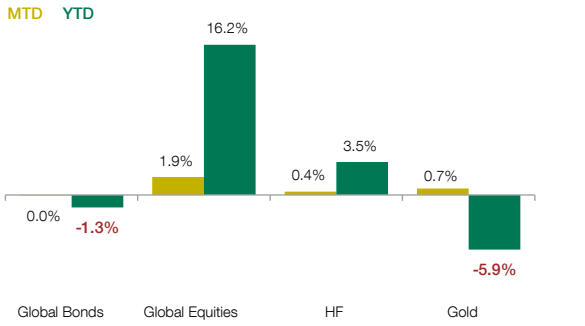
Consensus EPS growth expectations for glogal equities



Sources: Refinitiv, MSCI and UBP

Equities rebounded back after November sell-off

Major Assset Classes Performance



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

UBP ECONOMIC OUTLOOK

RENEWED RISK WEIGHING ON GROWTH

Key points

- The growth cycle is expected to continue at a moderate pace of 4% in 2022 after 5.6% in 2021. Nevertheless, growth trend should remain firmer than pre-COVID growth.
- Inflation should remain high in H1-22 and is expected to decline progressively during the year; inflation should come back within a 2%-2.5% range only by the end of next year.
- Economic policy should continue to support growth, via ongoing public investment and an expected moderate tightening of monetary policy in 2022. Risks related to virus may lead central banks to be cautious before hiking key rates.

Expecting a complete recovery in 2022…

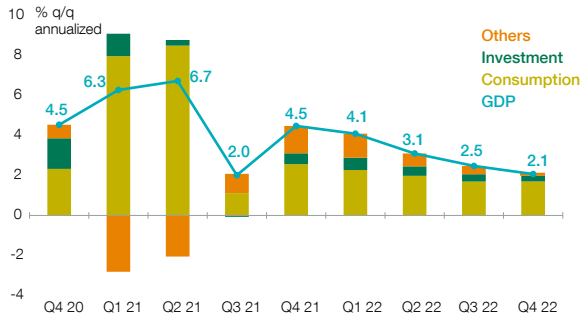
- Consumption should continue to lead the growth trend next year. Healthy labour markets and decline in saving should balance the erosion of the purchasing power.
- Investment should prolong the cycle thanks to public investment in climate change and new technologies. High profit and search for productivity should lead corporates to invest more.
- Bottlenecks in industry should progressively reduce next year, but at different pace according to sectors. Emerging countries should reinforce vaccination and may benefit from a complete recovery closing the gap with 2019.

… but tail risks are looming

- New variants of the virus are tail risks which could impact activity via a worrisome pandemic or could turn into a more benign endemic virus, leading to a "stop and go" on activity.
- Inflation being out of control is a risk for central banks which should opt to be patient before entering a tightening cycle; wages could fuel upward pressures on core inflation as labour markets remain tight in some countries.
- Policy errors could result from pressures on authorities to react to high inflation; a too early monetary tightening or a return to fiscal austerity may push the growth cycle into jeopardy.

Moderating US growth but still strong contribution expected from consumers

US GDP sector contribution to GDP growth



Sources: BEA, UBP

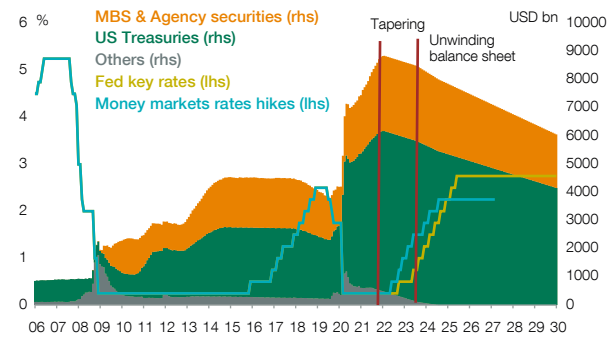
Slower growth expected in 2022

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	5.6	3.6
Japan	-4.7	2.5	2.5
Eurozone	-6.3	5.1	4.0
United Kingdom	-9.7	7.0	4.7
Switzerland	-2.5	3.5	3.0
Brazil	-4.1	5.4	1.7
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	5.0	3.6
Emerging countries	-1.7	6.0	4.3

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

A tighter monetary policy is in sight, but the Fed should remain vigilant to tail risks

US: Fed balance sheet and key rates



Sources: Federal Reserve, UBP

COULD THE NEW VARIANT DERAIL THE CYCLE?

Tougher restrictions in the short run

- Rising Delta cases in Europe and the emergence of the Omicron variant represent major tail risks that have reignited fears of stagflation and an end to the cycle.
- Governments have implemented tougher restrictions and efforts to promote vaccinations and booster shots. Travel bans have been selectively put in place in a pre-emptive way to avoid risks while a scientific consensus on Omicron risks forms.

What economic impact on economies from the new variants?

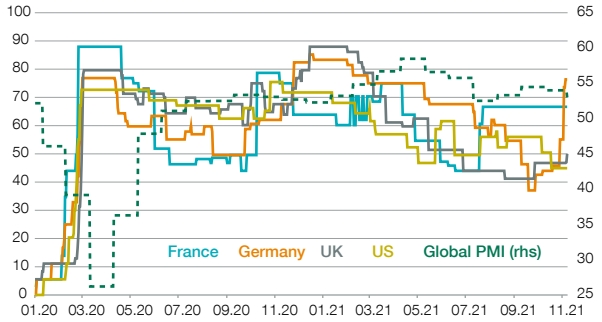
- At this time, Europe and a few emerging countries look more at risk than the US and Asia, but virus mutations could be capable of expanding rapidly across regions.
- We have identified three scenarios: Scenario 1: a mild contagion and a rapid easing of restrictions would have negligible impact on Q4-21 GDP (-0.5 pp according to various simulations) and mainly concentrated in the eurozone.
- Scenario 2: Delta-Omicron spread more broadly, obliging governments to adopt tougher lockdowns. A significant slowdown in Europe and beyond could result in a flat Q4-21 growth.
- Scenario 3: Omicron has capacity to resist existing vaccines and turns into a new pandemic. Global lockdown and stricter restrictions put activity under major stress, leading to a -2.0% recession in Q1-22, the time it takes for updated vaccines to be developed.

Full recovery delayed, but no breakout from the cycle

- In all scenarios, growth should be more fragile in Q4-21 and Q1-22 than expected in the base case scenario. But the activity looks resilient and the reactions from authorities and research on new variants were rapid; governments now have a larger set of tools to react.
- In past lockdowns, capital was not destroyed, and demand was just delayed; activity has recovered rapidly in the reopening phase.
- The economic policy should remain a support to growth: the budgetary policy should help labour and targeted sectors, while monetary policy adopts a risk management approach with a limited tightening in rates to preserve growth.

Tougher restrictions could weigh down on activity again

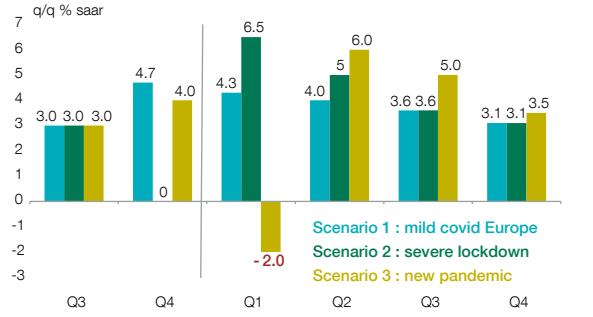
Stringency index & Business sentiment



Sources: Hale, Thomas, Sam Webster, Anna Petherick, Toby Phillips, and Beatriz Kira (2020). Oxford COVID-19 Government Response Tracker, Blavatnik School of Government

Tail risks from Delta-Omicron variants: exploring three scenarios on quarterly growth

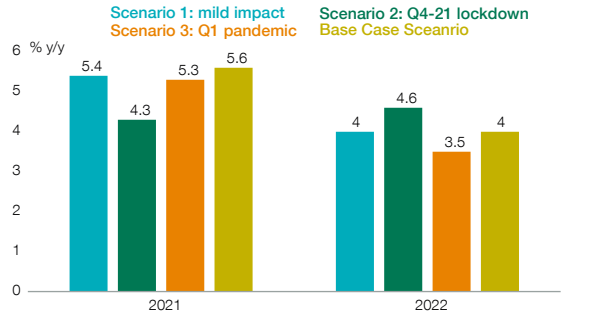
World growth in 2021-2022



Source: UBP

No major breakout of world growth expected according to various scenarios

World growth scenarios



Source: UBP

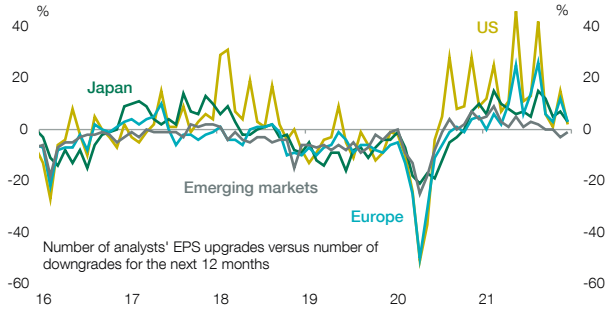
GLOBAL EQUITIES

LESS VISIBILITY GOING INTO NEXT YEAR

- Global equity markets fell sharply at the very end of November following reports relating to the Omicron variant but recovered almost completely amid reassuring news about its severity and vaccine effectiveness.
- The 2021E bottom-up EPS growth rate for global equities continues to rise and has now reached 53%. Due to base effects, the 2022 EPS growth estimate is trending lower, to 7% with little difference across regions.
- The increase in uncertainty related to the new variant and the significant rise in Covid cases across the world have not yet triggered cuts in earnings estimates. This may come depending on the still unknown impact on supply chains and, potentially, consumer demand, but the downside risk looks limited given the conservative consensus earnings estimates for next year.
- S&P 500 consensus EPS growth for the current quarter (22%) and next year (8%) remained steady over the last month. Earnings estimates for Q4 are again down q/q from Q3, which look conservative given historical patterns and the fact that activity has continued to grow and has been strong in most parts of the world; companies should again beat estimates by a wide margin when the Q4 reporting starts mid-January.
- Valuation metrics have come down over the year thanks to surging earnings but remain at the high end of their historical range. With economic growth set to soften and monetary policies looking to become less supportive in most regions, a further compression in multiples looks highly likely next year.
- This should be offset by still solid earnings growth, but uncertainty on the cycle, and hence on corporate profits, has undoubtedly increased, with the recent surge in global Covid-19 infections and the new variant not helping.
- In this context, we have recently increased our exposure towards Growth and quality stocks, whose profitability are unlikely to suffer from lower economic growth.
- The outlook for equities remains positive but given the inevitable slowdown in GDP growth next year, the coming Fed tightening and still elevated valuations, the risk-reward ratio for equities has slightly changed. This argues for switching part of the allocation towards alternative strategies such as long-short equities.

Earnings revisions remained slightly positive over the last month

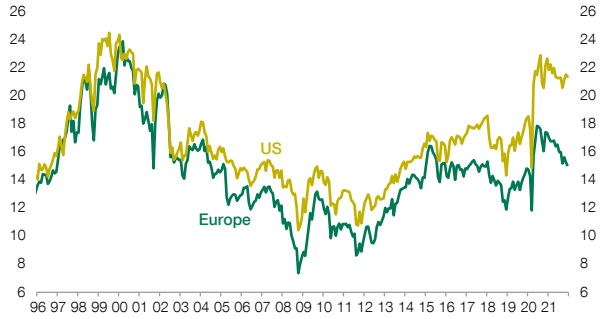
Earning revision ration: US, Europe, Japan & EM



Sources: Refinitiv, UBP

Valuations have declined over the year but remain elevated

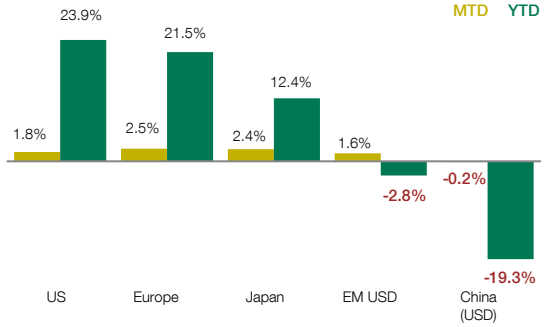
12-month forward PER: Europe & US



Sources: Refinitiv, UBP

Positive performance across regions except China

Equities Performance



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

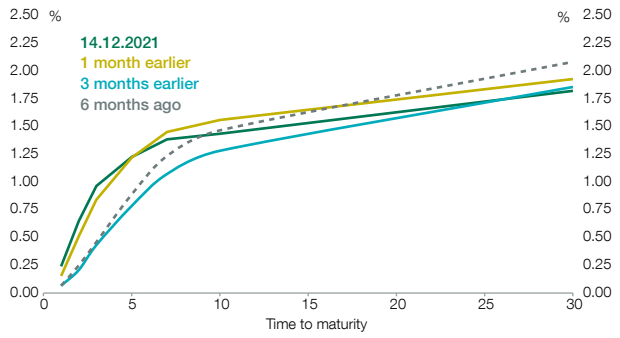
GLOBAL BONDS

TO FAVOUR HEDGE FUND STRATEGIES ON CREDIT

- Government bond yields (10y) have declined over the month on fears the virus and its new variant may end current expansion. But bonds faced high volatility and dispersion of performances across the yield curve. As high inflation remains an issue, the Fed adopted a more hawkish communication, pointing towards more persistent high inflation than estimated and pre-announcing a faster tapering in Q1-22.
- The US yield curve has flattened, as short-term yields (two years and five years) have priced in the tighter statement from the central bank and an early start to rate hikes, while the long end of the curve eased with rising concerns on growth and betting on lower terminal interest rates for the Fed.
- European rates were also volatile and the 10y yields have followed daily moves in US bonds. Spreads of peripherals also turned more volatile while the ECB communication has offered opposite views about the future of its asset purchases (PEPP) according to several governors but continued to deny any prospect of hiking rates in 2022.
- Given high inflation in US, the UK and the eurozone, money markets have priced in an early tightening cycle for key rates; but economies in post recovery phase still look fragile and the new developments from the virus require a risk management approach and a soft tightening in 2022.
- In our scenario, 10y Treasuries should rebound to 1.7% medium term, and the 10y Bund should drift close to 0%; high volatility and rising yields should give further opportunities to rebuild some position in favour of government bonds and a longer duration.
- Credit spreads have widened a bit with rising concerns on growth related to virus developments. Nevertheless, the move was limited, and spreads remained globally close to their lows, with news of the potentially less lethal Omicron virus.
- Given change in monetary regime and renewed uncertainties on growth, a selective approach to credit is justified. In a highly volatile environment with rising yields, credit offers limited protection and the risk-reward balance looks less attractive going forward.
- Investors should favour hedge fund strategies in their fixed income allocation to enhance returns, reduce sensitivity to volatile interest rates and seize opportunities via various strategies on credit.

The US yield curve flattened on growth concerns and more hawkish Fed

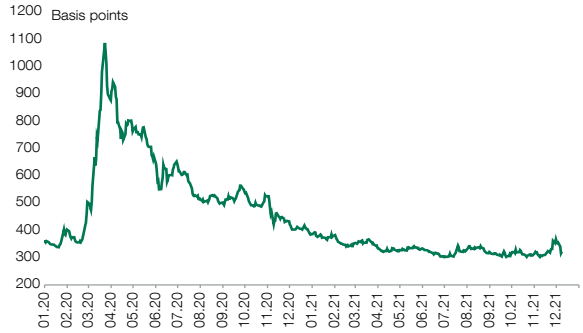
US Treasury yield curve



Sources: Refinitiv, UBP

Despite some volatility, spreads on US high yield appear tight

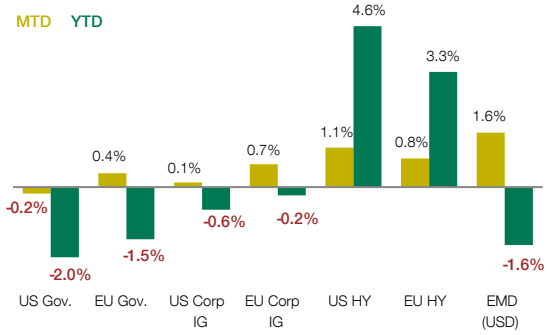
US High-Yield OAS spreads



Sources: BoA ML, UBP

Risky segments came back during the month

Fixed Income Performance



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

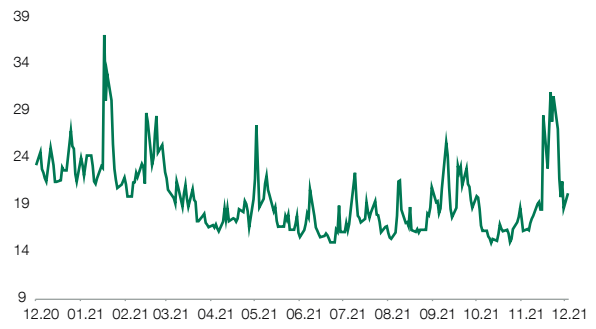
RECENT CHANGES

ADD QUALITY GROWTH AND SEEK ASYMMETRY

- Despite the volatility since the end of November, global markets have delivered a stellar year-to-date performance of around 20% a year after the global pandemic hit the world. The strong economic and earnings recovery occurred amid unprecedent monetary and fiscal support from central banks and governments across the world.
- Going into the year-end, some central banks shifted their monetary policy by winding down liquidly injections and signalling a start to a rate hiking cycle as inflation pressure mounted.
- At the same time, clouds started to appear over the horizon. The highly infectious new variant Omicron with its capability to escape the antibody provided by two doses of vaccines has pushed several countries to impose lockdowns again. Other tail risks are also rising with China's slowdown and geopolitical tensions related to Ukraine and Taiwan.
- In this context, we believe the year ahead will herald another challenging period for fixed income investors. The headwinds coming from the tightening monetary policy tilted the risk-reward of the asset class towards less attractive. As a result, we decided to replace it partially by alternatives in credit arbitrage and absolute return strategy, which are less sensitive to interest rates volatility.
- In the equity space, although the outlook remains positive for 2022, the return should be more moderate with higher volatility going forward. Earnings growth should continue to support the asset class, while valuations will moderate. We reinforced the quality growth bias in equity allocation as earnings will be key to deliver returns.
- Hedge funds are valuable in generating alpha when markets are volatile. As the market backdrop shifts towards higher volatility, we are seeking opportunities to switch some of our directional equity exposure into long short equity strategy.

Volatility can stay high going into year end

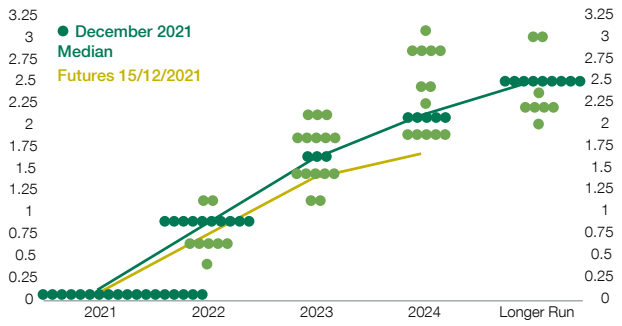
Implied Volatility Index



Sources: Refinitiv and UBP

Fed has turned to more hawkish

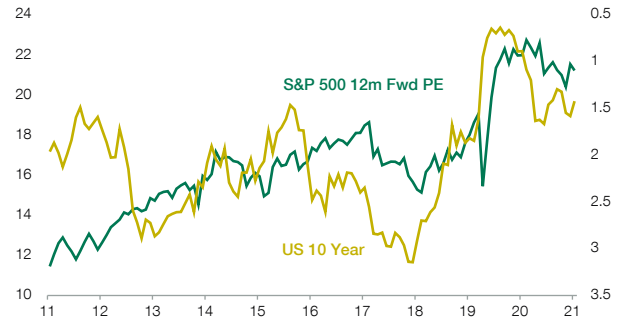
FOMC Dots vs Market expectation



Sources: Refintiv, Datastream, Fed, UBP

Increasing yields could be a headwind for equity valuations; earnings will be key

S&P500 12m fwd PE vs 10 year yield



Sources: Refintiv, Datastream, UBP

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