PICTET
Asset Management

BAROMETER OF FINANCIAL MARKETS NOVEMBER INVESTMENT OUTLOOK
November 2021

Barometer: Inflation presents greater risk to bonds than stocks

While inflationary pressures will cause bond yields to climb , a healthy rise in corporate profits should offer some support to equities.

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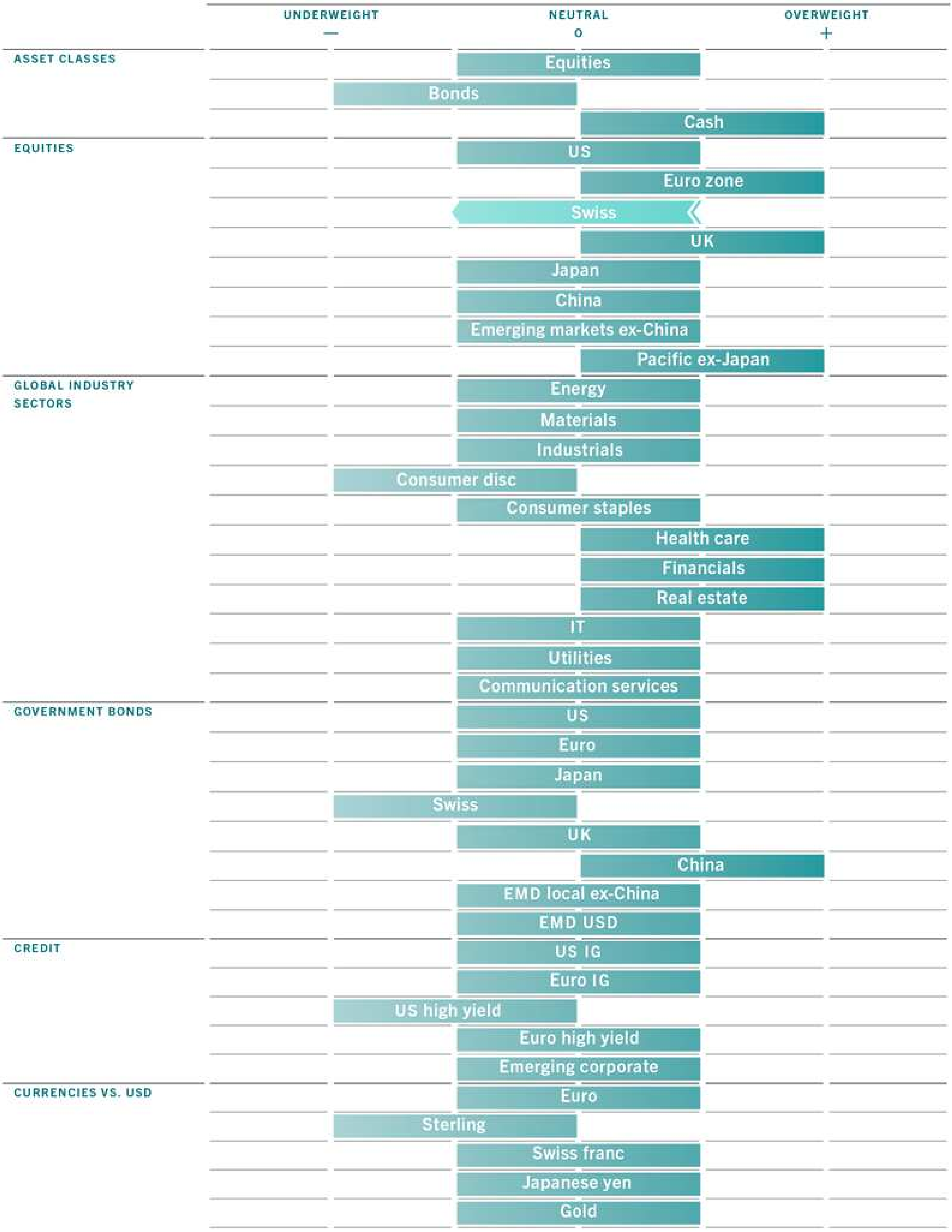
Asset allocation: tougher times ahead

Times are tough for global financial markets. Monetary conditions are tightening while supply chain bottlenecks are starting to take their toll on the global economy. At the same time, inflationary pressures are proving more persistent than previously expected.

We believe fixed income markets will be particularly hard hit, as yields adjust to higher inflation and the prospect of tighter monetary policy. High yield bonds appear especially vulnerable. Equities won’t be immune to market jitters either. But, on balance, we believe they should hold up better than bonds because economic growth is still strong enough to allow for positive surprises in corporate earnings.

Fig. 1 - Monthly asset allocation grid

November 2021



Source: Pictet Asset Management

Our **business cycle** indicators for the world have turned neutral after a year in positive territory. However, they still suggest that economic growth will remain comfortably above the long-term trend, at 5.9 per cent this year and 4.8 per cent in 2022.

That is consistent with corporate earnings growth of around 15 per cent next year – double the pace of the consensus forecast. Upside surprises in profits are more likely in Europe and Japan, where the economic recovery has further to run.

Although growth momentum in the euro zone appears to be stalling, with industrial production weighed down by supply frictions, government and central bank policies remains supportive. The risk of monetary and fiscal tightening here is lower than in other developed markets.

In Japan, meanwhile, confidence is recovering from historically depressed levels and business activity surveys are improving.

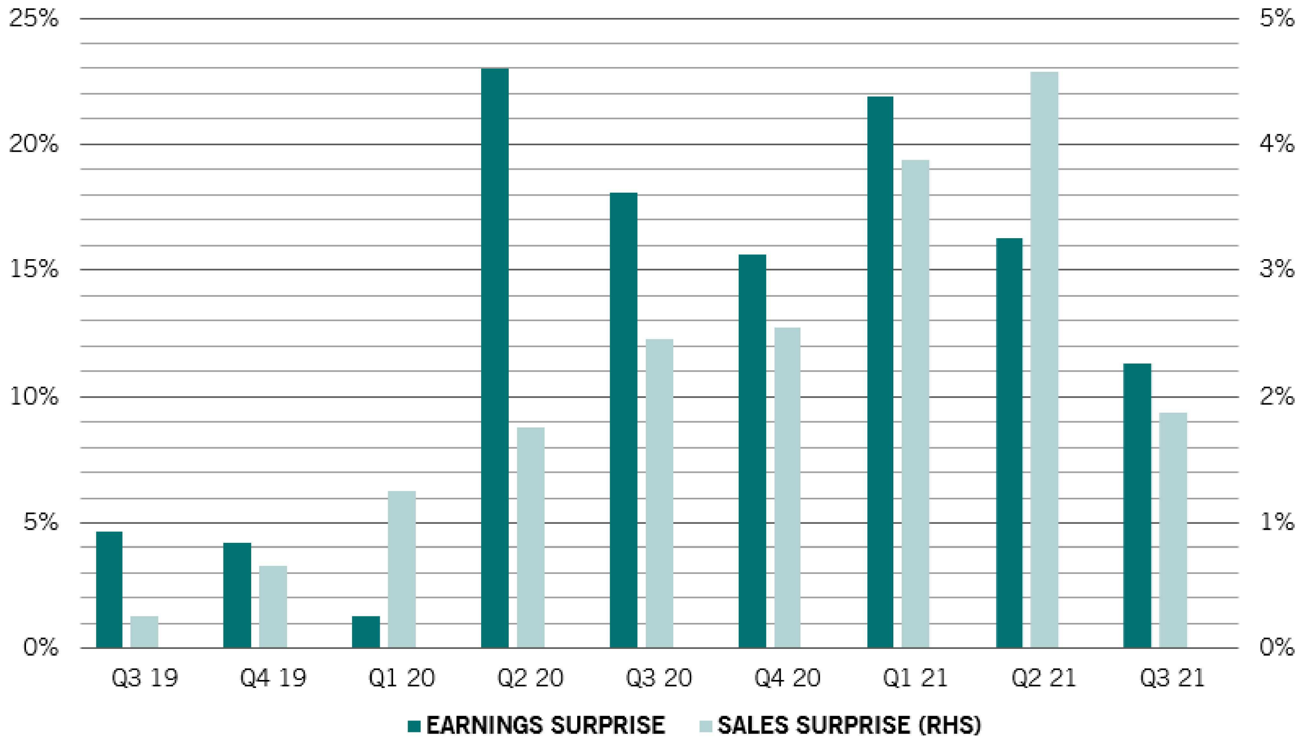
The situation is more negative in China, however, where activity continues to slow, whether that's in terms of industrial production, construction and fixed asset investment. However, sentiment surrounding the vital property sector (which account for around 25 per cent of the country's GDP) appears to be stabilising. That is in part due to debt-laden property developer Evergrande coming good on coupon payments, averting a default at the last minute. Authorities in Beijing, meanwhile, have encouraged banks to lend to the property sector.

While we still expect more stimulus from China, it has been less forthcoming than we originally expected, with policymakers prioritising deleveraging over short-term growth. Elsewhere central banks are starting to drain **liquidity**, particularly the US Federal Reserve and the Bank of Japan. Private credit creation, meanwhile, remains dormant and is not expected to recover until next year. As a result, the total liquidity provision among the world's five biggest economies has now dropped to the equivalent of 11.9 per cent of GDP, down sharply from last year's peak of 28.7 per cent. This prompts us to downgrade our global liquidity score to neutral.[1]

However this decline should be gradual in order to ensure the recovery remains on track. Indeed, central banks are likely to show higher tolerance for inflation, not least because their policy moves cannot address the most immediate cause of price increases – supply bottlenecks.

Fig. 2 - Positive surprises

Margin by which S&P 500 firms' EPS and sales beat consensus forecasts, %*



*Weighted average; Source: Bloomberg, Pictet Asset Management. Data covering period 01.07.2019-30.09.2021.

Nevertheless, tighter liquidity is sure to have a negative impact on **valuations** - both for equities and bonds. Our models suggest that a 100 basis points rise in real yields translates into a 20 per cent drop in stocks' price-earnings ratios. However, we believe we have already seen most of that move.

Although equities look expensive relative to bonds, our estimate of the equity risk premium still points to relative upside for stocks in most regions. Companies' sales figures are beating forecasts by less than the previous quarter, but corporate earnings surprises are still high, which points to healthy operating leverage (see Fig. 2). In the short-term, at least, we believe profit margins will be resilient to rising input cost pressures.

Valuations support our preference for defensive healthcare stocks (among the cheapest sectors in our model, in relative terms) and caution on expensive US high yield bonds.

Technical charts show positive seasonality for equities, as well as supportive medium-term trends. Some investor surveys, including the American Association of Individual Investors (AAII), indicate bullish sentiment.

In contrast, short-term momentum for bonds has deteriorated across the board. The Bank of America fund manager survey shows investors allocation to bonds sits at all-time lows. At the same, net short positioning for US Treasuries, especially in the 2- and 5-year maturities, has increased significantly.

[1] Measured as policy plus private liquidity flows, as % of nominal GDP, using current-USD GDP weights for US, China, euro zone, Japan and UK.

02

Equities regions and sectors: reopening favours value

Stocks around the world have either hit all-time highs or hovered near record levels, showing resilience in the face of a growing list of concerns including supply chain disruptions, labour shortages, China’s regulatory crackdowns and persistent inflationary pressures.

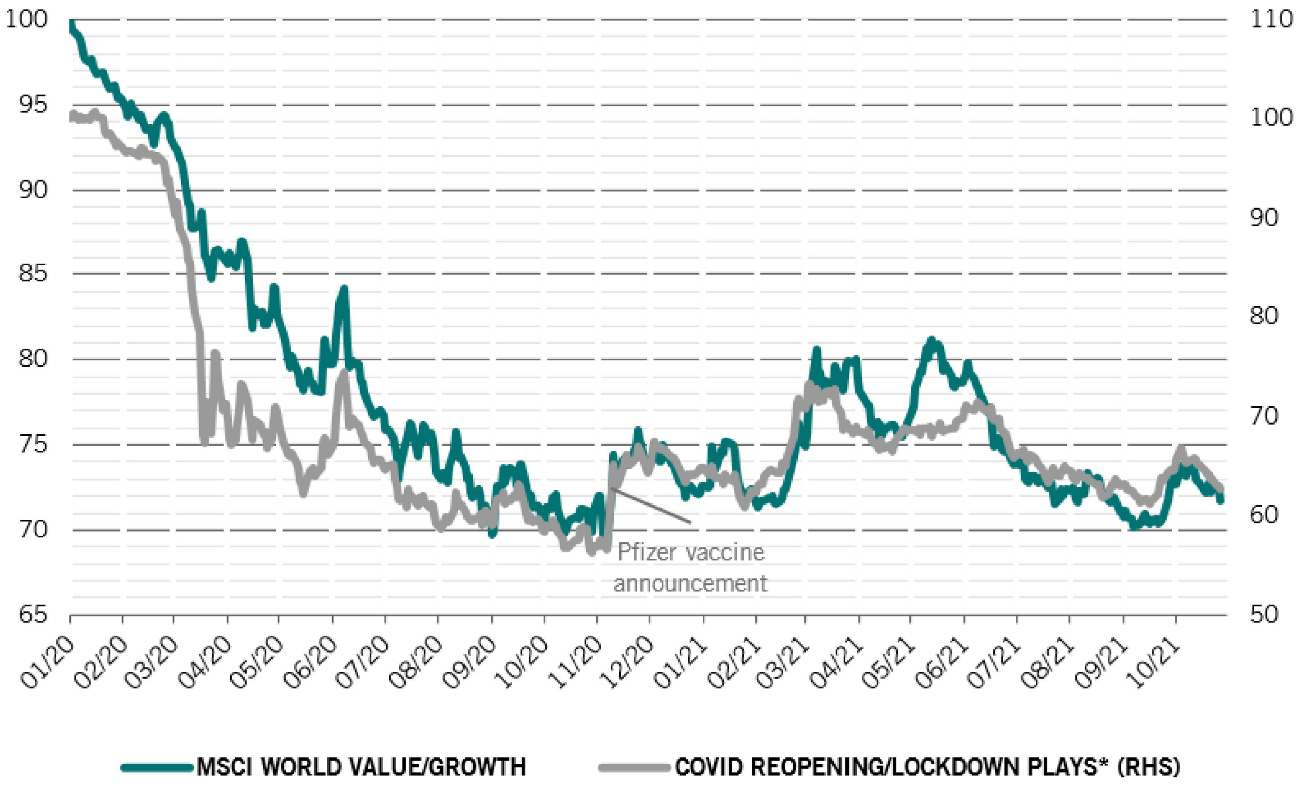
What’s more, our proprietary multi-asset risk appetite indicator is back in the top quintile level, just off record highs seen in the early part of 2021.

Underpinning optimistic sentiment is a strong recovery in corporate earnings.

The current macroeconomic backdrop of strong growth and declining central bank liquidity provisions favours value stocks – companies which are trading below their potential worth – over those which have strong growth potential (see Fig. 3). This supports our overweight position on financials.

Fig. 3 - Reopening trades

Value stocks to recover after underperforming during lockdowns



Source: Refinitiv, Pictet Asset Management, data covering period 01.01.2020 – 27.10.2021 *Reopening plays: Airlines, Office and retail REITs, Aerospace and Defense, Transportation infrastructure, Hotels and Leisure

Financials, combined with energy, have attracted investor inflows of more than USD7 billion in October, according to EPFR data.

We're also overweight real estate, which has an attractive valuation and should benefit from a further reopening of economies.

In contrast, we think quality stocks – those with stable businesses and defensive characteristics – will lose ground in this environment, having benefited from Covid-related uncertainties and economic slowdown of the last quarter.

As a result, we downgrade Swiss equities to a neutral stance, taking profits after recent strong performance. The Swiss market has gained 17 per cent in the first 10 months of the year in local currency terms.

We continue to be cautious on Chinese equities where we retain our neutral stance.

While debt-stricken Chinese developer Evergrande narrowly averted a formal default, a risk remains of a messy collapse that would require one of the biggest restructuring process in the country's history. A renewed surge in Covid cases in China is also a cause for concern.

That said, China's credit impulse is showing tentative signs of bottoming out and retail sales have rebounded. Therefore, economic activity could recover in early part of next year.

Our overweight stance on European and UK equities – which have more cyclical and value oriented stocks – remains unchanged. European authorities have stepped in to keep a lid on prices and we expect activity to rebound next year, particularly in Germany, assuming that supply problems abate. Inventory levels are low and will need to be rebuilt.

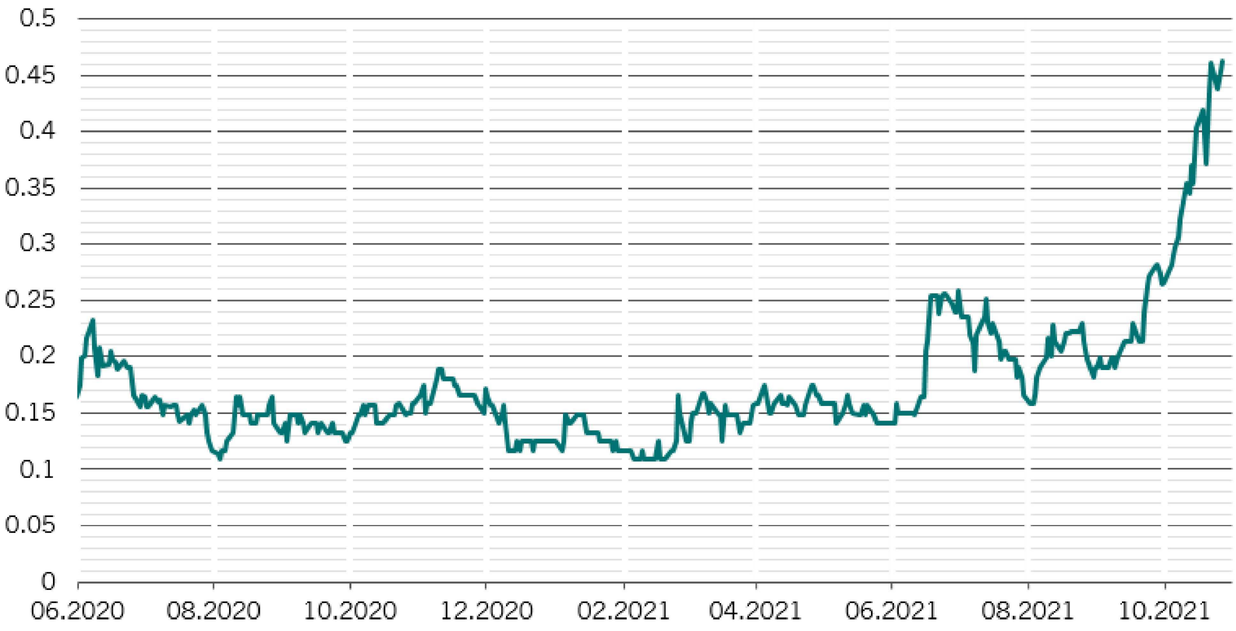
03

Fixed income and currencies: Chinese bond appeal

Our biggest overweight fixed income position remains Chinese government bonds. They offer an attractive initial yield of 3.0 per cent against a backdrop of lower inflation risks than elsewhere and expectations that the People's Bank of China (PBoC) will turn increasingly dovish.

The Chinese economy continues to soften, with a combination of slowing credit creation, increased regulatory tightening and the energy crisis all taking a bite out of industrial production, construction and fixed asset investment. The PBoC stepped in to ease some of the pain being felt by the country's property sector by incentivising banks to start lending to real estate companies again. Encouragingly, Evergrande was able to avoid at the last minute defaulting on coupon payments. We continue to expect policy easing in the coming months albeit lower and later than previously anticipated.

Fig. 4 - Tremors in the Treasury market
US 2-year Treasury bonds yield, %



Source: Refinitiv Datastream, Pictet Asset Management. Data covering period 01.01.2019 to 27.10.2021.

Elsewhere, the fear that inflation will prove less transitory than central banks have been claiming has started to feed through to the markets. For instance the yield on US 2-year Treasury bonds has more than doubled in little more than a month to a little under 0.5 per cent (see Fig. 4). Expectations that the Fed will need to react sooner rather than later makes particularly vulnerable the very richly priced US high yield market – the most expensive fixed income asset classes on our grid. We also retain our underweight on Swiss bonds, which are only neutrally valued on a relative basis.

In currencies, we expect the US dollar to strengthen further, albeit modestly. That's in part on the back of our above-consensus expectations for US economic growth. We expect a strong rebound in US growth next year on the back of strong personal consumption, driven by the release of some of the USD2.4 trillion households have accumulated in savings, and capital expenditure. This could well feed through to more significant Fed policy tightening than the market anticipates, though the greenback's rich valuation means there's limited upside.

We remain bearish on the sterling despite the Bank of England's recent hawkish rhetoric. That's because pressure for policy tightening is likely to come from inflationary pressures that are being fuelled by supply constraints – only some of which are Covid-related, with Brexit also playing a part – rather than by strong, sustained growth.

04

Global markets overview: fresh peaks for stocks

World equities continued their upward march, adding 5 per cent in October to take their gains for the year so far to 19 per cent in local currency terms.

The US market was one of the star performers, with the S&P 500 scaling a fresh record high (see Fig. 5). Although corporate earnings growth has peaked and third quarter results from some big names – such as Apple and Amazon – have fallen short of expectations, profit momentum remains positive. Around half of US blue-chips having reported June-September results, with 82 per cent of them beating analysts' consensus forecast for earnings according to I/B/E/S data from Refinitiv.

Equity market gains were also seen across most other regions, with two notable exceptions.

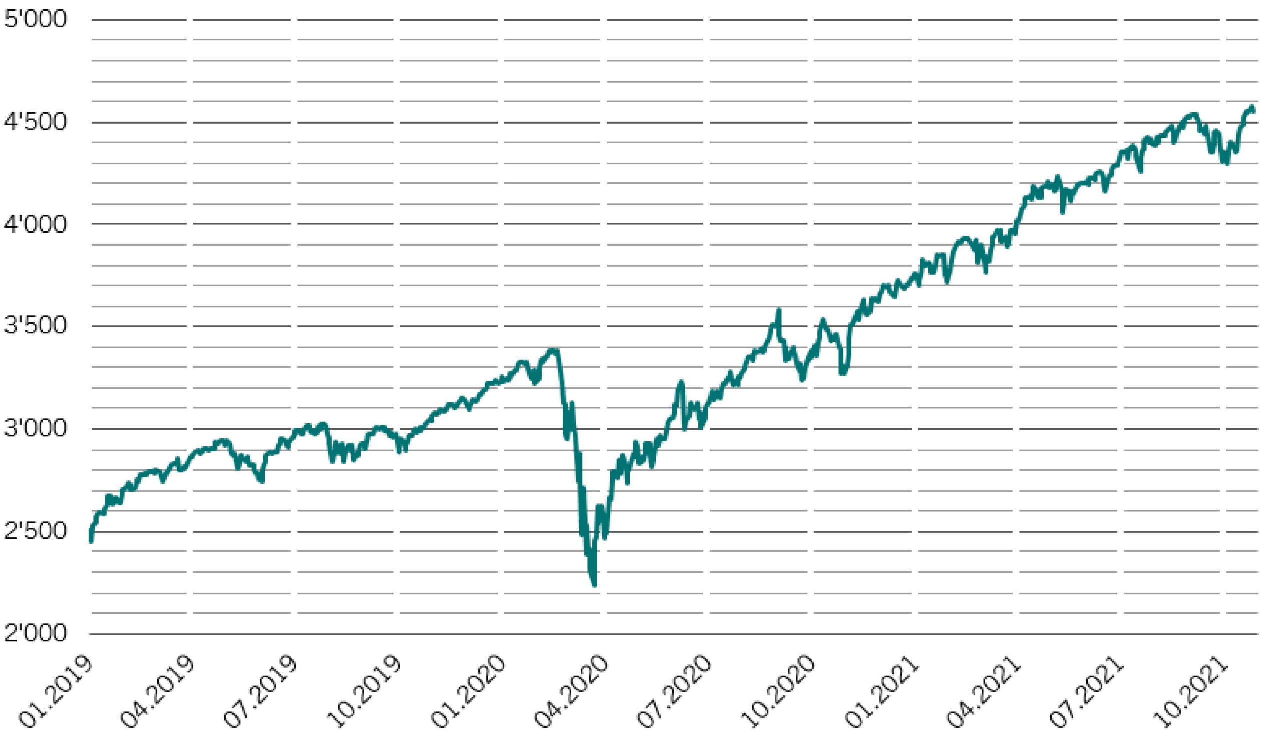
Japanese stocks lost ground ahead of a parliamentary election which ultimately paved the way for a rebound after Prime Minister Fumio Kishida's ruling LDP party unexpectedly held on to its strong majority.

Latin American stocks were also in the red as even a larger-than-expected 150 basis point rate hike by the Brazilian central bank failed to stabilise the real. Sentiment was also dampened by signs of rising tensions between the US and China.

Among sectors, gains were seen across the board. Consumer discretionary led the pack, adding some 8 per cent. Surging oil and commodity prices boosted energy and materials – the two sectors which are expected to report the strongest earnings growth for the third quarter.

Fig. 5 - Surging stocks

S&P 500 Composite - price index



Source: Refinitiv Datastream, Pictet Asset Management. Data covering period 01.01.2019-27.10.2021.

The month proved less positive for fixed income markets, with global bonds down 0.1 per cent in aggregate in local currency terms.

Euro zone bonds lost ground as stronger-than-expected economic growth opened the door to the possibility of an interest rate hike from the ECB in 2022.

Monetary tightening was also on the minds of US bond investors, with 2-year Treasury yields hitting 19-month highs.

Conversely, UK sovereign debt prices rose and yields fell after the governments slashed its planned debt sales for this year by GBP60 billion thanks to higher tax receipts.

Elsewhere, the Turkish lira hit a record low against the dollar after President Recep Tayyip Erdogan threatened to expel the ambassadors of the US and nine other countries. The currency was already on a weak footing following the surprise larger than expected 200bps rate cut despite inflation dynamics being far from benign. It finished the month down 7.6 per cent.

In contrast, the Russian ruble and the Australian dollar both fared well, each gaining over 2 per cent thanks to higher commodity and energy prices.

05

In brief

BAROMETER NOVEMBER 2021

Asset allocation

We maintain our underweight on bonds in the face of rising inflation and our neutral on equities.

Equities regions and sectors

We downgrade defensive Switzerland to neutral while we continue to prefer value stocks as economies reopen.

Fixed income and currencies

We maintain our overweight in Chinese government bonds amid an economic slowdown and signs the PBoC will turn more accommodative.

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