PICTET Asset Management

BAROMETER OF FINANCIAL MARKETS OCTOBER INVESTMENT OUTLOOK
October 2021

Barometer: No time to buy?

With China's strong economic recovery from the pandemic at risk from the Evergrande debacle, investors should look to shore up their defences.

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Asset allocation: autumn chill in markets

Expectations for tighter monetary policy are intensifying.

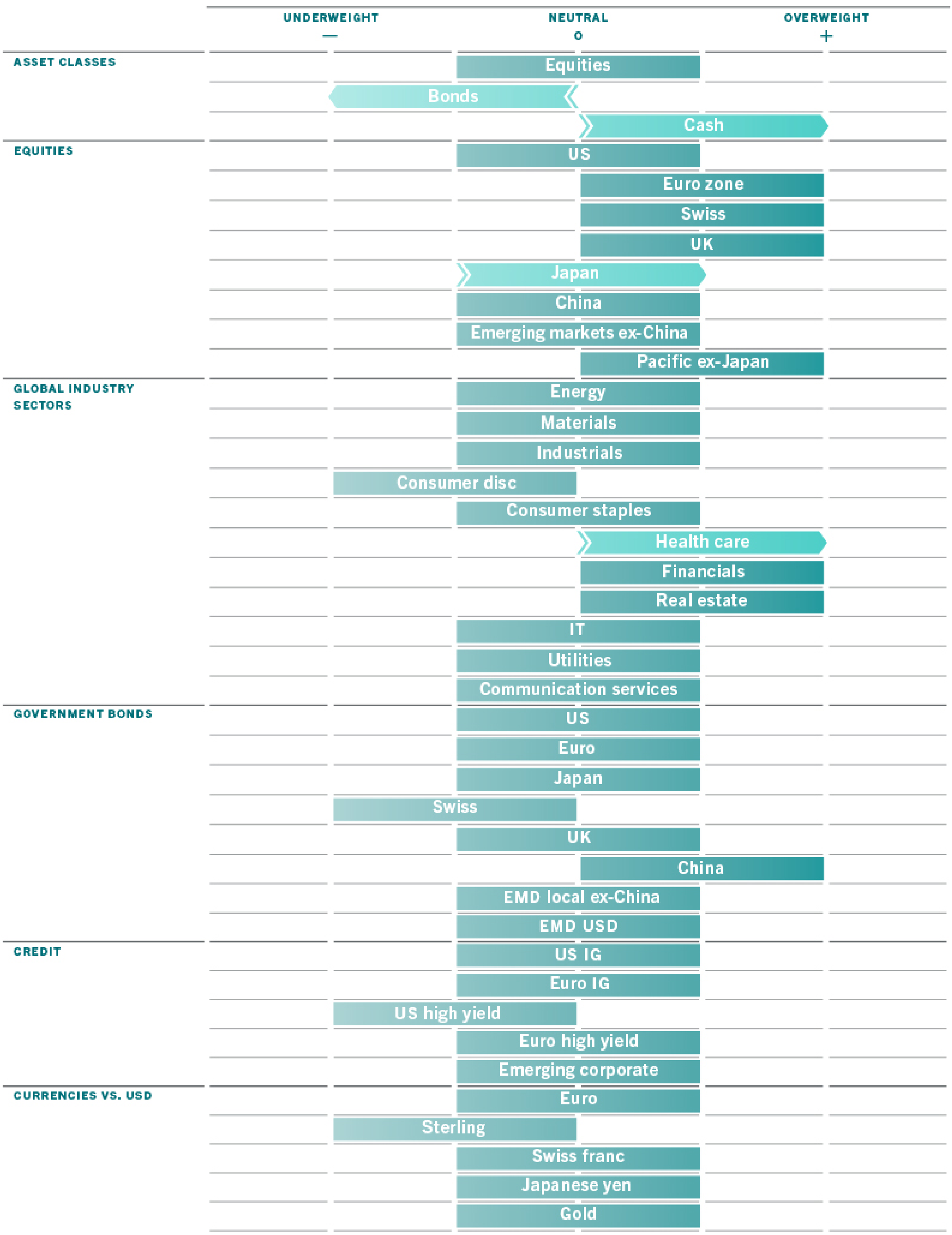
Central banks continue to lay the groundwork for a withdrawal of pandemic-era monetary stimulus in the face of rising inflation.

But higher interest rates are not the only concern for equity markets. Events in China are also worrying. Its strong recovery from the pandemic is now at risk as Beijing battles to avoid the collapse of its most indebted property company Evergrande.

We have reduced our forecasts for China’s economic growth by 1 percentage point for 2021-22 to 8.6 per cent as we expect the fallout from Evergrande debacle to spread throughout real estate sector. The country’s leading indicator is falling at a 5 per cent annualised rate, the same pace seen at the height of the Covid crisis in March 2020.

That shouldn’t come as a surprise considering real estate and related industries account for up to 30 per cent of Chinese GDP and property makes up more than two thirds of household wealth. Tighter monetary policy has led us to downgrade bonds to underweight while China's troubles have convinced us to increase exposure to defensive equity sectors and upgrade cash to overweight.

Fig. 1 - Monthly asset allocation grid
October 2021



Source: Pictet Asset Management

Business cycle analysis shows world economic activity is cooling. Our global leading indicators contracted in August for the first time since the start of the post-pandemic recovery. We cut our global GDP growth estimates for the third month in a row to 6.2 per cent for 2021 from 6.4 per cent last month, led by downgrades of the US and China.

While slowing, growth in the US is still significantly above potential and we expect the world's biggest economy to remain firm as job gains and wage increases boost consumer spending in the coming quarters.

Labour and raw material shortages and a spike in oil and gas prices are keeping inflationary pressures high, although the pace of consumer price rises has slowed in the most recent month.

Europe remains a bright spot as the region's leading index rose for the fourth month in a row, supported by a weaker euro, the European Central Bank's generous monetary stimulus and a successful vaccine rollout.

Our **liquidity** analysis shows central banks are still providing ample stimulus for now, but at a slower rate.

The world's five major central banks are pumping in just USD500 billion of liquidity on a three-month basis, the lowest in 18 months and compared with USD1.5 trillion during the peak of the pandemic.

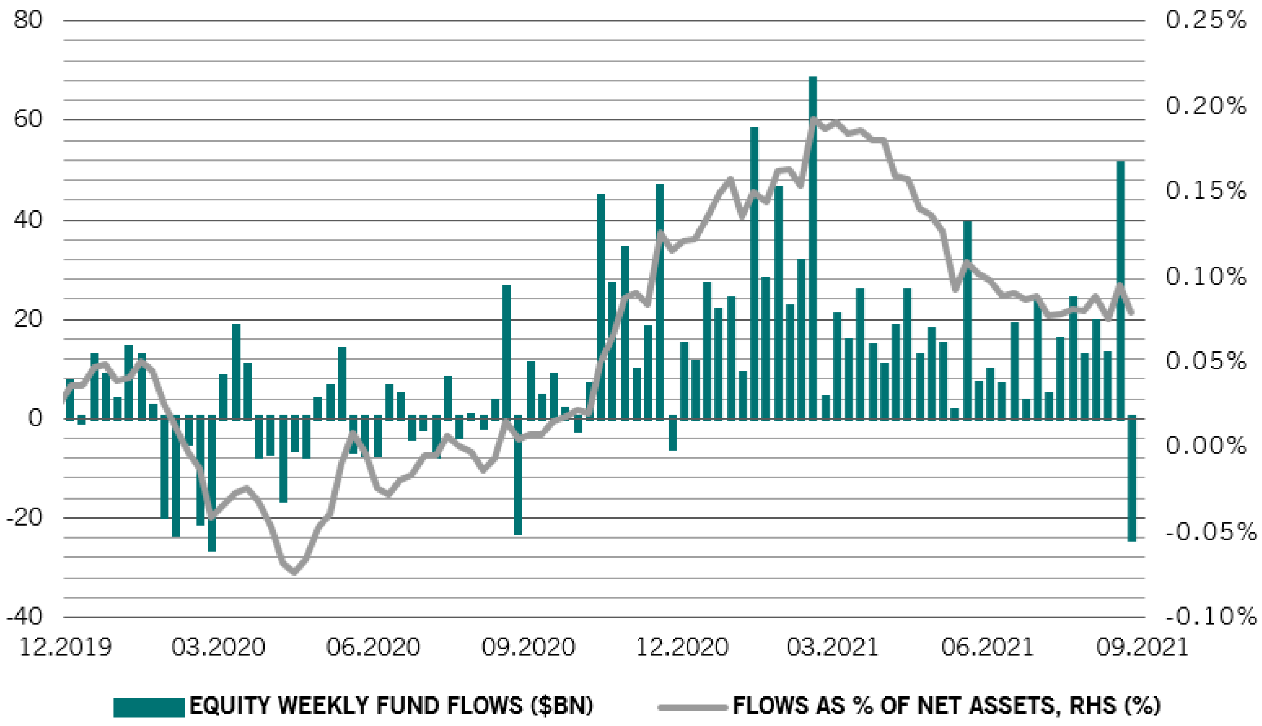
That said, our calculations show the US Federal Reserve's monetary tightening trajectory remains well behind the curve. The central bank's "shadow rate", adjusted for the effect of asset purchases, is about 500 basis points below its equilibrium levels.

That is despite Fed officials having taken a clear hawkish turn in their communications, suggesting a faster withdrawal of the central bank's USD120 billion monthly bond buying and a more aggressive interest rate hike campaign that could start as early as end-2022.

Liquidity conditions in the euro zone remain the loosest in the world and the European Central Bank should continue to provide stimulus in excess of GDP next year – the only monetary authority to do so among major economies.

China's central bank has stepped up net cash injections in response to a funding squeeze among real estate developers. We expect liquidity conditions to gradually loosen across the country in the coming months; the People's Bank of China may cut its reserve requirement ratio for banks for the second time this year when its medium-term loans mature.

Fig. 2 - Rare equity outflow
Stock funds weekly and cumulative flows



Source: Refinitiv, EPFR, Pictet Asset Management; data covering period 31.12.2018-30.09.2021

Our **valuation** model supports our downgrade of bonds and neutral equity stance.

Despite a recent rise in yields, bonds remain below fair value and we expect a further correction in prices.

Equities have suffered their first weekly outflow of this year, of more than USD24 billion (see Fig. 2).

Rising bond yields are likely to weigh on equity earnings multiples given the asset class' expensive valuation. Another red flag is corporate profits.

Earnings momentum has peaked, with 12-month forward earning per share now rising at 20 per cent for MSCI All-Country World Index, compared with 60 per cent in June.

Our models suggest earnings growth will continue to decelerate significantly in the coming quarters as the pace of economic expansion slows.

Our **technical** indicators paint a positive picture for riskier assets, supported by seasonal factors as well as moderate investor sentiment.

02

Equities regions and sectors: dialling up defensives

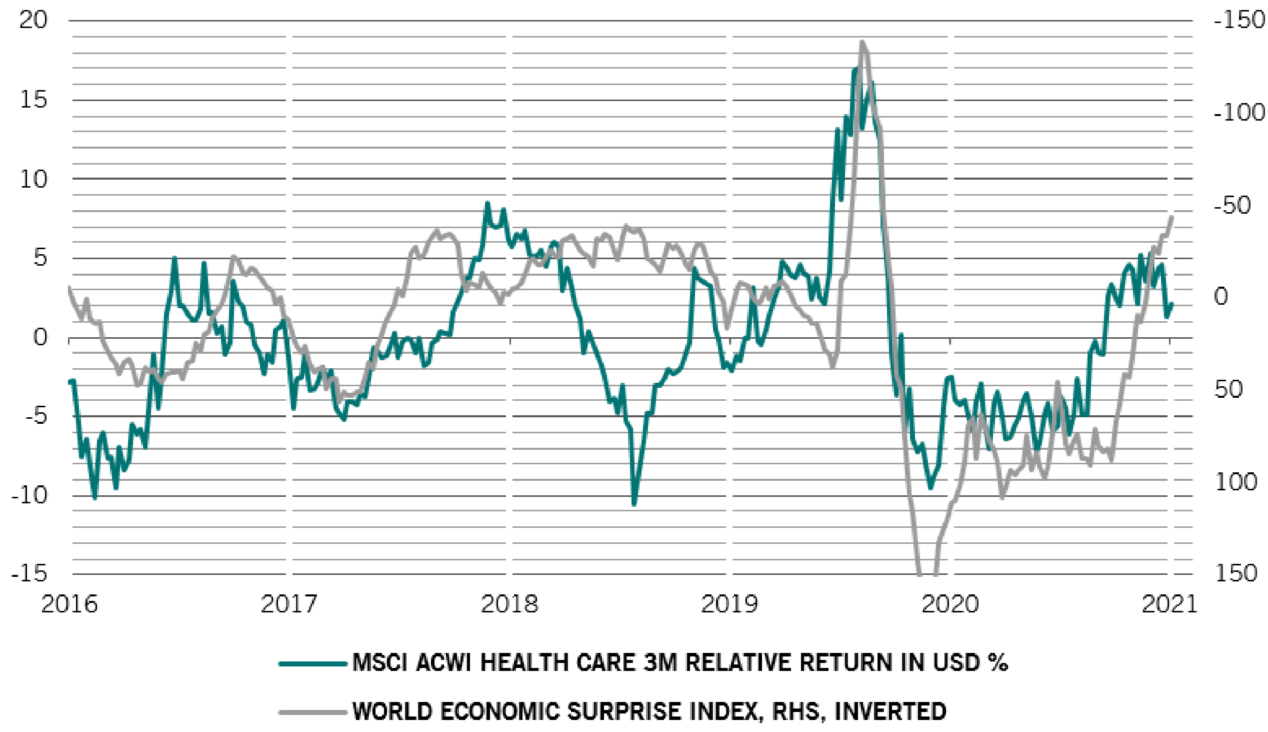
We remain neutral on equities, but continue to increase our allocation to defensive parts of the market on concerns about rising risks to global growth. The rally that started in the spring of 2020 is looking long in the tooth. Market volatility is picking up while economic and earnings growth are both slowing. Central banks are reducing monetary stimulus. And valuations are stretched.

We make two changes to our regional and sectoral equity allocations – we close our short position on Japanese equities, taking them to neutral, and we raise health care to overweight from neutral.

Although the fundamental story has not improved from last month in Japan – lead indicators are falling and the country is very exposed to a weakening global manufacturing cycle – the change of leadership in government, with Fumio Kishida as the next prime minister, opens up the prospect of policy changes that investors have been wanting for some time. That includes a return to Abenomics-style stimulus programmes.

More generally in our regional equity allocation, we maintain a strong preference for European equities and remain overweight UK, euro zone and Swiss stocks. In the euro zone, economic momentum is more resilient than elsewhere, vaccination roll-out is advanced, and the ECB is not set to tighten policy anytime soon. Moreover, stocks' valuations are still reasonable in both absolute and relative terms. The UK market, meanwhile, is the cheapest on our scorecard with a dividend yield in excess of 4 per cent and a good sector mix, dominated by value cyclicals and quality defensive stocks.

Fig. 3 - Healthcare stocks to shine as economic growth slows
Healthcare sector performance vs economic surprises



Source: Refinitiv Datastream, Citi, Pictet Asset Management. Data covering period 28.09.2016-23.09.2021.

The Chinese equity market's 30 per cent underperformance this year has been caused by surprisingly weak corporate results. Twelve month forward earnings are unchanged on where they were last December, even as they've climbed by more than 25 per cent in the rest of the world. But while this has left Chinese equities looking cheap, they're not yet cheap enough to set aside local risks – regulatory upheavals have now been compounded by an energy shock. We remain very optimistic on the medium- to long-term outlook for Chinese equities, but we are waiting for a bottoming out of economic growth momentum and a more material dovish shift in monetary policy to add to our tactical exposure.

We continue to increase our allocation to defensive sectors by upgrading healthcare to a single overweight. The sector has strong momentum and has outperformed its defensive peers year-to-date (see Fig. 3). Valuation is reasonable and a strong US dollar is historically a support. We maintain our overweight in financials, which should benefit from rising yields, and in real estate, which is relatively cheap and is a defensive trade that should be boosted by the re-opening of economies. We also stick to our underweight in consumer discretionary as rising inflation and the withdrawal of government transfers will eat into households' spending power.

Materials is now the cheapest sector in our models. The sector's de-rating comes on concerns about China's final demand and the strength of the dollar. Unusually, it comes at a time when energy stocks have appreciated.

More generally, earnings momentum has clearly peaked. Twelve month forward earnings per share growth for the MSCI All Country World Index was rising at a 60 per cent annual rate as recently as June. The annual rate has now dropped to 20 percent. Our models suggest that earnings growth will continue to decelerate significantly in the coming quarters as the pace of economic growth deteriorates.

03

Fixed income and currencies: influenced by inflation

Fixed income investors around the world are on high alert for inflation. In the long-term, it could push up rates and make bond yields attractive once more. But for now it threatens to eat into the real value of already wafer-thin returns.

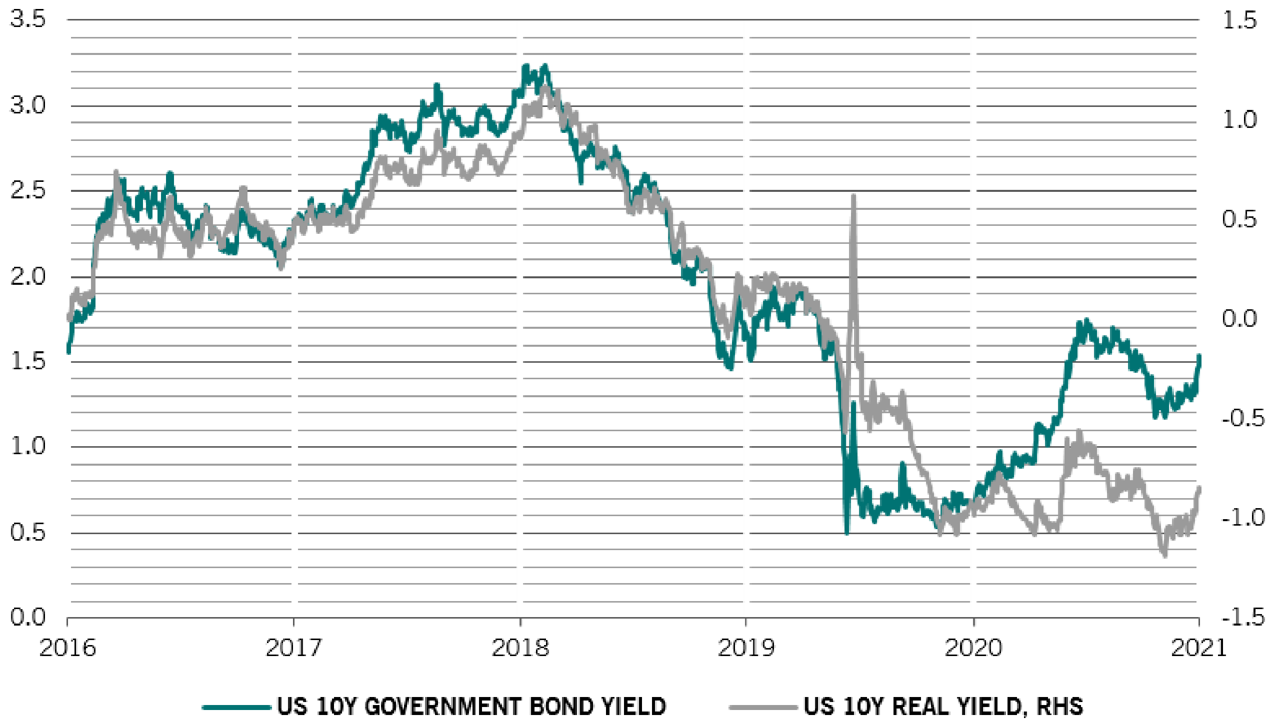
Globally, we expect inflation to remain above trend and consensus for this year and next – mainly due to strong demand arising from solid job gains and accelerating wage growth. Continued supply bottle necks should play a part too, given shortages of labour and record low inventory levels.

The key, therefore, is to find areas of the bond market which are best cushioned from inflationary pressure. Once such refuge, we believe, is Chinese sovereign debt. China's consumer prices rose by just 0.8 per cent in August, year-on-year – below consensus and far below the official 3 per cent target.

As well as having one of the lowest inflation rates in the world and the prospect of a looser monetary policy, China currently offers some of the highest bond yields, of around 2.9 per cent.

We expect further stimulus in China, including liquidity injections and cuts in the reserve requirement ratio (RRR). In the US, meanwhile, bond purchases should soon be tapered and rate hikes may start by the end of next year.

Fig. 4 - Still sub-zero
US Treasuries: 10-year yield versus real yield, bps



Source: Refinitiv Datastream, Pictet Asset Management. Data covering period 28.09.2016-28.09.2021.

Benchmark yields on US Treasuries remain in negative territory in real terms and circa 30bps below our estimate of fair value, despite the recent repricing in anticipation of monetary tightening (see Fig. 4).

US high yield bonds should prove particularly vulnerable to a tightening of US monetary policy. For a start, valuations are high – it is by the far the most expensive fixed income asset class in our model. Its yield spread versus Treasuries is just above 300bps, the tightest since 2007. Furthermore, earnings prospects among US firms are steadily deteriorating – analyst downgrades and profit warnings are already growing in number.

We are thus negative on US high yield. We are less pessimistic on high yield debt in Europe, where economic growth appears more resilient and lead indicators are still rising. Mobility restrictions are easing, vaccination rates are high and fiscal policy is still supportive.

In the currency arena, we do not see an obvious catalyst to reverse the ongoing strength of the US dollar, but any potential further gains will be limited by its lofty valuation. Sterling looks the most vulnerable among major currencies as the UK growth momentum has taken a sharp negative turn. Growth has almost stalled across all sectors, and is likely to be further hit by the inflation surge and petrol shortages. The Bank of England may find it difficult to hike rates in early 2022, as it is currently priced in.

04

Special feature: how vulnerable are stocks to rising bond yields?

Why might government bond yields continue to rise?

To begin with, there's the Fed's own policy stance, which looks excessively loose when set against the economy's ongoing recovery from the pandemic. According to our calculations, which take into account our own GDP growth and inflation forecasts, the Fed funds rate is currently 550 basis points lower than the "natural" or "neutral" rate, or the real interest rate consistent with an economy operating at its sustainable level. Even if we assume core inflation falls even more quickly than we currently expect – to 2 per cent from the current 3.6 per cent by year end – the implied Fed funds rates would still be 380 basis points lower than it should be. Moreover, should the Fed look to close that gap over the next year or so, by hiking interest rates by 25 basis points in each of its eight meetings in 2022, the Fed funds will still be 180 basis points below the neutral rate, effectively lagging the business cycle by two years.

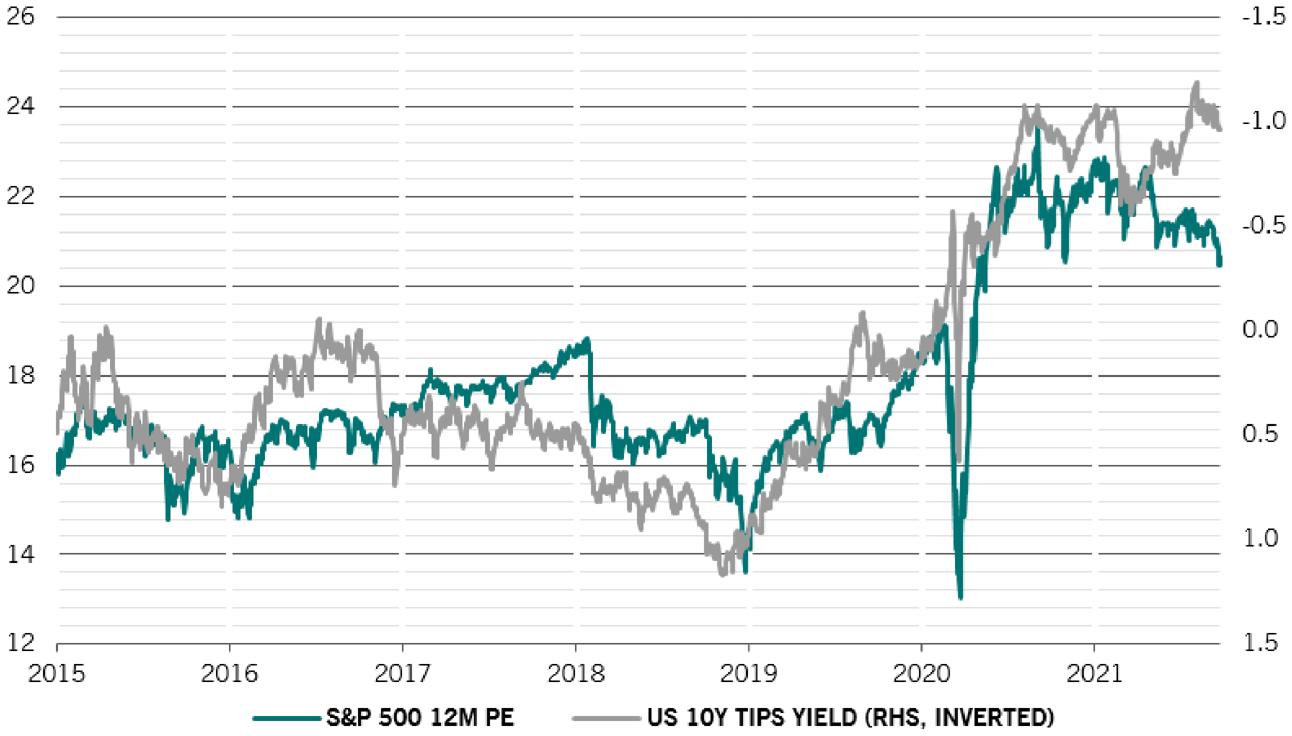
Then there's the market forecast, which is even more dovish than the Fed's. Currently, bond markets are pricing in interest rate rises that are some 50-70 basis points below the estimates in the Fed's dot-plot for 2024 and beyond. So, with both the Fed's and the market's interest rate projections at odds with underlying economic conditions, bond yields are set to trend higher. It is also worth noting that, historically, when bond yields rise during a monetary tightening cycle, approximately 50 per cent of that cumulative increase materialises after the first rate hike is delivered.

How great is the disparity between what our own analysis tells us about how quickly – and far – yields could climb and what the market is currently discounting?

The 10-year US bond yield can only really be considered fairly valued if the Fed continues to expand its balance sheet in line with GDP growth.

Realistically, though, we assume that the Fed's holdings of bonds, expressed as a percentage of economic output, will remain fairly flat at 38 per cent only until the second half of 2022, before falling to about 30-32 per cent by the end of that year. In this scenario, and taking into account our forecasts for real US GDP growth, the fair value of the 10-year bond yield comes to around 1.8 per cent, or approximately 30 basis points higher than it is at the time of writing (01.10.2021). (Note that our quantitative models suggest that the Fed's bond purchase programme has kept bond yields some 170 basis points below their equilibrium levels.)

Fig. 5 - Real bond yields have a key influence on equity valuations
US 10-year TIPS yield, %, and S&P 500 12-month price/earnings ratio



Source: Refinitiv, MSCI, IBES, Pictet Asset Management; data covering period 31.12.2014-30.09.2021.

If our estimates prove correct, what effect could this have on equity markets?

On its own, a rise in the real yield isn't positive for stocks. Over the past few years, there has been a very strong negative correlation between US real bond yields and stock's price-earnings (P/E) ratios. For every 100 basis point rise in the yield of the benchmark US inflation-linked bond, there has been a corresponding 20 per cent fall in the P/E ratio. But that, in isolation, is rarely enough to hold stocks back. Indeed, an analysis of the past two decades shows that equities have gained even when real yields have been rising. There is a simple explanation for the good run: corporate profit growth has been strong enough to overcome the contraction in stocks' earnings multiples.

Indeed, rising bond yields can reflect an improvement in economic conditions. And when economic growth improves, so do prospects for corporate profits. In fact, due to companies' operational leverage, corporate profit growth tends to be much more volatile than GDP growth – the beta of earnings growth to GDP growth is 5, which means that for every 1 percentage point rise in GDP growth, the corresponding rise in company earnings per share (EPS) is five times higher. (During the pandemic, the beta of EPS to GDP has been much lower, around 2-3 times, but this is due to the unique nature of the recession, which hit services more than goods consumption).

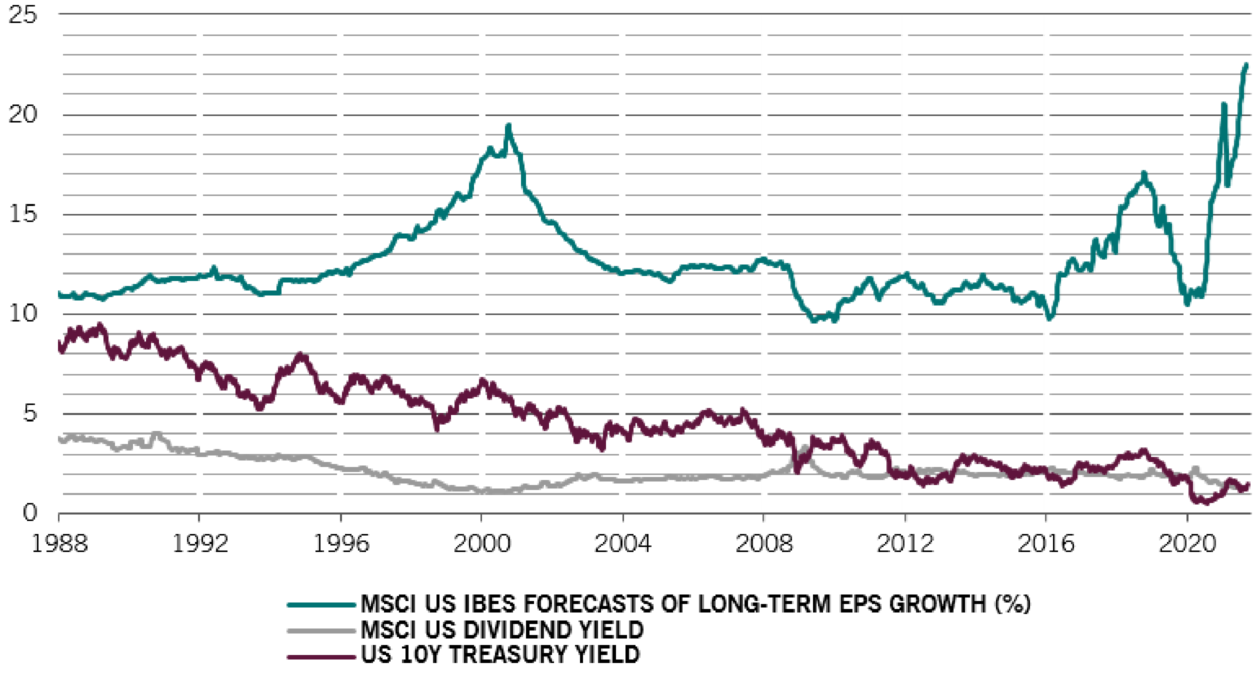
All of which means that what really matters for the relative performance of equities versus bonds are two variables – the gap between nominal GDP growth and the risk-free rate (which we call the "Fed put") and the gap between corporate earnings growth and GDP growth, which serves as a proxy for profit margins. The wider those gaps, the better the conditions for equities. Should one or both of those differentials narrow, however, and the environment becomes less forgiving for stocks. According to our analysis, both gaps look set to close, pointing to lower returns from equities in future.

One reason for the shift is a slowdown in profit growth. In their recovery from the pandemic, US corporate earnings have been rising at levels that are unsustainable over the long run; the profit increase analysts have pencilled in for 2023, for example, is some 20 per cent above the long-term trend. This, and the fact that profit margins are also off the charts suggests that the upside for corporate earnings is limited from this point. Another problem is the equity market's increased vulnerability to a rise in the cost of capital.

As a large chunk of the equity market's value derives from lofty projections for profit growth, even a small move higher in the rate at which those future cashflows are discounted could hit share prices. We find that the duration of the US equity market – a measure of how sensitive stock prices are to a 100 basis point upward move in long-term bond yields – is 40 per cent higher than a decade ago (add footnote to show calculation).

Which means that a 100 basis point rise in long-term bond yields would result – ceteris paribus – in an approximate 20 per cent decline in the fair value of equity markets, according to our discounted cashflow model. This is consistent with the beta of the P/E ratio to the yield on US inflation-linked bonds, which hovers at 4. The risk that rising bond yields present for equities is greater still considering that the economy is entering a late phase of its cycle, characterised by rising inflation. It is during such a phase that returns from equities and bonds tend to be more positively correlated – currently the correlation between the two major asset classes is the highest in 15 years.

Fig. 6 - Equities very vulnerable to rise in long-term bond yields
US stocks' expected earnings growth, dividend yield and US 10-year government bond yield, %



Source: Refinitiv, MSCI, IBES, Pictet Asset Management; data covering period 31.12.1987-30.09.2021.

Using history as our guide, which areas of the equity and market could be expected to do well and which would likely suffer?

Among the areas most vulnerable to rising bond yields are growth-oriented equity markets and sectors. The biggest beneficiaries, by contrast, would tend to be value-cyclical sectors and regions, such as financials stocks and Latin American equities.

However, changes in the shape of the yield curve may give a better clue on the relative performance of some asset classes. If history is a guide, and provided consensus GDP forecasts are broadly accurate, the US yield curve is set to flatten considerably in the coming year – as the economy recovers output lost to the pandemic. If that shift is a bear flattening – in other words is accompanied by a rise in yields across all maturities – then past experience suggests global equities tend to generate returns of some 10 per cent annualised, with non-US and value stocks outperforming (more so in common currency terms given that the US dollar tends to weaken).

So, while history suggests rising bond yields have, in themselves, not been a significant headwind for equity markets, stocks' expensive valuations, the growth-bias of major equity indices and a monetary policy that is lagging the economic cycle suggest that future returns on equities are likely to be materially lower than in the recent past. In our Secular Outlook, we forecast that global equities will return some 6 per cent annualised in US dollar terms over the next five years – less than half of the total return annualised over the past decade.

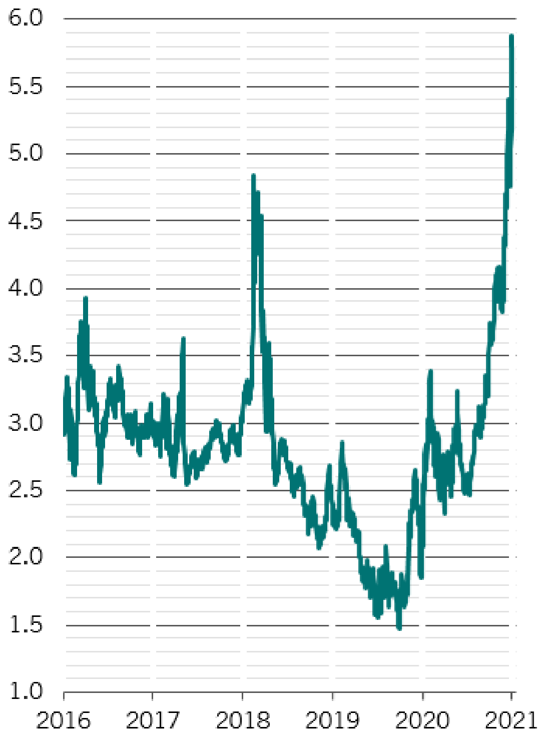
05

Global markets overview: pumps run dry

Global stocks and bonds both ended the month in the red as concerns intensified about the impact a debt crisis at Chinese property developer Evergrande could have on the country's already slowing economy. Investors were also bracing themselves for an end to pandemic-era monetary stimulus in the US.

Stocks struggled more than bonds, with the MSCI All-Country World Index ending the month down more than 3 per cent in local currency terms. Emerging markets were the worst performing region, with Chinese and Brazilian stocks dragging the developing world lower.

Fig. 7 - Foot on the gas
NYMEX Natural gas futures price, (USD per MMBTU*)



Source: Refinitiv, Datastream, NYMEX, Pictet Asset Management; data covering period 31.21.2015-28.09.2021; *Metric Million British Thermal Unit.

China-exposed sectors like mining and materials were the biggest losers, while energy stocks gained as gas prices surged due to supply shortfalls (see Fig. 7). Utilities continue to underperform even in a weaker market environment and are now trading at all-time low relative to the benchmark. The prospect of higher interest rates aided banks, which ended the month higher.

Japanese stocks outperformed developed equity markets as Covid cases fell and as expectations grew of fresh economic stimulus under new Prime Minister Fumio Kishida. US stocks, having hit a record high earlier in the month, ended sharply lower per after Fed officials suggested a faster withdrawal of monetary stimulus and more aggressive interest rate hikes.

In fixed income markets, Chinese government bonds fared better than their developed and emerging market peers, supported by a low inflation rate, the prospect of a looser monetary policy and the asset class's attractive yield of around 2.9 per cent. Elsewhere, both emerging market hard and local currency bonds fell, weighed down by a strong dollar which gained 1.7 per cent on an overall rise in risk aversion.

The Chinese renminbi (RMB) showed remarkable resilience by ending the month nearly flat despite falling domestic equity markets. Sterling fell 2 per cent as surging inflation, supply chain disruptions and a fuel shortage put the brakes on Britain's economic rebound from the Covid lockdown.

06

In brief

BAROMETER OCTOBER 2021

Asset allocation

We downgrade bonds and upgrade cash as central banks prepare to withdraw monetary stimulus.

Equities regions and sectors

We upgrade Japan to neutral on political developments and upgrade healthcare to overweight as part of a shift into defensives.

Fixed income and currencies

We favour Chinese sovereign bonds due to low inflation, likelihood of further central bank stimulus and attractive yields.

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Written by

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Important legal information