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Market returns of last week looked like business as usual. Global stocks were slightly up in developed markets and down -1% in emerging regions; interest rates were modestly firmer with the US 10-year Treasury rate adding 9 basis points to close at 1.45%, which translated into moderate negative returns across the fixed income universe. Oil prices kept on rising, with the Brent crude oil barrel gaining almost $3 to $78, getting closer to the $80 mark. Those benign numbers however don’t reflect the fact that volatility was definitely back last week, with two major concerns fuelling it, from respectively China and the US.

Indeed, the week started with immensely worrying news from China’s Evergrande, one of the world’s largest real estate developer and without a doubt the most indebted. With over $300bn in liabilities, and most of its assets being illiquid, the Chinese giant was unable to pay some interests due to banks. This triggered a global “risk-off” episode at the beginning of the week, with fears of a Chinese systemic Lehman-like moment. Of course, the financial situation of Evergrande is well known, actually for years, which is why their bonds are not on our recommended list. However, the prevailing view so far was that it was too big to fail. Its $300bn of assets represent 2% of Chinese GDP. More importantly, it’s real estate: the count of direct and indirect stakeholders is an astonishing number of millions, across clients, suppliers, employees and investors. A default of Evergrande would have severe consequences: a real
estate crisis impacting growth, local governments funding (for which land sales matter), and China’s overall bond market. Such a backdrop led to some investors being very confident, if not outright complacent, with the mountain of debt at Evergrande and the common sense of financial analysis. They were betting that Chinese authorities would not let it go. Authorities however remained silent on the topic last week, which of course roiled global markets. This crisis happens at the worst possible time for China’s markets: growth is in a clear downshift, and the ongoing regulatory crackdown under the “common prosperity” objective is relentless: after tech, education or gambling, additional scrutiny was announced precisely on real-estate. In the very short-term, anxiety moderated from last Wednesday, which was by coincidence when China’s domestic markets reopened after a holiday. Evergrande announced an agreement to settle some local note interest payment. It’s still not clear if the company will make a crucial payment on a US dollar denominated bond, due last Thursday. However, the local settlement was seen as a sign that authorities were quietly stepping in, and in addition, China’s central bank made its largest liquidity injection for months the same day, a whopping $71 billion. Later last week, the PBOC also suddenly announced that all crypto-related transactions are from now illegal, and that financial institutions are not allowed to offer any service in the field. This of course had an immediate adverse impact on crypto asset prices.

That’s a transition to the second key topic of last week: central banks meetings, starting with the most important, the US Fed. The institution marginally downgraded its outlook for growth, while releasing a new set of rates projections which was slightly more hawkish than before, leaving open the possibility of rate hikes in 2022. More importantly, the Fed almost announced that the tapering of asset purchases would start at the next meeting, i.e. in November, and also indicated that they may aim at completing the process by the middle of next year. From the current $120bn of monthly purchases, going to zero in 8 months requires a reduction of $15bn of the envelope every month. This is faster than many forecast, which explains why interest rates went up, with a steepening of the curve. Having said that and as often, the verbal comments were more nuanced than the cold numbers: the employment market remains the key factor behind monetary policy, rather than inflation, which is still seen as temporary. To have an idea of where we are to that extent, out of the 22 million jobs lost by the US economy during the pandemic, which is close to 15% of the workforce, around 17 million have come back. The recovery is not complete: some people have simply exited the labor market and almost 3 million are still looking for a job. This means that the Fed could find reasons to be cautious on rate hikes, and with regards to tapering, the institution has been excellent at preparing markets to the withdrawal of a now outsized support without creating a shock. Tapering without bond tantrum is on the cards and it’s good news.

The Fed wasn’t the only one to meet and make announcements. We would highlight the Bank of England, who doesn’t exclude a rate hike for the end of this year which can be seen as a way to prepare markets for it to happen in the first quarter of 2022. In Turkey, the CBRT surprised markets by cutting its one-week repo rate by 100 basis points to 18%, despite inflation approaching the 20% annualized level. The Central Bank seems to definitely target economic support over price moderation, and the lira was weaker on the news. Finally but importantly, the UAE Central Bank said on Thursday it was starting to gradually reduce their stimulus measures. The Targeted Economic Support Scheme, introduced last year, had been and still is very successful at preventing a credit crunch and supporting growth. Staying in our country, some changes in the UAE cabinet were unveiled, including the nomination of several new ministers, with a focus on major transformative projects. His Highness Sheikh Maktoum bin Mohammed was appointed as Deputy Prime Minister and Minister of Finance; Mohamed Al Hussaini was made Minister of State for Financial Affairs. Other changes included Justice, Human Resources and Emiratisation, as well as Climate Change and Environment.
Back to global markets and their backdrop. There is no doubt that the global economy has lost momentum, at a time when elevated valuations and consensual bullishness creates vulnerability in the short-term. With regards to growth, we remain reasonably confident: virus control is improving, which should support the most versatile component of growth: consumption. Monthly PMI numbers for September will be released in the coming days and they should confirm softness, but we do not think that markets will be surprised. Policy support remains significant, and we do not think that the current heated debates in Washington over the US debt ceiling are really a meaningful risk. Valuations are a concern in developed markets, for both stocks and bonds, as we write for some time now, which limits the potential returns especially in the short-run. However, earnings growth remains extremely strong and will mechanically reduce equity multiples – the Q3 earnings season will also start in the first part of October. Interest rates are too low for the backdrop but the adjustment should be very gradual. Finally, the good news in the current stress is that sentiment could have started to normalize – less optimism across the board. We cannot -ever- exclude the possibility of a material correction, but at this stage of the virus situation and of the global rebound, we would tend to see it as an opportunity to add to exposure. Opportunities are scarce globally, but the long-term prospects for assets in emerging regions remain compelling. EM debt is our preferred segment within the fixed income asset class. We do not recommend to put any money in Evergrande but we tend to think that China will avoid a systemic crisis. When it comes to stocks, we are only slightly overweight as short-term volatility could remain high, but our conviction for the long-run is intact.

Stay safe.

MAURICE GRAVIER
Chief Investment Officer
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