



Stagflation and debt ceiling at the forefront of investor minds

- **Q3 starts with questions about an unfavorable mix of growth and inflation and debt-ceiling angst**
- **Investors will be parsing company reports seeking possible inflation spill overs to earnings**
- **Our outlook remains constructive with markets climbing a steeper wall of worry**

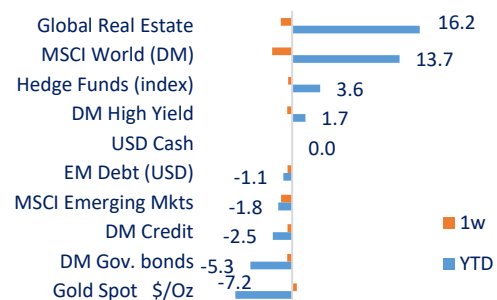
As central bankers barely start to acknowledge that price pressures are lasting longer than initially projected, inflation has reached new highs in the United States and in Europe on rising energy prices and supply bottlenecks restraining the recovery. Inflation gauges reached 4.3% in August on a yearly basis in North America, the largest increase since 1990, and 3.4% in the Eurozone. Energy costs rose on average in the low double digits across the Atlantic, compounded by an energy crisis in Europe fueled also by the phasing out of coal and a bad year for wind production.

If inflation is not showing signs of letting up, it is important that growth rebounds sooner rather than later, for markets to remain resilient. We could be seeing the first green shoots of a pickup in economic growth rates with the Citigroup US Economic Surprise Index coming off very depressed levels. In China the latest PMI reading was seemingly discouraging, although the details pointed to improving internal demand. Investors will be closely watching the forthcoming reporting season for possible signs of spill over into corporate earnings. In the three months ending September “inflation” was mentioned the most across the last two decades in global earnings transcripts.

In the month of October the US debt ceiling issue will be coming to a head, forcing the Democrats and Republicans to bridge the large rift dividing them, unless a political accident engenders the first default in US history, which would not be our base case.

Overall, we remain constructive on the outlook, while acknowledging that market volatility is unlikely to subside in the shorter-term.

ASSET CLASSES USD % TOTAL RETURN, YTD 2021 LAST WEEK



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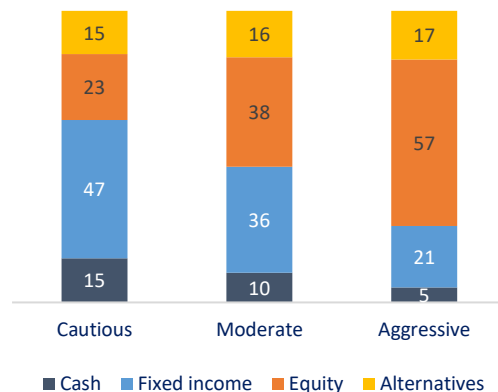
Cross-asset Update

Four leading central bankers on Thursday warned about lingering supply bottlenecks, as Jay Powell found it “frustrating” that they hold back the recovery and Christine Lagarde said that how long it will take for them to fade out is “a question we are monitoring closely”. The Fed chair also acknowledged that “scope and persistence of the supply-side constraints were missed”. Taken at face value, these declarations imply that the very monetary authorities steering the economy have such low visibility on the inflation outlook, that one may wonder about the kind of foresightedness others enjoy. Or maybe not. This year in March Larry Summers, ex Treasury secretary, went so far as to claim that inflation is caused by the Fed dismissing it as transitory; Jeffrey Gundlach, founder of the investment firm Double line Capital, in April mentioned that “there’s plenty of indicators that suggest that inflation is going to go higher, and not just on a transitory basis”; and Mohammed El Erian, renowned Wall Street investor and now Allianz advisor, said in May that supply bottlenecks “are not going away anytime soon”, citing macro data, and anecdotal evidence from many prominent CEOs complaining about their inability to secure imports, which would force them to increase prices. Many others have since joined the growing chorus of experts not buying into the “transitory” narrative, from JPMorgan’s Jamie Dimon, to Blackrock’s Larry Fink just to mention a few.

If one rightly wishes that central bankers were wearing a different pair of glasses, at least as far as price pressures are concerned, then one may as well wish that the Fed and other central banks know what they are doing with Quantitative Easing. Is there any reason to keep extraordinary stimulus going in the US, in a measure much bigger than after the Great Financial Crisis, if the current economic issues are more supply-than demand-side related? With excessive stimulus the Fed would eventually be forced to slam on the brakes of tighter policy, nobody wants that and markets could not afford it.

As stagflationary issues remain largely unaddressed by the authorities, investors had better do at least something about it. Protecting a portfolio from inflation can be achieved for instance by partially replacing the share of global Treasuries with Treasury Inflation Protected Securities, or TIPs. The only large and liquid market is in the United States, where currently one has to accept a negative real rate of almost 0.9% for the privilege of investing. For investors who are willing to take more risk a better option would be to look into oil stocks, boasting a dividend yield of slightly more than 4% in the US and 5% in Europe. The oil market is still tight due to the strong post-Covid recovery and the energy crisis in Europe should induce some gas-for-oil substitution effects, pointing to further tightening for the crude outlook.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

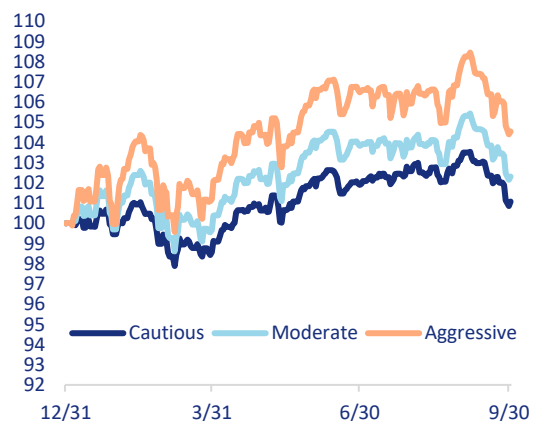


TAA – RELATIVE POSITIONING – MODERATE PROFILE

	UW	N	OW
Cash		=	
DM Gov.	<<<<<<		
EM Debt			>
DM Credit			>
DM H. Yield		=	
DM Equity			>>>
EM Equity		=	
Gold		=	
Real Estate			>
Hedge Funds		=	

UW/N/OW: Underweight/Neutral/Overweight

TAA – 2021 INDICATIVE PERFORMANCE



Source: Bloomberg. CIO Office calculation based on TAA applied to market indices, net total return in USD.

Fixed Income Update

Two narratives currently dominate the fixed income landscape, at the opposite ends of the credit spectrum.

Firstly, the focus is on the movement in the US Treasury yields. The yields are on the move post FOMC meeting, where Chairman Powell announced taper timelines that were slightly faster than market anticipation. The 10-year US treasury yields crossed 1.5% for the first time since June but settled at 1.46% on Friday, driven by uncertainties. The 30-year Treasury yields increased to 2.02%. There are critical macro data, including the September Jobs report and FOMC meeting minutes in the next couple of weeks which would affect the movement of the yields. The steepening of the yield curve resulted in a sea of red across the various segments of the asset class. EM Sovereign and GCC Debt, which have longer durations, had the lowest returns of -0.5% last week. The only segments which were relatively unscathed are Developed Market Treasuries and China Investment Grade bonds.

Secondly, Evergrande weighed on the minds of the Emerging Market investors even though we continued to see state intervention and flow of positive developments. After an eventful previous week where the company "settled" its onshore bond payments and defaulted in the payment to local banks, Chinese authorities have directed the company not to default on the offshore bonds in the short term. Moreover, Evergrande said on Wednesday that it had reached a deal to raise \$1.5 billion from selling its stake in Shengjing Bank to the local Shenyang government. In addition, Evergrande paid its first 10% instalment on wealth-management products due September, which may indicate improvement in its liquidity, at least for now. According to Bloomberg, there have been other signs of this in the last few days, for example, Evergrande resuming construction at about 20 property projects in Guangdong. But the saga is far from over, with Asia HY spreads further widening to 979 bps at the end of the week. As a result, we believe there is limited downside from current levels for Asia HY investors.

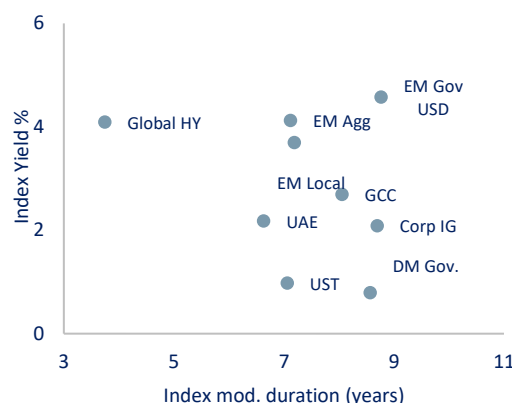
Outflows from Emerging Market bond funds have picked up space. In the last two weeks, the total outflows have reached \$4bn, which is the highest outflow since the onset of the pandemic. According to S&P, the 2021 global corporate default tally remained at 59, with no defaults in the last couple of weeks. There has only been one default in September so far and 12 in the third quarter, the lowest since 2014.

In a piece of exciting news for GCC markets, S&P revised Oman's outlook to positive, according to a report published yesterday. This could lead to the first upgrade for the nation in a decade. The rating rationale mentions that the authorities have outlined a solid path to reduce the historically high fiscal deficits, backed by a strong political will to implement the related reform measures. In its medium-term fiscal plan (MTFP) for 2021-2025, the government has set an ambitious target to achieve fiscal balance by 2025. We like the 7-10 years part of the sovereign curve and the Quasi sovereigns, including OMGRID, OMANTEL, and OQ.

FIXED INCOME KEY CONVICTIONS

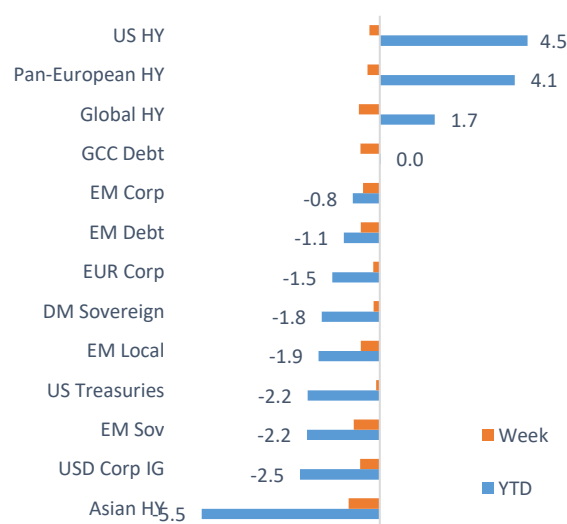
DEVELOPED MARKETS	
UW Government bonds	
Selective on Credit	
Now NEUTRAL High Yield	
EMERGING MARKETS	
OW Asia	
OW IG Sovereigns	
OW Latin America	

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

FIXED INCOME SUB ASSET CLASS RETURNS (YTD, LAST WEEK)



Source: Bloomberg

Equity Update

It is a good start to October for the UAE with the most inclusive opening of the Expo 2020, rebounding visitor arrivals and an increase of permanent residents with rents and real estate prices on the upswing. A successful listing of the ADNOC Drilling IPO. And amongst the best performing equity markets year to date, though September saw a mixed performance, with Dubai equities losing close to 2% and Abu Dhabi equities flat, in line with global market performance.

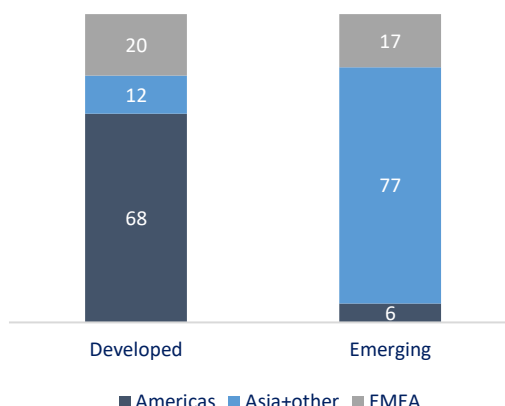
September was a volatile month for global equity markets, not uncommon as per statistical data. While virus fears are somewhat abating with global travel picking up, a number of factors led to last month's market downturn. For developed markets it is the approaching reduction of fiscal and monetary stimulus alongside rising sovereign bond yields, the already strong stock performance with markets priced for perfection, and inflation and supply chain imbalances as the world reopens. A common worry for EM and DM is rising energy costs related to oil, natural gas and coal. Brent is up around 50% ytd. In September global equities fell -4%, the S&P 500 -4.8%, the Eurozone -5.9% and China -2.6% whilst the U.S. 10 year treasury yield rose by 25bps to 1.48%. Last week was negative for most markets, though the US had an up day on Friday and has begun October well with a partial government shutdown averted. EM performance dominated by China also suffered in September as China overseas listed companies, particularly in the tech payment space or those with a large number of users continue to see increasing regulatory scrutiny. Last week however, saw China equities +0.4%, very small but a nice turnaround from the continuing negative news flow. Lingering worries over real estate leveraging remain. The A share market is now closed for the national holiday week.

We remain constructive on equity performance for Q4. We anticipate slower gains and more persistent volatility with peak earnings and economic growth for the developed economies having been achieved in Q2, though the higher base itself forms a constructive backdrop. An expected 27% y/y EPS growth for S&P 500 companies in Q3 is good following 88% in Q2, with even higher expectations for Eurozone earnings growth. Our fair value for the S&P 500 is at 4400 for the year end based on a P/E of 23X and earnings growth of 37%. With upside surprises, earnings growth should be higher at 42% as per consensus. Emerging markets have different stories with China on a longer term trajectory of common prosperity and India quick to take the baton and welcome foreign investment and technological advances, reflected in their ytd performance with the MSCI China Index -17% and MSCI India +26%.

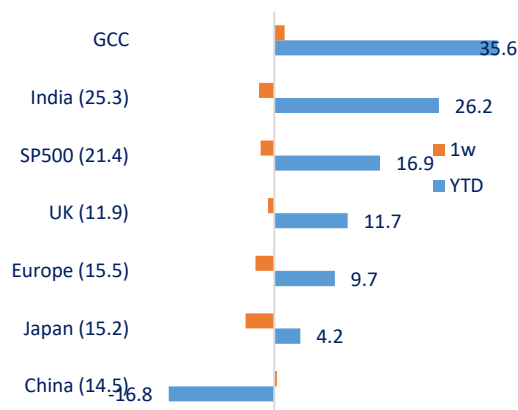
Our global sectoral preference remains for financials on higher yields and healthcare as a defensive positioning.

Inflation worries globally remain centred around rising energy costs, chip shortage and labour. The continuing semiconductor shortage could cost the global auto industry \$210 bn in lost revenues this year, with US September auto sales 25% below last year's. Tesla, the most valuable auto maker in the world, is however on track to achieve a growth rate of 50%.

EQUITY RECOMMENDED REGIONAL POSITIONING

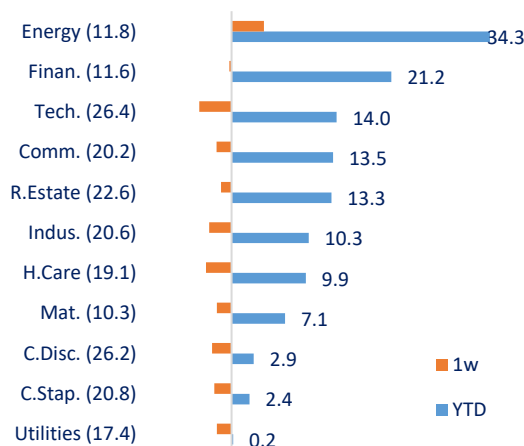


MAJOR INDICES PERFORMANCE (TR, US\$) AND 2021PE



Source: Bloomberg consensus. MSCI Indices unless specified.

GLOBAL SECTOR PERFORMANCE (TR, US\$) AND 2021PE



Source: Bloomberg consensus. MSCI All Country World sectors US\$.

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