# The power of earnings growth

- **Global stocks had their best week in 3 months, helped by a spectacular start to the Q3 earnings season**
- **Inflation is significant, but with even faster growth, stagflation fears are receding**
- **Our positioning remains reasonably pro-cyclical.**

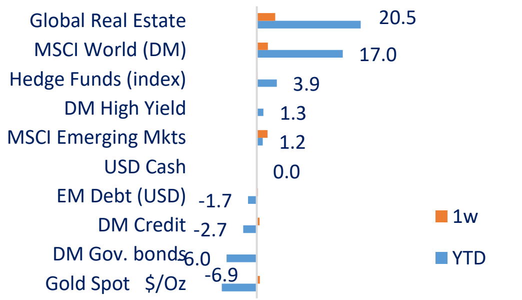
With regards to top-down market drivers, last week was all about inflation and the response from central banks. There was no surprise: US CPI came out slightly higher than forecast, while the minutes from the last Fed meeting confirmed that tapering should be on autopilot. Surprises were to be found in the corporate world, and they were positive: the first releases from the Q3 earnings season were simply excellent, especially from investment banks printing record levels of activity.

As a result, stocks were sharply up and interestingly, interest rates were - modestly - lower. It's good to remember that equities are after all nominal assets: inflation doesn't just affect their costs but also their top-line growth, and the cyclical dynamic is currently stronger than the headwinds. EPS growth is the single most important driver for stock prices, and the welcome side effect is that fast earnings growth mechanically moderates valuation multiples.

Our outlook remains constructive, as inflation is currently a by-product of extremely strong growth alongside temporary supply bottlenecks. This should unlock the modest but positive residual upside from stocks, while interest rates should continue to gradually adjust higher. Recent economic data tend to indicate a rebound after the softness of the summer, from September PMIs to the recently released US retail sales. Our positioning remains overweight equities, with a tactical preference for DM, and underweight bonds, with a long-term preference for EM.

The week ahead will see an avalanche of earnings releases. Beyond numbers, management guidance's will be key to assess the outlook, especially considering supply chain bottlenecks and inflation. Stay safe.

ASSET CLASSES USD % TOTAL RETURN, YTD 2021 LAST WEEK




MAURICE GRAVIER
**Chief Investment Officer**
MauriceG@EmiratesNBD.com

GIORGIO BORELLI
**Head of Asset Allocation**
GiorgioB@EmitatesNBD.com

SATYAJIT SINGH
**Head of Fixed Income Strategy**
SatyajitSI@EmiratesNBD.com

ANITA GUPTA & NAWAF ALNAQBI
**Equity Strategy**
AnitaG@EmiratesNBD.com

**Cross-asset Update**

Markets have started to discount the start of the Fed tightening cycle early in the second half of 2022, which would be basically coinciding with the projected end of the tapering of asset purchases. Yet, currently the uncertainty about actual Fed action on policy rates remains elevated and compounded by little visibility about the duration of supply-chain bottlenecks, with market valuations at the same time extremely vulnerable to tighter liquidity.

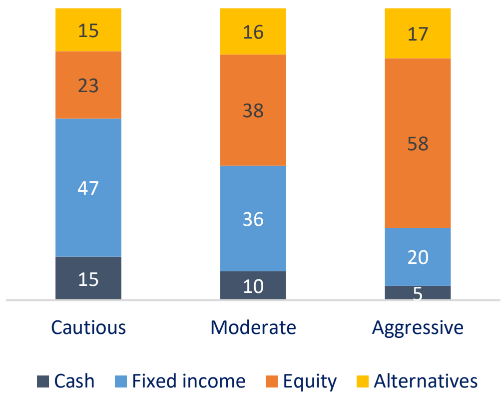
One argument runs that the Fed would not be keen to derail a stock market rally by inducing overly tight liquidity conditions with higher rates once it is done with the unwinding of asset purchases. By some time next year the global economy would have slowed further down, while inflationary pressures should have possibly faded, with supply-chain tightness and high energy prices somewhat easing and no longer exerting maximum pressure on the economy. So, Fed officials would be biding time, first assessing how the end of Quantitative Easing impacts the economy, and then pondering about future rate hikes. This would be a benign scenario where market swoons are averted in that the Federal Reserve adjusts policy in response to fading price pressures and the re-emergence of macro conditions similar to the ones predating the pandemic.

Yet, there is no assurance that price pressures related to depleted supply chains will last just enough for the Fed not to panic about higher inflation. Atlanta Fed president Bostic said that “transitory is a dirty word”, referring to inflationary pressures, and that “upside risks to the inflation outlook bear watching closely”. In addition, according to the FOMC minutes risks worsened, letting transpire Fed officials’ concerns about longer run expectations shifting higher and leading to “persistently elevated inflation”. Also, the Fed has boxed itself into a very uncomfortable corner, by keeping liquidity going as much as it could in spite of improving economic conditions, so getting exposed to the risk of falling behind the curve in terms of inflation management. So far, markets have given Jay Powell the benefit of the doubt about inflation not getting out of hand, since both longer-dated Treasury yields and market-implied inflation gauges are bell-behaved in spite of price spikes and much hesitation about starting the tapering. Should the Fed’s credibility take a hit, a disorderly rise in yields could hardly be averted.

For now, liftoff time is still way away and investors can wield patience about supply-chain related inflation, believing it is sufficiently transitory as to be properly managed by the Fed. So, markets are likely to continue to rally into year-end, with equities grabbing the lion’s share amidst overly plentiful liquidity and credit playing only second fiddle. The dollar should remain well supported as the US leads a rebound in economic surprises, and gold no longer so weak with the announcement of the tapering in November now a formality.

But the longer the system is unable to get rid of ‘transitory’ inflation, the more unstable today’s hunky-dory market conditions will become.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

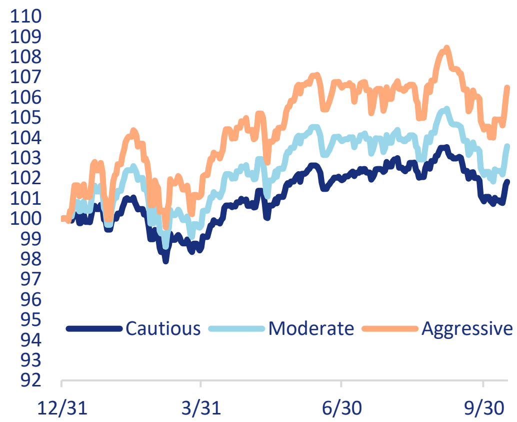



TAA – RELATIVE POSITIONING – MODERATE PROFILE

| | 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**

There are three key takeaways from last week's release of September FOMC meetings. Firstly, there should be no surprise in the timing and size of the Fed taper, which is expected to start later this year and finish by mid-next year. Secondly, there is a lot of anxiety about the level of inflation and its stickiness. Lastly, the members would like to see more improvement in the jobs market before the final lift-off happens, and hence employment numbers are the key to gauge the timing of the rate increase. Last week there was a flattening of the US Treasury yield curve with front-end rates rising and long-end coming down on the backdrop of the aggressive Fed tightening path post the taper regime next year. We remain bearish on the long end of the curve since we believe the market pricing of the terminal rate remains well below the Fed's long-run target of 2.5%. At the same time, we do not think a significant sell-off of the 10-year is possible from current levels due to softening growth levels. We believe in a more modest upward repricing as we progress to the end of the year.

The twist in the treasury yield curve resulted in various segments of the asset class finally returning in the green after weeks of negative returns. Long duration assets such as Emerging Market Sovereigns and Investment Grade debt were the primary beneficiaries of such a move returning more than +0.5% last week.

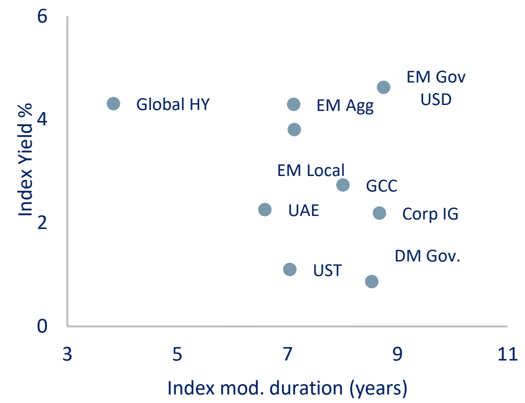
Asia High Yield remains under pressure as the market is still coming to terms with the elevated default levels. According to analysts, total default rates could reach 20% by volume for the China HY real estate sector, the majority of which would be from the Evergrande's bond complex. Our calculations indicate the market is pricing in a pessimistic 35% default rate over the long-term average for the segment. Evergrande would finish its 30-day grace period for the first dollar bond next week on Oct 22. Investors do not expect interest payment despite the authorities' directive not to default on the offshore obligations in the short term. Further downside to the asset class would stem from unexpected corners of credit risk such as the Fantasia case rather than evolving news on Evergrande. We continue to like the bonds complexes of the Investment Grade Chinese Real Estate Companies on our recommended list. But would remain cautious on the beta from the segment, and selectivity remains critical.

Closer home, Oman was a firm outperformer this week with sufficient demand for the credit from US RM, especially after Moody's upgrade of the credit from Negative to Stable outlook with bonds +2.25pts higher on the week. We had mentioned our preference for the Oman sovereign/quasi-sovereign bonds in our last weekly publications. After several months of underperformance Egypt seems to have turned a corner last week as bonds are up by +1 pt. On the contrary, the MENA IG bonds have remained weak in the belly and long-end as spreads widened by +7 bps.

FIXED INCOME KEY CONVICTIONS

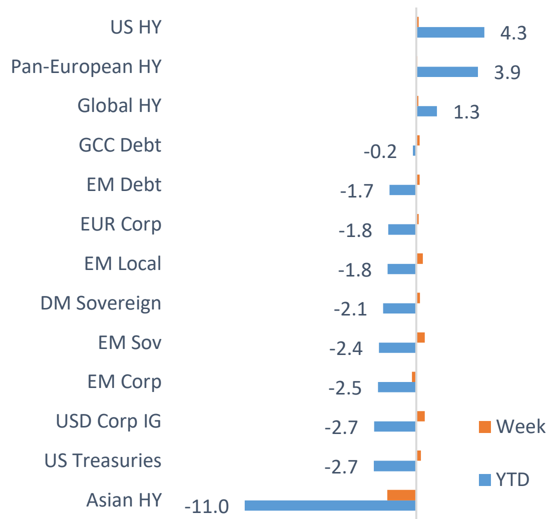
| |
|---|
| **DEVELOPED MARKETS** |
| UW Government bonds |
| Selective on Credit |
| Now NEUTRAL High Yield |
| **EMERGING MARKETS** |
| OW Asia |
| OW IG Sovereigns |
| OW Latin America |

FIXED INCOME VALUATIONS




Source: Bloomberg, indices modified duration and YTW

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




Source: Bloomberg

## Equity Update

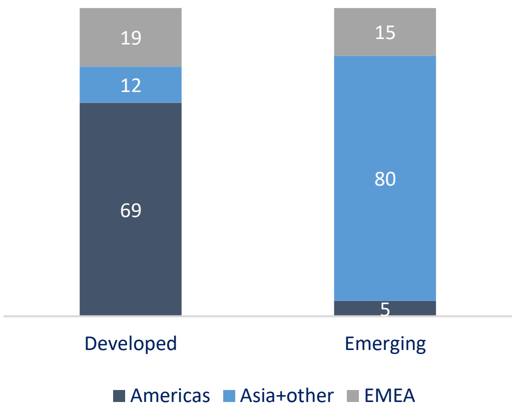
A good week for equities with both Emerging and Developed Market up 2.1% and our overweight positioning has been vindicated, after a September which saw global equities down over 4%. Good performance from U.S. equities last week, the S&P 500 gained 1.8%, and the Nasdaq 2.2%, with upbeat earnings and economic data that eased concerns about a slowdown in growth, amid an elevated inflationary environment. September retail sales activity came in stronger, import prices lower than estimated. European markets gained in line with the U.S. with Energy and Financials notable contributors, the former as oil prices resumed their rally and the latter in line with the spectacular US bank earnings.

EM equities ended the week with gains from the UAE, India and MSCI China with the Hang Seng Index the outperformer at +5% as China authorities provided assurance on real estate credit issues, mitigating immediate investor concerns. However, we remain neutral EM Asia/ China as profitability of many sectors have been affected by the new China regulation oversight. Social media has been one of the key targets with regulators worrying about data on China residents being monopolised by a few corporations. LinkedIn is shutting down its social networking site in China, the last major US social media company to exit after "facing a significantly more challenging operating environment and greater compliance requirements in China"

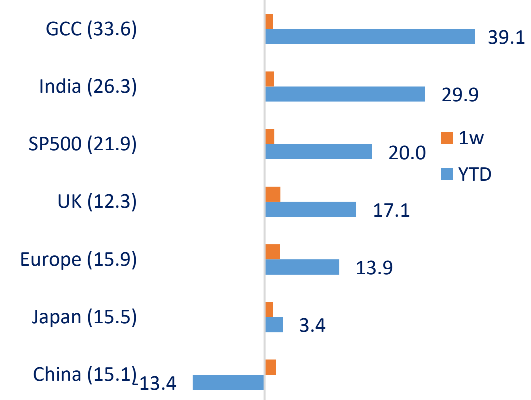
We are currently overweight equities and our stronger preference for DM equities continues with the earning premium provided by the US and Europe in 2021. However, we would watch closely rising commodity prices, supply chain constraints and inflation data. And of course, the path of monetary tightening. The U.S. Dept. of Energy estimates that heating costs for households will be 30% higher this winter, Chinese coal futures had their biggest weekly rise on record, Europe continues to be impacted by rising natural gas prices and in UK fuel shortages continue. Supply chain limitations are increasing with the US facing a shortage of warehouse space and truck drivers, congestion at the LA/ Long Beach port (40% of goods imported into the US), Salesforce estimates logistics, labour and manufacturing problems combined could add $223bn to US retailers' costs this holiday season, Germany is seeing a shortage of chips essential for EV batteries.

Consensus expectations for Q3 earnings growth for the S&P 500 is 28%, the third highest y/y growth since 2010, but guidance remains key, as well as the impact of rising input costs. Bank earnings saw strong growth in investment banking revenues as M&A and IPO activity has been robust, as has trading revenues in the equity markets, with strong, asset inflows continuing, while loan loss reserves were released. The one relatively soft spot remains net interest income as loan growth continues to be outpaced by deposit growth. Whilst Q3 EPS was up over 20% for the main US banks, Goldman's CEO put out a note of caution, pointing to the trajectory of inflation, the Delta variant of Covid-19, the debate around US economic policy and "complicated" US-China relations as risks. For the European Stoxx 600 consensus earnings expectations for the third quarter are 60% y/y growth.

EQUITY RECOMMENDED REGIONAL POSITIONING

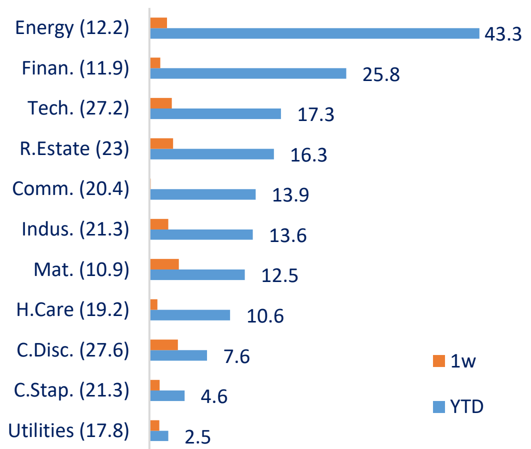



MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE




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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