The third quarter in full details

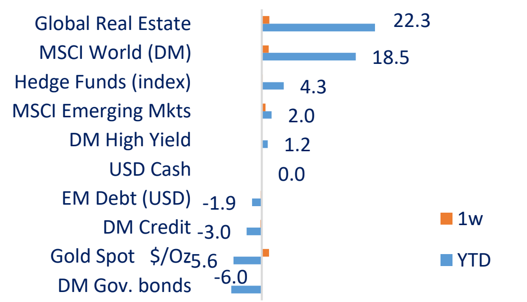
- **Last week was positive on global markets, led by risk assets**
- **The week ahead is all about Q3 GDP and corporate earnings reports**
- **Softness should be confirmed, but green shoots for Q4 could also appear.**

Last week was relatively positive for financial markets, led by risk assets. Stocks were up +1.4% in developed markets and +0.7% in emerging ones, with a welcomed rebound from China after Evergrande paid a coupon on a bond. The early days of the Q3 earnings season were overall good with a large majority of companies beating EPS forecasts. Interest rates were modestly firmer, weighing on the fixed income asset class. The US 10-year yield ended the week at 1.63% after having almost touched the 1.7% mark on Thursday.

With regards to top-down data, last week started with a disappointing Q3 GDP report from China, growing by only +4.9% year-on-year. We will get numbers from major economies in the coming days, which should confirm the softness of the summer, with the Eurozone being the positive exception. Having said that, flash PMI numbers are not bad for October, and we tend to believe that Q4 should be better, opening the door for a more balanced 2022 with continuously improved control over the virus, and hopefully supply chain bottlenecks starting to abate. This view seems to be shared by Jerome Powell who confirmed an imminent tapering of asset purchases and patience on inflation.

The focus next week will however be on the bottom-up drivers. Almost half of US listed companies and one third of European ones will report their Q3 earnings. Both numbers and guidance will matter, especially with regards to supply chains and costs. We are also relatively confident as we believe that the benefits of strong top-down growth should greatly help margins. Our scenario for the end of the year is that growth should come back on a sustainable track, unlocking the modest but still positive upside potential on risk assets. Stay safe.

ASSET CLASSES USD % TOTAL RETURN, YTD 2021 LAST WEEK



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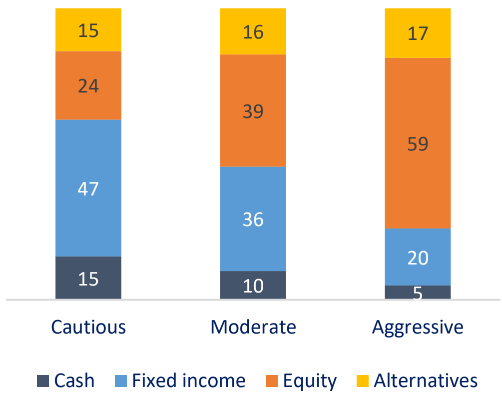
Cross-asset Update

After a long period of denial Fed chair Powell has thrown in the towel and shifted the inflation narrative from 'transitory' to likely to last 'well into next year', admitting 'risks to long and more persistent bottlenecks' during a virtual panel Friday. He sees the need for tapering, yet by no means for higher rates any time soon. Views are split on whether the Fed is already late on that, and hence will need to slam on the breaks harder once reality dawns, or inflation will rather moderate just in time for Powell to stay put after the end of tapering and be able to bide time with the next move. For now markets are starting to discount a policy mistake, as expectations for rate hikes are being pulled forward to the second half of 2022 alongside rising 2-year yields, even as inflation is rampant, market implied inflation is at the highs of the year, and yet the longer-end of the curve is flattening. The shorter-end is telling us that price pressures will run for a while, but the longer-end that the Fed won't tolerate that for much long. The market is not necessarily right and can meantime change its view, which currently ties in with the fact that for the first time in many decades we are confronted with a supply problem, not enough of supply due to bottlenecks on many fronts, not so much a demand problem. And central banks are ill-equipped to tackle supply-related issues, hence they might in the end be reluctantly pushed to do something thinking that things could otherwise get out of hand.

Inflationary issues won't go away any time soon. Most commodity markets are tight and will remain tight into 2022 according to some major studies, with the most likely beneficiaries being copper and oil. The latter feeds straight into inflation expectations, as the correlation between market-implied inflation and crude returns has always been very tight. Oil and base metals inventories are projected to be significantly lower by year-end, and the persistent energy crisis in Europe should continue to drive gas substitution for oil. Green policies seem now to have been clumsily orchestrated, as oil investments are running at net-zero, "while at the same time demand is not following the net-zero trajectory", as remarked by an oil strategist in a major investment bank.

The conclusion is that, apart from more near-term upside for commodities, long dated Treasury yields have still room to rise, cyclical stocks should continue to outperform, and the equity-bond correlation would be staying in positive territory, reducing bond diversification benefits unless price pressures subside. What about gold, if inflation lingers at multi-year highs still for some time? As long as inflation stems from supply-side issues, real rates should fail to rise, and actually could drop further, with market-implied inflation creeping higher faster than nominal rates. Under these conditions gold prices would again find reason to surge. Of course, the Fed should also avoid hiking policy rates in 2022. So, the combination of a policy mistake amidst persistent bottleneck-related inflation would be sending gold through the roof, until the Fed slamming hard on the brakes would have it come back down to earth, maybe crashing.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

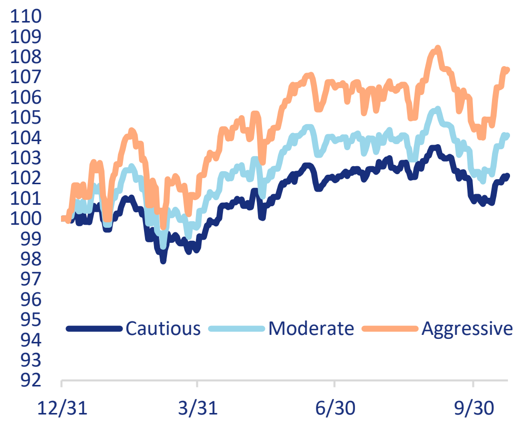


TAA – RELATIVE POSITIONING – MODERATE PROFILE

	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

Last week inflation expectations reached multi-decade highs, and as a result, traders started bringing forward the Fed's rate hike timelines with one rate hike fully priced in by July 2022. As a result, the treasury yield curve flattened with front-end 3-year yields increasing by 7.5 bps. The front-end continued to trade soft as a rate hike premium rebuilt after Fed Chair Jerome Powell said the central bank would raise rates if it sees serious risks of higher inflation expectations. The benchmark US 10-year yields traded between 1.6% - 1.7% bumping against the highs of 2021. An interesting analysis by Bloomberg puts the total losses at $2.7 trillion if yields increase by 50 bps from here to reach 2019 average of 2.14%. It could bring back the memories of significant losses in 1994 to bond market veterans when the Fed doubled the short-term rates between 1994 and 1995. While we don't see the number being reached this year, next year could be another story. Consequently, we continue to be cautious on long-duration assets.

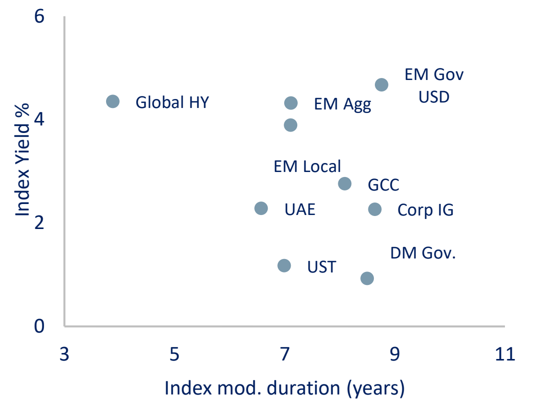
The US Treasuries and Emerging market Corps were the worst performers last week, while China IG and Asia HY ruled the returns table. In a positive development for Asia HY, Evergrande seems to have found "some cash under the sofa" to pay back its dollar bondholders days before the expiry of the 30-day grace period and thereby avoiding a technical default. As a result, high-yield dollar notes from China gained about 4.5% last week after a jump on Friday, putting them on track for the biggest weekly gain since 2012. This has also boosted the funding markets as the Chinese HY issuers rushed into the primary debt market this week to sell nearly $16 billion of new dollar bonds taking advantage of the relatively positive mood among investors. However, this does not signal an all-clear for the asset class. In a significant development, the deal to sell its Property Management arm to Hopson's fell through. Hence, the liquidity stress remains elevated for the company. Moreover, there is a slew of coupon payments and bond maturities due for some weaker entities until the end of November.

GCC markets outperformed the broader Emerging Market last week, driven by a solid performance from HY sovereign bonds' front-end. Both Oman and Egypt continue to trade strongly as the market reprices the country risks on the backdrop of high oil prices and renewed comfort on the credit risks of Asia HY. Turkey bonds remain soft against the backdrop of unconventional monetary policy while inflation is stubborn. The dollar touched a record high against the Lira after the central bank exceeded all dovish expectations with a 200 bps rate cut last week. Similar policy mistakes have always resulted in a weak Lira, which won't be any different this time. Emerging Market investors would be expecting more macro imbalances, constraining the returns of Turkey Sovereigns in the near future.

FIXED INCOME KEY CONVICTIONS

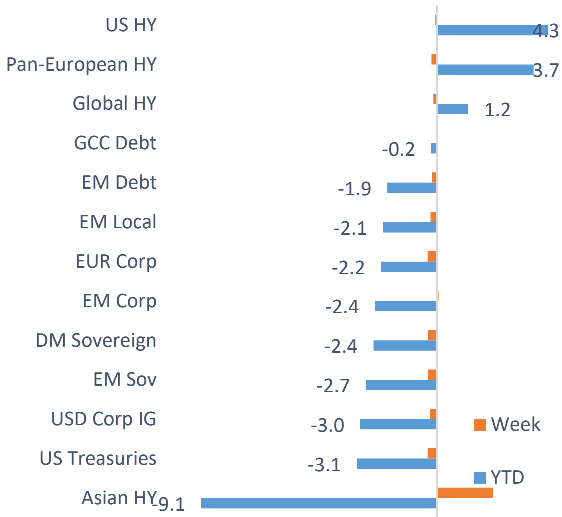
DEVELOPED MARKETS
UW Government bonds
Selective on Credit
Now NEUTRAL High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

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



Source: Bloomberg

Equity Update

Despite inflation concerns dominating market talk, sentiment was boosted by travel restrictions continuing to ease and global stocks had a third weekly advance +1.3%, a broad rally across DM and EM, though slightly better for DM equities. Strong 3Q earning releases from Europe and the US led to their outperformance with S&P 500 October to date gains at 5.5% and the Eurostoxx 600 at 4.4%. Our higher overweight on DM is paying off but post earning season, we need to identify the next catalyst. We see EM as mid to long term growth leaders but remain tactically neutral EM Asia. China shares gained almost 4% last week as Evergrande Group default fears subsided, easing concerns about a near term contagion for property developers. However, property taxes are being tested and could take a further toll on the beleaguered property sector, with stricter credit controls and off plan sales at a standstill. US China relations remain fragile as US intelligence warns companies over links with China businesses in AI, Quantum computing, biotech, semis and autonomous systems, on worries about U.S. data compromise.

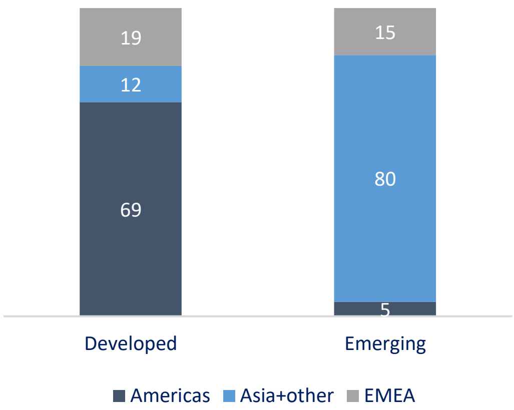
UAE equities retain their leadership with another strong week of returns, with the Dubai Index +2.4% and the Abu Dhabi Index +0.8% last week. New capital raisings are broadening the market. Fertiglobe's IPO is set to price at the top end of the range, raising $830 mn in what will be Abu Dhabi's third-largest listing.

The 10-year U.S. Treasury yield ended the week at 1.63%, and along with Fed Chair Powell's comments on persistently high inflation, though distinguishing between tapering and tightening guidelines, led to tech stocks not having a good end to what was otherwise an upbeat week. Also, not helping was a warning on ad revenue guidance from Snap feeling the brunt of Apple iOS privacy controls. This also affected social media peers Facebook, Alphabet, Pinterest and Twitter.

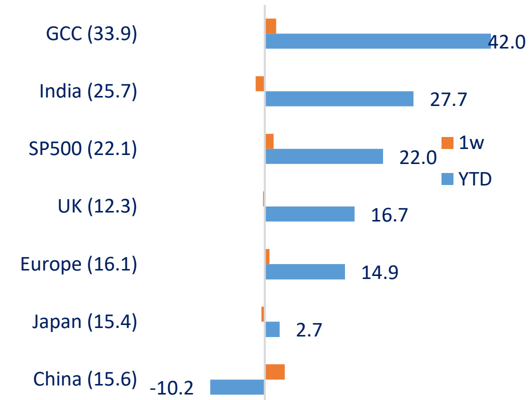
Q3 earnings season has about 23% of S&P 500 companies having reported thus far, with sales growth 15% higher y/y and earnings up 33%. The consensus is for earnings growth of 22% for Q4 and 44% for the full year. Consumer companies Unilever in Europe and P&G in the U.S. beat estimates, but spoke of raising product prices as costs rise. After earnings, we think central bank policy shift is the most important catalyst with longer term effects on margins. Supply chain bottlenecks, surging energy prices and rising labour wages, whilst key concerns for companies and much touted in their guidance, should eventually ease. In Europe the auto makers are seeing a chip shortage affect production in contrast to U.S. based Tesla which had a great quarter and is now the 6th largest company by market cap in the S&P 500. Worries that Q3 S&P 500 EPS would be below Q2 seems unfounded as corporate margins are retained above 12%. Netflix reported a stellar quarter helped by Squid Game and added 4.4 mn subscribers. So far the Q3 reporting has been largely dominated by financials and big tech earning/ guidance is set to direct markets this week.

We remain constructive on further gains from equities, with the higher DM valuations mitigated by strong earnings growth.

EQUITY RECOMMENDED REGIONAL POSITIONING

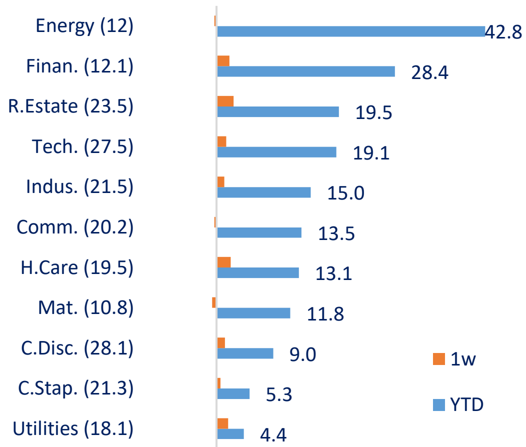


MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE



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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