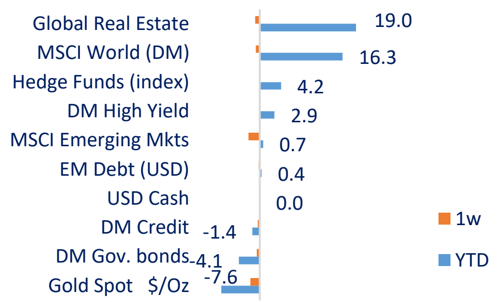
Stagflation concerns chill markets

- **Last week was negative across asset-classes, with decelerating growth and rising inflation prospects**
- **Growth disappointment is explained by the Delta wave, impacting consumption and supply chains.**
- **We believe that the softness is temporary and that inflation should not overshoot**

Last week was all about market participants being scared by what looks like a deadly combination: slower growth meeting a material inflation. No surprise other than that almost all asset classes were in the red, either the defensive, affected by potentially higher interest rates, or the cyclical ones, in a decelerating growth context. Stocks from emerging markets were the worst performer again, as they also had to deal with a relentless regulatory crunch from Chinese authorities.

Let us be clear: we are not surprised by volatility as elevated valuations leave no margin of safety for any concern. However, we do not think that the recovery is derailed and that inflation will rise out of control. To start with growth, manufacturing activities show some resilience, except for the impact of supply chain disruptions from the Delta wave. The virus is the key factor to explain the weakness in consumption. As a result, with more vaccines everywhere, from booster shots in the West to faster rollouts in the East, the virus situation should improve, and it is the key explanation behind the current softness. We believe it to be temporary. When it comes to inflation, of course, absolute numbers are impressive – around 5% year on year in the US for consumer prices. They are however also slightly milder than expected. We tend to think they are temporary, even if it's not obvious how to time it. Should they persist however, this would be an additional reason to favour stocks over bonds: equities are a nominal assets and price increases reflect in nominal earnings. Of course, the importance of inflation for markets is primarily the role it plays in monetary policies. The week ahead will bring indications, with the Fed and almost a dozen of others having their monthly committees. Stay safe.

ASSET CLASSES USD % TOTAL RETURN, YTD 2021 LAST WEEK



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Cross-asset Update

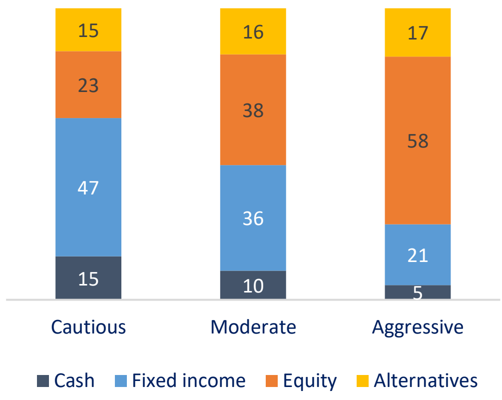
Concerns about the economy going down a stagflationary path, whereby higher inflation would be matched just by muted growth, are multiplying, amidst continued calls of a soft patch in activity and unabated supply-side bottlenecks and labor shortages. Economic growth seems to have now peaked in the developed markets and the slowdown phase in China is showing no signs of improvement, so it is unclear when indicators will start to be looking up again. The latest jobs and CPI reports were below expectations in the US and retail sales in China were indeed way below, and, yet, it could all be a matter of perspective, at least as far as activity anxiety is concerned. The peak in global business confidence occurred in May this year and ever since economic surprises have deteriorated, with the Citigroup Global Economic Surprise Index subsequently slipping into negative territory, and now at levels where in the past actually economic surprises started to climb again. With no recession in the offing, we should rather be looking for signs of improvement in the shorter term. Korean exports, that often lead global growth being South Korea a manufacturing hub, were above expectations for the month of August, as well as business confidence for smaller companies in the US and retail sales. China fiscal policy should turn expansionary and reverse the slowdown phase, with fixed asset investments boosted by more issuance of local government bonds and increased lending for SMEs. In the end, we should not be extrapolating the soft patch indefinitely, as green shoots of robust growth seem to be already visible.

As for inflation, on the other hand the jury is still out, hence the relevance of economic activity holding up. In spite of the Fed's narrative that price pressures will be temporary, some prominent investors, lately Mohammed El Erian and Jeffrey Grundlach, believe on the contrary that they will be lingering for long. For now supply disruptions and labor shortages continue, as indicated by the elevated price pressures in the Empire State survey and the yet unfilled vacancies by 50% of the respondents of the small business confidence survey.

In last week's CPI report the weakest components were linked to reopening categories where disincentives to spending could come from concerns about the delta variant, so it would be questionable to conclude that inflationary pressures are abating. Supply-side constraints, commodity prices recording new multi-year highs and the tapering of asset purchases suggest in turn that Treasury yields will tend to rise this year, pointing to a scenario of robust growth, higher yields and for now persistent inflation.

Where is all of this leaving us in terms of asset allocation? We would expect equities to continue to be supported, with possibly cyclical stocks being rediscovered. We would still be cautious on long-duration assets, in particular high-quality bonds and gold. Gold should be weakening until the tapering announcement has been made, at which point a reassessment would be warranted.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

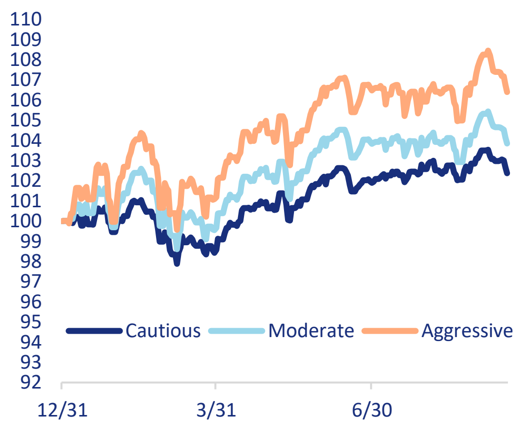


TAA – RELATIVE POSITIONING – MODERATE PROFILE

	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

The upcoming FOMC meeting could be a non-event if the Fed indicated a November start or announcement of taper. However, a faster pace, which is not our base case scenario, would surprise the market and lead to yield increases due to the hawkish tone. Dot Plots should not change much aside from a couple of dots moving up. Looking at the trouble spots in the credit landscape, PBOC seems to have injected 90 Billion liquidity in the system last Friday after 7-day repo rates increased. While a looming Evergrande technical default is priced in, the worst-case scenario of zero recoveries could be avoided if authorities play their cards right. The OAS spread of Asia HY has increased to 926 bps which is the highest since May 2020. If Evergrande liquidation is avoided, then this asset class could give investors the best returns over the next 12 months.

The treasury yields widened towards the end of the week after touching lows on Tuesday. The 10-year treasury yield ended the week at 1.36% after hitting a low of 1.28% mid-week. Global High Yield was the bright spot in the asset class, returning +0.1% last week, while Asia High Yield was the worst performer with a -2.3% weekly return resulting in the YTD return to be around -4.4%.

Flows into global fixed income funds also picked up slightly on the week (+$16bn vs. +$13bn the prior week). Most product categories experienced higher net inflows, except for IG credit funds and EM bond funds, both of which saw moderately lower (but still positive) net inflows. Within EM bonds funds, the mix of demand shifted toward hard currency and away from local currency this week.

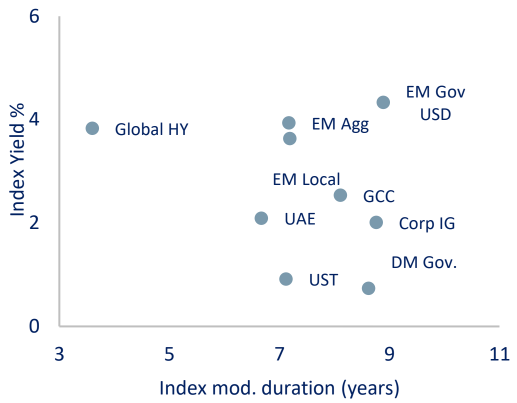
Another bright spot, the 2021 corporate default tally remained at 59 after no defaults since Aug. 13 according to a report from S&P. Globally, at this point in 2020, there were 173 defaults in the year, while in 2018 and 2019, there were 60 and 80 defaults, respectively. So far, the third quarter has seen the fewest number of defaults (12) since the first quarter of 2014. Additionally, credit quality has stabilized as upgrades have outpaced downgrades, propelled by exceptionally favorable financing conditions. Both the U.S. and European default rates have been downward, reflecting the lower projection of speculative-grade corporate default rates.

GCC markets have had a good week with +0.1% returns. Investment-grade spreads tightened in the belly with 7-10 year maturity bonds outperforming. In the High Yield space, Oman and Bahrain performed well with spreads tightening in the 5-10 year maturity ranges. However, in the wider MENA region, Egypt curve steepened with an 11 bps widening in the Egypt 50s. The issuance scene moderated last week with the focus on sizeable upcoming equity IPOs. Nevertheless, YTD MENA issuance still stands at a respectable $78 Bn

FIXED INCOME KEY CONVICTIONS

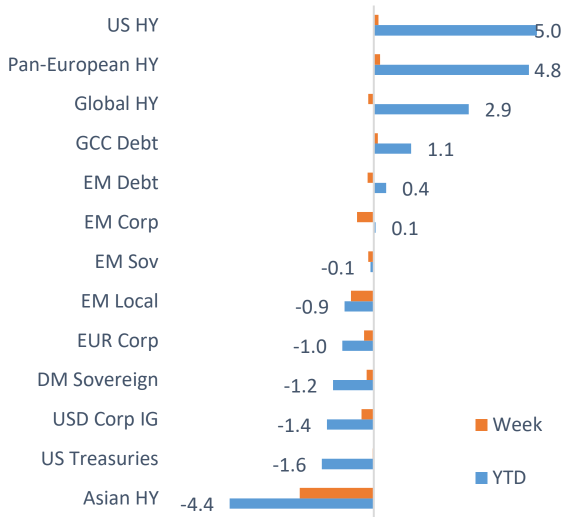
DEVELOPED MARKETS
UW Government bonds
Selective on Credit
Now NEUTRAL High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

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



Source: Bloomberg

Equity Update

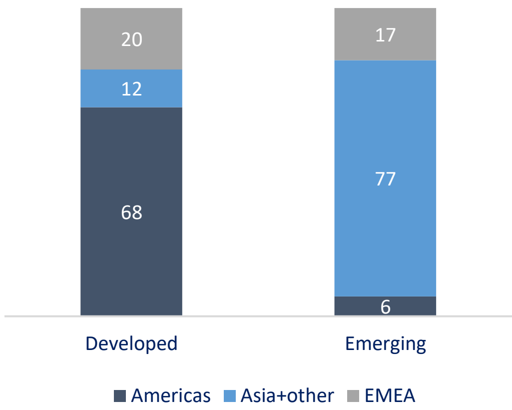
Global stock markets remained choppy for the week with global equities down a percent, and September living up to its volatile history. The major developed markets remain close to record highs, though only Japan added to its previous week's gain. Uncertainties persist regarding the Delta variant impact, fiscal and monetary policy paths, supply-chain disruptions and continuing China regulatory crackdowns. Treasury yields were higher, whilst inflation worries subsided marginally. The only sector with a positive close last week was energy, in line with higher oil prices, bolstered by a larger-than-expected drawdown in oil inventories, and the defensive Healthcare sector was the next best performer at -0.4%, followed by Financials. Materials lost -3.8% as metal prices fell, though from a very strong year to date commodity rebound.

We expect developed markets, trading at around our year-end fair values, to trade sideways. For the U.S., potential corporate tax hikes to fund the hefty government spending plans and a potential government shutdown are negatives for sentiment. September consumer sentiment improved from the prior month but at a pace that was below forecasts. Upside risks exist if Q3 earnings and guidance beat expectations. U.S. equities saw inflows of $45bn last week as per EPFR data, with the largest inflows into large cap and tech. We are currently overweight equities with a bias towards developed markets. We expect very strong EPS growth in 2021and hurdle rates for Q3 and Q4 are relatively low. In absolute terms, P/E multiples are high, but not equity yields vs bond yields, and the stage of the cycle is supportive of valuations.

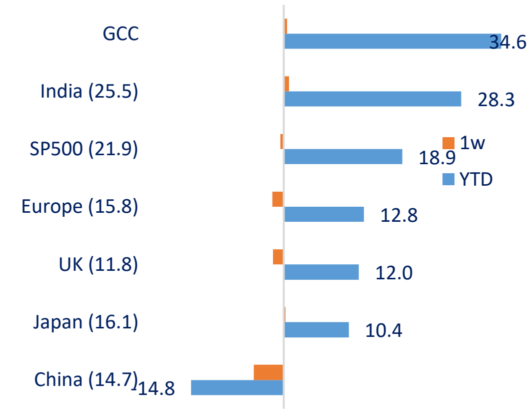
Emerging markets saw the MSCI China lose 5% last week, the positive performance of India as the country rebounds quickly on the economic front and the UAE is onto a good September so far. China's intensified crackdown on sectors seen as detrimental to social welfare remains a drag, with the latest focus on the casino industry in Macau. Also, debt problems at real estate company China Evergrande exacerbated the pressure on stocks in the region, notably Hong Kong. We remain neutral with a preference for China domestic listings, companies focused on ESG and electric vehicles. Our overweight for the UAE continues, as the new listings provide high-quality, government-supported entities with strong balance sheets, with ADNOC possibly listing their fertilizer venture, following the ADNOC Drilling IPO. The KSA is seeing a number of capital offerings well received and the latest in the renewable power sector supports the KSA goal of net zero emissions by 2050.

Apple's product launch event was well received, in spite of delays on a new watch, possibly with BP reading features. IDC expects smartphone shipments to grow by more than 7% this year and 3% next year, with faster connection speeds offered by 5G attractive. Only 5% of smart phone owners have 5G phones. Last week marked the first ever delivery by drone of MMR and influenza vaccines in India. The elaborate drone delivery network for COVID-19 vaccines transportation will improve access to vital healthcare supplies in remote communities.

EQUITY RECOMMENDED REGIONAL POSITIONING

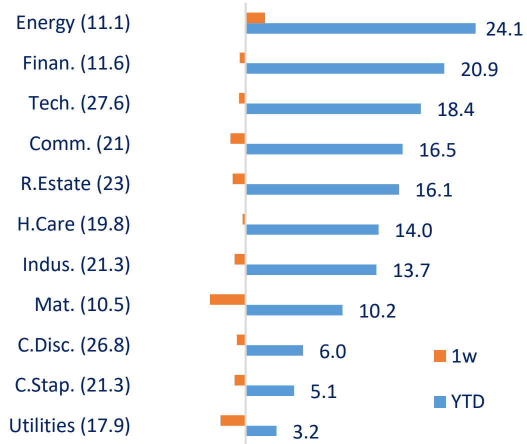


MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE



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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