12 May 2021

INFLATION AT ITS HIGHEST SINCE 2008 MAY WELL CAUSE A SHOCK TO EQUITY MARKETS

Equity markets are threatened by rising interest rates following the historic rebound in inflation. Trend change in the "Growth" vs "Value" match. Complicated outlook for US equities. European equities are already approaching their 2021 targets.

Key Points

- **Rising US inflation and long rates threaten equity markets**
- **Trend change in the "Growth" vs "Value" match**
- **Complicated outlook for US equities**
- **European equities are already approaching their 2021 targets**

Rising US inflation and long rates threaten equity markets

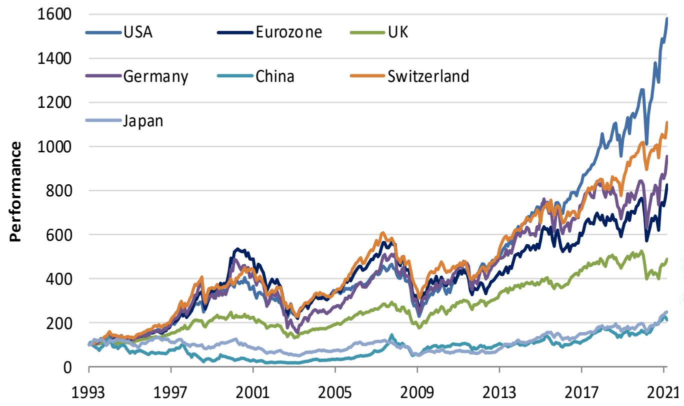
The acceleration of global economic growth is clearly a favourable factor for the evolution of the outlook for corporate sales and revenue growth. However, the rise in long-term interest rates, which could intensify and become more widespread following the release of the latest US inflation figure for April of +4.2%, the highest since 2008, could pose a valuation problem for equities. The investment climate has so far remained optimistic due to the better economic outlook and was only slightly influenced by high valuation issues. In this rather constructive and positive stock market environment many risky assets were already quite generously valued and were often already trading at high valuation multiples that could trigger value corrections. Indeed, a rational analysis of valuations already suggests risks of overvaluation of assets that benefited from a euphoric stock market climate at the end of the year. The acceleration of inflation well above economists' expectations could cause long rates to rise above 2% again and call this optimism into question. The economic situation should nevertheless remain favourable for listed companies and other cyclical assets in particular. However, given the current level of valuation, we believe that caution is once again warranted in anticipation of better short-term reinvestment opportunities. Over the year as a whole, economic conditions and the flow of funds probably increasingly directed towards remunerative assets should contribute to a positive performance of "risky" assets.

Trend change in the "Growth" versus "Value" match

For the past three months, technology stocks and, more broadly, the growth stocks and sectors previously favoured by the fall in interest rates have not benefited as much from the influx of investor funds.

The upward trend is losing steam, with the Nasdaq index already having slipped nearly 10% after retesting its previous peak in April. The doubling of US ten-year rates from 0.9% in December 2020 to nearly 1.8% at the end of the year had caused a slight decline before returning to this level after the publication of US inflation figures for April, which effectively weighed on these stocks, whose valuations are often extremely high. During the same period, the Dow Jones index followed a similar trend and was also influenced by rising interest rates, although to a lesser extent. A pause in the rise in interest rates has given some support to growth stocks, but the expected further rise in 10-year dollar rates above 2% could instead trigger more profit-taking affecting growth stocks and Nasdaq stocks in particular.

Marchés actions long terme (base 100)



Actions chinoises A et B (base 100)

The first round of 2021 seems for the moment to finally favour substance values after a long period of underperformance. The second quarter should be a little more mixed, at least initially. Growth stocks, which are most often at the heart of the development of economies and new modes of consumption or production, will continue to be the main drivers of value creation and profits and will remain sought after by a whole generation of investors.

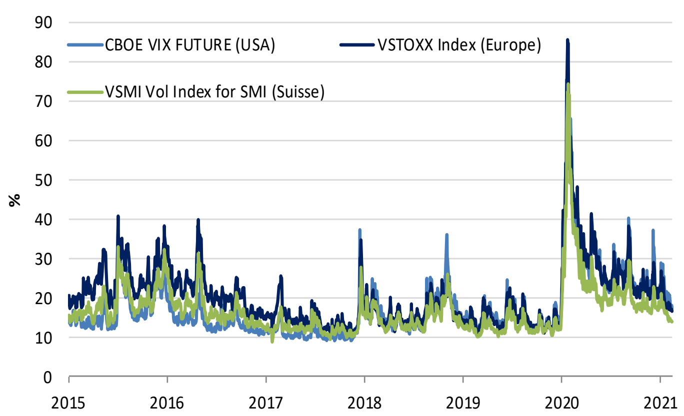
In the short term, substance stocks can still outperform growth stocks by benefiting from an accelerating economic outlook, more reasonable valuations and greater resilience to the risks of rising interest rates. A continuation of the current outperformance seems to us more difficult to sustain in the long term, if it causes valuations of substantive stocks to rise at the same time. A limited rise in long-term rates should not have a major impact on growth stocks, but a real change in trend will certainly require higher tensions, which we do not believe will occur immediately. Overall, the second round of the game could still be won by value stocks in the second quarter.

Complicated short-term outlook for US equities

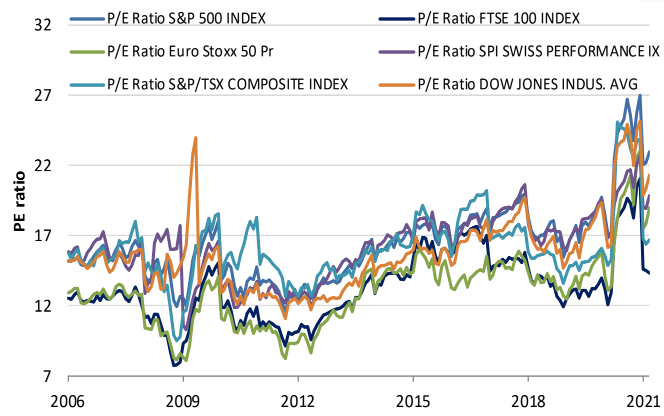
Equity markets are benefiting from the abundance of liquidity despite high valuations. The US market has continued to rise without worrying about rising interest rates and high valuations until now. The sector rotation that we had been predicting, which now favours substance stocks at the expense of growth stocks, had been taking place for several months, but optimism remained fairly high. The price corrections in the technology sectors, in certain digital stocks and above all on the stocks of companies that are still far from presenting convincing profitability sequences, did materialise, but they have not yet largely affected investor sentiment. The current more favourable stock market climate for substance and cyclical stocks is now benefiting the financial, energy, materials and industrial sectors, which have outperformed since the beginning of the year.

Recent developments on the inflation and long term interest rate front may well pose a significant new risk to future equity market performance. Price growth expectations for S&P500 stocks by December 2021 have almost been reached, leaving little room for further price gains, unless we can count on significant revisions to corporate earnings for the year as a whole. The year 2021 looks positive for most companies, but at 23x earnings for 2021, we must now already look ahead to 2022 to expect further gains. We again recommend a temporarily more cautious exposure.

Indicateurs de volatilité (USA, Europe, Suisse)



PE des marchés développés



European equities are already approaching their year-end price increase targets

The European market, which has little exposure to growth stocks compared to the US market, seems better placed to take advantage of the change in investor perception from technology stocks to cyclical stocks. The current stock market climate, which is more favourable to substance and cyclical stocks, is indeed benefiting the European indices. However, price growth expectations for the Stoxx 600 and Stoxx 50 stocks in 2021 have already been almost reached, leaving little room for further price gains, unless we can count on significant revisions to corporate earnings for the year as a whole. The year 2021 looks positive for most European companies and valuations of 18x earnings still offer a significant discount for them compared to the 23x 2021 earnings valuations expected for S&P500 companies. However, we again recommend a slightly more cautious temporary exposure to European equities before we can expect a real recovery in activity and earnings growth in 2021.

Recent price correction encourages new investment in Chinese equities

The profits of Chinese industrial companies largely surprised observers by rising in January and February by +179% year-on-year. This increase reflects the jump in industrial production growth of +35.1% over the same period. It goes without saying that the base effect due to the -38.8% drop in profits during the pandemic in 2020 contributed to this performance.

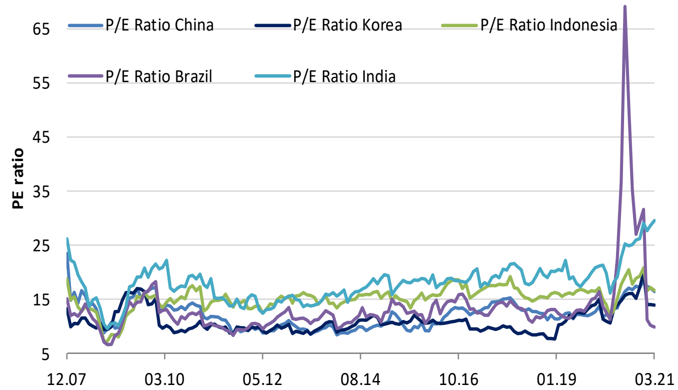
Rising commodity prices also had a positive impact on mining companies' earnings (+83%), but manufacturing companies saw their profits grow even faster (+219.5%). Chinese stocks have recently suffered from the return of political and trade tensions between China and the US on the front of the new technology war. But Chinese stocks have also been affected by the increased risks posed by rising US long rates, affecting the high valuations of Chinese digital and technology companies as well. Investors' concerns have turned to high multiples and caused significant price adjustments. The recent correction in the Chinese market could thus be an initial reaction to the growing risks of rising interest rates and tighter monetary policies. Especially since China is ahead of the global business cycle and fears of an end to accommodative monetary policy may logically seem higher in China now. However, at current levels, we believe Chinese stocks offer attractive prospects by international comparison. The Chinese market has also become more liquid and is attracting an increasing number of investors because of its high growth prospects, reasonable valuations and decorrelation with developed markets.

Japanese equities will benefit from the earnings revision cycle

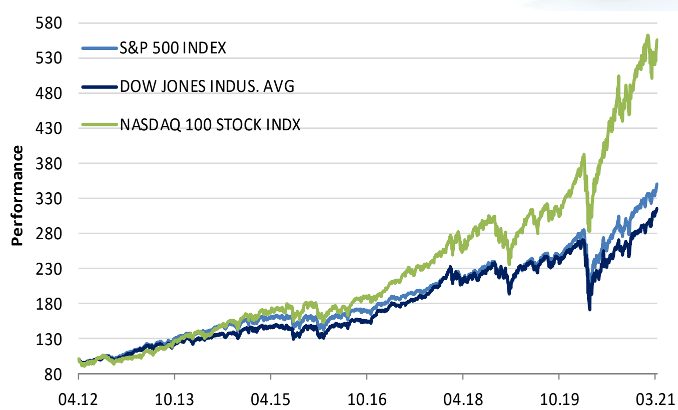
Japan's GDP growth is already particularly export-led, and an acceleration in 2021 should largely favour exporters, who will benefit from the global cyclical recovery driven by Asia and, more broadly, by the convergence of regional economic cycles. Japanese corporate profits in cyclical sectors should rebound strongly and benefit from this convergence as well as from a return of demand for capital goods in particular. The Nikkei index exceeded 28,000 points for the first time since 1991, a rise that certainly did not benefit foreign investors, who have been largely absent from the market in recent months.

However, the upward earnings revision process could reach +30% and develop positive effects in the coming months on the international demand for Japanese stocks. Despite these favourable future developments for 2021, in the short term, we believe that a loss of momentum seems likely due to the already high valuation of Japanese stocks, which is about 20% higher than European equities by comparison, and recommend a reduced relative allocation.

PE des marchés émergents



Marchés actions US (base 100)

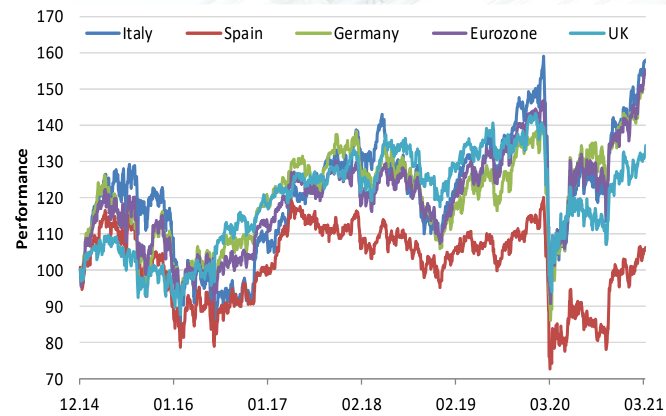


UK equities enjoy a 20% risk premium

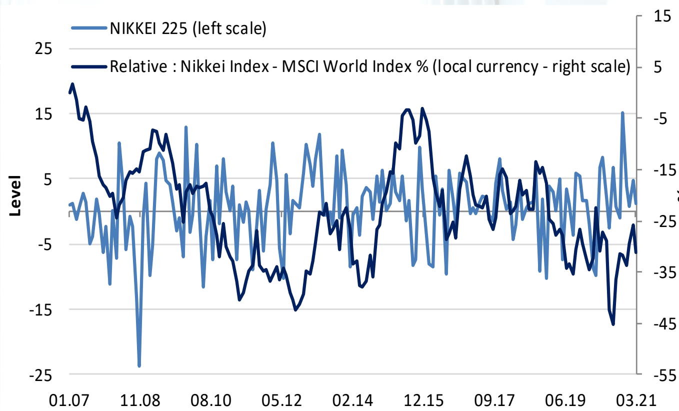
The UK equity market is still not benefiting from a new positive momentum and lags most other European markets in 2021 as well as over the whole of 2020.

The FTSE 100 index is growing at a much lower rate than European equities in euro terms. UK stocks are still suffering from Brexit-related uncertainty. The FTSE 100 index is still trading at just over 14x expected earnings for 2021 and thus benefits from a favourable risk premium of around 20% compared to the Eurostoxx 50 (18x). This valuation gap should be favourable, but the composition of the British stock market is certainly still a brake on the adjustment of prices and valuations of British stocks.

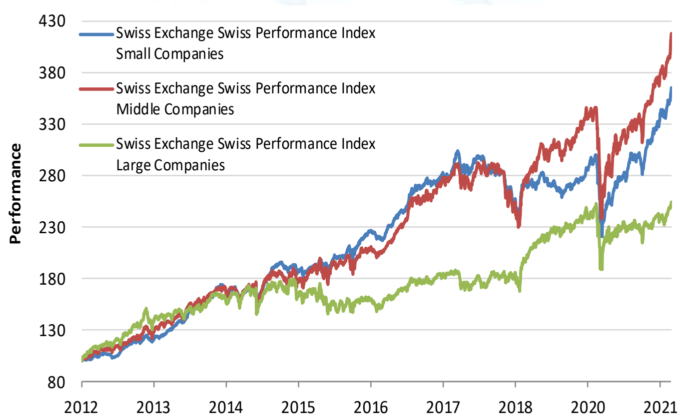
Marchés actions (base 100)



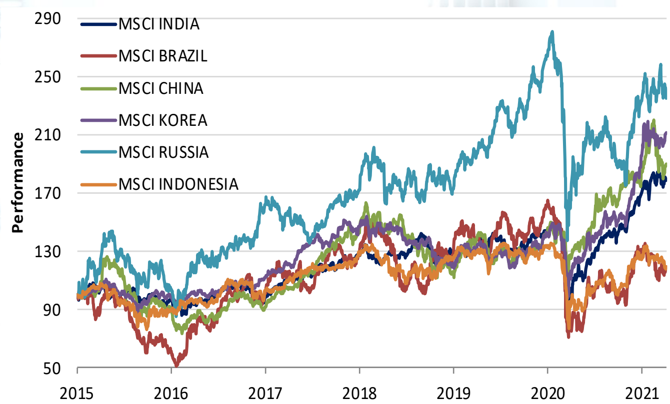
Marchés actions Japon VS MSCI Monde



Actions Suisses (large - middle - small caps/base 100)



Marchés actions émergentes (base 100)



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