BearBull
Global Investments Group

Investment Strategy

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Graph sources: Bloomberg/BearBull Global Investments

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The third quarter ended with virtually all asset classes in almost all regions falling in September. In bond markets, Swiss (-1.29%) and international bonds (-1.78%) ended the quarter with still limited declines of -0.44% and -0.88%, respectively. In equity markets, the fall in September was clear in Switzerland (-5.66%) and significant internationally (-4.15%). Over three months, the correction in Switzerland (-1.97%) was more significant, while international equities resisted and remained stable (-0.01%). In Switzerland, less volatile securitised real estate (-0.28%) ended the quarter on a similar note (-0.27%). Abroad, real estate investments lost about -5.59% over the month and ended down -1.61% for the quarter. Even private equity slipped by -3.2% despite a net increase of +6.81% over the quarter. Finally, alternative funds limited their decline to -0.38% and -0.14%. Only commodities made a positive contribution to the performance of diversified portfolios in September (+6.03%) and over the last three months (+5.22%) thanks to the performance of the energy segment, which rose by around +10%. The Federal Reserve's announcement of a forthcoming change in monetary policy finally triggered a change in investors' perception of risk, the consequences of which are already beginning to be felt in most financial asset classes. Although a gradual reduction in liquidity injections by the US central bank was a very likely possibility before the end of the year for many rational observers, the Fed's announcement acted as a real wake-up call for others. While not really having any major consequences for the time being, it will bring about significant changes in risk perceptions. Thus, factors such as the abundance of central bank liquidity injections or the fear of not participating in the uptrend (FOMO), which were often mentioned as driving upwards momentum in the previous months, could soon become less important. The third quarter could therefore be a period of transition in financial markets between a period marked by a certain euphoria and a period that now looks perhaps more rational.

The Fed's monetary policy could well become more restrictive from November onwards, with a gradual reduction in liquidity injections and bond purchases, before drying up completely in 2022. In the UK, the BoE is already considering a first rate hike in February 2022, while the ECB has announced that it will also reduce its liquidity injections under its PEPP programme, which would then end in March 2022. Central banks are therefore gradually announcing the end of their massive interest rate support programmes just as the risks posed by the Delta variant are diminishing and doubts are being raised about the temporary nature of inflation. With countries' GDPs returning to near pre-pandemic levels in 2021 already, there is no longer a need for exceptional cyclical support. As regards the impact of the Delta variant on growth in developed countries, Q3 saw the emergence of concerns and then their gradual disappearance. It now appears that economic growth is likely to remain solid at the end of September and decrease slightly at the end of the year. The Delta variant does not really seem to be a threat, as vaccination of the population has reached almost 70% in many developed countries. GDP growth in the US (+6.5%), Europe (+5%), the UK (+6.9%) and Japan (+2.4%), for example, is likely to quickly bring US and European GDP back above pre-pandemic levels. The coming quarter will certainly still be influenced by the uncertainty surrounding the rise in inflation and the question of its duration in particular. While central banks are not yet changing their rhetoric, we still think it likely that inflation will be much less temporary than central banks would like. Continued logistical and supply difficulties in global production chains are having lasting effects on production, import and sales prices. The difficulties encountered by the majority of companies in terms of recruitment are also having repercussions on wages and costs.

Finally, the rise in energy prices, and in particular gas prices, will also have an impact on inflation in the coming months. The factors supporting higher prices do not seem to us to be so transitory, and their effects on bond markets may still be significant in the future. While most central banks will still hold back on raising policy rates for a while, we believe that long-term rates will not withstand a rapid normalisation of yields in bond markets. Renewed growth and historically high inflation must now be taken into account when determining nominal interest rates. A general rise in yield curves is increasingly likely in this context. Prior to the pandemic, 10-year US Treasury yields stood at 2% in December 2019 for an inflation level of +2.2% and GDP growth of around +2% as well. They are still at 1.5% today, while inflation is above +5% and GDP growth is expected to be +6.5% for the last quarter. However, investors do not yet seem ready to consider that a significant increase in yields would be justified in the current environment, especially if central banks discontinue their asset purchase programmes, which are at the root of the current interest rate distortion. For risky assets and equity markets in particular, a normalisation of financing costs could start to pose a valuation problem, especially if margins were to be impacted by rising production costs. Therefore, the risks of corporate earnings revisions should not be overlooked in an environment of possible PE contraction.

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Graph sources: Bloomberg/BearBull Global Investments

BIG PICTURE

Main convictions

- Logistical problems threaten growth and price stability
- Central banks realise that the inflation shock is not so transitory
- Monetary policy shifts and global liquidity squeeze
- How will interest rates likely adjust?
- What new paradigm for risky assets?

Logistical problems threaten growth and price stability

Most countries are now facing new logistical challenges posed by the global health crisis. The international economic recovery led by China, the United States and Europe in 2021 represents the strongest convergence of economic cycles in a long time. The simultaneous emergence of these economies from the health crisis is therefore logically causing imbalances due to extremely rapid adjustments in demand to which supply is unable to adjust. Both the manufacturing and service sectors are struggling to secure the raw materials and labour they need. There are many examples of bottlenecks in most sectors. These tensions have already had an impact on import, producer and consumer prices. For the time being, supply has been able to partially adjust to demand by drawing on inventories without affecting GDP growth. This leeway has disappeared, which constitutes a new risk for the year-end outlook. We believe that growth in the last quarter will not yet be too affected by this risk, but this threat should not be ignored.

Central banks realise that the inflation shock is not so transitory

Through 2021, central bankers have held fast to their analysis that inflation was only a transitory price shock induced by commodity price volatility, but they are now beginning to question this. They will also likely have to revise their position on the issue of labour costs and wage increases given that unemployment rates are still far from the low points that prevailed before the health crisis. In the US, the Federal Reserve certainly considered until recently that the unemployment rate, which dropped to 5.2% in August, was still too high (3.5% in February 2020) to already risk creating tensions in the labour market in 2021. This assessment of inflationary risks is probably changing marginally, as central banks are only just admitting their surprise at the start of Q4. However, recent policy announcements by several central banks suggest that they are taking this possibility into account in their assessment of risks after having long underestimated them. Continued price pressures at the end of the year and early in 2022 are likely to further reinforce this shift in central banks' stance.

Monetary policy shifts and global liquidity squeeze

Q4 began with a perceptible paradigm shift in central banks' communication on the economic outlook for 2022 and the appropriateness of their policies as the end of the health crisis is becoming increasingly clear. We are witnessing a certain convergence of rhetoric emphasising the strength of countries' economic conditions and the reduced need for central banks to support the economic recovery process. The first shifts in monetary policies are already perceptible in the US, Europe and the United Kingdom. The US and European central banks very recently announced that they will reduce the amounts devoted to debt purchases in their extraordinary support programmes.

After a phase of exceptional balance sheet growth, they have announced that their liquidity injections will soon be reduced and that their programmes will end in 2022. In the UK, the change in monetary policy will instead involve a rise in key rates as early as February 2022. In China, the shift in monetary policy has already led to a reduction in the PBOC's balance sheet since June. In the coming months, these monetary policy shifts will lead to a reduction in the liquidity provided by central banks. In the US and Europe alone, winding up injections will represent a withdrawal of USD 120 billion per month and EUR 80 billion. Especially at this point in the financial cycle, even a gradual change of this nature is likely to have an impact on financial assets.

How will interest rates likely adjust?

In the spring of 2021, yield curves had benefited greatly from increasing economic uncertainty linked to the emergence of the Delta variant. A general drop of around 30 to 50 basis points could be seen in various bond markets. Central banks' communication on inflation was one of the determining factors in the overall decline in yields. The change in central banks' perception of the outlook for inflation and economic growth is already affecting investor sentiment in bond markets. In just a few days after the announcement on 22 September of the Fed's upcoming tapering, the rise in yields has intensified. In the US, 10-year Treasury yields rebounded from 1.30% to 1.57%, though still below the March level of 1.7%. In the UK, the acceleration took 10-year gilt yields from 0.8% to 1.15% in ten days. Overall, we believe that yield curves are starting to steepen, with varying degrees of intensity across countries. However, the correlation among interest rate markets remains significant, as illustrated by the rise in the 10-year Swiss government yield from -0.4% in August to -0.10% today. Recall that before the health crisis, US GDP growth was +2%, and 10-year US dollar yields were also at 2% with inflation at +2.3%. The comparison with the current situation offers a clear indication that US growth and inflation above +5% suggest a very sharp rise in long rates. We therefore believe that a steepening of the yield curve is essential given the above-mentioned normalisation of monetary policies in the coming quarters.

New paradigm for financial assets

With the shift in monetary policies, global liquidity is likely to first undergo a phase of contraction that will correspond to a stabilisation and then a reduction in the size of central banks' balance sheets. This trend will take place in a context where governments will still have high financing needs in 2022 to fulfil economic stimulus commitments by increasing spending and investment budgets. Future budget deficits will therefore have to be financed by debt, which will continue to grow in 2022. Such an environment will necessarily have an impact on financial markets, which will no longer have the same access to the insurance policy offered by central banks during recent crisis episodes.

Graph sources: Bloomberg/BearBull Global Investments

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