PICTET 1805

HOUSE VIEW

Which investment themes for the rest of 2021?

PICTET WEALTH MANAGEMENT

SEPTEMBER 2021

EXECUTIVE SUMMARY

We have a generally upbeat, but nuanced, view of the rest of the year, with this *House View* looking at the corresponding opportunity set. As long as the covid situation does not deteriorate, we believe that growth should remain healthy. We are aware too that could be some short-term disappointment as momentum subsides. But we believe US consumers will continue to spend as the employment situation improves. We believe, too, that ambitious infrastructure plans could boost growth (although how ambitions translate into reality remains to be seen), kick-starting a new capital investment cycle. However, there are plenty of uncertainties too.

Consumer confidence indicators are sending mixed signals and US job growth cooled considerably in August . Big infrastructure spending plans may well mean higher taxes. And it is still unclear just how 'transitory' inflation will be, even after supply bottlenecks are overcome. Unit labour costs have been coming down, but rising wage pressure will have to be monitored. In China, regulatory zeal continues to cause investor angst and economic indicators have turned down significantly. Globally, new covid variants continue to emerge. True, slowing growth could push the Chinese toward more stimulus. Europe and the US too will benefit from the roll-out of fiscal stimulus. However, with equity indexes having reached record highs, valuations still looking rich, and earnings estimates increasingly been challenged, **we could well see a period of market consolidation in the coming months**.

INVESTMENT THEMES

Pages 6–8

- **The 'Who pays the bill?' investment theme we outlined at the start of this year remains valid**, with differences in the post-pandemic recovery making country (and sector) differentiation especially important. The shape of recovery plans means that we remain committed to our 'Green Marshall Plan' theme, while persistent supply bottlenecks make the 'companies with pricing power' theme even more relevant than before.
- **As restrictions on payouts to shareholders are lifted and earnings rise, 'dividends are back' remains a favourite theme**. And a look at deal volumes means 'The resurgence of M&A' is still on the investment agenda.
- **We still see opportunities in corporate bonds, as per our 'credit trilogy'**, while negative real rates mean we are underweight government bonds in the US and Europe. In a low-yield world, we continue to believe in the virtues of private and real assets.

MACROECONOMY

Pages 9–13

- We believe that advanced economies will prove resilient to lingering covid concerns. However, **we continue to monitor the potential for pandemic developments in Asia to put further pressure on global supply chains**.
- Recognising slowing growth momentum amid supply-chain and labour-market issues, **we have cut our 2021 GDP growth forecast for the US to 6.1% (from 6.5%)**. But we are raising our forecast for 2022 to 3.9%. With all eyes on the German federal election this month, **we have revised up our GDP forecast for the euro area this year to 5.0%** (from 4.3%). We have left our 2022 forecast unchanged at 4.5%.
- A sharper-than-expected deterioration in data and stringent response to new covid outbreaks have led us to **revise down our GDP growth forecast for China this year to 8.7% (from 9.0%). We have also downgraded our forecast for Japan, to 2.1% from a previous forecast of 2.5%.**

CURRENCIES

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- Given that the Fed still looks unlikely to raise rates before 2023 and given our belief that the global economy will prove resilient to covid variants, **we see limited potential for the US dollar in the months ahead and a chance that cyclical currencies rebound from their recent poor showings**. But dollar weakening may be shallower than expected at the start of the year.

EQUITIES

Page 17

- After an exceptionally strong Q2 earnings season, H2 should see earnings start to normalise. But **we still believe the short-term outlook looks good for European financials, particularly banks**. Despite the issues they face, industrials likewise still look attractive, as does Big Tech (including in China).

EQUITY SECTORS

Pages 15–16

- **Despite some slackening, earnings growth in developed markets (DM) should remain healthy in the coming quarters. We expect cash returns to assume greater importance** as earnings normalise, particularly in Europe. As we revise up our year-end price targets for equity indices, we expect valuations to fall relative to historical data and sovereign yields. We remain neutral on DM equities overall, while a peak in earnings momentum has led to a slowdown in sector rotation.
- More subdued upwards earnings revisions and rising concerns about the growth outlook and regulatory crackdowns in China mean emerging-market (EM) equities have been underperforming their DM peers. **While EM earnings trends remain robust, at this stage we continue to favour DM equities**.

FIXED INCOME

Pages 18–19

- With Fed tapering already well telegraphed, **we have decided to reduce our year-end forecast for the 10-year US Treasury yield to 1.6%**. But we think yields could continue to climb gradually in 2022 if inflation proves sticky. We expect TIPS yields to remain negative over the coming months. Our year-end forecast for the 10-year TIPS yield is now -0.8%, compared to our previous forecast of -0.1%.
- While spreads on corporate bonds have continued to contract, we still see opportunities. These can be found by **investing in financials' subordinated debt and corporate hybrids as well as by taking advantage of credit spread movements to add duration tactically**. We also continue to like 'rising stars' (companies on the cusp of being upgraded from high yield to investment grade). But we continue to avoid the lower reaches of the ratings scale.

ASSET CLASS CONVICTIONS

Our asset class convictions remain unchanged from the August issue.

OUR TACTICAL ASSET CLASS CONVICTIONS*

	Strong underweight	Underweight	Neutral	Overweight	Strong overweight	MONTHLY CHANGE**
LIQUIDITY				■		
FIXED INCOME		■				
Global government		■				
US		■				
Core Euro		■				
Periphery Euro		■				
Switzerland		■				
UK		■				
Japan			■			
China				■		
Global IG			■			
USD Investment Grade			■			
EUR Investment Grade		■				
Global High Yield			■			
USD High Yield			■			
EUR High Yield		■				
Emerging Markets			■			
EM Corporates Hard Curr.				■		
EM Sovereign Local Curr.		■				
EQUITIES			■			
Global Developed			■			
USA		■				
Euro Area			■			
Switzerland			■			
UK			■			
Japan				■		
Global Emerging			■			
Asia Emerging			■			
Equity World Small Cap.				■		
ALTERNATIVES				■		
Hedge Funds				■		
Private Equity (PE)				■		
PE Real Estate			■			
REITs			■			
PRECIOUS METALS			■			
Gold			■			
CURRENCIES (vs. USD)						
EUR			■			
CHF			■			
GBP				■		
JPY		■				
EM FX			■			

*At 31 August 2021

Source: Pictet Wealth Management

**Change compared with previous month. One arrow means a one-place move place to the left or the right, two arrows means a move of two places, etc.

Notice: This asset class conviction table is provided for illustrative purposes only. In general, asset allocations will differ among investors according, in particular, to their individual circumstances, risk tolerance, return objectives and time horizon. Therefore, the asset allocation in this publication may not be suitable for all investors and shall not be used as the basis of an investment decision.

ASSET CLASS RETURNS

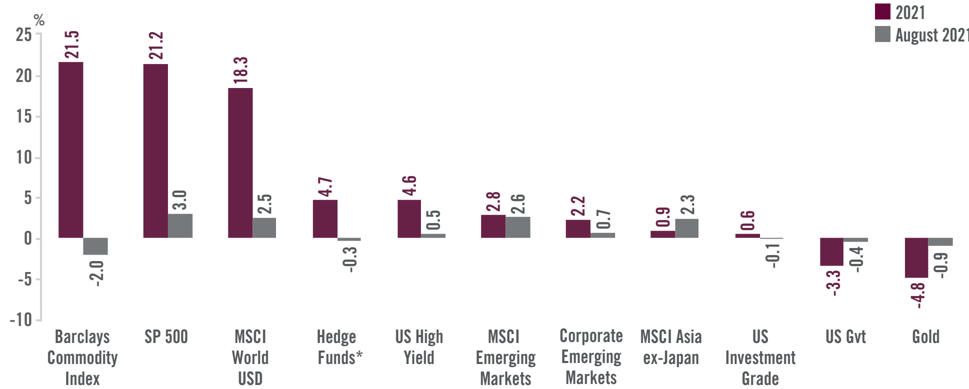
– **Stocks continued to rise in August as vaccination rollouts together with strong corporate and economic data managing to overcome surges in the coronavirus and worries about supply bottlenecks.** US equity indexes notched up record highs, assured by signs that the Federal Reserve is still far from contemplating rate increases (although it will soon start to reduce its monthly asset purchases). European and Japanese indexes were slightly behind in local currency terms, but still recorded positive returns. Emerging-market equities also performed positively in August despite sagging commodity prices, continued US dollar strength as well as slowing growth momentum in China and a stepped-up regulatory drive there.

– Government bond yields drifted up slightly and performance sagged, reflecting some technical demand-supply issues and persistent inflation worries. Notwithstanding a limited sell-off in Europe, the relative stability in government bond yields overall continued to reflect doubts over growth prospects and belief that monetary policy 'normalisation' remains distant. **High-yield bonds provided modest returns as spreads declined further, especially in the US. Investment-grade bonds were off the pace, but emerging-market corporate bonds logged a positive performance**, despite concerns about Chinese credit. Commodity prices declined, while gold failed to capitalise on persistently low US real rates.

ASSET CLASS RETURNS IN USD

(as of 31 August 2021)

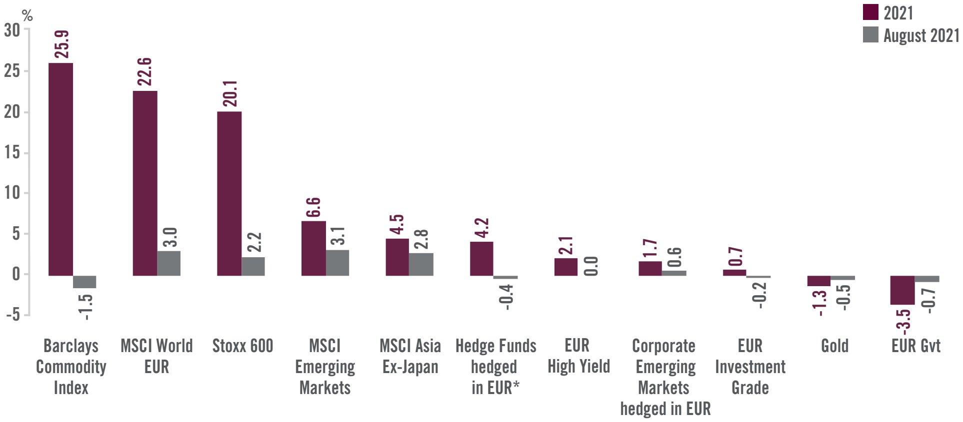
Source: Pictet WM-CIO Office, Refinitiv Datastream, Chronos (Pcube)



ASSET CLASS RETURNS IN EUR

(as of 31 August 2021)

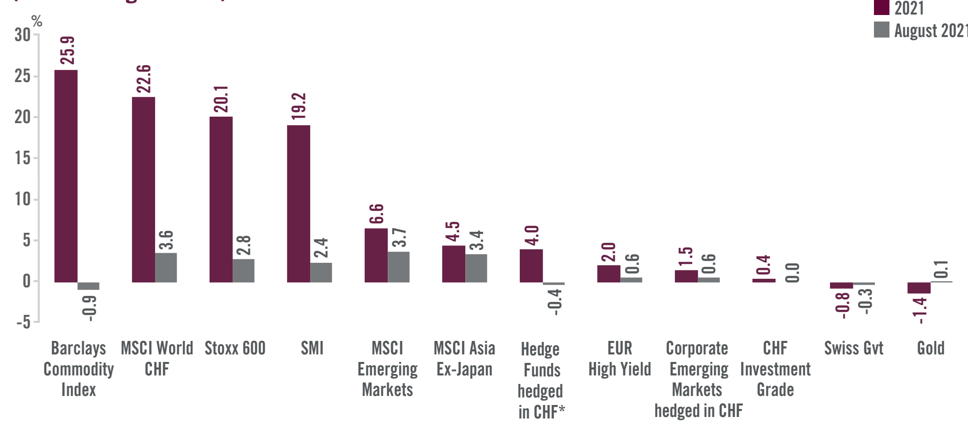
Source: Pictet WM-CIO Office, Refinitiv Datastream, Chronos (Pcube)



ASSET CLASS RETURNS IN CHF

(as of 31 August 2021)

Source: Pictet WM-CIO Office, Refinitiv Datastream, Chronos (Pcube)



Notice: Past performance must not be considered an indicator or guarantee of future performance. See page 20 for past five years' performance. *Hedge Funds: 2021 (to end July) July 2021

EXCHANGE RATE MOVEMENTS

– **Increasing concerns about the global growth outlook, notably because of the rapid spread of the Delta variant, have been helping the safe-haven US dollar** as well as the defensive Japanese yen, which were among the best performing currencies in August.

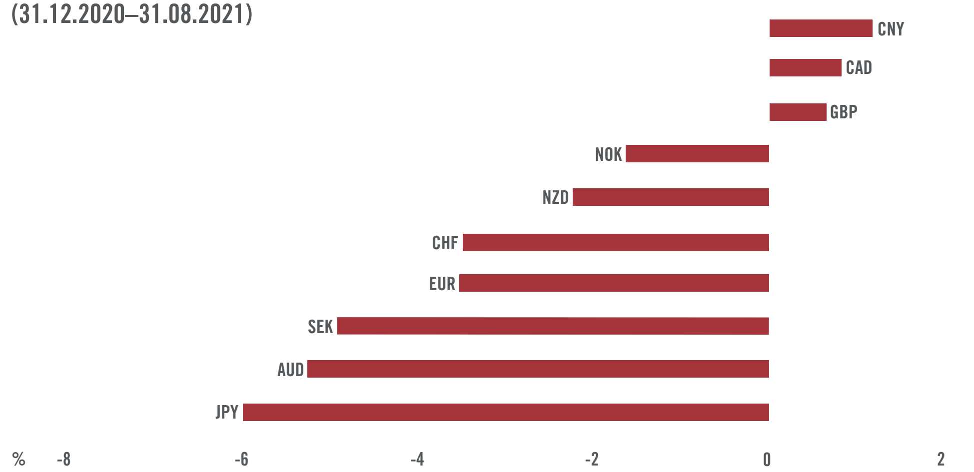
– Interestingly, **the Swiss franc performed relatively poorly**, perhaps because the currency is close to levels where the Swiss National Bank has intervened in the past.

– **Cyclical currencies underperformed during the month**, penalised in particular by the decline in oil prices. But the Norwegian krone and the New Zealand dollar bucked the trend as it looked like their central banks could raise rates at their next policy meetings.

– Despite concerns about China's growth outlook, **the renminbi ended August unchanged against the US dollar**. Balance of payments flows remain a key support for the renminbi.

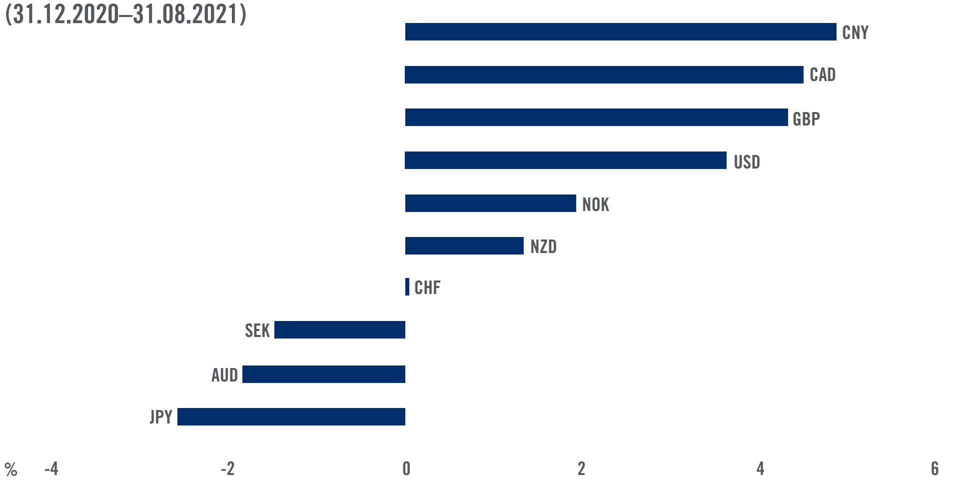
AGAINST USD
(31.12.2020–31.08.2021)

Source: Pictet WM, Refinitiv



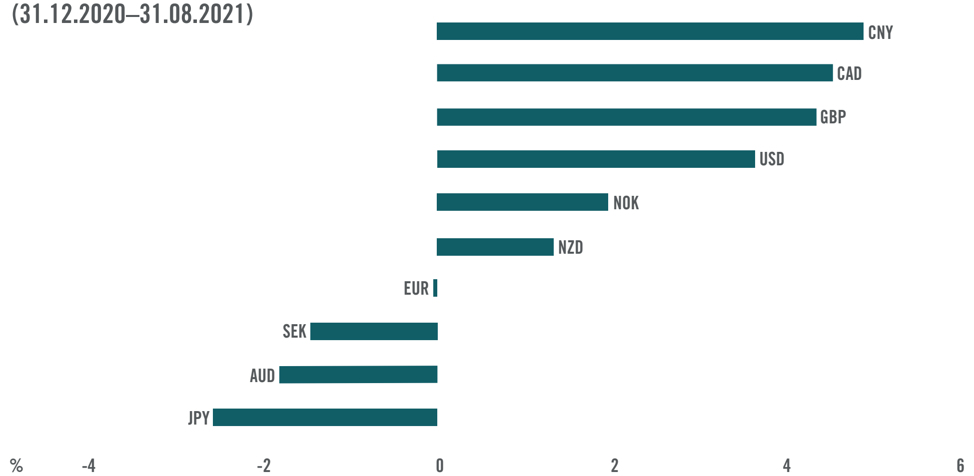
AGAINST EUR
(31.12.2020–31.08.2021)

Source: Pictet WM, Refinitiv



AGAINST CHF
(31.12.2020–31.08.2021)

Source: Pictet WM, Refinitiv



Notice: Past performance must not be considered an indicator or guarantee of future performance. See page 20 for past five years' performance.

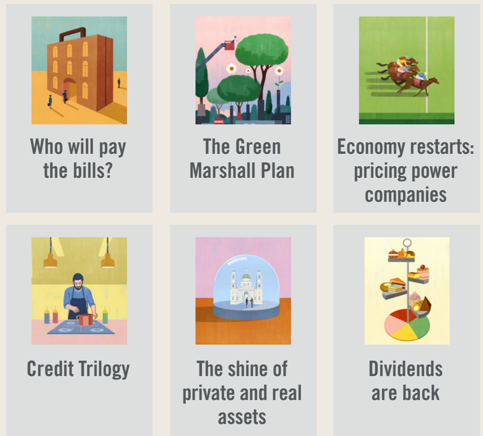
THE THEMES OF PRICING POWER, WHO PAYS THE BILL AND INFRASTRUCTURE REMAIN VALID

– **As we move into the final third of 2021, now seems a good time to revisit some investment themes we outlined at the start of the year** A. In particular, differences in the pace of recovery are appearing, so answering the question **'Who pays the bill?'** is becoming more pressing. As the recovery becomes more self-sustained, governments will gradually remove support measures while big fiscal spending plans could make tax rises necessary, thus affecting return expectations for equities.

– **We continue to press the Green Marshall plan as an investment theme**, as US infrastructure spending plans wind their way forward, EU Next Generation funds begin to flow, and China moves to support flagging growth momentum.

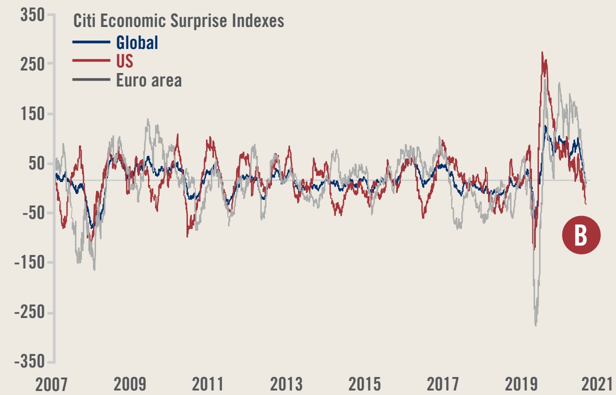
– An exceptionally strong Q2 earnings season has helped keep equities aloft. But **as supply bottlenecks persist, pushing up producer inflation, the pricing power theme we set out at the start of the year remains highly topical**. We remain committed to investing in companies and sectors that have the ability to ride out the current margin pressure.

Themes for the rest of 2021 A



Source: Pictet Wealth Management, 31 August 2021

Forward-looking data are pointing down from high levels, especially in the US



Source: Pictet WM-CIO Office, Bloomberg, 20 August 2021

CONCLUSION

Volatility could pick up as markets turn their attention to slowing growth momentum B and lingering supply bottlenecks. We remain neutral on equities overall, but believe companies exposed to increased green and infrastructure spending and those with pricing power all remain relevant investment themes.

Macro hedge funds remain a good way to play falling correlations between countries' equity markets, as per our 'Who pays the bill?' theme.

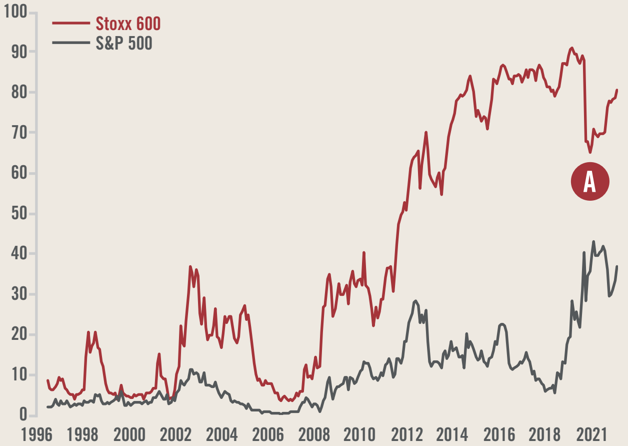
M&A AND DIVIDENDS IN THE SPOTLIGHT

– Having been severely restricted at the height of the pandemic, dividends are back. **Companies likely to pay good and sustainable dividends (A) therefore remain a strong investment theme.** Meanwhile, we continue to believe the expected uptick in market volatility can be played to tactical advantage via options.

– With liquidity plentiful and funding costs low, we also firmly believe that **the resurgence of M&A (B) remains a valid investment theme, with deal volume gathering pace in a growing range of sectors.** We retain our overweight stance on hedge funds overall, and believe that event-driven hedge fund managers in particular are well placed to exploit pricing inefficiencies surrounding corporate events.

– While they can be justified, equity valuations remain elevated. **The increased dispersion in valuations between companies and sectors means effective security selection is paramount.** As 'stock picking' becomes more important, the attraction of investing in US equal-weighted indexes has faded somewhat. Our risk-reward analysis has not turned in favour of emerging markets, with regulatory pushback in China augmenting our caution.

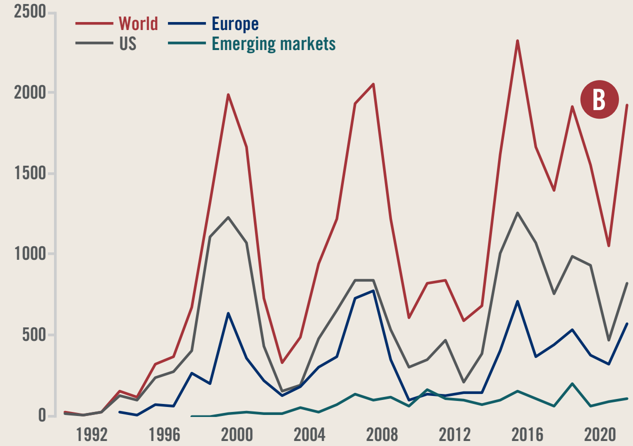
Percentage of companies with dividend yields greater than corporate bond yields



Source: Pictet WM-CIO Office, FactSet, 22 August 2021

M&A volumes are rebounding

Total transaction volumes in USD bn



Source: Pictet WM-AA&MR, FactSet, 10 August 2021

CONCLUSION

With strong companies continuing to benefit from low financing costs to fund acquisitions, we are seeing a wave of consolidation across industries. This, together with divergences in the rate of post-pandemic recovery, underlines the importance of active investing.

THE VIRTUES OF PRIVATE ASSETS AND PERSISTENT OPPORTUNITIES IN CREDIT

- Despite low yields and spreads, **opportunities remain in corporate bonds, in what we call the '<u>credit trilogy</u>'**. This consists in: going down the capital structure to invest in the subordinated debt of financial companies and hybrid securities; moving carefully along the duration curve, taking advantage of movements in the credit spread curve; and 'rising stars' (companies likely to be upgraded from high-yield to investment-grade status).
- In a low-yield world, we continue to believe in the virtues of <u>private and real assets</u>. **Well-positioned REITS and private-equity real estate should benefit from a post-pandemic reset in commercial real estate** A and help protect portfolios against inflationary risks. Along with hedge funds, we continue to have an overweight stance on private equity.
- The big post-pandemic gains in commodities have shown signs of wavering. **The US dollar has been strong of late, but remains overvalued against the euro, in our view**. Our belief that real US rates will rise by year's end (although not as much as before) means we remain tactically cautious on gold.

Where the ESG real estate opportunity lies

A

15 tonnes of CO_2
for the **renovation** of an old building

vs.

50 tonnes of CO_2
for the **construction** of a new building

75% of **European buildings** were built before 1990, hence they offer an opportunity for alpha generation through refurbishment and renovation, which is ecologically sounder than demolishing old properties and building new ones.

Improving existing assets benefits both investors and the planet

Source: The Global alliance for buildings and constructions, BPIE, August 2021

The volume of negative-yielding bonds has been growing again

Source: Pictet WM-CIO Office, Bloomberg, 21 August 2021

CONCLUSION

We remain overweight Chinese government bonds in view of good yield pick-up and expectations of further policy easing by the People's Bank of China. But nominal yields paid on developed-market government bonds remain low and often negative in real terms B. Once inflation is taken into account, yields look even more unattractive, especially in view of persistent inflation worries.

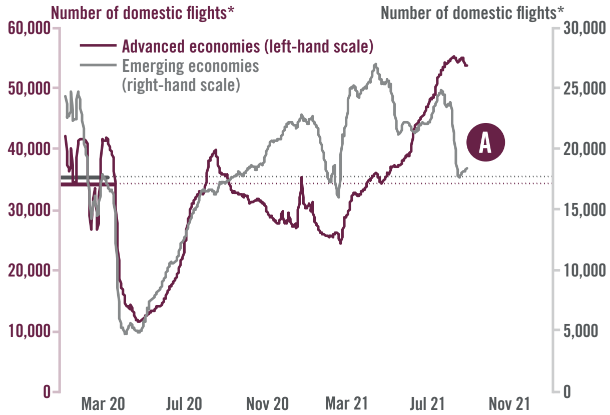
ADVANCED ECONOMIES REMAIN RESILIENT DESPITE DELTA STRAIN

– News on the pandemic front has tended to deteriorate in recent weeks, with a rise in daily new cases in advanced economies and south-east Asia. Nonetheless, some encouraging early signs have been emerging in BRICS countries (Brazil, Russia, India, China and South Africa), while **daily cases have been relatively stable in the euro area and there are indications they may have peaked in parts of south-east Asia**.

– **One notes a certain divergence in responses to the latest pandemic concerns:** while western economies have tended to put even greater emphasis on vaccinations (even promoting a third vaccine dose in some cases), a few dozen new cases (in a population of 1.4 billion!) have caused the authorities to close parts of the Chinese economy.

– High-frequency data show the economic impact of these differences in policy responses. **Mobility (notably driving, footfalls in retail and recreation places, flights A), appears resilient in advanced economies, but less so in emerging Asia, notably in China.**

New wave of pandemic dents domestic flights in emerging markets



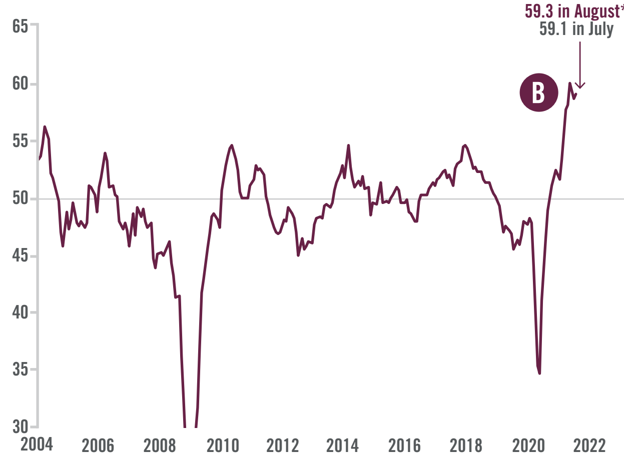
*7-day moving average

Advanced economies: US, Europe, Japan Emerg. economies: China, Emerging Asia, South America

Sources: Pictet WM-AA&MR, Pictet AM-Tech-Insight, 26 August 2021

Backlogs in advanced economies

Components, manufacturing puchasing manager indexes



*based on backlogs of manufacturing PMIs in the US, euro area and Japan

Sources: Pictet WM-AA&MR, IHS Markit, Refinitiv, 27 August 2021

CONCLUSION

At this stage, it looks unlikely that pandemic concerns in emerging Asia will spill over significantly to the rest of the world. The most likely impact is an extension of ongoing supply bottleneck problems and input price pressures as industrial production and transport are impaired. Preliminary purchasing manager index figures for August would seem to bear out this scenario B.

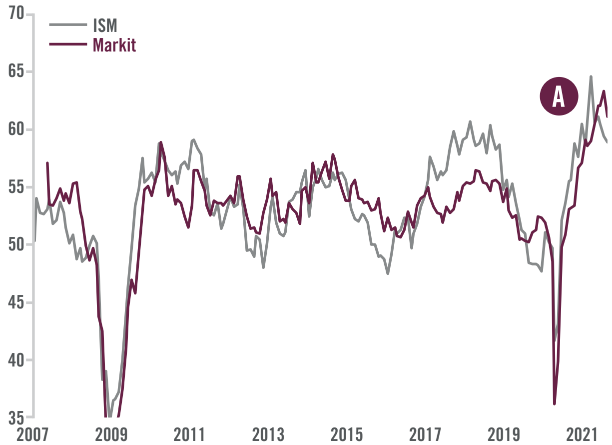
GROWTH NORMALISATION AHEAD, BUT CONSUMERS SHOULD KEEP SPENDING

– **We have decided to cut our 2021 growth forecast for the US to 6.1% from 6.5% but to raise our 2022 forecast to 3.9% from 3.2%.** Large accumulated savings and signs of a revival in credit-card usage mean we expect US consumer spending to keep helping domestic growth in the near term.

– The manufacturing sector (A) remains solid, but is subject to persistent supply-chain bottlenecks. **The recent erosion in business surveys echoes our view that growth will normalise, especially in 2022.**

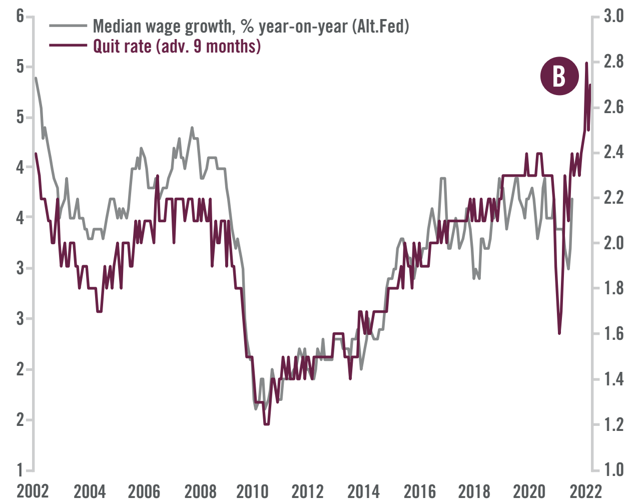
– **We have raised our 2021 core PCE inflation forecast to 2.9% from 2.4% and raised our 2022 forecast to 2.9% from 2.2%** due to lingering supply-chain bottlenecks. Inflation pressures could spill over into services and rents in 2022. Due to a tight labour market, wages have been rising (B). While we do not think they pose a medium-term risk to inflation yet, this would change if annual wage growth reached 5%.

Purchasing manager indexes for US manufacturing are fading but remain strong



Note: ISM figure for August is market consensus
Source: Pictet WM-AA&MR, FactSet, 24 August 2021

US wage growth could remain well supported



Source: Pictet WM-AA&MR, FactSet, 24 August 2021

CONCLUSION

We expect the Fed to officially unveil plans to taper its monthly asset purchases before year's end. We see the first rate hike in June 2023 compared to our previous forecast of December 2023.

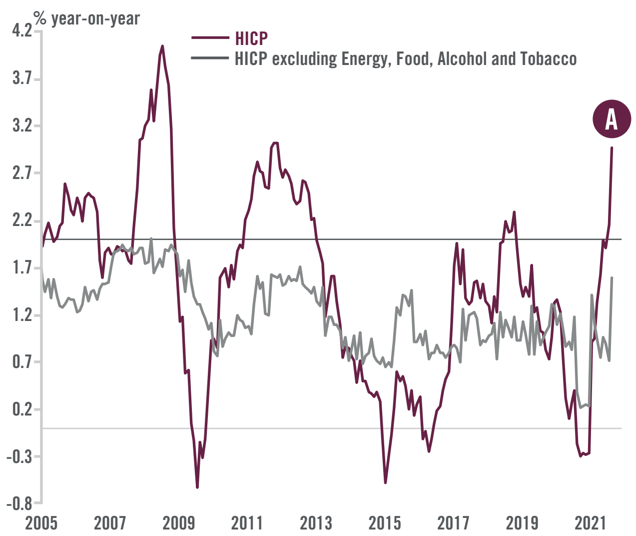
US household consumption should remain robust despite concerns over the Delta variant. While we have cut our 2021 GDP growth forecast to 6.1%, we have raised our forecast for 2022 to 3.9%.

ALL EYES ON THE GERMAN FEDERAL ELECTION

– **The acceleration in core and headline inflation in the euro area in August (A) could only be the beginning.** Euro area HICP inflation is expected to rise strongly over the coming months due to multiple factors, including supply bottlenecks, so that we have revised our 2021 forecast for headline inflation to 2.1% (from 1.7%) and for core inflation to 1.2% (from 1.0%). Risks to these new forecasts are skewed to the upside, mainly because of supply issues.

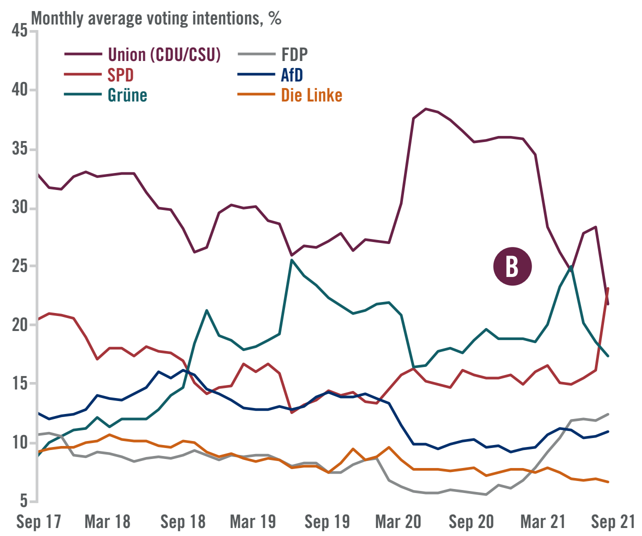
– German federal election on September 26 will be the main political event of H2 2021 in the euro area, with much uncertainty over what comes after Angela Merkel steps down from the chancellorship (B). It could take tortuous coalition negotiations to form a government (with the possibility we see the first three-way coalition in German post-war history). **Will the election mark a shift in German fiscal policy? Our view is that it will become a bit more expansionary, but to what extent depends on the kind of government coalition that prevails.**

Euro area HICP inflation



Source: Pictet WM-AA&MR, Eurostat, 31 August 2021

Voting intentions in German federal election



Source: Pictet WM-AA&MR, various polls, 31 August 2021

CONCLUSION

Euro area GDP growth was better than expected in Q2. As a result, we have revised up our full-year GDP growth forecast for the euro area to 5.0% in 2021 (from 4.3%) but left unchanged our forecast for 2022 at 4.5%.

CYCLICAL HEADWINDS CONTINUE TO GATHER AS BEIJING PURSUES ‘COMMON PROSPERITY’

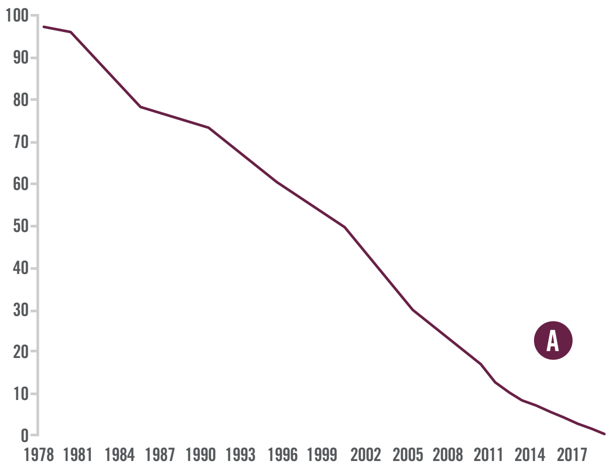
– **Chinese growth momentum has decelerated recently for a variety of reasons**, including a catastrophic flood in central China, an upsurge in covid cases (due to the Delta variant), the impact of government moves to rein in the property sector and local government debt as well as moderating demand for exports.

– While the Chinese government has been quick to bring the latest covid outbreak under control, **the authorities’ restrictive ‘zero covid’ strategy could well continue to constrain household demand, especially demand for services.**

– **We expect the Chinese to step up policy support in the rest of the year**, especially fiscal support. Local government bond issuance will likely pick up speed and the People’s Bank of China may cut banks’ required reserve ratios further.

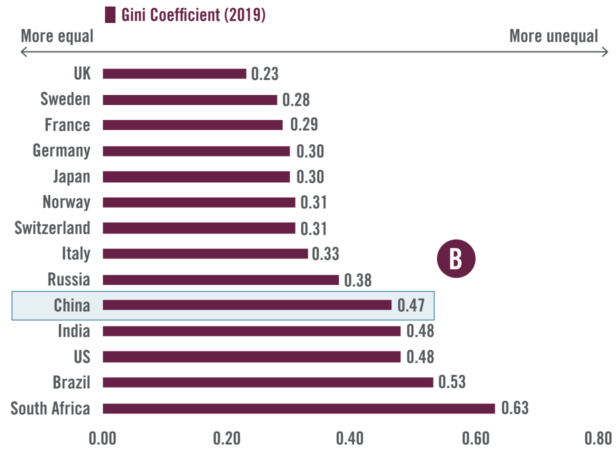
– After eliminating absolute poverty A, **Beijing is setting its sights on ‘common prosperity’**, suggesting that the policy priority is shifting from growth to a balance between growth and social equality B. Some regulations introduced to achieve this goal may pose short-term headwinds for corporates.

Poverty rate in China (% of population)



Source: Pictet WM-AA&MR, The World Bank, Wind, 2019

Gini coefficients of selected countries (2019)



Source: Pictet WM-AA&MR, Wind, 2019

CONCLUSION

We have revised down our 2021 GDP forecast for China to 8.7% from 9.0% given the sharper-than-expected deceleration in activity in July and the drag on household consumption caused by government efforts to contain covid outbreaks. The shift in the Chinese government’s policy priority towards greater social equality could be challenging for the corporate sector in the short term. Our 2021 headline inflation forecast remains unchanged at 1.2%.

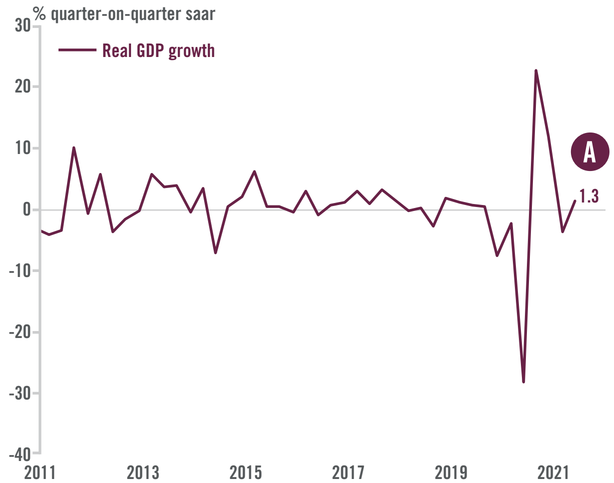
THE DELTA VARIANT WEIGHS ON JAPAN'S ECONOMIC REBOUND

– **Japanese GDP expanded by 1.3% q-o-q annualised in Q2, having contracted in Q1** A**. However, the rebound was by no means strong** and the Japanese economy is still 3.8% smaller than in Q3 2019 in real terms.

– Industrial production maintained its strong momentum in Q2, helped by solid external demand, while household consumption picked up after shrinking in Q1. However, the outlook for **the Japanese economy is hampered by the spread of the Delta variant**, which led the Japanese government to prolong the state of emergency decreed in Tokyo until mid-September.

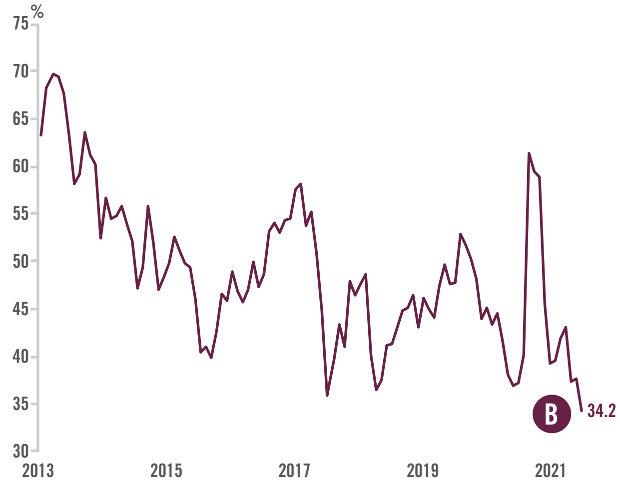
– **At the start of September, prime minister Yoshihide Suga announced he would not seek reelection as head of the governing Liberal Democratic Party (LDP).** Suga had hit the lowest approval ratings for a sitting prime minister ever B, in large part because of his handling of the pandemic. However, the LDP will likely win a majority in the general election for the Lower House of parliament scheduled to take place before end November.

After Q1 contraction, the Japanese economy expanded by 1.3% in Q2



Source: Pictet WM-AA&MR, Cabinet Office Japan, 17 August 2021

Suga's approval rate has plummeted as covid cases have risen



Source: Pictet WM-AA&MR, Real Politics Japan, July 2021

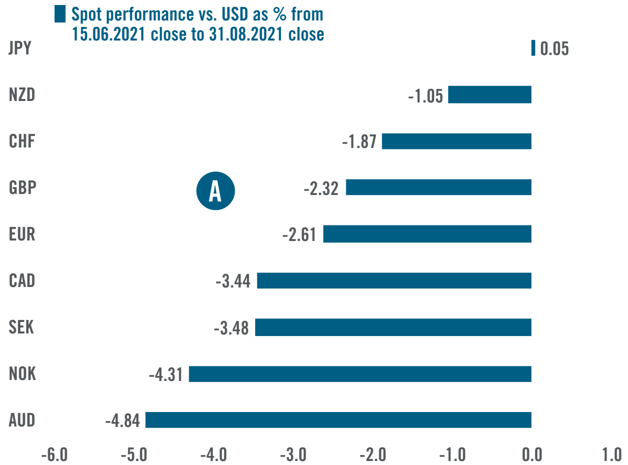
CONCLUSION

Weighed down by a resurgence of covid cases and the extension of states of emergency in some major cities, Japan's economic rebound in Q2 was not impressive. We have thus decided to downgrade our GDP growth forecast for Japan in 2021 to 2.2% from a previous forecast of 2.5%. Our core inflation forecast for Japan remains at 0.4% in 2021.

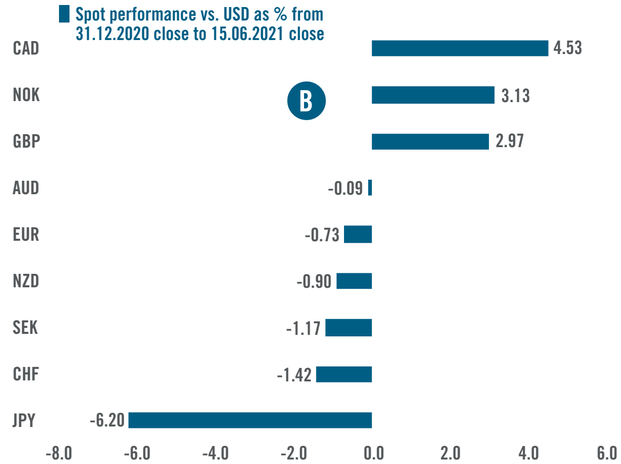
DON'T DISCARD CYCLICAL CURRENCIES

- **A Fed showing signs of becoming less accommodative since its June meeting and increasing concerns about the global growth outlook have recently favoured the US dollar and penalised cyclical currencies** A, in a sharp reversal of previous trends B.
- We continue to believe it **highly unlikely that the Fed will raise policy rates before or by more than the market currently expects (three quarter-point rate hikes in 2023)**. We also think the global economy will cope with the latest covid surge (thanks largely to higher vaccination rates), supported by high global household savings.
- Valuations and external imbalances in the US still suggest that the path of least resistance for the US dollar is lower.
- Ongoing reopening should help cyclical currencies. In particular, the Norges Bank and the Reserve Bank of New Zealand are expected to raise rates in the coming weeks, as long as the covid situation does not deteriorate. **Overall, the environment for cyclical currencies should improve over the rest of the year.**

Cyclical currencies have been suffering of late....



...in sharp contrast with earlier trends



Source: Pictet WM-AA&MR, Refinitiv, 31 August 2021

CONCLUSION

We see limited upside potential for the US dollar and see cyclical currencies rebounding after their recent poor performance. That said, we acknowledge that the Fed is becoming less accommodative and that covid remains a source of uncertainty. For these reasons, dollar depreciation and cyclical currency appreciation may prove shallower than previously thought.

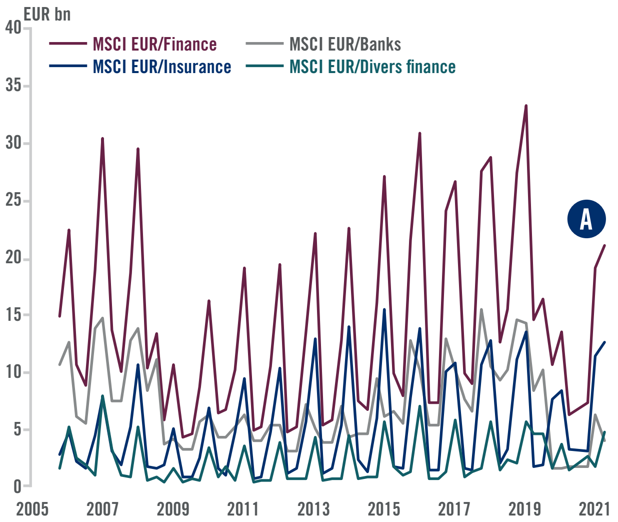
FURTHER EARNINGS UPSIDE, BUT PACE SHOULD SLACKEN

– After a stellar Q2 reporting season, earnings growth is expected to slacken in the coming quarters due to more challenging base comparisons. But earnings growth should remain healthy, with quarterly growth should remain healthy, with quarterly annualised **earnings growth above 20% for the S&P 500 and above 25% for the Stoxx Europe 600 in H2**. Just as reassuring, earnings guidance in the US remains positive, largely thanks to technology, industrials and materials.

– **Equity valuations should continue to fall relative to historical data and sovereign yields**. We are revising up our year-end targets for equity indices, while provisional figures up to June 2022 also show more upside.

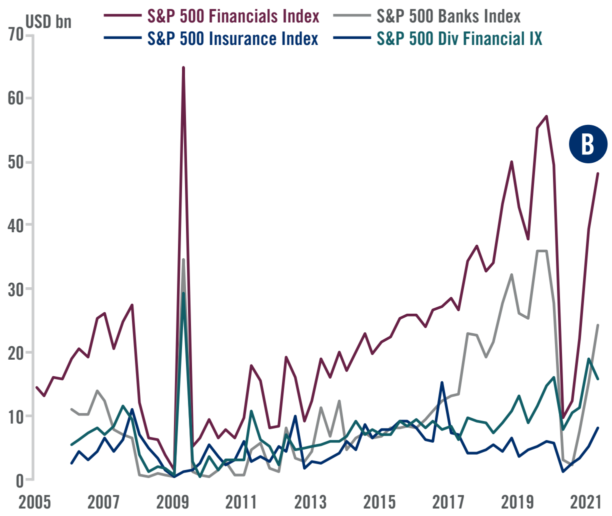
– Dividend payments rebounded in Q2 21 in Europe but remain far below pandemic levels. **We expect cash returns to shareholders to play a progressively greater role in European equity returns** as earnings move back to pre-pandemic levels and banks resume dividends A. In the US, improvements in the banking sector should drive an increase in share buybacks, which play a greater role than dividends there B.

European financials' quarterly dividend payouts



Source: Pictet WM-AA&MR, Bloomberg, 31 August 2021

US financials' quarterly share buybacks



Source: Pictet WM-AA&MR, Bloomberg, 31 August 2021

CONCLUSION

We are keeping a neutral stance on developed-market (DM) equities overall. On account of better earnings than originally expected, we have slightly upgraded our year-end price targets for DM equities. Sector rotation has slowed as earnings momentum has peaked.

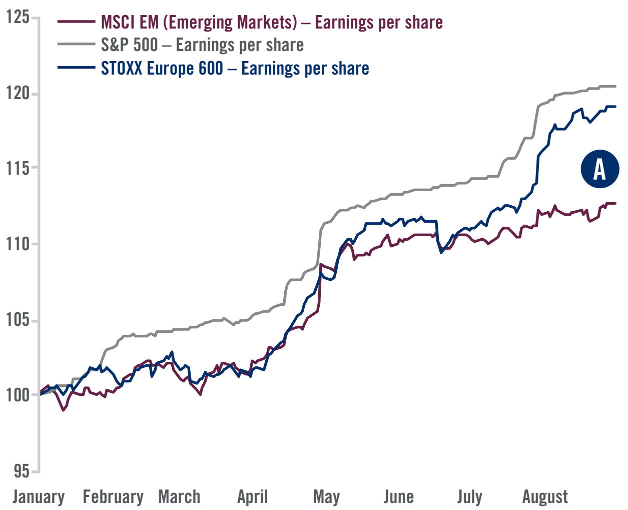
JUMPING THE HURDLE BUT LOSING THE RACE

– From a pure seasonal standpoint, **emerging-market (EM) equities typically underperform developed-market (DM) equities during the summer months.** This year has proved no exception, as earnings revisions in EM have lagged A and the ongoing regulatory drive in China has raised concerns.

– In July and August, 12-month forward earnings for the MSCI World were revised up by 5.4%, only slightly offset by a 1.6% drop in the aggregate price-earnings (P/E) ratio, whereas **MSCI EM earnings rose by a timid 2.1% and P/E ratios fell by 9.4%**, with Asia (particularly China) a major contributor to these numbers.

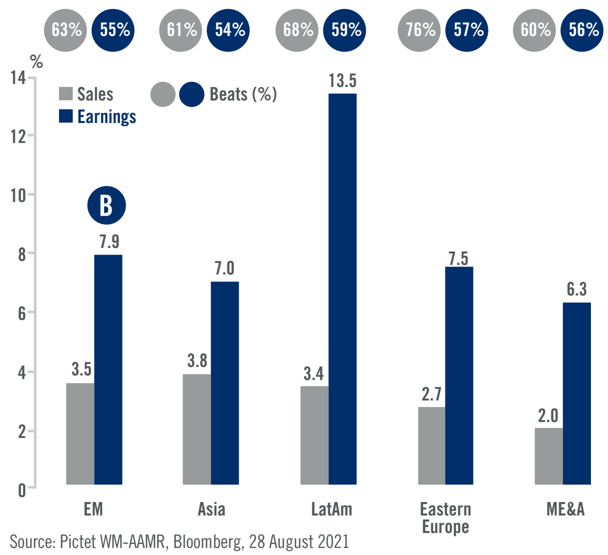
– **While comparatively unappealing, earnings trends for EM equities nonetheless remain robust.** All EM regions beat sales and earnings expectations in Q2 B. Latin America stood out, beating earnings expectations by 13.5%, while other regions exceeded them by about 7% (still below the 12% surprise registered by equities in the US and Europe). From a sector perspective, energy, technology, materials and financials shone, while travel and leisure and industrial goods & services (incl. airports) continued to disappoint.

2021 earnings revisions year-to-date (in USD)



Source: Pictet WM-AAMR, Factset, 31 August 2021

2Q 2021 sales and earnings surprises



Source: Pictet WM-AAMR, Bloomberg, 28 August 2021

CONCLUSION

While our earnings scenario for EM equities is playing out (currently standing at +18%, we see a 25% rise in 12-month forward earnings by year's end), the ramping up of China's regulatory drive means the contraction in valuations has been more severe than anticipated. Given our cautious stance on Chinese equities and China's weight in the MSCI EM Index, we continue to favour DM over EM stocks at this juncture.

SOME SECTORS HOLD PROMISE AS VALUATIONS DECLINE

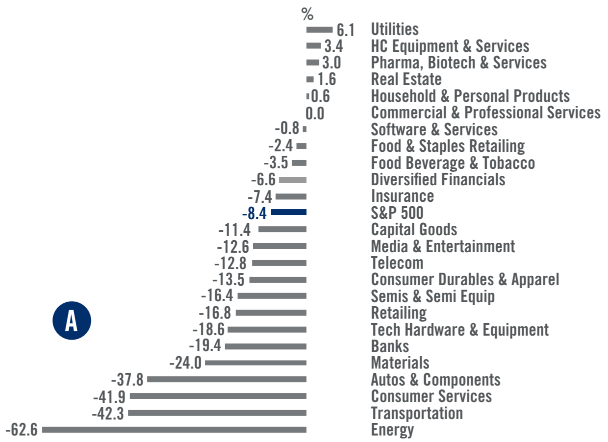
– Cyclical/value sectors have seen valuations decline since their post-pandemic peaks A. Financials are one such sector B. Yet loan growth at European banks is good and their asset quality increasingly robust. We should see an acceleration in capital returns as banks pay catch-up dividends. The outlook will in part depend on bond yields (a rise in yields would help interest-rate margins), but after superior returns year to date, **the case looks strong for continued outperformance by European banks in the short term**.

– Valuations for Big Tech (FAANG) stocks have also been declining as covid lockdown effects fade. Yet **Big Tech's structurally faster and durable growth potential has been clearly established**. And for all their regulatory zeal, the Chinese authorities know that Big Tech remains essential to continued economic growth. Big Chinese tech companies can adjust to the new regulatory dynamics and their current low valuations provide support against further downside.

– **Industrial-sector companies with good pricing power still hold promise**, especially as infrastructure spending programmes ramp up.

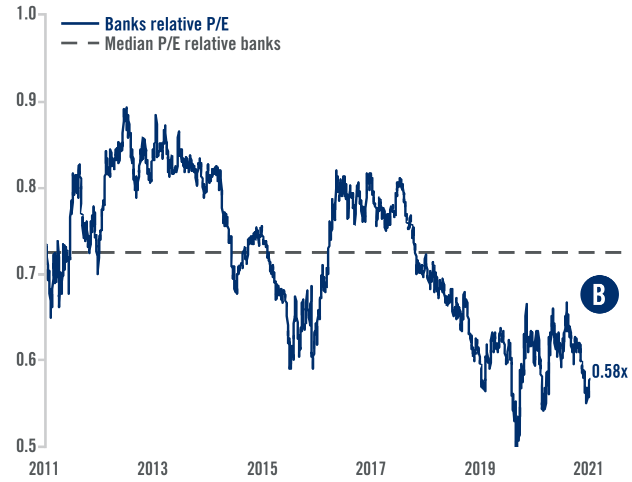
Greater dispersion in sector valuations

Late-August valuations (12-month forward price-earnings ratio versus peak during covid-recovery phase)



Source: Pictet WM-AA&MR, Morgan Stanley, Datastream, 20 August 2021

Forward 12-month price-earnings ratio for Stoxx 600 banks versus the overall Stoxx 600 index



Source: Pictet WM-AA&MR, Bloomberg, 10 August 2021, Datastream, 10 August 2021

CONCLUSION

The Q2 earnings season was very strong in Europe and the US, with energy, financials and most cyclical sectors in the vanguard. While forward guidance is also robust, it could be that the earnings recovery has been pulled forward. Given that raw material inflation and semiconductor shortages remain an issue, we expect earnings to normalise in 2H. Although sliding in some sectors, valuations remain high, but with significant sector dispersion.

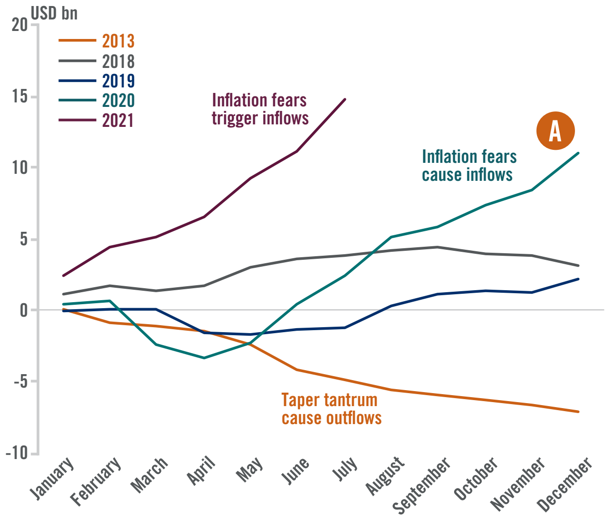
NEGATIVE US REAL YIELDS ARE HERE TO STAY

– **Since its recent peak last March, the yield on US 10-year Treasury Inflation-Protected Securities (TIPS) has fallen,** reaching -1.0% to post a solid year-to-date performance of 3.6% on 24 August.

– **Amid much speculation surrounding the driving forces behind this fall, we have identified three factors:** fading US growth momentum; inflation fears and the attractive carry offered by TIPS attractive to investors, leading to strong inflows into TIPS exchange-traded funds (ETFs) A; and the Fed's increasing presence in the TIPS market. This has contributed to supply-demand imbalances, with the estimated 10-year TIPS liquidity premium sinking to -0.5% B.

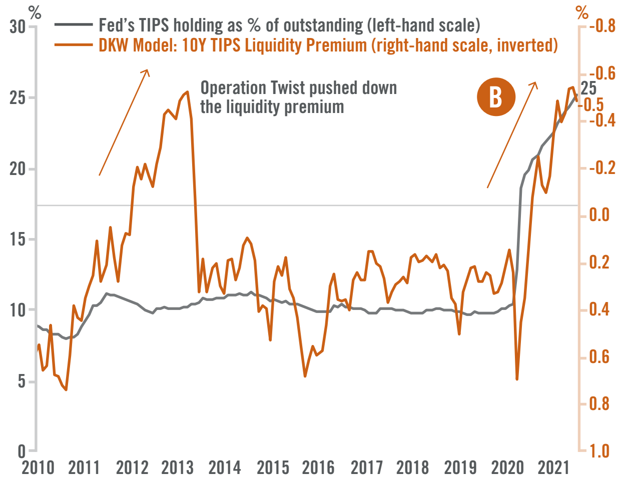
– **As these factors are unlikely to abate significantly in the coming months, the 10-year TIPS yield (equivalent to the real yield) is likely to remain well in negative territory.** Although many expect an upcoming Federal Reserve announcement regarding tapering of its monthly bond purchases to push TIPS yields up, we now see the 10-year TIPS yield rising only towards -0.8% by year's end (against our previous forecast of -0.1%).

Cumulative monthly flows into US TIPS ETFs



Source: Pictet WM-AA&MR, FactSet, July 2021

Fed's share of TIPS market and TIPS liquidity premium



Source: Pictet WM-AA&MR, US Federal Reserve, FactSet, 3 August 2021

CONCLUSION

As we do not expect a well-telegraphed Fed tapering to fully make up for other factors supporting bond prices, we are adjusting down our year-end forecast for the 10-year US Treasury yield from 2.1% to 1.6%. Still, inflation expectations could push the 10-year yield gradually further up thereafter; after price rises linked to supply bottlenecks, the strong post-covid recovery this year could mean the US economy experiences cyclical inflation in 2022.

OPPORTUNITIES IN A TIGHT CREDIT SPREAD ENVIRONMENT

– **Year-to-date US and euro credit spreads have continued their downward slide**, with US and euro investment-grade (IG) spreads hovering around 90 bps above government bonds and their high-yield (HY) counterparts slightly above 300 bps at the end of August.

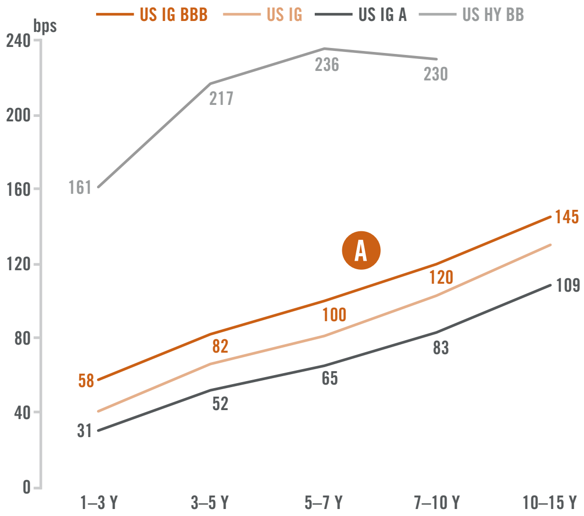
– Despite these tight spreads, we still see opportunities, incorporated in **our 'credit trilogy'**.

1. **Going down the capital structure to invest in financials' subordinated debt or corporate hybrids** to capture some additional yield. But we continue to avoid the lowest-rated credits.

2. **Taking advantage of steep credit spread curves A to add duration tactically.** This involves investing in five-to-10 year IG corporate bonds, timing the entry for when long-term core sovereign bond yields have risen further towards our year-end forecasts.

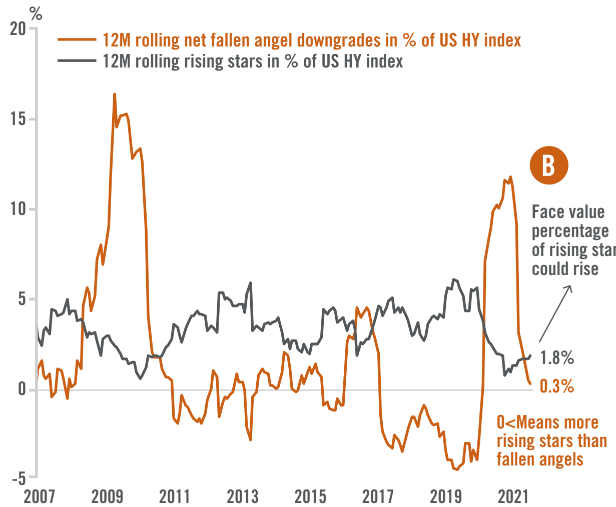
3. **Investing in 'rising stars' (companies likely to be upgraded from HY to IG),** as the ongoing economic recovery is likely to mean last year's wave of downgrades gives way to a wave of upgrades B. Typically, spreads tighten for rising stars in anticipation and often also right after the upgrade.

US investment-grade and high-yield spreads



Source: Pictet WM-AA&MR, FactSet, 25 August 2021

US high-yield bonds: ratings migration



Source: Pictet WM-AA&MR, BofA Merrill Lynch, July 2021

CONCLUSION

We expect the global hunt for yield to continue in the current low-yield environment. In particular, the high percentage of negative yielding euro IG bonds (45% of bonds outstanding) is likely to continue pushing investors into riskier credit buckets. In this environment, we continue to look for carry while refraining from going into the lowest-rated credits.

ECONOMIC INDICATORS & PICTET WEALTH MANAGEMENT ESTIMATES (E)

(At 31 August 2021)***

ASSET CLASS	TIME HORIZON		
EQUITIES INDEXES	**CURRENT**	**DEC 2020**	**DEC 2021E**
S&P 500	4,523	3,756	4,600
Stoxx 600	471	399	485
MSCI UK	1,997	1,810	2,050
SMI	12,411	10,704	12,700
Euro Stoxx	470	398	485
CAC 40	6,680	5,551	6,800
DAX 30	15,835	13,719	16,300
MSCI Italy	66	58	69
MSCI Spain	106	97	110
TOPIX	1,961	1,805	2,050
MSCI EM (USD)	1,309	1,291	1,400
MSCI China (HKD)	94	109	100
MSCI India (INR)	1,998	1,600	2,000
BOVESPA (BRL)	118,781	119,017	130,000
MSCI Russia (USD)	797	669	725
INTEREST RATES (IN %)	**CURRENT**	**DEC 2020**	**DEC 2021E**
Switzerland – Deposit rate	-0.75	-0.75	-0.75
Switzerland – 10 year	-0.32	-0.55	-0.20
Euro area – Refi rate	0.00	0.00	0.00
Euro area – Deposit rate	-0.50	-0.50	-0.50
Germany – 10 year	-0.38	-0.57	-0.25
France – 10 year	-0.03	-0.34	0.20
Italy – 10 year	0.71	0.54	0.65
Spain – 10 year	0.34	0.05	0.40
US – Fed rate (mid range)	0.13	0.13	0.13
US – 10 year	1.31	0.91	1.60
UK – Bank rate	0.10	0.10	0.10
UK – 10 year	0.71	0.20	0.80
Japan – Deposit rate	-0.10	-0.10	-0.10
Japan – 10 year	0.03	0.02	0.00
EM sovereign (local currency)**	4.99	4.22	4.70
CREDIT SPREADS (IN BP)*	**CURRENT**	**DEC 2020**	**DEC 2021E**
European IG	86	93	80
Itraxx Europe IG CDS***	45	48	40
European HY	303	355	300
Itraxx Europe Xover CDS***	228	242	230
US IG	92	103	95
US CDX IG CDS***	46	50	45
US HY	321	386	335
US CDX HY CDS***	-	293	285
EM Corporates (USD)**	296	316	290

ASSET CLASS	TIME HORIZON		
FOREIGN EXCHANGE	**CURRENT**	**DEC 2020**	**DEC 2021E**
EUR/USD (1 EUR per USD)	1.18	1.22	1.19
EUR/CHF (1 EUR per CHF)	1.08	1.08	1.10
USD/CHF (1 USD per CHF)	0.92	0.89	0.93
GBP/USD (1 GBP per USD)	1.38	1.37	1.39
USD/JPY (1 USD per JPY)	110	103	111
COMMODITIES	**CURRENT**	**DEC 2020**	**DEC 2021E**
Gold (USD per troy ounce)	1814	1898	1730
Oil (USD per barrel of Brent)	65	50	72
GDP GROWTH RATES	**CURRENT**	**2020**	**2021E**
US	12.2%	-3.4%	6.1%
Euro area	13.7%	-6.7%	5.0%
UK	22.2%	-10.1%	6.5%
Switzerland	-0.5%	-3.0%	3.3%
Japan	7.5%	-4.8%	2.2%
China	7.9%	2.3%	8.7%
World	1.7%	-3.2%	6.0%
CONSUMER PRICE INFLATION	**CURRENT**	**2020**	**2021E**
US (core PCE)	3.6%	1.4%	2.9%
Euro area (headline HICP)	2.2%	0.3%	2.1%
UK (headline CPI)	2.0%	0.9%	2.0%
Switzerland (headline CPI)	0.7%	-0.7%	0.4%
Japan (core CPI)	-0.8%	-0.2%	0.4%
China (headline CPI)	1.0%	2.5%	1.2%
World (headline HICP)	2.0%	3.3%	3.8%

* Bank of America Merill Lynch indices
** JP Morgan indices
*** Past performances or forecasts are not per se a reliable indicator of future performance.

Source: Pictet WM-AA&MR, Bloomberg, Factset, Eikon

5 YEAR ASSET CLASS PERFORMANCE

5 year asset class performance in EUR (%)

	2016	2017	2018	2019	2020
EUR Gvt	0.3	-2.6	-1.6	4.3	2.3
EUR Investment Grade	3.5	1.7	-0.6	4.0	1.4
EUR High Yield	9.1	6.7	-3.6	11.3	2.7
Stoxx 600	1.7	10.6	-10.8	26.8	-2.0
MSCI Emerging Markets	14.5	20.6	-10.3	20.6	8.5
Barclays Commodity Index	18.5	-5.7	-7.6	17.2	-10.9
Gold	12.2	-1.1	3.3	20.8	14.5
MSCI World EUR	11.4	8.1	-3.6	30.8	6.9
MSCI AC Asia Ex-Japan	8.9	24.8	-9.8	20.7	15.0
Hedge Funds hedged in EUR	-0.4	6.0	-6.7	5.2	9.0
Corporate Emerging Markets hedged in EUR	8.5	6.2	-4.3	9.8	5.8

5 year asset class performance in USD (%)

	2016	2017	2018	2019	2020
US Gvt	-1.3	0.1	-1.2	4.3	3.8
US Investment Grade	3.6	3.4	0.4	9.1	7.3
US High Yield	17.5	7.5	-2.3	14.4	6.2
S&P 500	12.0	21.8	-4.4	31.5	18.4
MSCI Emerging Markets	11.6	37.8	-14.2	18.9	18.7
Barclays Commodity Index	15.0	7.3	-12.0	15.1	-2.9
Gold	9.0	12.6	-1.7	18.7	24.8
MSCI World USD	8.2	23.1	-8.2	28.4	16.5
MSCI AC Asia Ex-Japan	5.8	42.1	-14.1	18.5	25.4
Hedge Funds	0.5	7.8	-4.0	8.4	10.3
Corporate Emerging Markets	9.7	8.0	-1.6	13.1	7.1

5 year asset class performance in CHF (%)

	2016	2017	2018	2019	2020
Swiss Gvt	0.0	-0.6	0.5	0.0	0.0
CHF Investment Grade	0.5	0.0	-0.1	0.9	0.0
EUR High Yield	7.5	16.5	-7.2	7.4	2.2
SMI Total Return	-3.4	17.9	-7.0	30.2	4.4
MSCI Emerging Markets	13.3	32.1	-13.2	16.8	8.3
Barclays Commodity Index	16.8	2.9	-11.0	13.0	-11.3
Gold	10.6	8.0	-0.6	16.6	13.9
Stoxx 600	0.9	21.4	-13.5	23.1	-2.0
MSCI World CHF	9.8	18.0	-7.1	26.1	6.3
MSCI AC Asia Ex-Japan	7.4	36.2	-13.1	16.4	14.4
Hedge Funds hedged in CHF	-0.8	5.6	-7.1	4.8	8.6
Corporate Emerging Markets hedged in CHF	7.8	5.6	-4.8	9.4	5.5

Source: Pictet WM-CIO Office, Thomson Reuters

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