QUARTERLY COMPASS

REYL innovative banking

Q4 2021

KEY CALLS

Time to shift to value names

Maintain an underweight rate duration stance

Long USD vs fragile cyclical FX

Favour "uncorrelated" hedge funds

GLOBAL MACRO AND ASSET ALLOCATION

The tide is turning on global monetary conditions, as the Fed should start reducing the pace of its monthly asset purchases (tapering) by year end, with a likely conclusion by mid-2022. Meanwhile, Norges Bank is the first central bank in developed economies to have hiked in this cycle, a move that should be followed soon by the RBNZ, the BoC, and the BoE. Financial markets will lose a key support going forward, and we therefore expect an increase in volatility in the medium-term.

The other key macro topic is inflation, and whether the current spike is permanent or merely transitory. We remain cautiously in the "transitory" camp but acknowledge that the pace of upside inflation revisions keeps gaining traction, evidencing that price increases are stickier than anticipated. We could even see an acceleration in wage growth in the coming months, as the US labour shortage is higher than ever (c.f. chart below).

Post-crisis peak growth has already passed, and we see global growth momentum fading on most macro data. In fact, the growth forecasts revision has turned south in Q3, increasing the odds of stagflation. However, in the short-term we might see an economic rebound in Q4.

In Asia, macroeconomic conditions have soured, with most of China's domestic indicators weakening in Q3 as the government prioritised structural reforms. The RRR cut in July may signal a shift in policy to provide more support for the economy. RRR cuts typically mark a bottoming of the credit impulse indicator, which would be a positive development for Chinese assets.

All in all, we stick to a pro-cyclical positioning, being ready to buy the dips, as long as there is no significant economic slowdown.

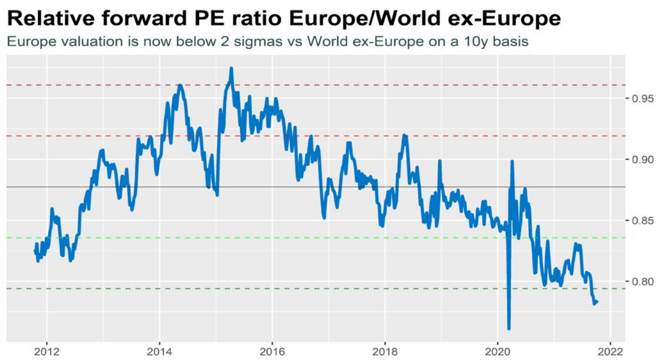
EQUITIES

In the current inflationary backdrop, we focus on pricing power as it is key to maintain margins. Wage growth is thus an important factor and, in this perspective, corporates' labour intensity is paramount. Our work shows that, on a sales per employee metric, retail, hotels, restaurants and auto parts are the most at risk of margin pressure.

Cyclical stocks have massively derated in Q3, likely due to renewed Covid fears from the delta variant. However, we expect financials, materials and industrials to catch-up in the near term on the back of the eventual rebound of Chinese economic activity and the continued grinding higher in DM yields that should support value and cyclical stocks outperformance.

With impressive EPS growth globally, equity valuation came down from recent peak levels, alleviating some pressure. Against the hurdle of 2021 base effect, 2022 expected earnings growth has been revised downward across regions (US 9.5%, Europe 7.4%, Japan 10.9%, EM 6.1%). Equities are still more attractive than bonds on equity risk premium metrics but is even more so in Europe than in the US.

The case for European equities is strong based on absolute and relative valuation (c.f. chart below). In our analysis, the most "value" markets in Europe, such as Italy (FTSE/MIB), are looking attractive to bet on the resumption of the reflation trade.



Sentiment has come back to neutral, after a period of high complacency, or even euphoria. Long term technicals remain in bull mode on most developed market indices but the narrowing breadth might become an issue should it continue to erode. Europe finally broke out above its key 20-year long resistance while emerging markets posted a false breakout and may lag DM in coming months. US yields are key in driving factor performance such as value vs growth and small caps vs large caps.

From a portfolio construction standpoint, we continue to favour a barbell strategy between secular growth companies and deep value stocks. We foresee 10.5% upside on the Europe Stoxx 600 and 6.5% on the S&P500 over the next twelve months.

FIXED INCOME

With the COVID crisis fading and economic growth becoming more robust, central banks have become increasingly worried about inflationary pressures and willing to reduce the huge amount of liquidity injected into the markets. At the last FOMC meeting, Fed members delivered quite a hawkish message, with the new "dot plot" already indicating 1 rate hike in 2022, and an acceleration thereafter. Additionally, a tapering of asset purchases is expected to be formally announced in November, which could be completed already by mid-2022. Several central banks have already started to hike rates, such as Norges Bank, or announced forthcoming rate increases this year, like the Bank of England. This marks the beginning of a new "regime" in the accommodation stance with less largesse and tightening financial conditions, which could increase assets volatility. A perilous exercise that needs cautiousness and skilful communication from monetary authorities in order to avoid any disorderly markets reactions.

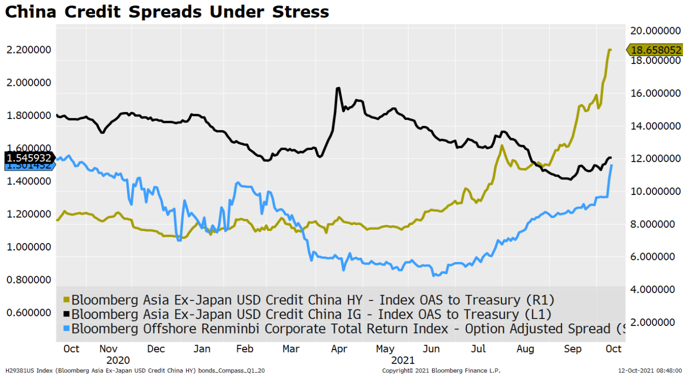
Core government yields have climbed markedly under the double threat of reduced liquidity and rising inflationary pressures, and we believe they have still some upside potential, which warrants an underweight rate duration positioning for now. Still, we maintain our long-end of the US curve exposure (20+ segment) as we find the close-to-2.2% yield attractive given our expectations for a gradual flattening of the curve with the Fed slowly embarking into its monetary policy tightening. Additionally, it represents a good risk diversifier in a portfolio.

Inflation-linked bonds have continued to outperform nominal ones in Q3, despite the recent rise of real yields weighing on their performance. Inflation seems to have peaked in the US while it is still rising in Europe and UK; the inflation carry should remain attractive for several more months. We contemplate moving to a shorter duration exposure in this space but want to keep our position in these securities as a hedge against enduring inflationary pressures that may prove less temporary than expected.

In the credit space, the gradual withdrawal of liquidity by central banks is typically not good news for lower-rated issuers and should increase volatility and hence risk premia. Therefore, cautiousness is warranted. Still, companies' fundamentals remain sound and the underlying economic backdrop is supportive. We consider there is still some value in the High ield space, especially compared to Investment Grade (spread premium and shorter duration). We maintain an overweight in the sector but with a focus on low duration. We favour senior loans which have a floating coupon feature and whose spreads are more generous than bonds. As mentioned, Investment Grade corporate bonds offer little value: they will move in tandem with government bonds, have expensive spreads / low yields, and quite some duration risk. We remain underweight and prefer some higher-beta pockets in the credit space.

A toxic cocktail of higher US yields, a stronger dollar and fundamental challenges in many countries threatens Emerging Markets. Rising commodities prices are good for exporters, but also create inflationary pressures leading to some EM central banks tightening rates. China's regulatory crackdown is clearly not helping (c.f. chart below), and an impact on the country's growth is to be expected. We believe the balance of risks has deteriorated for Emerging Markets and we have decreased our exposure to underweight, preferring other segments of high beta markets such as high yield or subordinated financials bonds. The latter remains our top pick - AT1s in particular. The financial sector benefits from rising yields, therefore bringing some decorrelation to a credit portfolio. Banks have posted good results this year and their credit fundamentals are solid. The carry remains attractive despite spreads tightening markedly this year; the return/ risk ratio is still good in our view.

China Credit Spreads Under Stress



FOREX

Since the Fed's hawkish pivot in June, the dollar index has advanced substantially as the market started to price in higher short term rates. Our call for a tactical dollar bounce in Q3 proved to be correct as the greenback advanced against all G10 FX (DXY +1.5%), albeit with high dispersion resulting from idiosyncratic stories. We observe the strong influence of short term yields in driving G10 FX, and conclude that relative monetary policy expectations are key in the current post-crisis backdrop. The greenback also found support on the slowing global macroeconomic momentum, and we suspect these two factors will remain key in Q4.

The hawkish surprise at the Fed's September FOMC has only resulted in a muted response from the dollar. By our analysis, this shows scepticism that the Fed will deliver on its signalled monetary policy path. Hence, we believe that the dollar is not priced for perfection yet and we see ample room for the Fed to continue to apply upward pressure on short-end rates, thereby supporting the dollar against low yielders such as CHF, JPY and EUR.

Since the summer, relative GDP growth expectations have turned in favour of EUR but failed to support EURUSD as the pair fell below 1.21 that prevailed when EZ-US growth forecasts troughed. We believe the reason is that the dollar is more sensitive to global growth in the current backdrop. Macro data shows that we have already passed the post-crisis peak in global growth and is now being revised downward (c.f. chart below). The dollar could also benefit from further downgrades of

Chinese growth in the wake of the Evergrande situation and an increase in policy regulatory risks. In this context, we expect the dollar to fare well, supported by its anti-cyclical behaviour, and particularly vs fragile cyclical currencies such as AUD and SEK.

Speculators have deleveraged the massive long EURUSD and is now marginally long USD. Interestingly, the FX market is short cyclical FX (AUD, NZD, CAD, GBP) in aggregate, as well as safe haven currencies (CHF, JPY), albeit by less. There is still plenty of room for fast money to increase their USD long exposure, hereby offering a potential key support for the dollar in the medium term. From a technical analysis perspective, the case for a stronger dollar is even starker as evidenced by the recent breakout on the dollar index and on many G10 pairs.

HEDGE FUNDS

Long term hedge fund performance has been positive but rather poor for all major strategies (+2.6% p.a. on average over the last ten years), especially when compared with global equities (over +13% p.a.). Similarly, over the long term, most hedge fund strategies have shown a strong and stable dependence on global equities, with no dependence on global treasuries. However, the average performance of hedge funds over a shorter period (last two years) amounts to +6.8% p.a. despite the March 2020 correction. This good performance, especially on a risk-adjusted basis, attracted more investors and assets under management in the hedge fund sector reached a new all-time high. We believe that most investors have been attracted by this good performance without realising that it was largely due to the strong performance of global equities. Strangely, over the last couple of years, hedge fund returns have also been significantly correlated to global treasuries, but a closer look shows that this dependence was significant when bond markets were rising and insignificant when markets were falling.

A simple statistical analysis allows us to quantify the potential impact of an equity market correction on the performance of hedge funds strategies. A 10% correction in global equities should have an average negative impact of 2.5%, with the largest potential impact on the "Equity Hedge" strategy (-4.0%), followed by "Macro/CTA" (-2.5%), "Event-Driven" (-2.0%), and Relative Value Arbitrage (-1.0%).

Our positioning on hedge funds has not changed: within each strategy, we favour hedge funds that have no correlation to traditional asset classes and good risk-adjusted returns. This is the most efficient way to improve the Sharpe ratio of a diversified asset allocation portfolio. The universe of funds with these two criteria is very limited.

ESG (Environment, Social, Governance) is one disruptive trend that has rapidly changed the asset management landscape, primarily for ethical, philosophical, reputational, regulatory, business, and economic reasons. Large, well-established traditional asset managers have already adopted ESG criteria into their investment processes, and the pressure is on hedge funds to follow suit. We are confident that the hedge fund industry will catch up in terms of ESG integration, especially as many different approaches are being found to assess the ESG rating of any type of investment vehicle. ESG has become a new investment style, i.e. a factor that can be subject to excesses (bubble or crash). That's why in the future we favour hedge funds that are ESG aware and agnostic.

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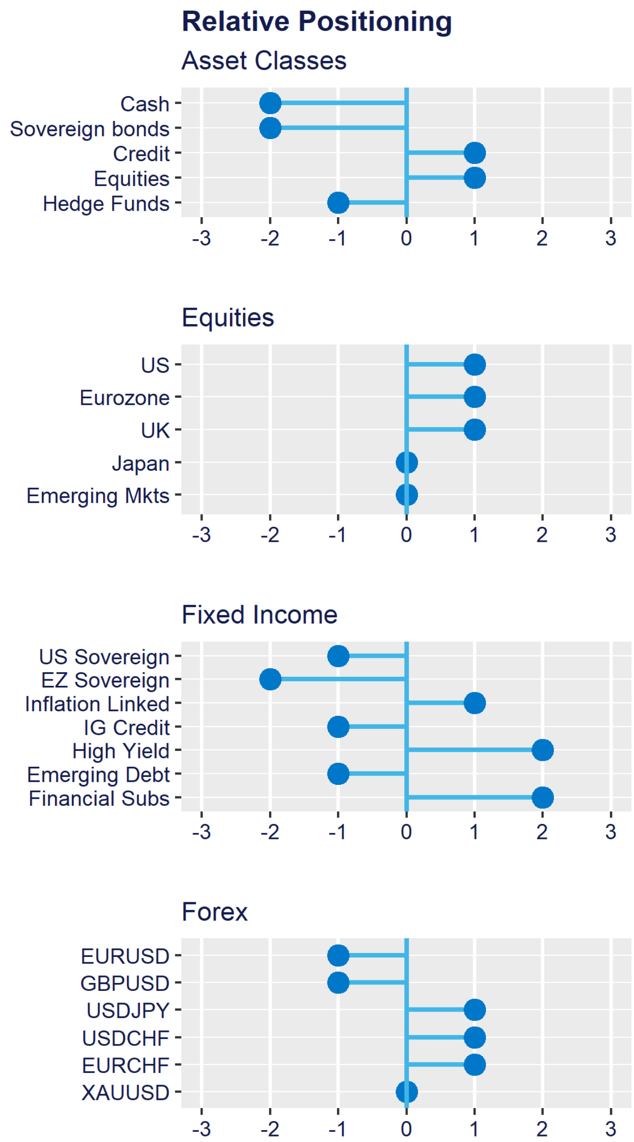

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