CITÉ GESTION

Newsletter : Peak Growth and Inflation | July 2021

1. Macro, Fixed Income and Rates
2. Equity
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Key Take-Aways

- While macro data from the US still points to an expanding economy, latest readings in some areas such as auto and home sales have disappointed
- We are probably past "peak inflation" and "peak growth" in the US
- Equities have posted a strong 2Q21 performance with all major indices ending June up
- Sector rotation was strong again and tech and growth, which were recent laggards, have again outperformed value on the back of falling yields
- Technological innovation and transformation as well as pricing power of big tech are creating a disruptive environment where smaller companies are constantly losing market share. We think this trend could continue and recommend to "stick with the winners"
- The Fed impacted fixed income markets. The US yield curve flattened with the short end rising markedly together with a small fall in the long end. Inflation-expectations seem to level-off around 2.5%
- In FX major pairs are still range-bound. The USD was strong recently on the back of flows into the dollar for purchases of US assets
- EM currencies will be torn between weaker growth in these regions and capital flowing into the US on one hand and renewed hiking-cycles in EM's on the other hand
- Three potential risks could derail a smooth way forward: 1) Supply-chain bottle-necks leading to higher inflation, 2) The rise in O/N repo rates could reduce cheap liquidity and impact leveraged strategies, 3) a resurgence of the delta variant of the Coronavirus

Review : June 2021

In June, the recent "risk on" sentiment continued and helped provide a very strong 2Q performance for equities. All major indices ended the month and quarter higher. The S&P 500 added 2.16% in June while the Nasdaq rose by 5.61%. The Swiss SMI index benefitted from a weaker CHF and a rebound of the large caps dominating the index, returning 5.1%.

June again saw a strong sectorial rotation back from value to growth. While materials and financials in the S&P 500 fell by 5.83% and 3.14%, respectively, the IT component rose by 6.84%.

There were some fundamental changes supporting this renewed sector rotation. Firstly, on June 16th the Fed reiterated its dovish stance at least until 2023. While 10-year Treasury yields briefly spiked, they trend downward since and have fallen below 1.5% at the end of the month. Secondly, the US dollar continued to benefit from strong macro data coming from the US. Recovery trades and especially commodities, with the exception of oil, came under pressure. Thirdly, some large cap tech stock remained virtually "flat" since 3Q20and were thus "rediscovered" by investors as "laggards".

The flip side of the above-mentioned rotation was weakness in traditional safe-havens such as gold and the Swiss franc. Gold fell by 7.28% in June.

Oil has hit new post-pandemic high and WTI ended the month at $73.47. Differences within the OPEC+ Group regarding production limits have supported oil.

Finally, the US yield-curve flattened after the FED in mid-June, and more precisely following Bullard's rather hawkish comments which cast doubt on the Fed's 2023 rate-hike target. The short end of the yield-curve rose sharply while longer yields fell slightly. Inflation fears are waning with the US 5-year forward rate settling below 2.5%.

As for now, the bulls prevail and volatility remains low with a VIX at 16. Global PMIs, which continue to point to a strong expansion, support that view.

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	4 295	0.08	1.25	2.16	8.11	14.35	20
Nasdaq	14 520	-0.05	1.74	5.61	9.61	12.66	29
Russell 2000	2 312	0.16	0.39	1.92	4.14	17.09	27
Euro Stoxx 50	4 064	-1.05	-0.29	0.61	3.70	14.40	16
Stoxx 600 EUR	453	-0.77	-0.06	1.36	5.41	13.49	16
FTSE 100	7 037	-0.71	-0.52	0.21	4.82	8.93	13
SMI	11 943	-0.71	0.37	5.10	8.10	11.58	17
NIKKEI 225	28 792	-0.07	-0.29	0.00	0.00	4.91	18
CSI 300 China	5 224	0.65	1.49	0.00	0.00	0.24	14
MSCI EM Index	1 377	-0.27	1.22	0.07	4.61	6.65	13

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	4 295	0.08	1.25	2.16	8.11	14.35	20
UTILITIES	322	-0.15	-0.19	-2.42	-1.12	0.80	17
ENERGY	406	1.08	-1.48	4.27	9.89	42.05	15
TELECOM	264	-0.25	0.95	2.69	10.46	19.10	20
CONS STAPLES	720	0.54	1.29	-0.70	2.99	3.45	20
REAL ESTATE	279	-0.22	-0.08	3.32	12.93	22.39	49
CONS DISCRET	1 436	0.35	1.26	4.07	7.11	10.26	27
MATERIALS	515	-0.07	0.18	-5.83	4.18	13.10	18
HEALTH CARE	1 465	-0.29	0.92	1.94	7.72	10.67	16
INFO TECH	2 593	-0.16	2.16	6.84	11.23	13.16	25
FINANCIALS	610	0.43	1.75	-3.14	7.89	24.46	14
INDUSTRIALS	864	0.56	0.77	-2.55	3.83	15.25	20

Currency % Change	Price	1 day	5 days	MTD	QTD	YTD
DXY	92.408	0.39	0.66	2.64	-0.88	2.75
EUR-USD	1.1853	-0.37	-0.61	-3.06	1.05	-2.97
USD-JPY	111.05	0.47	0.08	1.32	0.30	7.02
USD-CHF	0.9251	0.44	0.71	2.83	-2.00	4.31
EUR-CHF	1.0965	0.05	0.10	-0.23	-0.95	1.40
GBP-USD	1.3808	-0.20	-1.12	-2.84	0.18	1.01
EUR-GBP	0.8584	-0.16	0.50	-0.22	0.86	-4.11
JP EM FX Index	57.27	-0.29	-0.02	-0.99	2.01	-1.13

10 yr Yield Bps Char	Price	1 day	5 days	MTD	QTD	YTD
US	1.44	-3	-5	-16	-3	53
Germany	-0.21	-4	-3	-2	-4	36
UK	0.72	-2	-6	-8	-2	52
SWITZERLAND	-0.22	-4	-3	-6	-4	33
Japan	0.06	-0	0	-3	0	4
US IG Spread	88	0	-2	-4	-10	-14
US HY spread	230	5	-17	-12	-19	-97
EUR HY spread	306	-0	-1	-7	-17	-45

Commodity % Chan	Price	1 day	5 days	MTD	QTD	YTD
BBG Commo Index	94.6	1.49	2.54	1.90	13.36	21.19
Gold Spot $/OZ	1768.1	0.39	-0.60	-7.28	3.53	-6.86
Crude Oil WTI	73.7	1.04	0.63	11.19	1.04	51.98

Volatility	Price	1 day	5 days	MTD	QTD	YTD
VIX	16.0	-0.04	-0.34	-0.78	-17.63	-6.77

Source: Bloomberg 30.06.2021

Macro, Fixed Income and Rates : Inflation Peak

We come to the end of June, Q-2, and H-1 and our main conviction remains that we have seen peak growth and peak inflationary fear. It seems like the end of fiscal stimulus will result in lower consumer demand, more supply, and lower prices.

Mr. Powell is correct to be less worried, than the market, about inflation and more worried, than the market, about employment. We do not expect the Fed will raise rates this year nor will it jeopardize financial market liquidity by reducing stimulus. The expected reduction of disposable household income will exert a substantially more harmful impact on growth, revenues, and profits.

It seems like the action in the commodity markets, materials stock prices, and the Treasury market is consistent with peak inflation fear. The loss of fiscal stimulus is much more significant than most realize. The propensity on the part of consumers to spend is plunging. Sentiment on the part of consumers and small businesses is falling. It appears that aggregate price increases are not being passed-on to consumers. Spending has slowed as prices have risen. Those rising prices risk losing market share- immediately.

The last data points on the US economy disappoints: Auto Sales: -7.8%, New Home Sales: -5.9%, Existing Home Sales: -0.9%, Personal Income: - 2.0%, Real Disposable Income: -2.3%, Real Average Weekly Earnings Y-o-y are running at: -2.2%. It is no wonder that Real Consumer Spending: - 0.4%. Sentiment Indicators are turning south as well: Home buying Plans have collapsed: 114 to 74 – the lowest since 1982., Auto buying plans: 118 to 87.

In the meantime, net Private Savings is running at $4.8t This is the second highest ever recorded. At the same time Q-2 Net Private investment is running at less than a fifth of that. It will be difficult for interest rate to rise if there is no demand for money?

Deposits at the 25 largest banks are rising at 16% while New loan growth is falling at -8%. These are the worst levels in this cycle. Again…How do interest rates rise when there is no demand for money?

Government spending as a percent of GDP is running at 30% . And the percent of personal Income from government transfers is running at the same percentage 30%.

Money supply at $20t is 90% of GDP ($22t) . Its s growth rate is running at … 30%. This is all meaningless when the velocity of that money is the lowest in a generation. It's the multiplier on money that matters.

We are surprised, that GDP figures have not been higher considering how much the government is willing to spend to get it.

We identify 3 great market risks:

1 - The supply chain bottle neck and higher prices.

2 - The loss of collateral in the O/N Repo market : The Fed raised Reverse Repo Rates from 0% to 0.5% at its last FOMC meeting on June 16th. The backstory on this development is that the Treasury wants to reduce outstanding T-Bill supply. This makes sense as they do not want to pay their T-bill investors to buy its dept. The $2trillion of bills held in Investment portfolios, many of which have a S/T return of 0%, have been being lent out to hedge funds. This is a profitable option for bill owners and it's a major source of liquidity for the Hedge funds who need to borrow collateral overnight. As this collateral disappears market risk rises. Less collateral means market liquidity dries up and equity trading volumes do down. That's a problem.

3 - A resurgence of the Delta variant is also a development which can have an immediate effect of thwarting recovery trends.

We hope that none of these things happen, but the odds are not zero.

Equity : Go with the Winners

As of writing, the S&P 500 index is still clinging to its pre-4th of July holiday new all-time high at 4'352.34. It has rarely been so expensive: with a P/E ratio of 30 the index is in the same lofty spheres as during the dot-com bubble. No doubt, many things are different now. Firstly, interest rates are extremely low and real interest rates are negative; secondly, corporate America is highly profitable as margins are at high levels.

However, it is also quite certain that financial asset prices would not be here without government support, i.e. fiscal policy on the rise on the back of already ultra-lose monetary policy.

In this environment, investors are right to conclude that a long equity position represents a lower risk and higher reward proposition than most other risk-adjusted strategies investing in other asset classes.

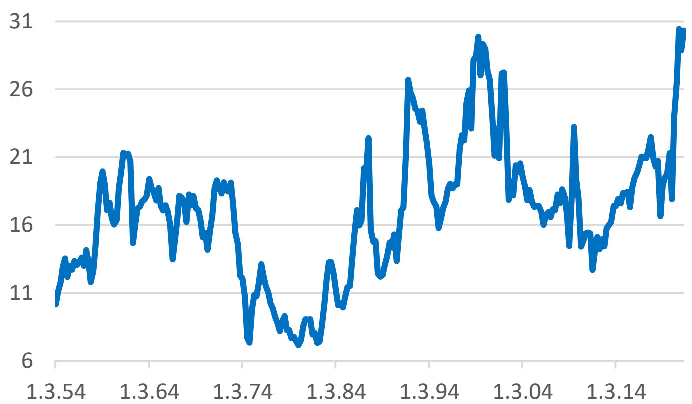
It is no wonder investor bullishness has rarely been higher. Macro-economic data from the US continues to be overall good and the latest non-farm payrolls have risen more than expected. Fed chairman Powell has made it clear that fighting unemployment is now the main target of US monetary policy.

The S&P 500 has not had a 5% correction in eight months and has just ended the second quarter up 8.17%.

We continue to believe that large cap technology companies are best poised to gain market share in this disruptive market shake-out. Cloud profit margins for example are running at 30%. Smaller companies who lack purchasing power are forced to eat cost increases and maintain steady prices to customers. Loss of market share is the fear.

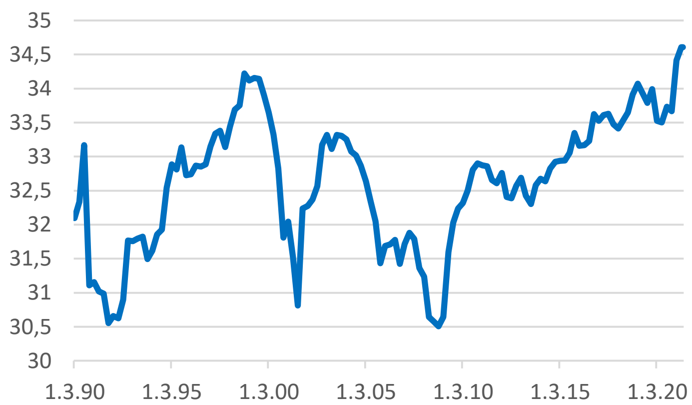
Banks and oil companies seem overpriced as do the recovery plays in general. The Nasdaq is up 12% since the Ever Given, a large container ship, blocked the Suez canal in March. That is three times as much as materials and in spite of the sectorial rotations that took place over the period. We expect this outperformance trend to continue. Keep it simple: buy companies that have pricing power and have the ability to demand concessions to their suppliers.

S&P 500 P/E Ratio

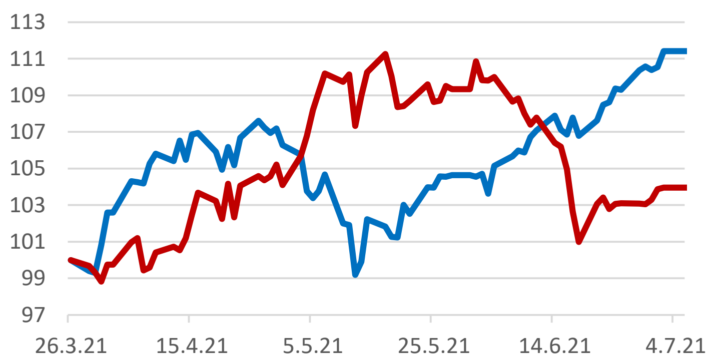


Source: Bloomberg

S&P 500 Gross Margin - normalized



Nasdaq index (blue) vs. S&P 500 materials index (red) since 26.3.211



Source: Bloomberg

FX and Commodities: G3 currencies in a tight range

This era of central bank activism extends beyond interest rates. Globalization, if that is the goal, requires managed currencies. The Japanese yen, Asia Pacific safe haven currency benchmark reigns supreme. The Euro stands alone as the stalwart currency between East and West.

We stick to the view that any move in the big G-3 currencies of more than say 5% would be met with enough high level response for traders to unwind any aggressive bets. And truthfully in the grand scheme of things: Are the finances of the 3 regions that terribly different?

Some may argue the U.S. trade deficit is the glaring and frightful exception. Dollar bulls would submit that is the price which a country must pay as a reserve currency nation. Some others may argue it is a luxury to have the ability to print money to facilitate 2/3's of global trade.

Either way the current state of affairs provides us with a modicum of comfort at current levels.

Currency trading is about relative performance. Currency pairs twitch with a far greater sensitivity than do bond yields and equity moves. The reason being is that to go long something , you have to go short something. You must be correct on two trades. Similar to the world of bonds, the art of currency trading is about isolating the inputs responsible for price changes - which constantly fluctuate.

With that in mind, let us consider the main themes and the main shift in the probabilities in outcome of those themes. If Wall street strategists are perhaps a little too enthusiastic in their inflationary recovery theme then the market is trading accurately.

Look no further than real yields. 10y real yields at -1.00% have plunged 25 bps this month and 55 bps from the March high of -55%. On February 16th 10y real yields jolt higher by 60bps -0.55% by Feb 25th.

That was "The Fear of Inflation" Trade. It has reversed- almost completely. The other key variant at the moment is the divergence in monetary policy.

Canada and England in particular are lurching towards a tapering policy much quicker than is the Fed. Perhaps the market anticipates they will be wrong in assuming higher inflation is the great risk to their economies. In the last month, Canadian dollar and Sterling collapsed respectively 5 and 4% against US Dollar.

The most important dollar cross is the Euro. The ECB is beginning to verbalize its tapering intentions along the same story-line: That inflation represents the greatest risk.

These may be legitimate fears and they may not be. Time will tell. For the moment though The U.S. investor mind-set has clearly taken a different course.

Most analysts share a comfort level with SNB policy regarding the EURCHF anchor and we believe this to be true.

Most investors would concur grave risk dangers with EURCHF are hard to find.

A slower-recovery and a fading of prices will hurt export driven developing countries. The economic risk in these countries is rising. Risk capital is flowing to The U.S.

The EM currency Index is also down 4% in the last month.

The global risk-off environment is clearly favorable to all G-3 currencies. But The dollar is getting most of the flows. Foreign flows in to the U.S equity market are running at record levels.

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