CITĒ GESTION

Newsletter : Buy the Dip | November 2021

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Key Take-Aways

- Despite a solid momentum for GDP growth in October, signs of deceleration start to appear
- Overall, a slight decline in the unemployment rate and modest increase in salaries could continue to improve the job market situation
- Inflation expectations have risen sharply, and the PCI indicators had a faster pace of growth than anticipated. The inflation expectation direction remains still one of the principal concerns in the market
- Going forward the biggest dangers for the market are still the delta variant, a further spike in inflation and central bank policy
- The 10 year Treasury yield is close to the upper bound of the recent range, while still below pre-pandemic levels. We have seen the longer end of the Yield curve in the US invert and that could be precursor of a market slowdown
- Equities, while boosted by better than expected earnings, approach again expensive levels. However, with a lack in alternatives, we remain constructive on the asset class.
- Constant pressure for the pair EUR/USD, that moved in line with interest rate differential, could indicate a fair value for USD vs EUR at current levels
- The transitory inflation and its impact on real interest rate direction is currently uncertain and too noisy. This makes it difficult to predict the direction of gold
- Energy in the form of oil and natural gas all rose sharply. However, taking into account seasonality as well as some specific supply issues, there is reason to assume that energy prices might have reached their highs for now

Review : October 2021

Surge in the Market

October has seen the market finishing the month in the green numbers, making most of the indexes offsetting their previous September corrections. Among the best performers MTD were the NASDAQ (+7.26%) and the S&P500 (+6.91%). Despite having some troubles in the last 5 days of the month, Emerging market and China have finished slightly positive with +0.93% and+0.55%, respectively,

CSI 300 China and MSCI EM Index remain the 2 soles indexes with a current negative YTD performance.

Having a look on the sectors, the main beneficiaries of the equity boost have been the consumer discretionary (+10.91%) and the energy (+10.18%), materials, that was the worst performer of the previous month, gained +7.60%. the come-back of real estate was also noticeable by increasing by +7.46% MTD. Finally, telecoms was the smallest performer, up by +2.65%.

Despite a negative dollar index (-0.02% MTD), the USD continued to rise vs the European currency and the Japanese Yen with EURUSD -0.19% and USDJPY +2.65%. Only the Swiss Franc and Sterling have been stronger than the greenback. EM market currencies continued to suffer as reflected by its JP Morgan Index that lost -0.78%.

October has also seen a rising Treasury yield environment, but with far less intensity as it was in September.

As reflected by the US 10-year Treasury that added up 7 bps, the German 10 Bund +9 bps or the Swiss 10 years that have increased the most with 13 bps.

Corporate spreads have increased for US and European countries, the US IG went up by +3bps and HY +12bps, same magnitude for the EU HY with +15bps.

Finally, within the energy sector, oil took up +11.38% and the BBG Commodity Index rose by 2.30%. Gold remained steady with +1.51%.

The volatility, showed by the VIX Index, declined sharply but logically in this positive environment, ending the month at 16.3%..

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	4,605	0.19	1.33	6.91	6.91	22.61	20
Nasdaq	15,498	0.33	2.70	7.26	7.27	20.25	28
Russell 2000	2,297	-0.03	0.26	4.21	4.21	16.32	25
Euro Stoxx 50	4,251	0.39	1.47	5.00	5.00	19.65	15
Stoxx 600 EUR	476	0.07	0.77	4.55	4.55	19.17	16
FTSE 100	7,238	-0.16	0.46	2.13	2.13	12.03	12
SMI	12,108	-0.37	0.43	4.00	4.00	13.12	17
NIKKEI 225	29,647	2.61	3.66	0.66	0.66	8.03	17
CSI 300 China	4,893	-0.32	-1.74	0.55	0.55	-6.11	13
MSCI EM Index	1,265	-0.89	-2.51	0.93	0.93	-2.05	11

Equity % Change	Price	1 day	5 days	MTD	QTD	YTD	EST P/E
S&P 500	4,605	0.19	1.33	6.91	6.91	22.61	20
UTILITIES	340	-0.63	-0.53	4.70	4.70	6.51	19
ENERGY	436	-0.67	-0.77	10.18	10.18	52.44	12
TELECOM	275	0.83	2.04	2.65	2.65	23.98	17
CONS STAPLES	741	-0.12	0.05	3.71	3.71	6.43	20
REAL ESTATE	299	-1.19	0.30	7.46	7.46	31.12	47
CONS DISCRET	1,586	-0.02	3.98	10.91	10.91	21.74	29
MATERIALS	534	-0.50	0.32	7.60	7.60	17.27	17
HEALTH CARE	1,559	0.95	1.62	5.08	5.08	17.77	17
INFO TECH	2,837	0.43	1.97	8.12	8.12	23.81	26
FINANCIALS	669	-0.43	-0.90	7.12	7.12	36.43	15
INDUSTRIALS	883	0.00	-0.28	6.83	6.83	17.85	20

Currency % Change	Price	1 day	5 days	MTD	QTD	YTD
DXY	94.212	0.09	0.43	-0.02	-0.02	4.75
EUR-USD	1.1558	0.00	-0.43	-0.19	-0.19	-5.39
USD-JPY	114.32	0.32	0.53	2.65	2.65	9.68
USD-CHF	0.9168	0.08	-0.34	-1.63	-1.63	3.45
EUR-CHF	1.0596	0.12	-0.79	-1.79	-1.79	-2.03
GBP-USD	1.3669	-0.10	-0.71	1.45	1.45	-0.01
EUR-GBP	0.8456	0.12	0.26	-1.62	-1.62	-5.70
JP EM FX Index	54.81	-0.00	-0.83	-0.78	-0.78	-5.38

10 yr Yield Bps Change	Price	1 day	5 days	MTD	QTD	YTD
US	1.56	1	-7	7	7	65
Germany	-0.11	3	-0	9	9	46
UK	1.03	3	-11	1	1	84
SWITZERLAND	-0.03	6	1	13	13	52
Japan	0.09	-1	-1	2	2	7
US IG Spread	95	2	1	3	3	-7
US High Yield spread	268	3	12	12	12	-59
EUR High Yield spread	343	-2	-12	15	15	-8

Commodity % Change	Price	1 day	5 days	MTD	QTD	YTD
BBG Commo Index	103.1	-0.27	-2.61	2.30	2.30	32.06
Gold Spot $/OZ	1783.5	0.01	-1.34	1.51	1.51	-6.05
Crude Oil WTI	83.6	0.92	-1.23	11.38	11.38	72.24

Volatility	Price	1 day	5 days	MTD	QTD	YTD
VIX	16.3	-0.27	0.83	-29.73	-29.73	-6.49

Source: Bloomberg 01.11.2021

Macro and Rates : Transitory Inflation?

GDP growth recovery post pandemic continues around the world. However, we can observed in some areas like in the US and China some signs of normalization.

Indeed, in the US, Real GDP expanded at a 2% annual rate in 3Q21, lower than the 2.6% consensus estimate and a sharp slowdown from robust gains earlier in the year. Weakness was led by a marked deceleration in consumer spending, growing just 1.6%, along with slower home building and a wider trade deficit. Weaker auto sales alone detracted significantly from GDP, and the rotation to services continued at a slower pace. While supply chain issues may persist well into 2022, recent data confirms economic momentum is beginning to pick up. The October flash PMIs overall shaped up better than expected on a composite basis. Manufacturing fell more than expected to 59.2, but services bounced sharply to 48.2 from 54.9.

The situation in the job market continues to improve despite some noises.

The September jobs report was both weaker and hotter than expected. Nonfarm payrolls increased by a meager +194,000, well below expectations. However, this miss was mitigated by a 169,000 upward revision in payroll gains for the prior two months, a decline in the unemployment rate from 5.2% to 4.8% and a modest increase in the average workweek. Further, the miss in jobs was concentrated in the government education sector, while the important COVID-19-sensitive sectors added jobs. Importantly, wages continue to climb, rising by 0.5% m/m and 5.5% y/y.

Inflation and inflation expectations remain the biggest risks for financial markets. Supply bottlenecks, higher labor costs and higher commodity prices could lead to a more persitent and less transitory global price increase. This could lead to pre-emptive monetary policy adjustments from Central banks.

In the US, Inflation has well surpassed the FOMC's 2% target, with the headline PCE price index rising +0.3% m/m and +4.4% y/y in September. The core PCE deflator also rose to +0.2% m/m and +3.6% y/y. The September CPI report showed consumer prices have resumed a faster pace of growth as more sustainable sources of inflation are now picking up. Headline CPI for September rose +0.4% m/m and +5.4% y/y, primarily driven by increases in the prices of food and shelter. Further increases in shelter costs, which make up a third of the overall index, could provide a more durable tailwind to inflation in the coming months.

The good news is that the market has already anticipate extreme monetary policy adjustments without derailing stock markets so far.

In the US, it looks like an awful lot priced in for the second half of next year. Assuming that effective Fed funds stays at its current 0.08%, the market is pricing 40 bps of hikes by September of next year and a little more than 60 by year-end. As a reminder, the September dot plot only had three participants projecting rates at 0.625%.

In places like Canada, of course, the pricing is even more extreme, with the bankers' acceptance futures market pricing rate rises of 150 bps by the end of next year. In Australia and the UK, similar aggressive adjustment have been observed.

At some point, we expect global GDP growth deceleration, moderate monetary policy adjustments and necessary time to reduce bottleneck and shortage effects will help inflation to slowdown during next year.

We identify 3 major risks that could delay a return to a pre-pandemic economic enviornment:

- *The delta variant and global vaccine delays could slow the economic reopening.*
- *Inflation could spike in the medium term.*
- *Extremely accommodative monetary and fiscal policies could lead to a boom-bust recession.*

Fixed Income: transitory inflation or not?

What is the bond market telling us? If you look at the level of US 10-year Treasury yields: nothing dramatic is happening. The 10-year Treasury yield is around 1.6% - still far away from the pre-pandemic levels of 2% and the previous highs around 3.2%. However, if you look at the YTD total return of the10-year Treasury bond, the picture is quite different: with -4.5% YTD, this is one of the worst performances since 1973.

Indeed, we are living in a world of two tales. While most still believe that current inflation is transitory and at normal levels on its way "back to normal" levels, others see a more structural change. Fed Funds Futures have been pricing a first rate hike in January 2023 back in March of this year. Meanwhile, the are pricing a first rate hike in July 2022, followed by hikes in December 2022, March 2023 and July 2023. The market has sharply increased its hiking-expectations over the last six months.

Meanwhile, core PCE forecasts have also risen across the board. The Fed's forecast for 2021 inflation has risen from 1.5% in June 2020 to 3.7% in September of this year.

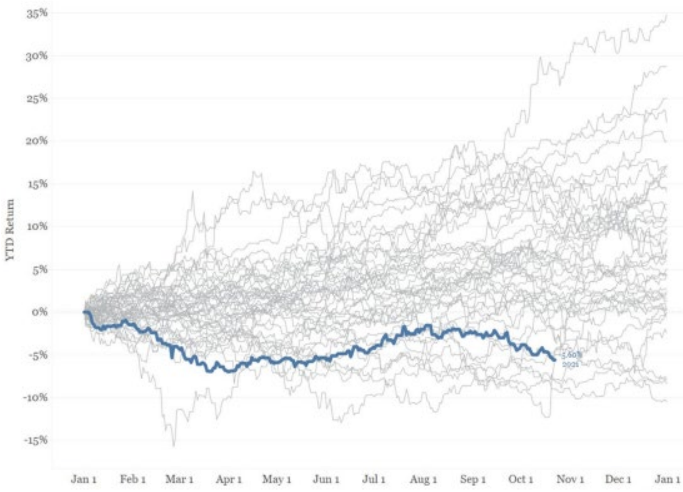
A recent Bank of America global fund manager survey found, that respondents who saw inflation as transitory fell from 69% to 58%, recently. Both the market and forecasters apply a higher probability to a higher inflation for longer.

What can we conclude from this? Probably we have to admit that we all underestimated the length of the overshoot in inflation. Does it mean that we are entering a period of structurally higher inflation? Not necessarily. The US consumer received cash hand-outs and higher demand met a struggling supply-chain.

Commodity prices also show a mixed picture. While energy is expensive, other commodities have recently begun to correct on the back of a slowing economy in some parts of the world.

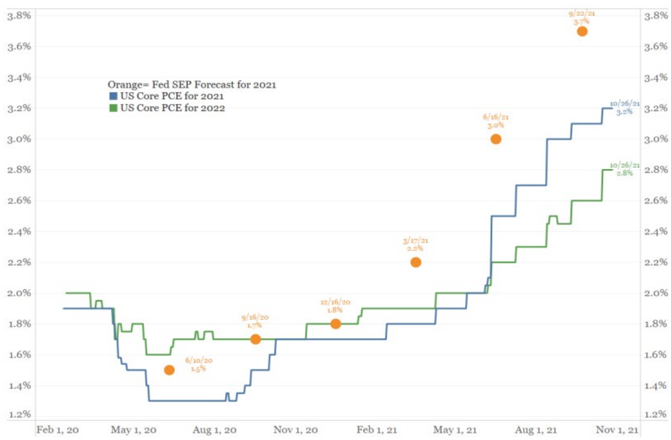
We believe that the US 10-year Treasury yield at current levels is close to its upper medium-term bound. Moreover, the longer end of the yield-curve in the US has recently inverted, thereby indicating fear of a slowdown. With this scenario, we do not anticipate uncontrolled inflation and hence remain constructive on bonds and duration at current levels.

YTD total returns for the Ryan 10-year Treasury index



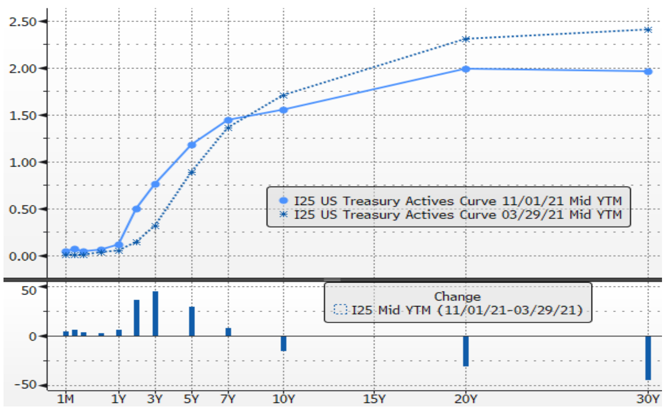
Source: Bianco Research L.L.C.

Core PCE Forecasts



Source: Bianco Research L.L.C.

US Treasury active curves on 29.3.21 and 1.11.21



Source: Bloomberg

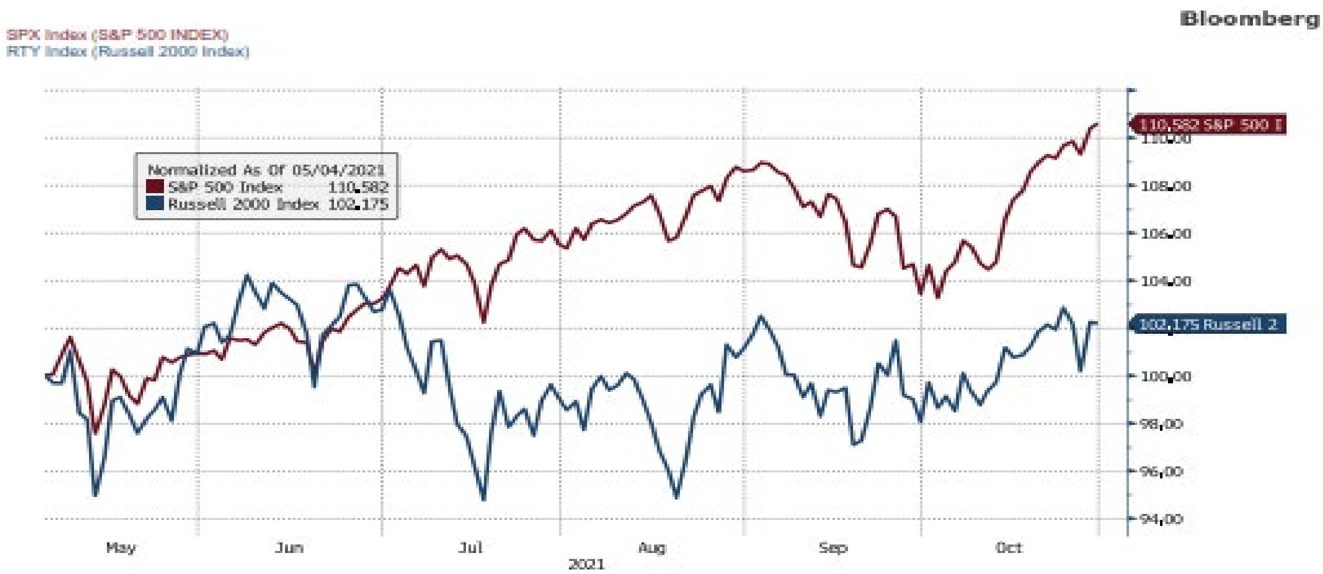
Equity : All time high, no where else to go

Equity remains the best place to be. With a particular tilt on Japan and Europe.

After last month's correction, in October the S&P 500 rallied back to record highs, gaining over +6%, making this the best month this year. Excess liquidity continues to pour into financial markets, with investors channelling $ 7 trillion of government stimulus into the stock market. That is 33.6% of $ 21 trillion of personal income. The U.S. savings rate is 9.4%, higher than the 7% average rate in the decade before the pandemic. In the first year of the pandemic, the savings rate averaged an extraordinarily high level of 30%. The drawdown in the last six months is 20% of disposable personal income. After each significant correction, we see a buy the dip from investors and the recovery cycle operates over 30 or 40 days.

In the current context of less vigorous but still solid growth, we continue to favour equities. We particularly prefer Japanese equities. Under the new Prime Minister, Fumio Kishida, the recovery plan could reach 30 trillion yen, approximately 5% of GDP. The TOPIX is currently trading at 14x forward earnings, a small multiple compared to the 20x for the S&P 500. We also have a small preference for European Equities, with the Eurozone being one of the few regions where we expect GDP growth to accelerate next year (5.4% versus 5.2% this year). Fiscal spending should be supportive as disbursements from the EU recovery fund kick in. In Germany, the new ruling coalition also seems less conservative than its predecessors. EM markets are to be watched closely and could surprise positively after the strength of the US dollar.

With 3% underperformance over the month, a catch up of small and midcaps versus large caps cannot be ruled out by the end of the year.



Q3 earnings have been strong with 80% of the S&P companies reporting better than expected. The combined revenue of the 4 largest US companies (AMZN, AAPL, GOOGL, MSFT) hit a record $1.24 trillion over last 12 months. This is larger than the GDP of all but 14 countries. Tesla has now gained over $300 billion in market cap over the past two weeks. The increase alone is bigger than the market cap of 90% of S&P 500 companies and propelled the automaker to a market cap of over $1.1 trillion. In the last week of October, Call purchases represented 85% of the volume of options traded. Out of this volume, 85% of premiums dealt on Tesla Calls. Also important to highlight that Facebook changed its name to Meta, as it focuses on the virtual world, moving aggressively to distance itself from a social media business embroiled in crisis.

All of this combined with a positive seasonality keeps us positive and constructive for the end of the year.

FX and Commodities: The end of USD appreciation?

The EURUSD consolidated in October, trading in a tight range. The currency pair has been under constant pressure since the end of May this year with the US dollar appreciating more than 5.5% versus the single currency.

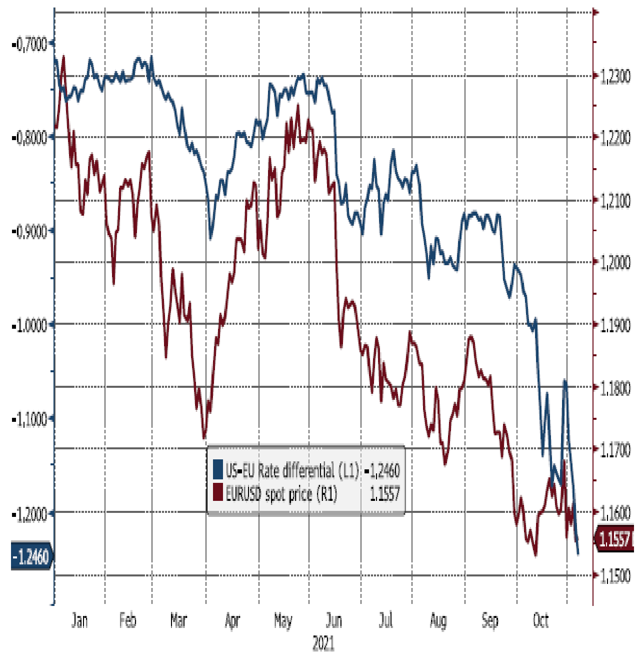
For once, the move in the currency pair has been in line with the interest rate differential expectation between Europe and the US. Indeed, the relationship between EURUSD and rate differential expected in one year indicated a fait value in the currency pair at current level. Therefore, the focus points to the relevance of what the market is pricing in terms of future monetary policy, especially concerning the Fed. As of today, the market anticipates the Fed to lift rates by 60bps by the end of 2022. As a reminder, the December 2022 Fed dot plots had only 3 participants projecting rates at 0.625% with a median still at 0.25%. In our view, this pricing looks somewhat excessive and the Fed is likely to follow the RBA and the ECB, by downplaying market bets on aggressive and pre-emptive rate hikes. In such scenario, it will likely signal the end of the USD dollar appreciation..

Surprisingly, gold didn't follow the upward trajectory following the collapse of real interest rate by the end of October.

We keep aware of the biggest danger for gold that could be related to transitory inflation and its impact on real interest rate. As we advance in the recovery, we could expect real interest rate to take over the inflation expectation and being the main driver for gold price. Lack of visibility on the market current situation and too much noise on real interest rate direction, made it difficult to have a proper conviction on the future Gold.

October has seen the Oil price increasing by the largest in the last decades on a YTD basis, originated mainly by energy and Gas prices that reached the top. The future oil level should now partially depends on how long Natural Gas price will remain elevated. Despite winter coming, clash of supplies issue and post Covid demand implies that the spike in Natural Gas could be temporary. Moreover, price pressure and capital constraint could initiate a switch from Government between Natural Gas and Oil. However on a short term perspective, a drastic switch could be difficult to implement, according to Saudi Arabia, it would only impact slightly more than 0.5% of global demand. Furthermore, Oil is not dependent on any seasonality and the demand is historically plateauing. Expectations of OPEP are going even down and reserves are still robust to meet short term supply. As a consequence we don't see any reasons to maintain a bullish view on the Oil.

EURUSD fair valued vs rate differential



Source: Bloomberg

Difficult reading for Gold relative to real yields

Source: Bloomberg

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