INDOSUEZ
WEALTH MANAGEMENT

Marketing Material

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Focus

US Monetary Policy: From Tapering to Tightening?

Architects of Wealth

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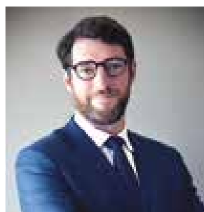
DRY JANUARY



VINCENT MANUEL

Chief Investment Officer, Indosuez Wealth Management

Dear Reader,

Cheered by the euphoric market, investors took off for the holidays in high spirits, and woke up in 2022 to a new scene playing out in front of their eyes with virtually no time to react. Rates were rising sharply, tech and luxury goods leaders in a correction, and sabres rattling in Eastern Europe and Central Asia. This was enough to persuade them to shift gears and embrace a kind of monetary and financial dry January, breaking with the end-2021 market complacency and when the central banks' most accommodative members (the "doves") give in to the proponents of tighter monetary policy (the "hawks"), it's time to turn the page on 2021 and correct its most visible excesses.

What do these stocks in correction have in common? Valuation levels are still what matter most when trying to make the market take its medicine. With rate hikes becoming more urgent, investors are massively selling securities whose valuation multiples exceed 40-50x earnings, a level dangerously close to their return on equity with long-term rates. The risk is that they are discounting these stocks' growth outlooks, record profitability and pricing power. These factors make them a good defence against inflation, which has remained high for longer than expected. Conversely, some of the winners of 2021, mainly banking stocks and energy, got off to a great start in 2022.

Is this a movie we have already seen? Some may be tempted to draw a parallel with the beginning of last year, which was also characterised by rate hikes and an equity rotation. But the situation is not exactly the same. Last year, it was the growth acceleration, the Biden plan, the democratic Senate, the vaccine rollout, and, lastly, the first warnings on inflationary risk that led to this set of circumstances.

This year, the environment is one of normalisation for both growth and monetary policies, with the exception of China as regards the latter. Inflation might have already peaked, but rate hikes and the reduction in the Fed's balance sheet lie ahead. That is the big difference with 2021 in that real interest rates will end up rising. The change since December is that the topic has shifted from rate hikes to balance sheet reduction, from short-term rates to long-term rates, and from currencies to equities. It's possible that a better comparison would be early 2018, when the Fed accelerated its rate hikes and January began with a sector rotation and ended with a correction.

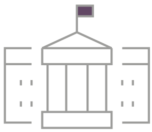
But let's maintain some perspective, the US 10-year net of inflation is at -4% to -5% and will remain in negative territory throughout 2022, which should remain favourable for risky assets. However, one risk just as great as ignoring the changes underway would be to overstate these risks and fear a shock similar to the bond crash of 1994; since then, the Fed has conditioned us to change course almost every time the markets start to wobble.

Rather than trying to predict an uncertain future, the most important thing investors can do is adapt to whatever comes next while keeping a watchful eye on signals from the central banks and corporate news. Ultimately, the key to the equity markets' trajectory will continue to lie in equities' profitability and growth trajectory. This is the only asset class where it is possible to both withstand erosion in real returns and find sectors that hold promise even in the face of rate hikes. The good news is that volatility should offer some entry points, which were almost nowhere to be found in 2021.

US MONETARY POLICY: FROM TAPERING TO TIGHTENING?

The Fed's narrative has evolved a lot over the past few months. We have gone from a single rate hike expectation for 2022 and inflation still considered transitory in the summer of 2021 to the removal of this adjective to qualify inflation and the acceleration of Fed's tapering more recently. Since then, there has been talks of three to four rate hikes in 2022 while the reduction in the Fed's balance sheet is at the centre of the debate since early January.

While the rise in rate hike expectations has driven a flattening in the US interest rate curve at a level which started to cause concerns in December, the narrative on quantitative tightening in January has led to a steepening movement of the rate curve, with a US 10-year yield close to 1.9% recently. The key questions surrounding this theme are directed to the magnitude and speed of the potential reduction of the Fed balance sheet and potential impact for investors.



THE FED to REDUCE ITS BALANCE SHEET one or two quarters after the first rate hike

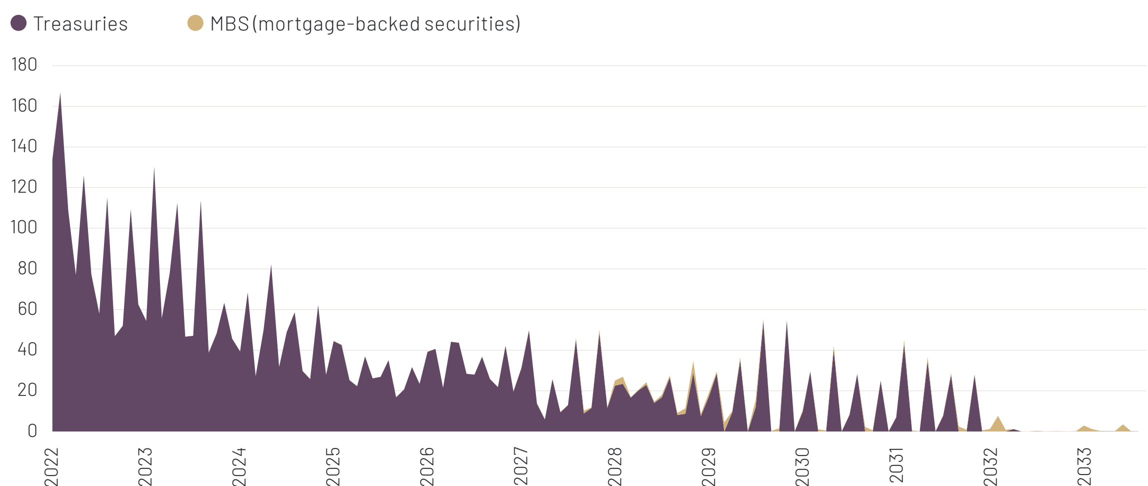
BE READY FOR FED BALANCE SHEET REDUCTION

As the US economic outlook is seen strong, with persistently high inflation and a tight labour market, the Fed's latest minutes indicated that it may soon be time to reduce its balance sheet, which currently stands at USD 8.8 trillion, more than double its pre-pandemic level. This announcement has reminded some investors of 2018 year end, a period during which the Fed had a goal of reducing its balance sheet by about USD 600 billion a year. But the amount of reserves they thought would be sufficient was not, forcing the Fed to stop its tightening when its balance sheet reached 18% of GDP.

Today, some analysts agree that a reduction of the balance sheet to around 25% of GDP (against 37% currently) would be a reasonable target by mid-2023. The Fed would reduce its balance sheet one or two quarters after the first rate hike, the first of which should materialise as early as March according to market expectations. This would bring us to the beginning of tightening in Q3 2022.

However, tightening does not necessarily mean that the Fed will start to sell its assets but rather that it will stop reinvesting funds that have come to maturity. About USD 2 trillion of assets held by the Fed will mature in the next two years (Chart 1). Since the weighted average maturity of the Fed's holdings is shorter than at the beginning of the previous normalisation episode, the balance sheet would melt down faster.

CHART 1: US FED ASSETS MATURING IN THE NEXT 10 YEARS, USD BILLIONS, MONTHLY



Source: Bloomberg, Indosuez Wealth Management.

CONTEXT IS DIFFERENT FROM 2018

Does this mean we should be worried about the Fed's shrinking balance sheet?

First, quantitative tightening does mean less Fed intervention on the demand side (i.e. no more Treasuries purchases), but we should take into account other elements. Assuming that the US federal deficit falls from 12% to 5% of GDP, which is equivalent to a USD 1 trillion decrease in financing needs, the markets would have to absorb about the same amount of Treasuries than in 2021 resulting in a lower impact on the US curve. This scenario would, however, go against the preference of several FOMC participants to reduce agency MBS more than Treasury securities, which are maturing later (Chart 1) while currently representing around 30% of the Fed's balance sheet (Chart 2).

USD 2 TRILLION of treasuries maturing in the next two years

Secondly, one of the differences with the last monetary tightening cycle is the amount of liquidity in demand for collateral via the reverse repo programme. Huge excess cash in mutual market funds since early 2021 translated into a higher use of the reverse repo programme (RRP) facility, resulting in USD 1.5 trillion demand to borrow collateral. This cash could be redeployed and offset the USD 2 trillion of treasuries maturing in the next two years, but if the Treasury decides to issue more T-bills. On the opposite side, if the latter decides to issue long debt the risk for the market is steepening of the yield curve through the supply channel.

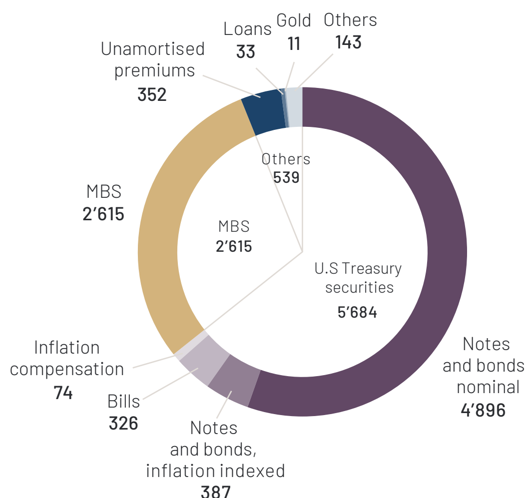
Thirdly, last July the Fed reintroduced a permanent repo facility (SRF). The use of this facility could create a sort of ceiling for short-term rates. It offers banks the possibility to convert their securities into reserves when needed, which should encourage banks to be less watchful to buy Treasury paper and thus help the Fed to manage its runoff.

INVESTOR IMPLICATIONS

More than the reduction of the balance sheet, it is the manner and speed of the path that the Fed will take that will matter most to the markets. With QE (quantitative easing) ending and QT (quantitative tightening) looming, the marginal appetite of investors to move down the risk curve should be impacted. The magnitude of risk premium expansion will be key in 2022.

For investors, this translates into different impacts. Firstly, we can expect more steepening of the US curve, although this could be capped by its attractiveness to foreign investors to some extent. Secondly, all other things being equal, quantitative tightening means less liquidity in the market and therefore more volatility ahead. Thirdly, a monetary tightening could reduce market liquidity, withdrawals from fixed income assets globally and may involve a possible widening of spreads on the credit segment. Finally, on a cross-asset view, the impact on the dollar remains difficult to assess. The greenback could benefit from a widening of the transatlantic spread, but historically it has started to fall after the first rate hikes. As regard to equity markets, this represents a catalyst for the rotation from growth style to value (as we have seen since the beginning of the year, as in Q1 2020) and probably a higher volatility regime.

CHART 2: US FED BALANCE SHEET, USD BILLIONS



Source: Fed, Indosuez Wealth Management.

ECONOMIC DECELERATION, MONETARY NORMALISATION AND INFLATION

Last year was a year of economic catch-up, expansion of monetary policies and acceleration of inflation. 2022 will be a year of normalisation of growth and monetary policies in the advanced economies, in the midst of which inflation will continue to play its role but with a change in its main drivers.

FROM EARLY TO MID-CYCLE, OR TO THE END OF THE CYCLE ?

After a rebound in activity at the beginning of Q4 2021, the rapid spread of the Omicron variant disrupted economic activity at the end of 2021 and should be felt in the upcoming economic data for January 2022 in the most affected areas. Alternatively, the low mortality rate and a decline in cases already underway in South Africa, where the variant was discovered, show that economies have become more resilient to the pandemic. Any loss in activity should therefore be largely recouped by early Q2 and not materially affect our macro scenario for the year as a whole. The global economy is expected to grow by approximately 4% in 2022, with growth rates in developed countries expected to decelerate and gradually converge towards their potential growth level in 2023. Only certain countries in South East Asia (India, Vietnam, Indonesia and Thailand), which were affected by the pandemic in 2021, could show an acceleration in economic activity in 2022.

More specifically, in the US as in Europe, job creation, restocking and the use of surplus savings should continue to support demand, with a probable rebalancing of consumption towards services. Investment should be a growth driver as well. However, policy mix will become much less supportive with the reduction of monetary and fiscal support (for instance government expenditure contribution to GDP should come down from 0.6 pp to 0.4 pp within the Euro Area), although the latter will still be fuelled by the previously voted infrastructure stimulus packages.

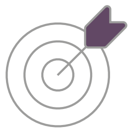
CORE INFLATION should remain HIGHER than expected initially by central banks

CHANGE IN THE DRIVERS OF INFLATION

Inflation, which reached 7% in the US and 5% in the Euro Area, is expected to peak in the first half of 2022 and gradually decline over the course of the year. Several encouraging signs can be mentioned with the easing of tensions on supply chains as evidenced by the decline in supplier delivery times or input prices (although this remains conditional on a total reopening of economies and a decline in the pandemic), as well as the ongoing decline in freight prices and some raw materials such as gas or coal.

Nevertheless core inflation should remain higher than expected initially by central banks (Chart 3), driven by rising real estate and services prices, while wage inflation should be the main focus this year.

Most notably in the US, where the unemployment rate fell again in December to 3.9%, close to full employment. Rises in minimum wages and negotiations with trade unions may also be starting to sustain an upward pressure on wages in Europe this year.



70% OF CENTRAL BANKS should raise rates by Q2 2022, compared to 40% last year

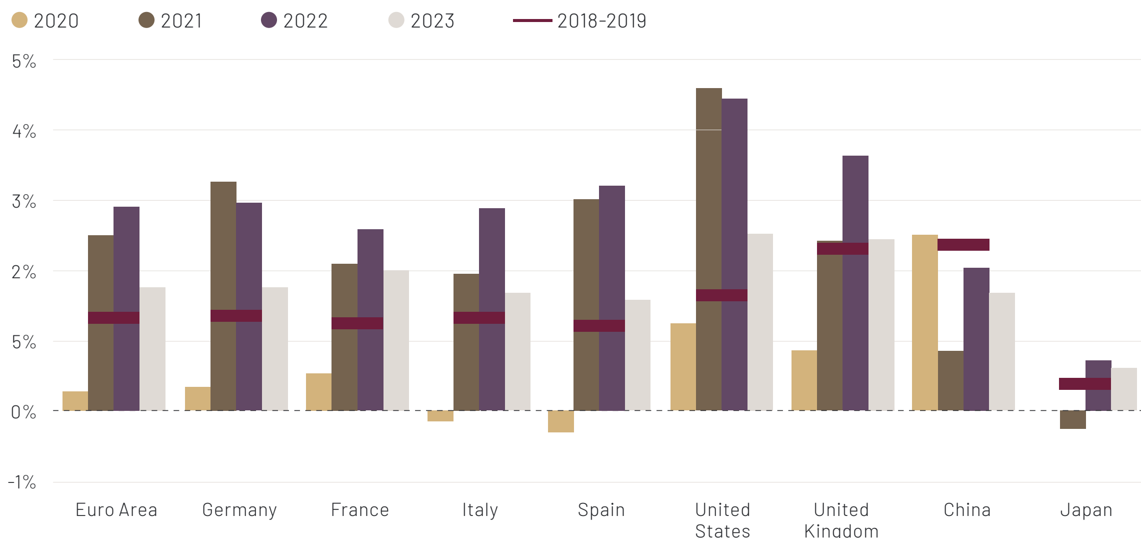
MORE AGGRESSIVE CENTRAL BANKS, EXCEPT IN CHINA

In this context of persistent inflation, central banks in developed countries, led by the US and the UK, will continue to normalise their monetary policy at a more robust pace than expected, particularly in the US (see Focus). This year, nearly 70% of central banks are expected to raise rates by the end of Q2, compared to 40% last year. However, some divergence in paths should be expected. For its part, the European Central Bank has given a clear indication that it will continue to make net asset purchases, albeit at a reduced pace, with an expected end to the PEPP in March but with a longer reinvestment horizon.

Further East, the PBoC is the exception as it is now seeking to ease China's monetary policy, with already a double rate cut in early January to counteract the impact of the slowdown, particularly in the real estate sector, on the eve of the 20th CCP Congress. The Chinese government should also accelerate its targeted spending on infrastructure projects. Zero-COVID strategy adopted by China in the run-up to the Olympics implies a risk to domestic demand as Omicron lands in in the country. But some figures are encouraging: 1.6% growth in Q4 (vs. 1.1% expected), a larger trade surplus and industrial production surprising positively in December on the back of recovery in energy production.

As a final word, we maintain our scenario of solid but decelerating growth and a gradual normalisation of inflationary pressures but with a change in its nature. Paradoxically, the risks to our scenario lie in a too abrupt normalisation of monetary policies (likely to affect growth) and on the other hand both an uncontrolled rise in wages and a prolongation of tensions on supply chains (likely to increase the narrative of permanent inflation).

CHART 3: INFLATION SHOULD REMAIN ABOVE PRE-CRISIS LEVELS, WITH THE NOTABLE EXCEPTION OF CHINA, YOY, %



Source: Amundi Research, Indosuez Wealth Management.

04 • Fixed Income

THE FED IS LOOKING TO STEEPEN THE US YIELD CURVE

The Fed balance sheet runoff expected to start this year implies a future steepening of the US yield curve. To us, it is not priced currently and it will put upward pressure on real rates and term premium. The size, the speed and the breakdown of the quantitative tightening will determine the magnitude of the movement.

CENTRAL BANKS

In the US, after displaying patience in the face of the supply-driven surge in inflation, the Fed has decided to act. The last hawkish FOMC minutes signalled that the strengthening of the economy and higher inflation are leading to earlier and faster interest rate increases than previously expected. During its congressional confirmation hearing, Fed Chair Powell also mentioned that the central bank was on course to begin reducing its USD 8.8 trillion balance sheet. He portrayed those steps as a move away from an ultra-expansionary emergency policy put in place to fight the pandemic, not as a shift to a restrictive stance aimed at cooling off an over-heating economy.

We expect that after ending bond purchases in March, the Fed should begin the reduction of its balance sheet at mid-year. At this stage, we do anticipate four rate hikes this year (4.1 rate hikes are priced by current forward rates). Till now, the hiking cycle is seen as short and sharp. Far from higher-than-trend inflation necessitating a shift beyond neutral, the market expects rates to stall around 1.8%.

The ECB reiterated that it would continue net asset purchases until the end of the year at its December meeting. With TLTROs (Targeted longer-term refinancing operations) financing program to be unattractive in June implying a potential EUR 700 billion reduction in ECB balance sheet, we believe that the market pricing "partially" in a rate hike already this year is somewhat aggressive.

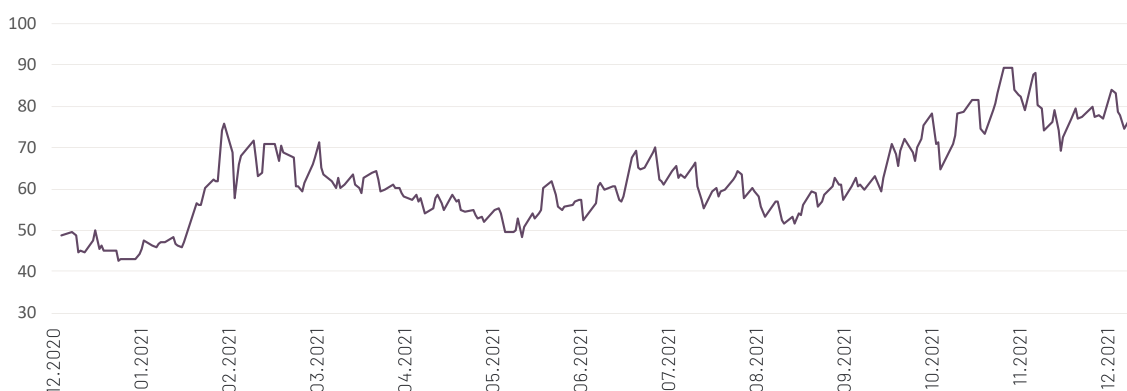
After its 15 bps rate hike in December, the Bank of England is expected to hike four times this year in order to cool UK inflation.

GOVIES

In Europe, the rise in yields reflects the end of QE and higher term premium. The movement has been exacerbated by an even stronger move in US rates (Chart 4). In the short term, we believe that this movement was fast and could now fade, offering room for a potential short term reversal in case of a rise in geopolitical risks. Euro yield curves implicitly price the ECB to hike rates this year which is not our scenario. In the long term, European rates remain low, strongly negative net of inflation and therefore require cautiousness.

After a material flattening, the US yield curve bear steepened in December, with long-term yields underperforming (+32 bps for 2-year yields; +40 bps for 10- and 30-year yields). More recently, it has flattened again on the back of an anticipation of a rate hike at the March meeting.

CHART 4: EVOLUTION OF US RATE IMPLIED VOLATILITY, BPS



Source: ICE BofA MOVE Index, Indosuez Wealth Management.

Balance sheet runoff not priced-in:
UPWARD PRESSURE ON REAL RATES EXPECTED

Normally when the Fed is turning more hawkish, it implies a flattening of the yield curve but this time the 5-year-30-year (5y-30y) spread already narrowed strongly (by 100 bps since March 2021). Moreover, the US Fed balance sheet runoff expected to start this year implies a future steepening of the US yield curve. To us it is not priced currently and it will place upward pressure on real rates and term premiums. A reduction of the balance sheet would be equivalent to several rate hikes. The size, the speed and the breakdown of the quantitative tightening will determine the magnitude of the movement. Thus, on the back of the recent and heavy 5y-30y flattening and the expected balance sheet runoff, we do anticipate a moderate steepening for the US yield curve. However, in the short term, this fast movement of long term bond yields could fade as the yield curve probably now integrates most of the Fed normalisation expected as of today (1.75% of rate hikes priced until the end of 2023).

INFLATION

European inflation is expected to normalise progressively in 2022, as base effects disappear but could be replaced by the effects of rising wages, and with a question mark on the speed of supply chain stabilisation. While the impact of the green transition could affect long term inflation expectations, it should not affect medium term ones.

The December CPI release in the US provides no reason for the Fed to back away from their recent tilt toward hawkishness. With the Fed viewing curbing inflation as its most important task for the coming months, the upward pressure on US inflation breakevens has calmed down.

In our central macro scenario, we expect inflation to normalise progressively over the next 12 to 18 months, even if it should stabilise at higher levels than in previous cycles in the US. Under this assumption, inflation breakevens are already pricing most of the inflationary pressures recorded so far and offer less value than a few months ago. The level of the landing point for US inflation rate will be key. However, if an alternative macroeconomic scenario with greater structural inflation has to take place, current inflation breakevens would remain attractive.

CREDIT

The credit asset class outperformed last December despite the rising rate environment. Fundamentals look good so the main risk for 2022 is in the technicals with higher supply or lower market liquidity. It is the case for euro investment grade (IG) with an expected supply of EUR 235 billion vs. EUR 178 billion in 2021. For US IG, the gross supply is forecasted in line with last year and lower in net terms. Rates volatility is a natural driver for spread widening but higher yields will attract demand.

Investors are not buying because they see the market as necessarily offering a strong total return near term, but because they have to do so for regulatory, prudential and fiduciary reasons. We still favour BBB with low to medium maturities. Regarding subordinated debts, corporate hybrids offer decent value but new supply and crowded long positions remain the biggest cons.

In December, euro and US high yield spreads substantially tightened by roughly 35 to 40 bps. Fears around the COVID-19 variant have decelerated and with the hawkish turn from central banks, segments with less duration sensitivity have been favoured. With low realised default, thin default forecast and few redemption expected this year, carry strategies remain attractive. We still do favour BB's with low duration.

TAKE ADVANTAGE OF ROTATION!

Despite the recent sell-off, we keep a positive view on Equity for 2022. Equities are supported by still high global economic growth, central bank policy broadly accommodative in Europe and China and earnings expectations which could slightly be revised on the upside.
As of now, valuations appear more attractive, and continue to benefit from some multiple compression since the end of 2021.

UNITED STATES

Since November, we have seen a sharp rebound in Value relative to Growth. The origin of this style rotation is largely linked to concerns about the Fed's change in monetary policy and the evolution of the 10-year yield (Chart 5), with sectors such as energy and financials outperforming while sectors identified as bond proxies, namely real estate, healthcare and technology, being the main laggards. These movements of bond yields generally lead almost mathematically to a repricing of growth stocks which are long duration assets, regardless of the quality of their fundamentals.

From a fundamental standpoint, earnings forecasts remain globally well oriented with EPS growth expectations standing currently at around 8% in 2022, a level that leaves room for positive revisions given the macroeconomic scenario (past correlation would suggest EPS growth around 14%). For Q4, the earnings season should show a 21.8% year-on-year increase in earnings. Revisions remain positive on technology companies which should largely receive more than 40% of capex over the year 2022 from companies still looking for productivity gains.

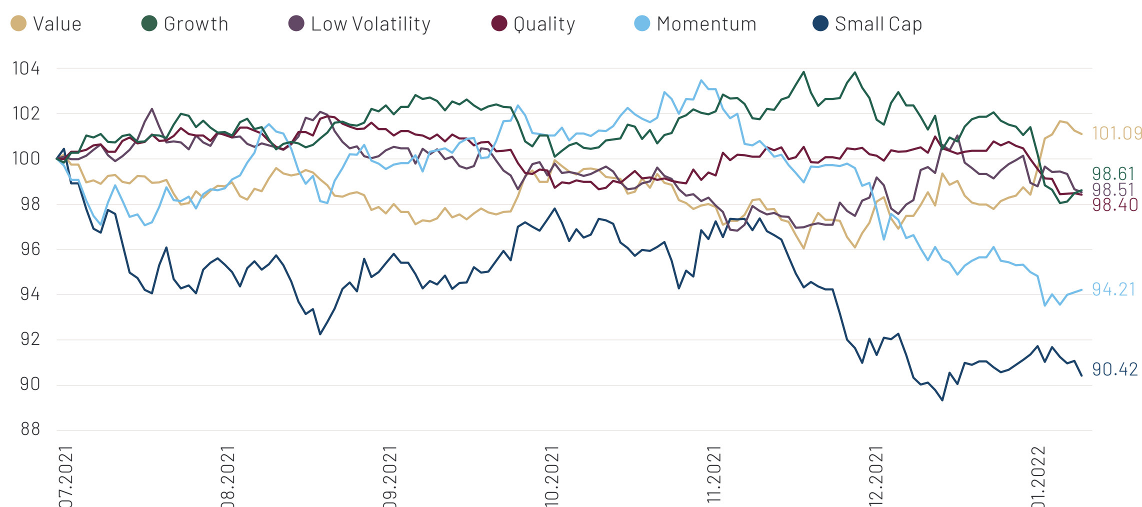
EPS growth expectations currently around

8%

EUROPE

From a regional stand point, Europe continues to be our favoured region for several reasons. Valuation is attractive in absolute terms and in relative terms compared historically, to other regions or other asset classes. EPS expectations for 2022 are probably on the cautious side and the coming earnings season should continue to fuel the positive revision trend despite well-known headwinds on margins (input costs and salary inflation, supply chain disruptions, Omicron). Finally the rise of nominal and real interest rates is a clear tailwind for the Value style which is very well represented in Europe.

CHART 5: RELATIVE PERFORMANCE OF ALL FACTORS VS MSCI US NET RETURN



Note: Value has strongly outperformed MSCI US net return since the end of 2021, benefiting from the surge of the US 10-year yield and inflation peaked.
Source: Bloomberg, Indosuez Wealth Management.

EMERGING MARKETS

Global investment sentiment towards China remains tense for now yet we believe Chinese equities are well positioned for a substantial rebound later in the year, probably in the second half of 2022. Firstly, China could be the only major economy in the world to continue easing monetary policy when all other major economies start their tightening cycles.

Moreover, Chinese equities look attractive for 2022 based on their EPS growth/valuations (highest expected EPS growth for North Asia over the next 12 months, and double the expected EPS growth for Asia ex. Japan) while exhibiting 20% discounts from their 5-year average P/E ratios.

Finally, China's current COVID-19 suppression policy and associated temporary targeted lockdowns seem to be delaying the country's full economic recovery for now. As such, we believe that substantial pent-up consumer demand will be at the core of the next growth leg in China and the rest of Asia.

For Asia ex-Japan, earnings have already fully recovered and above pre-COVID levels. India, Singapore and the Philippines have recently seen earnings upgrades into 2022. South Korea and Taiwan continue to offer opportunities driven by technology and a global cyclical recovery.

JAPAN

EPS revisions continue to be positive and one of the best geographical areas. These expectations combined with record cheap valuations should drive equity markets. Moreover, the acceleration of vaccinations with the tax support plan and the improvement in supply chain situation expected this year, this should support domestic consumption.

Finally, the Japanese market is historically a good regional hedge on potentially rising bond yields. Among the risk factors, beyond macro risks, one should note the negative correlation to the currency, which lead Japanese stocks to underperform during risk-off phases when yen behaves as a safe heaven.

STYLE: THE STRONG REBOUND OF VALUE VS. OTHER FACTORS

Since December 2021, the value strategy surged in particular through the recent strengthening on the 10-year yield and real yields rising. Even since then, interest rate seems to be the main driver of the equity market. Value appears cheap and during periods with high and rising inflation, short duration value stocks usually outperformed growth. In order to take advantage of the value rebound, we favour financials, which should benefit from global economic activity in early 2022 and the rise in interest rates. Energy sector would also be a good hedge on inflation.

We maintain a positive view on growth but with a particular focus on valuation levels as companies with multiples of 40 to 50 times earnings are likely to be more affected by the rise in long-term rates. Finally, with the normalisation of EPS growth this year, shareholder returns, whether in the form of dividends or share buybacks, should represent a significant portion of the total return expected from equities this year, opening the door to certain opportunities in this theme.

HIGH UNCERTAINTY FOR FOREX TOO

As the Fed continues to tighten its hawkish stance, the Swiss National Bank (SNB) reveals new and significantly bullish information for the CHF, whilst GBP appears vulnerable and the EUR sees a shallow bounce in January.

POUND
AT STRONGEST LEVEL
vs EUR since Brexit

POUND STERLING

The rally that started in early 2021 and pushed the pound above USD 1.37 is probably over, there was basically no (fundamental) reason for it, other than a positioning squeeze. A significant part of the expectations around the Bank of England rate hikes have been priced for a while now. Thus, the record employment and inflation (highest in almost 30 years) figures had little impact on the markets, which had already predicted a 25 bps rate hike in February and a total of 100 bps for 2022. In the middle of January risk sentiment rose to the detriment of the pound sterling. There remains some political risk for the GBP: Boris Johnson, who is about to lift COVID-19 restrictions, is also currently fighting to maintain his position, even though some of the lawmakers in his own majority have signalled to trigger a leadership challenge. This situation should however represent a limited risk for the pound.

US DOLLAR

For the markets, the question is no longer if the Fed will raise rates but rather when and in what proportion. Following a brief period of weakness at the beginning of the year, the USD has stabilised. Record high CPI made some view that the Fed is so far behind the curve in fighting inflation that it must be more aggressive by hiking rates four times this year, commencing as early as March. Since most of the movement on the US Dollar was related to the rise in short term bond yields, and since the tapering discussion mostly affects long-term bond yields which affect currencies less, the greenback hardly reacted to the Fed minutes, but did instead to the capital flows and investor's positioning. Going forward, we anticipate the current dollar strength to gradually dissipate in 2022, as markets fully price in the US rate hikes. Provided the old saying "buy the rumour - sell the news" is accurate, the end of Q1 2022 could be good timing to diversify beyond the dollar, notably around the French elections uncertainty. The main risk to this scenario would be weaker macro momentum in Europe and stronger inflation readings in the US provoking even higher rate hike expectations.

EURO

Unlike the dollar, the euro had a very good start to the year, but the rally is over and the situation has returned to end-2021 levels (Chart 6). The euro seems quite vulnerable currently, indeed, increased divergence between Fed and ECB policies, but also soaring oil prices and the energy crisis are weighing on the euro (unlike the US, the Euro Area is highly dependent on foreign supplies). Inflation has hit record levels in the Euro Area, but the ECB sees a rate hike this year as "very unlikely". Interest rates in the Euro Area are rising as well but at a slower pace compared to most of the G10. Some in the market are convinced that the inflation pressure is so high (and not transitory) that the ECB must rapidly exit the APP and start hiking rates by year-end for a total of 20 bps. The evolution of the ECB's speech is to be followed closely.

SNB allowing
CHF TO APPRECIATE
in order to mitigate inflation

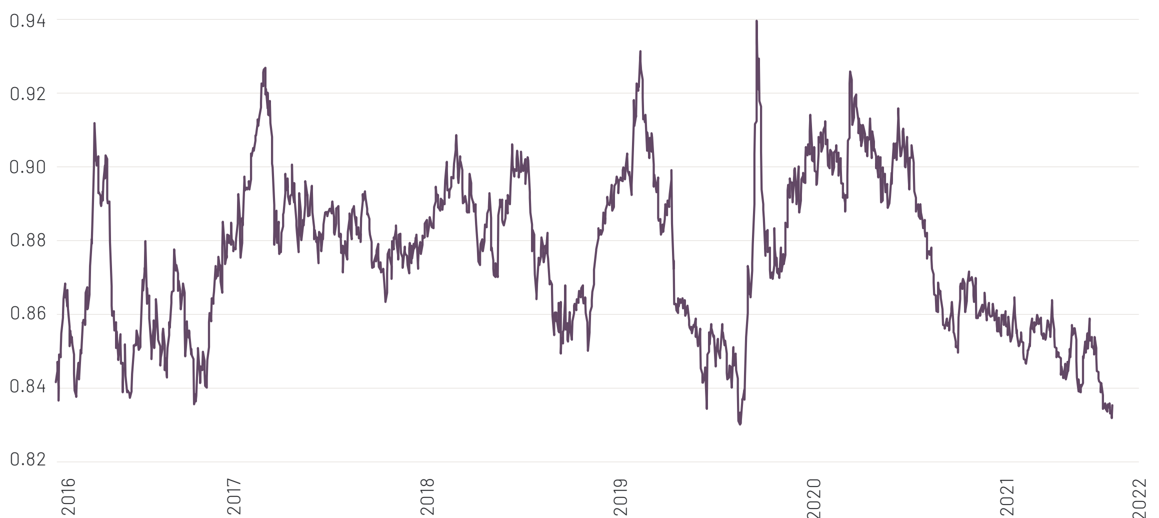
SWISS FRANC

One question increasingly asked - what is the level at which the SNB defends the CHF? We may have the beginning of an answer. At the end of 2021, the franc was at the highest since 2015 (abandonment of its cap on the currency). Whilst SNB President Jordan continued to reiterate the CHF is "highly valued", a pivotal message was given in a 16 December speech where he said the SNB had allowed the CHF to strengthen to mitigate inflationary pressures. Whilst we do not yet know where the SNB might want to intervene again, we certainly know it will be at least a few cents lower. At the same time, in the current risk-off environment, the CHF starts to look like an attractive risk-off hedge.

CNY – DIVERGING PBoC TO THE RESCUE TO COUNTER WEAK Q4 SLOWDOWN

In stark contrast, just as the Fed embarks on its long awaited monetary tightening cycle, the Chinese Central Bank via its first move since April 2020 has instead cut several key interest rates to ensure economic stability. The ever stable and outperforming renminbi has enabled such welcomed stimulus as its currency strength has insulated China from the imported commodity inflation rampant elsewhere. Given inflation at home is thus well anchored, the PBoC has pledged more monetary relaxation which will further support government bond prices. As such, we can now expect a well manoeuvred pause phase favouring CNY stability above all as interest rate differentials to peers narrow in. The record trade surplus posted further buoys the yuan on any bouts of weakness ahead that we hope to pounce upon.

CHART 6: EUR/GBP AT LOWEST SINCE BREXIT



Source: Bloomberg, Indosuez Wealth Management.

INVESTMENT SCENARIO AND ALLOCATION

January markets are driven by a triple narrative of reflation, monetary normalisation and reopening of economies. This drives long-term bond yields higher and generates a repricing of growth stocks, while value outperforms: 2022 starts as a year of relative value with more volatility and less directionality, with a "rendez-vous" set with the Fed in March on rate hikes and guidance on balance sheet reduction.

CENTRAL BANKS engaged on a MULTISPEED NORMALISATION TREND

- **Global Growth:** 4% GDP global growth, economic activity trending lower in major economies but still above potential growth. Some acceleration expected in 2022 in some South East Asian countries that have been sharply affected by COVID-19 outbreaks in 2021.
- **Inflation:** Total inflation stabilising at elevated levels in Q1 2022 before receding in H2, but core inflation to stay high with growing contribution from wages and services offsetting diminishing base effects and stabilisation of energy prices, while value chains are expected to be affected for several additional quarters by shortages, variants and zero-COVID policies in China.
- **Central banks** engaged on a multispeed normalisation trend, with the Fed and Bank of England leading, while the ECB is expected to stay cautious, contrasting with a more accommodative PBoC in China. Given the importance of the Fed easing in the performance of equities and credit in the past two years, this is a crucial moment for risk assets with limited margin for errors on the fundamentals. Globally speaking, long duration assets (long dated bonds, growth stocks) are facing volatility in the short term.

- **Equities:** Earnings are expected to grow in the high single digits in developed economies, with room for positive surprises, but risks concentrated on the inflation impact on margins, notably on services. Positive surprises should notably come from the two extremes of the spectrum - profitable techs companies and value stocks. Companies with high capital returns (through either dividends or buybacks) could be supported this year. From a geographical standpoint, developed markets still benefit from better earnings momentum than emerging markets. In China, we are waiting for EPS revisions to revert to north before adopting a more positive position in the short term.
- **Default rates** on corporates are expected to remain low in mature markets, while the attention remains focused on the restructuring of Chinese developers affected by deleveraging and refinancing constraints.
- **Asset valuations:** Corporate spreads should remain relatively compressed, although the history of Fed policy changes over the last decade (2013 and 2018) suggest that more volatility on spreads can expected. Equity valuations argue for more exposure to European stocks rather than American counterparts.
- **Cycle positioning and macro regime:** The cycle has entered the normalisation phase, which drives asset class and style rotation and with a volatility regime stabilising at higher levels, and greater performance dispersion between styles and sectors.
- **Implications for portfolio positioning:** We believe that investors should remain invested on risk assets, but with risk calibration adapted to higher volatility regime. Cash buffers are the best shock absorbers in a normalisation cycle. Macro and monetary divergences still favours developed markets over emerging markets ahead of Fed interest rate hikes, but a rebound on emerging markets and notably China expected in the second half.

KEY CONVICTIONS

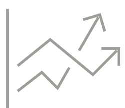
	TACTICAL VIEW (ST)	STRATEGIC VIEW (LT)
FIXED INCOME		
GOVERNMENTS		
Core EUR 10Y (Bund)	=	=/-
EUR Periphery	=/-	=
USD 10Y	=	=/-
EUR Breakevens Inflation	=	=
USD Breakevens Inflation	=/-	=
CREDITS		
Investment grade EUR	=	=
High yield EUR/BB- and >	=	=/+
High yield EUR/B+ and <	=	=
Financials Bonds EUR	=	=/+
Investment grade USD	=	=
High yield USD/BB- and >	=	=/+
High yield USD/B+ and <	=	=
EMERGING DEBT		
Sovereign Debt Hard Currency	=	=/+
Sovereign Debt Local Currency	=/-	=
Latam Credit USD	=/-	=/-
Asia Credit USD	=/+	=/+
Chinese Bonds CNY	=	+
EQUITIES		
GEOGRAPHIES		
Europe	+	=
United States	=/+	=/+
Japan	=/+	-/=
Latin America	-/=	=
Asia ex-Japan	-/=	=
China	=	+
STYLES		
Growth	=/+	+
Value	+	=
Quality	-/=	=/+
Cyclical	=	=
Defensive	-/=	-/=
FOREX		
United States (USD)	=/+	=/-
Euro Area (EUR)	=/-	=/+
United Kingdom (GBP)	=/-	=/+
Switzerland (CHF)	=/+	=/-
Japan (JPY)	=/+	=/-
Brazil (BRL)	=/-	=/-
China (CNY)	=/-	+
Gold (XAU)	=/+	=

Source: Indosuez Wealth Management.

08 • Market Monitor (local currencies)

OVERVIEW OF SELECTED MARKETS

DATA AS OF 20 JANUARY 2022



GOVERNMENT BONDS	YIELD	4 WEEKS CHANGE (BPS)	YTD CHANGE (BPS)
US Treasury 10Y	1.80%	31.13	29.39
France 10Y	0.36%	24.50	16.80
Germany 10Y	-0.03%	22.60	15.50
Spain 10Y	0.66%	15.60	9.80
Switzerland 10Y	0.04%	22.20	17.70
Japan 10Y	0.14%	8.30	7.80

BONDS	LAST	4 WEEKS CHANGE	YTD CHANGE
Governments Bonds Emerging Markets	39.43	-0.23%	0.54%
Euro Governments Bonds	217.51	-0.75%	-0.48%
Corporate EUR high yield	213.17	-0.17%	-0.21%
Corporate USD high yield	327.96	-1.06%	-1.34%
US Government Bonds	316.21	-1.25%	-1.27%
Corporate Emerging Markets	50.04	-1.69%	-1.88%

CURRENCIES	LAST SPOT	4 WEEKS CHANGE	YTD CHANGE
EUR/CHF	1.0376	-0.26%	0.01%
GBP/USD	1.3600	1.43%	0.50%
USD/CHF	0.9169	-0.17%	0.44%
EUR/USD	1.1312	-0.13%	-0.51%
USD/JPY	114.11	-0.24%	-0.84%

VOLATILITY INDEX	LAST	4 WEEKS CHANGE (POINTS)	YTD CHANGE (POINTS)
VIX	25.59	7.63	8.37

EQUITY INDICES	LAST PRICE	4 WEEKS CHANGE	YTD CHANGE
S&P 500 (United States)	4'482.73	-5.14%	-5.95%
FTSE 100 (United Kingdom)	7'585.01	2.87%	2.71%
Stoxx Europe 600	483.35	0.07%	-0.91%
Topix	1'938.53	-2.56%	-2.70%
MSCI World	3'082.25	-3.86%	-4.63%
Shanghai SE Composite	4'823.51	-2.53%	-2.37%
MSCI Emerging Markets	1'255.74	2.96%	1.93%
MSCI Latam (Latin America)	2'249.25	7.81%	5.61%
MSCI EMEA (Europe, Middle East, Africa)	285.44	3.66%	3.53%
MSCI Asia Ex Japan	802.24	2.75%	1.64%
CAC 40 (France)	7'194.16	1.24%	0.58%
DAX (Germany)	15'912.33	0.99%	0.17%
MIB (Italy)	27'570.00	2.05%	0.82%
IBEX (Spain)	8'814.60	2.93%	1.16%
SMI (Switzerland)	12'560.70	-1.76%	-2.45%

COMMODITIES	LAST PRICE	4 WEEKS CHANGE	YTD CHANGE
Steel Rebar (CNY/Tonne)	4'728.00	1.46%	3.96%
Gold (USD/Oz)	1'839.29	1.69%	0.55%
Crude Oil WTI (USD/Bbl)	86.90	17.77%	15.54%
Silver (USD/Oz)	24.716	7.78%	5.84%
Copper (USD/Tonne)	9'990.00	3.93%	2.77%
Natural Gas (USD/MMBtu)	3.80	1.90%	1.93%

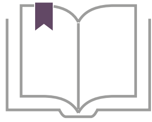
Source: Bloomberg, Indosuez Wealth Management.
Past performance does not guarantee future performance.

MONTHLY INVESTMENT RETURNS, PRICE INDEX

FTSE 100 · Topix · MSCI World · MSCI EMEA · MSCI Emerging Markets · Stoxx Europe 600 · S&P 500 · Shanghai SE Composite · MSCI Latam · MSCI Asia Ex Japan

	OCTOBER 2021	NOVEMBER 2021	DECEMBER 2021	4 WEEKS CHANGE	YTD (20.01.2022)
BEST PERFORMING	6.91%	-0.83%	-0.83%	7.81%	5.61%
	5.59%	-1.56%	-1.56%	3.66%	3.53%
	4.55%	-2.30%	-2.30%	2.96%	2.71%
	2.43%	-2.46%	-2.46%	2.87%	1.93%
	2.13%	-2.64%	-2.64%	2.75%	1.64%
	1.32%	-3.40%	-3.40%	0.07%	-0.91%
	0.93%	-3.64%	-3.64%	-2.53%	-2.37%
	0.87%	-3.92%	-3.92%	-2.56%	-2.70%
	-1.43%	-4.14%	-4.14%	-3.86%	-4.63%
WORST PERFORMING	-5.38%	-7.05%	-7.05%	-5.14%	-5.95%

Source: Bloomberg, Indosuez Wealth Management.
Past performance does not guarantee future performance.



Basis point (bp): 1 basis point = 0.01%.

Blockchain: A technology for storing and transmitting information. It takes the form of a database which has the particularity of being shared simultaneously with all its users and generally does not depend on any central body.

BLS: Bureau of Labor Statistics.

BNEF: Bloomberg New Energy Finance.

Brent: A type of sweet crude oil, often used as a benchmark for the price of crude oil in Europe.

CPI (Consumer Price Index): The CPI estimates the general price level faced by a typical household based on an average consumption basket of goods and services. The CPI tends to be the most commonly used measure of price inflation.

Deflation: Deflation is the opposite of inflation. Contrary to inflation, it is characterised by a sustained decrease in general price levels over an extended period.

Duration: Reflects the sensitivity of a bond or bond fund to changes in interest rates. This value is expressed in years. The longer the duration of a bond, the more sensitive its price is to interest rate changes.

EBIT (Earnings Before Interest and Taxes): Refers to earnings generated before any financial interest and taxes are taken into account. It takes earnings and subtracts operating expenses and thus also corresponds to non-operating expenses.

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation): EBITDA takes net income and adds interest, taxes, depreciation and amortisation expenses back to it. It is used to measure a company's operating profitability before non-operating expenses and non-cash charges.

ECB: The European Central Bank, which governs the euro and Euro Area member countries' monetary policy.

Economic Surprises Index: Measures the degree of variation in macro-economic data published versus forecasters' expectations.

Economies of scale: Decrease in a product's unit cost that a company obtains by increasing the quantity of its production.

EPS: Earnings per share.

ESG: Non-financial corporate rating system based on environmental, social and governance criteria. It is used to evaluate the sustainability and ethical impact of an investment in a company.

Fed: The US Federal Reserve, i.e. the central bank of the United States.

FOMC (Federal Open Market Committee): The US Federal Reserve's monetary policy body.

GDP (Gross Domestic Product): GDP measures a country's yearly production of goods and services by operators residing within the national territory.

Gig economy: system characterised by flexible, temporary or freelance jobs.

IEA: International Energy Agency.

IMF: The International Monetary Fund.

Inflation breakeven: Level of inflation where nominal bonds have the same return as inflation-linked bonds (of the same maturity and grade). In other words, it is the level of inflation at which it makes no difference if an investor owns a nominal bond or an inflation-linked bond. It therefore represents inflation expectations in a geographic region for a specific maturity.

Inflation swap rate 5-year, 5-year: A market measure of what five-year inflation expectations will be in five years' time. It provides a window into how inflation expectations may change in the future.

IPPC: The Intergovernmental Panel on Climate Change.

IRENA: International Renewable Energy Agency.

ISM: Institute for Supply Management.

Japanification of the economy: Refers to the stagnation the Japanese economy has faced in the last three decades, and is generally used to refer to economists' fears that other developed countries will follow suit.

Metaverse: A metaverse (portmanteau of meta and universe) is a fictional virtual world. The term is regularly used to describe a future version of the internet where virtual, persistent and shared spaces are accessible via 3D interaction.

OECD: Organisation for Economic Co-operation and Development.

Oligopoly: An oligopoly occurs when there is a small number of producers (supply) with a certain amount of market power and a large number of customers (demand) on a market.

OPEC: Organization of the Petroleum Exporting Countries; 14 members.

OPEC+: OPEC plus 10 additional countries, notably Russia, Mexico, and Kazakhstan.

PMI: Purchasing Managers' Index.

Policy-mix: The economic strategy adopted by a state depending on the economic environment and its objectives, mainly consisting of a combination of monetary and fiscal policy.

Pricing power: Refers to the ability of a company or brand to increase its prices without affecting demand for its products.

Quantitative easing (QE): A monetary policy tool by which the central bank acquires assets such as bonds, in order to inject liquidity into the economy.

SEC (Securities and Exchange Commission): The SEC is an independent federal agency with responsibility for the orderly functioning of US securities markets.

Spread (or credit spread): A spread is the difference between two assets, typically between interest rates, such as those of corporate bonds over a government bond.

Secular stagnation: Refers to an extended period of little or no economic growth.

SRI: Sustainable and Responsible Investments.

Uberisation: Term derived from the name of US company Uber which develops and operates digital platforms that connect drivers and riders. It refers to a new business model that leverages new digital technologies and is part of the sharing economy, insofar as it puts customers in direct contact with service providers, at a reduced cost and with lower prices.

VIX: The index of implied volatility in the S&P 500 Index. It measures market operators' expectations of 30-day volatility, based on index options.

WTI (West Texas Intermediate): Along with Brent crude, the WTI is a benchmark for crude oil prices. WTI crude is produced in America and is a blend of several sweet crude oils.

WTO: World Trade Organization.

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