How long is "transitory"?

Sticky inflation and more hawkish central banks saw a sharp rise in yields last month, and while economic activity continues to slow, it remains strong.

Macro outlook – Reduced growth expectations at a high level

Economists have recently reduced their growth forecasts in view of increased uncertainty regarding the future global growth path. However, due to extensive liquidity measures and stimulus programs, the demand side is not the problem. Rather, it is the supply side that has led to recent disappointing sales expectations among companies. Disrupted supply chains, high energy prices and significantly increased freight costs are weighing on global growth. Investors are unsure whether the sharp rise in input prices can be passed on to consumers or will largely be at the expense of corporate profit margins. Investors seem to agree that this development is merely temporary. However, this is not a certainty at this point in time.

Freight costs have risen sharply

Source: Refinitiv, J. Safra Sarasin, weekly data, 1.1.2020 to 8.10.2021

In recent weeks, market participants have therefore continued to focus on the U.S. Federal Reserve, its inflation assessment and the expected rate path. The Fed's inflation forecast for the coming year has been repeatedly revised upward by the monetary watchdogs in recent months, most recently to 2.3%, the highest level since these forecasts were published in 2007. The message of their latest inflation assessment was: "Transitory" is likely to last longer. The monetary policy consequence is directly reflected in the "dot plot", i.e. the graphical representation of the rate expectations of the members of the Federal Open Market Committee. For the first time, this now suggests that rates will be raised as early as next year. This is also in line with our forecasts. Our economists expect the first rate hike in the fourth quarter of 2022. With regard to the tapering of bond purchases, Fed Chairman Jerome Powell indicated that this would be carried out rather quickly and ended as early as mid-2022, provided that the economy develops as expected.

Editorial

Dear Reader

The sharp rise in energy prices has fueled the inflation debate in recent weeks. Is inflation really only temporarily high? The issue is likely to continue to preoccupy financial markets in the coming months, and investors must be prepared for the fact that it could take even longer for inflation to settle down. As a result, interest rates are likely to rise and market volatility and the risk of setbacks will remain high. However, as the economy remains robust and corporate earnings continue to rise, we expect positive returns for a multi-asset portfolio in the medium term and are cautiously optimistic that the year will end on a positive note.

Philipp E. Bärtschi, CFA, Chief Investment Officer

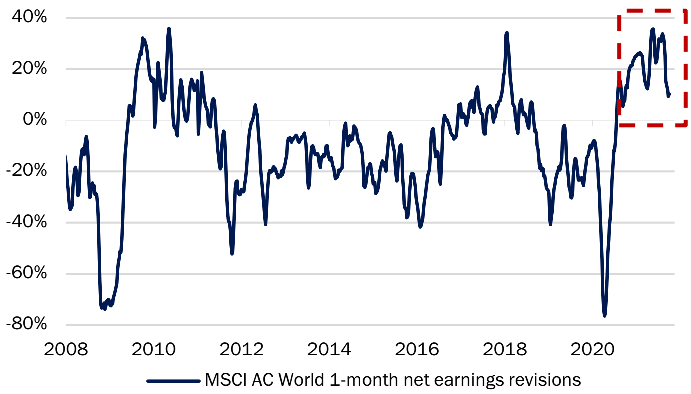
Bonds – Apparent movement in the interest rate landscape

Government bond markets reacted to this with substantial rises in interest rates. In the US, political uncertainty due to the approaching US debt ceiling added to the upward pressure on rates. Ten-year US government bonds rose to over 1.50% in this environment, their highest level since mid-June. The main reason for this was the significant rise in real rates. However, this was not due to improved growth expectations, as was the case a year ago, but due to the steeper interest rate path in the context of the US Federal Reserve's monetary policy normalization, which was communicated at the September meeting. Interest rates in European government bond markets were not immune to this development and also continued their upward trend that started in August. The upward pressure on interest rates is likely to persist until the end of the year and return expectations will remain correspondingly low. The U.S. dollar strengthened significantly in this environment and, along with political risks and the Evergrande saga in China, was a further drag on emerging market bonds. However, credit spreads have now reached attractive levels and so have return expectations.

Equities – Fragile environment

In recent weeks, equity markets have also been adversely affected by uncertainties regarding the US Federal Reserve's monetary policy stance, future inflation trends and rising interest rates. The latter weighed particularly on growth stocks. The technology sector came under heavy selling pressure. This was compounded by declining earnings expectations in the run-up to the reporting season due to lower growth forecasts and significantly higher commodity prices. Whereas at the beginning of the year stock markets countered rising interest rates, weaker growth and rising inflation expectations with rising profits, this support is currently missing - and is creating a correspondingly fragile environment for equity markets.

Earnings upgrades have started to drop



Source: Refinitiv, J. Safra Sarasin, weekly data, 4.1.2008 to 3.10.2021

Asset Allocation – Positive medium-term outlook

Investors are always operating in an uncertain environment. After all, they are compensated for these risks with a return. Structuring a robust multi-asset portfolio that can safely navigate potentially choppy waters and limit losses, especially in uncertain times like these, should not be underestimated in its relevance to an investor's long-term investment success. However, the past few weeks have also been challenging for multi-asset portfolios as not only equities, but also bonds suffered price losses due to rising interest rates. The market followed a stagflation narrative (i.e. growth standstill combined with high inflation). However, the current economic situation, with declining but still high growth rates, combined with inflation rates that have risen significantly but not run away, does not indicate that we are actually in the beginnings of a stagflation period as in the 1970s.

In the medium term, the cyclical environment is crucial for the development of equity markets. And this continues to be robust. In the short term, however, we are keeping a wary eye on further inflation and interest rate developments and their potential implications for the stock market. The coming weeks are likely to remain volatile due to macroeconomic and monetary policy uncertainties. The risk symmetry is rather adversely affected in the short term. Nevertheless, we remain slightly overweight equities due to the positive medium-term outlook. We still see strong catch-up potential in areas that have lagged the broad market in recent months - our focus in this context is on banking and emerging market equities.

Due to continuing inflation and interest rate risks, we remain strongly underweighted in investment grade government and corporate bonds. In this segment, we continue to favour high-yield and selectively also emerging market bonds. To ensure positive diversification effects in an environment of rising interest rates, we are overweight in alternative investments that are as uncorrelated as possible. Cat bonds in particular contribute to a stabilization of the return behaviour.

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Attractiveness of individual investments

Asset class	Weighting	Relative attractiveness within the categories			
Equities	= / +	Developed markets =	Emerging markets +	Large caps =	Small caps =
Bonds	–	Government bonds – –	Corporate bonds – –	High-yield bonds +	Emerging markets +
Alternative assets	= / +	Money market +	Convertible bonds –	Other alternatives +	Real Estate =

Source: Refinitiv, J. Safra Sarasin

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