J. SAFRA SARASIN
SUSTAINABLE ASSET MANAGEMENT

CIO Update

Investment Committee Bank J. Safra Sarasin
8 July 2021

Welcome to the consolidation phase

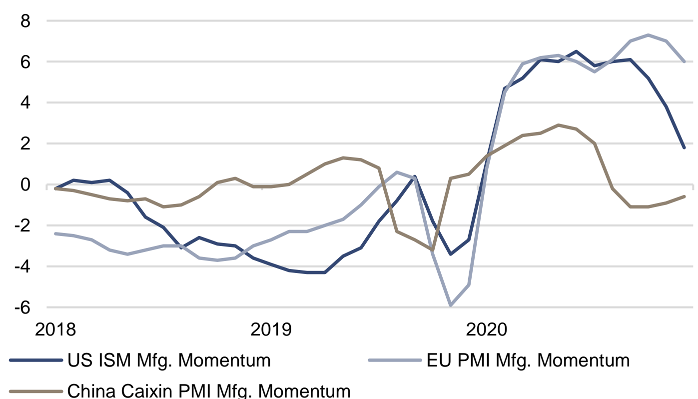
A US central bank that wants to raise rates sooner and a slowdown in growth momentum are leading to strong moves in financial markets.

Macro outlook – Robust economic environment
The global economy has made considerable progress since the beginning of the year, despite COVID-19-related challenges. The positive economic momentum accelerated again in the second quarter in an environment of significant vaccination progress, particularly in the developed countries. Emerging market regions still have some catching up to do in this respect. But here, too, significant improvements can be observed – and further progress is likely to be made in the coming months. According to its latest forecast, the World Bank now expects the global GDP to grow 5.6% this year. That would be the strongest growth in 80 years.

However, as strong as the current growth environment is, there have been increasing signs in recent weeks that the economic recovery is now past its peak. Although European purchasing managers' indices once again surprised on the upside in June, the momentum has recently slowed considerably. This is particularly true for the USA, where macroeconomic data have been rather mixed in recent weeks.

Another aspect that became clear on the basis of the purchasing managers' indices was the sharp rise in their price components, indicating a significant increase in inflationary pressure. In this regard, the U.S. Federal Reserve had considered for the first time at its June Federal Open Market Committee (FOMC) meeting the possibility that the recent rise in inflation could be higher and in certain elements more persistent than they previously assumed. 13 out of 18 FOMC members are now in favor of at least one rate hike by the end of 2023 – twice as many as three months ago.

Economic environment robust, but with slowing momentum



Source: Refinitiv, J. Safra Sarasin, monthly data, July 2018 to June 2021
momentum = 3-months-average minus 12-months average

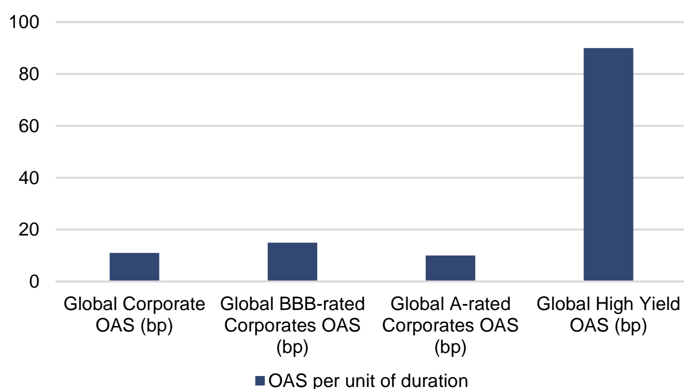
Editorial
Dear Reader

We have already left the first half of the year behind us and with it some of the trends in financial markets that have been with us since last year. The recovery phase is over and we are now in a consolidation period. Risk assets remain well supported and interest rates are also likely to rise again after a pause. We are largely sticking to our positioning with broad diversification and small active bets. It is difficult to predict how long this phase will last. However, it seems clear that portfolio returns are likely to be lower than during the recovery phase. In this phase, investors should not go too far out on a limb, because they will no longer be compensated accordingly for higher risk.

Philipp E. Bärtschi, CFA, Chief Investment Officer

Bonds – Flattening of the yield curve
While the yield on ten-year U.S. government bonds has fallen below 1.3%, yields at the short end of the yield curve have reacted to the change in the U.S. Federal Reserve's communication strategy with strong increases. The U.S. yield curve has thus flattened considerably. This is rational insofar as the shorter part of the curve naturally moves upward when the central bank holds out the prospect of interest rate hikes in the near future, while the longer part, in which medium-term inflation expectations are priced in, tends to fall with a view to tighter inflation control.

Investment-grade bonds offer only little value



Source: J. Safra Sarasin, as of 30.6.2021, OAS = Option adjusted spread

Following the recent decline in interest rates, investment-grade bonds hardly seem attractive to us. Credit spreads in this segment are close to record lows, with relatively long duration. High-yield and emerging market bonds with shorter duration have a more attractive starting position in this respect and remain supported by the still robust growth environment. The debt situation of companies has recently improved further. This is also reflected in significantly more upgrades than downgrades of credit ratings by rating agencies. In addition, expected default rates in the high-yield segment for 2021 have fallen to their lowest level since 2011.

Equities – Short break in the reflation trade
When the U.S. Federal Reserve's monetary policy communication became "hawkish" in June, it led to increased uncertainty about a potential reversal of the reflation trade. Yield curves flattened, inflation expectations declined, cyclical and value stocks fell sharply relative to growth stocks, the commodity sector came under pressure, and the U.S. dollar strengthened. In this environment, investors have recently reduced their equity exposure slightly and realized gains in market segments that had benefited particularly strongly from the reflationary environment. Does this mean that the trends established since November last year have come to an end? Not necessarily. Rather, we are in a consolidation phase. The inflation pendulum, which has been swinging strongly in one direction since last summer, is now moving back. The U.S. Federal Reserve's communication, which is more focused on inflation risks and their containment, has recently supported this countermovement. How much the pendulum will swing back and whether it will even swing in the other direction is difficult to say. In our base scenario, we assume that both growth and inflation will remain above trend for several quarters. Thus, it should only be a matter of time before the reflation trades driven by higher interest rates return.

Asset Allocation – The risk environment remains constructive
We also realized gains in equities in the second quarter, but remain slightly overweight in our multi-asset portfolios. The robust economic environment - albeit with slowing growth momentum - and ample liquidity continue to support the asset class. At the regional level, we favor emerging market equities, which still have catch-up potential. The cyclical recovery in the second half of the year is likely to be more pronounced in the emerging market regions than in the US. In China in particular, we see initial signs that growth is stabilizing and should accelerate again towards the end of the year.

We remain underweight investment grade and government bonds. We maintain our overweight in emerging market and high-yield bonds despite the sharp tightening of credit spreads. Corporate fundamentals and the hunt for yield should continue to support the asset classes in the coming months. As we expect yields to rise slightly by the end of the year, we are focusing on the shorter duration segments within the asset class, which translates into an underweight in emerging market sovereign bonds and an overweight in EM corporate bonds and emerging market local currency bonds.

We remain overweight in alternative investments. Due to positive diversification characteristics to bonds and equities, we prefer investments that are as uncorrelated as possible, such as catastrophe bonds, whose return behaviour is very robust over the economic cycle and against different inflation and interest rate regimes.

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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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