J. SAFRA SARASIN
SUSTAINABLE ASSET MANAGEMENT

# CIO Update

Investment Committee Bank J. Safra Sarasin
9 September 2021

## Good prospects until year-end

### The spread of the delta variant weighs on the recovery. But the outlook for the equity markets remains solid.

**Macro outlook – Supply bottlenecks weigh on economic growth**
The decline in global growth momentum has become more pronounced in recent weeks. Purchasing managers' indices in many regions disappointed in August. This is particularly true for China. Not only the manufacturing sector, but also the services component was well below expectations. The latter fell to 46.7 points in August, below the contraction threshold. The economic development continued to be burdened by the spread of the delta variant. This is also true, albeit certainly to a lesser extent, for countries in the euro zone and the USA due to differences in the progress of vaccination. Here, however, it is to a large extent also the still disrupted supply chains, the bottlenecks in intermediate products that have arisen in this context, and the labor shortage in some sectors that are burdening and restricting economic activity. It is therefore not the demand side but primarily the supply side that is weighing on economic momentum. However, a closer look shows first signs of improvement with regard to supply bottlenecks and inflation. This gives reason to be optimistic about the future. The business cycle is therefore likely to gain momentum in the coming months and the economic expansion is likely to continue.

The US labor market also surprised on the downside in August. Only 235,000 new non-farm jobs were created. Analysts had expected an increase of 725,000. In July, more than one million jobs had been created. At the same time, there is a shortage of workers in sectors such as hospitality and tourism. That could change with the end of benefit programs, which expired this week. However, in addition to a significant increase in labor supply, it is also likely to lead to lower consumer demand - both deflationary forces.

This development plays into the hands of the U.S. Federal Reserve, as it is basing its monetary policy path on an inflation forecast that assumes only transitory high inflation rates. In the coming months, the central bank should then be able to continue to pursue its monetary policy path without running the risk of having to take significantly more aggressive measures due to inflation developments getting out of control and thus jeopardizing stability on the financial markets.

**Bonds – Rise in yields remains limited**
Meanwhile, the environment for bond investors remains challenging. Although we do not expect yields to rise sharply, the still positive economic development and, in particular, the monetary policy intentions of the US Federal Reserve are likely to lead to slightly higher yields. This will primarily weigh on investment grade bonds.

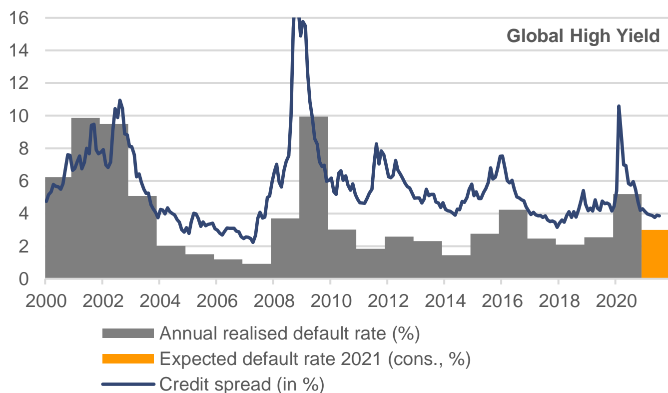
**Editorial**
Dear Reader

Equity markets performed very well in the summer months, with many indices reaching new highs. Although a setback is possible at any time, we expect the prospects to remain good until the end of the year. The economic environment is robust and corporate earnings should continue to surprise on the upside. In Asia, growth is likely to pick up again in the fourth quarter after a period of weakness, resulting in improved sentiment. The main risk remains high inflation rates, which could lead to discussions among central banks and a more restrictive monetary policy. However, this issue is unlikely to become a serious problem for equity markets this year but much later.

Philipp E. Bärtschi, CFA, Chief Investment Officer

We therefore position ourselves in the short maturity segment. In this segment high-yield bonds have a particularly attractive risk-return profile. Although the credit spreads are low in a historical context, as is the case for all bond segments, it is high enough to offer investors a sufficient risk buffer in an environment of rising yields. This is particularly true compared to investment grade bonds. In addition, the high yield asset class is benefiting from a robust growth environment, as default rates will remain at low levels next year.

**Low default rates should support credit spreads**

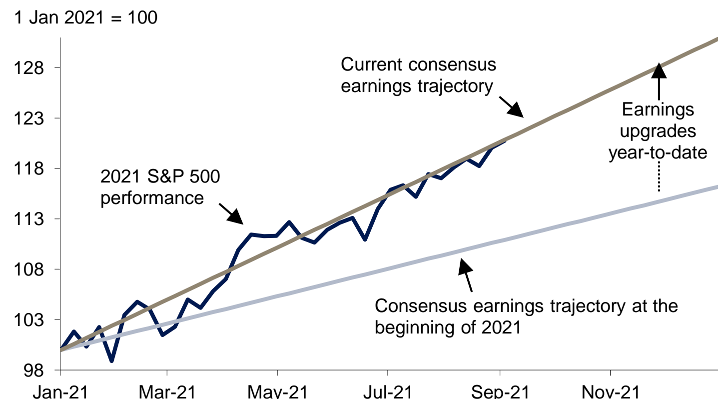



Source: Refinitiv, Bank J. Safra Sarasin, monthly data, Feb 2002 to Aug 2021

**Equities – Still positive return expectations**

The economic recovery is expected to continue in the coming months. The disrupted supply chains and existing bottlenecks in intermediate products have smoothed out the cycle rather than stalling it. This is because demand remains high and companies have full order books. Positive corporate earnings and sales growth should therefore continue, albeit not with the same strong momentum we have seen in recent quarters, and support equity markets in the months ahead.

**Strong earnings growth likely to lead to higher share prices**




Source: Refinitiv, Bank J. Safra Sarasin, weekly data, 1.1.2021 to 3.9.2021

Meanwhile, the risks in China remain. However, this is primarily a short-term problem. The regulatory measures, perhaps not necessarily in their implementation, but from a structural point of view, are largely similar to the developments in Europe and the U.S. a few decades ago. This means protecting competition by limiting monopolies and other structural measures that have the potential to lead to higher and more sustainable productivity growth in the long run. The renewed monetary policy support from the Chinese central bank should also lead to further stabilization of the domestic stock market.

**Asset Allocation – Prospects good, but do not underestimate risks**

Even though the performance and valuation of risk assets have already largely anticipated the economic upswing, the medium-term outlook for equities remains constructive due to solid earnings growth. The continued robust economic environment and a revival of the cyclical upswing should allow the asset class to continue its upward trend. We therefore maintain our slight overweight. However, the U.S. Federal Reserve is expected to start reducing its asset purchase program at the end of this year and, as a result, volatility on the equity markets will increase due to declining market liquidity. We therefore position our portfolios defensively within the equity allocation. For example, we are overweight in healthcare at the sector level. The sector has the ability to perform positively both in an environment of robust growth but also in more defensive market conditions. On a regional level, we remain overweight in emerging market equities. Political risks in China remain. However, cyclical indicators seem to have found a bottom and should rise again in the fourth quarter. On the other hand, the case for continued outperformance of US equity markets is not very convincing. Even if the infrastructure measures and further social spending that have been set in motion are adopted, the fiscal stimulus is likely to weaken more than in other regions. This is particularly true compared with the euro zone, where spending from the Recovery Fund should provide support in the coming quarters.

In fixed income, we remain underweight in investment grade bonds, while maintaining our overweight in high-yield and emerging market bonds. The unchanged robust growth environment, low default rates and favourable return behaviour in a rising interest rate environment speak in favour of high-yield bonds.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**Attractiveness of individual investments**

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

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