October 2021

RISING HEADWINDS MOVING INTO YEAR END

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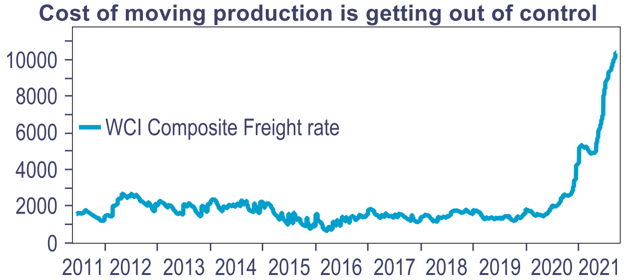
Going into year-end, and at current valuation levels, we see less opportunities for risky assets and scale equities down to neutral. The inflation narrative has shifted. Price pressures now go hand in hand with risks to output and consumer spending. We expect monetary normalisation to be very gradual, but still lead to slightly higher rates by year end, keeping us underweight on sovereign bonds. China exposure starts to be compelling from a valuation perspective, but uncertainties are too high in our view.

During the summer, the market environment and the economic backdrop have progressively changed. Headwinds for risky assets have increased, prompting us to scale down our positions by one notch to neutral. To be clear, we do not expect the longer term uptrend in equity markets to be derailed. In the short term however, and given current valuation levels, upside seems somewhat limited until year-end, and, given our expectation of higher volatitliy, risk reward has deteriorated.

On the macro front, we expect absolute growth levels to remain strong but momentum to fade. Indeed, peak growth is now behind us, and we see increased downside risks. China is one of them. Tighter regulation and high uncertainty have undermined markets, but they will quite certainly also impact economic activity as profit seeking behaviour, which was at the core of China's strong growth during the last decade, is partly being nationalized. The same goes for the Evergrande debacle. Authorities and China's central bank are stepping in to prevent systemic risk, but the restructuring will inevitably have a negative impact on the housing sector (30% of Chinese GDP). Part of these negative effects could be smoothed out by a more accommodative policy mix, but weaker growth could be the short term price to pay for "common prosperity".

Covid-19, in our view, remains another potential downside risk. In Europe, vaccination rates have now reached reassuring levels (around 60% of the population is fully vaccinated), but this is not the case in the United States, where death rates are rising again, nor in China, where Covid resurgence is met with a zero tolerance policy that could add to supply disruptions as we enter winter.

Cost of moving production is getting out of control



Source: Lyxor AM, Macrobond, Bloomberg

Last but not least, on the inflation front the narrative has clearly shifted from fears of a demand-driven overheating to supply-side driven price pressures. Supply bottlenecks and surging shipping and energy costs – natural gas prices are up by more than 100% since the start of the year – are adding to price pressures which every day are a little bit less "transitory". Moreover, they are simultaneously weighing on production as factory lines are partially shutting down and on consumer purchasing power.

Given the strong growth backdrop, we are still far away from a '70s stagflation type of scenario, but markets are not necessarily pricing in a scenario that would be detrimental for both equities and bonds.

Overall, and after a strong year, the current backdrop argues for some profit taking and a risk reduction in our portfolios. We thus move global equities to neutral and keep our underweight stance on sovereign bonds. In term of regional preferences we remain overweight on Europe (still a good candidate for the reflation trade with solid EPS prospects and attractive relative valuations) and we are very selective as regards Emerging Markets and remain cautious on China where drastic policy change has blurred the investment outlook, warranting a close monitoring.

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