OUTLOOK S2 2021

THE 10 KEY FACTORS OF THE RECOVERY

As the economic threat of the Covid crisis recedes and economies recover, what are the key factors investors need to keep tabs on? In a press conference in Paris on Wednesday June 30, Lyxor Asset Management's CIO Florence Barjou and Global Head of Market Research Jeanne Asseraf-Bitton outlined the 10 key factors that will determine the pace of the recovery, and the implications for investors.

1. Commodities and growth prospects

The conjunction of economic stimulus programmes and the pandemic fading away have created the perfect environment for economic growth. While much of the focus has been on the US, the momentum is likely to shift to the EMU in H2.

One dark cloud is the spread of the highly contagious Delta variant, which is now in 80 countries, with a recent surge in Africa, Russia, Portugal and the UK. It will likely become the dominant strain in the US and Europe.

The good news is that vaccinations appear to protect against serious infection, even though the Delta spread could delay reopening, especially in developing markets.

Commodities are also a mixed picture. Base metals, which rallied strongly in H1, have softened due to uncertainty stoked by the Delta variant. OPEC+ will likely add oil supply cautiously, allowing oil prices to stay firm. Whether the commodity boom lasts will also determine whether inflation is here to stay.

2. Are we on the cusp of a new inflation regime?

Recent inflation figures have spooked investors, especially in the US where the latest headline figure shot up to 5%, the highest in a quarter century. Even stripping out base effects due in particular to the bounce-back in oil prices as economies are exiting lockdowns, inflation figures are generally above central banks' targets.

This has led to investor asking: is the inflation trend transitory?

Much of the inflationary pressure has been linked to rising commodity prices, such as the price of oil, but this is likely to fade in Q2.

Another indicator is rent, which is linked to the housing boom and which could have a more lasting effect.

Finally, the key variable to watch is wages. Salary rises have been modest so far, but anecdotal evidence suggests we will see higher wages as companies are compelled to offer more attractive packages to hire or retain employees.

From a structural standpoint, we think it is premature to talk about a change in the inflation regime. Even though the potential spending of savings accumulated during the crisis, massive stimulus programs and dents to globalization are inflationary factors, we think that persistent employment and growth gaps, a rise in productivity and the monetary policy cycle being close to its peak, will likely counter any rises in salaries.

On that basis, our central scenario is one of transitory inflation, with US inflation stabilizing around 2.5%.

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3. Are central banks behind the curve on inflation?

This question has clearly been rattling markets for the past few weeks. After several decades of fighting deflation, investors are concerned that central banks risk being complacent towards inflation and let inflation spin out of control.

There is a growing central bank tolerance for higher inflation rates, which is being written into policy, especially by the Fed.

All in all, what with ultra-accommodative monetary policies, Keynesian stimulus programs, the economic boom in the US and possible central bank complacency, this makes for a cocktail where transitory inflation could become permanent.

This is not our central scenario, but it has emerged as a new tail risk scenario which we didn't have six months ago. As recent history has shown, there can be no happy ending when central banks are failing to keep inflation in check, as this often translates into abrupt rate hikes.

However, we are encouraged by the latest Fed declarations, which were interpreted as hawkish by markets: instead, we think the Fed has shown itself willing to adapt its monetary stance in balancing growth with the need to limit runaway inflation.

4. What about the corporate debt wall?

Debt surged during the Covid crisis as companies borrowed heavily to remain afloat. However, credit risk remains contained, supported by liquidity, public support, and the cyclical recovery.

But, if interest rates were to surge, the corporate sector could come under pressure, especially companies which were already weak before the pandemic. However, mild inflation, accompanied by gradual monetary normalization, would be supportive, making corporate debt servicing manageable in our view.

5. From Monetary to Fiscal policy

Central banks have made a huge effort to prop up bond markets since 2020 to counter the Covid-induced economic shock.

The Bank of Japan, for example, holds almost half of the Japanese sovereign bond market, while in the eurozone, the ECB holds almost 35. The US have been somewhat less aggressive, at 25%.

Central banks have repeatedly been calling on governments to pick up the slack and boost their fiscal stimulus programs, and states are finally stepping up to the plate: the fiscal pulse is surging from low levels, with massive positive impulse in 2020 and 2021, led by the US $5 Tn Covid rescue plan.

6. Is profit growth sustainable?

Investors are now looking ahead at the unwinding of fiscal stimulus plans and especially weighing whether tax hikes currently debated to fund Biden's infrastructure and family support programs are likely to dent corporate profits from 2022 onwards. We think corporate tax hikes will remain moderate, possibly eroding S&P 500 corporate profits between 3% and 10% next year, also depending on how quickly these hikes are implemented, with brisk economic growth in 2021 and 2022 tempering the impact of rising taxes.

7. What is the EURUSD outlook?

We have a neutral stance on the EURUSD as neither of the two currencies has a more compelling case than the other. Any rate hike in the future is more likely to come from the Fed, which would favor the dollar, which would retain its global safe haven status.

On the other hand, strong reflation in Europe would attract capital flows into Europe, boosting the euro. But looming political uncertainties, with upcoming elections in Germany and in France, could weigh on the single currency.

8. Are EMU equities cheap relative to the US?

European equities have long been perceived as cheaper in relative terms than US ones. Looking closely at metrics, this is no longer the case: P/E ratios in Europe display a 17% discount vs US peers, in line with the long-term average.

Price to cashflow ratios show a little more upside, due to the more deflation-prone structural nature of the euro-zone economy compared with the US, as Europe has been lagging the US in nominal growth terms for several years.

Only a structural catching up by Europe would warrant higher valuation for European equities, but it's a little too early for that. Europe nevertheless remains attractive in our baseline scenario due to the reflation theme.

9. Where do we stand on sector rotation?

Factor rotation from growth into value stocks has been a key driver of portfolio performance since the beginning of the Covid crisis in March 2020.

However, it has lost some of its momentum in the last two months. Not one sector in Europe has a valuation that is lower than its average in the last 15 years.

While the value theme may have played out at the macro level, it remains an interesting theme to explore from a more granular stock-picking perspective. Indeed, we believe it's still too early to anticipate an end of cycle. In our central scenario, we see that activity remains robust, with a recovery that's starting to shift from manufacturing to services and Europe standing to benefit the most from the next reflation cycle, after China at the end of 2020 and the US earlier this year.

10. Is Bitcoin the new gold?

Bitcoin has experienced massive volatility, up to 8 times more than US equities. It peaked in April at around €52,000, falling back €30,000 in July. It hardly behaves like a safe haven, such as gold. Its high volatility is coupled with weak diversification attributes, while having weak liquidity.

Bitcoin is deeply untrusted by central banks. At the same time, central banks are developing their own cryptocurrencies, and inevitably, Bitcoin (and the other digital currencies) will start falling under increasingly heavy regulation. Notably, China has said it is halting 90% of Bitcoin mining activity on its territory, for ostensibly environmental reasons (Bitcoin mining consumes a huge amount of energy), which could have a material impact, as China represents more than 70% of the world mining activity. There could however be a silver lining: some observers say that Bitcoin, if it can't be trusted as a currency, could serve as a storage asset, used to store value. But its limited decorrelation and diversification powers keep us wary.

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Conclusion: What are the implications for portfolio allocation?

We keep a long positioning on risk assets, albeit less aggressive than at the start of the year due to the ongoing rally on financial markets.

The reflation theme is still valid, especially in Europe, where we see growth as well as prices accelerating slightly, prompting us to have an overweight stance on European equities, which will also benefit from a positive corporate profit growth momentum.

Due to the expected gradual normalization of monetary policy, long-term interest rates should rise, leading to an underweight stance on most fixed income asset classes. We have a slight overweight recommendation on gold as a hedge as our portfolios have a strong equity bias.

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