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RATE HIKE REPRICING: EQUITIES PASSED THE TEST

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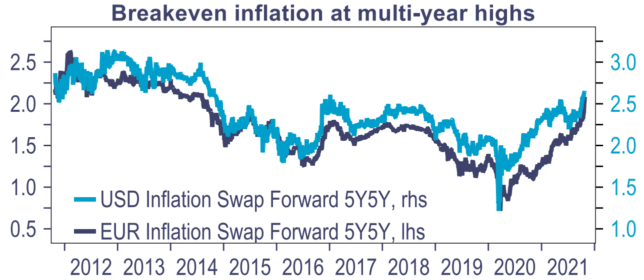
After a volatile September, most developed equity markets staged a rapid recovery at the end of October, closing in on their all-time highs. Equities took comfort from a very supportive earnings season to overcome what could have been potential headwinds: fading growth, stubbornly high inflation, and a drastic adjustment in global rate hike expectations.

Growth for instance has been softening both in absolute and relative terms, with economic surprises for G10 economies now coming in on the negative side. After the strong recovery from last year's crisis this was to be expected, but in a context of worsening supply chain issues, the slowdown has been a bit more pronounced than what had been pencilled in by most forecasters. China's regulatory crackdown on the economy and the impact of Evergrande's meltdown on the housing sector have also increased downside risks to global activity.

Higher and stickier than expected inflation, which had been a key focus for markets, also failed to derail risky assets. In the US, 5-year break evens reached their highest level in over 15 years, briefly reaching 3%. In Europe, the move was slightly less pronounced, but the ECB's favourite measure, the 5Y5Y forward, topped 2%.

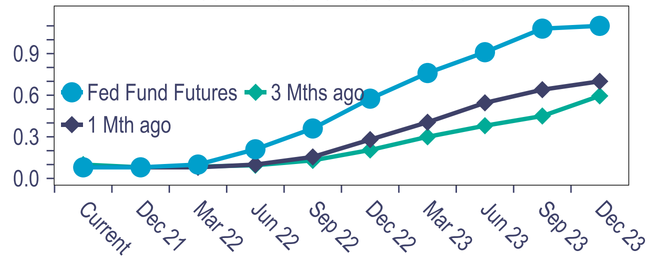
Breakeven inflation at multi-year highs



Source: Lyxor AM, Macrobond, Bloomberg

Last but not least, equity markets brushed aside the brutal repricing that occurred on the short end of interest rate curves. The move was triggered by a combination of hawkish comments from developed markets central banks (Developing markets' central banks have already embarked on a hiking cycle). The Bank of Canada for instance put an end to its bond buying program while simultaneously bringing forward the timing of rate hikes. The Reserve Bank of Australia also reacted to stubbornly high inflation readings by dropping its yield target. As for the UK, additional hawkish comments – which were partially reversed during the Bank's last meeting – led the market to expect a first rate hike by the end of this year.

Fed Funds Forward Curve



Source: Lyxor AM, Macrobond, Bloomberg

That this repricing of the global monetary policy scenario left equities unscathed is, in our view, relatively comforting. If we take the example of the US, markets now expect two rate hikes next year, with a lift-off in June. To us, this is as hawkish as the Fed could get. Indeed, the Fed has always stated, and Jay Powell confirmed this during the November FOMC, that tapering would come first and rate hikes second. It thus seems difficult to pencil in a third rate hike for 2022. As for the long end of the curve, it barely moved (which led to a large bear flattening), and rightly so, as this would not be tolerable given the large public debts that have been accumulated during the crisis.

All in all, the risk of rising rates, which had been one of our key worries for equity markets, seems to have abated, at least in the short term. Near term tightening has been priced in, and, with headline inflation figures set to ease by year end, we could even see the short end moving down somewhat.

At current lofty equity valuation levels, this is nevertheless not sufficient for us to move our equity positioning back into aggressive territory. We prefer to stick to our neutral positioning. Some uncertainties remain, such as the debt ceiling gridlock in the US, which has only been postponed. In China, were growth is already slowing sharply, the zero-tolerance policy for Covid could exert additional pressure on global supply-side issues as cases increase with the winter season. For now, these supply issues have mainly been visible in higher inflation data, as strong demand allowed corporates to protect their pricing power. A larger impact on growth and profits could still be seen beginning of 2022, if wages accelerate. Finally, support from the earnings season will fade as we enter winter, while global growth data will probably continue to slow.

On the corporate credit side however, we have moved from an underweight positioning to neutral. We acknowledge that spreads are hair-thin, but with duration risk having receded, defaults remaining low, and real rates firmly anchored in negative territory, we prefer the segment to cash.

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