2pm PERSONALIZED PORTFOLIO MANAGEMENT

Quarterly marketreview

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Editorial

The first two months of summer were pretty bright. Apart from a small drop in luxury goods in mid-August when the fight against inequalities was recalled by the Chinese authorities as a priority objective, the equity markets were more oriented upwards. From June 30 to August 31, the US S&P 500 index rose 5.24% while the Eurostoxx50 gained 3.25%. Only emerging markets were down 4.80%, China being first. Operators, already wary of the slowdown in the Middle Empire against a backdrop of monetary tightening, were somewhat surprised by the acceleration of regulatory pressure in a number of sectors (education, internet, video games, health, real estate, etc.).

This summer hike did not happen in a vacuum, far without fault:

> Monetary policies have remained very accommodating and liquidity abundant.

> Corporate earnings releases for the second quarter were very good in Europe and the United States, where all the companies making up the S & P500 index even had the luxury of posting the strongest year on year growth profits for 10 years! Even more striking, the manner in which this progression of profits was made. Overall, US companies have beaten analysts' expectations, not only in terms of earnings per share, but also in terms of revenue growth. This seems to suggest that even if inflation (note our The Big Picture on page 2) leads to an increase in production costs, many American companies certainly have the pricing power to compensate for this.

> Activity in terms of mergers and acquisitions was strong.

> Vaccination campaigns have proven to be effective with good results on hospitalization figures, despite the high contagiousness of the Delta variant, which has allowed Western economies to gradually reopen.

The equity markets then took a break and began to consolidate over the first two weeks of September, horizontal consolidation for Europe, slightly bearish in the US, the starting point of which is certainly to be linked to the symposium in Jackson Hole, where J. Powell, president of the FED, formalized what had already been rustling in the corridors of the American central bank for several weeks, namely the principle of an upcoming reduction of the asset buyback program, all while specifying that tapering was not synonymous with simultaneous rate hikes. A few days later, the publication of the FED's Beige Book confirmed a structural improvement in the economy, despite the local effects of the Delta variant and the emergence of supply constraints and tensions in the labor market, two rather inflationary factors. That said, the impact on long rates remained moderate and market volatility contained.

Things changed during the weekend of September 18 and 19 through the setbacks of one of the biggest Chinese real estate developers, Evergrande, with the sudden emergence of doubt in the minds of operators: This Chinese real estate giant, crumbling in debt… could it not become the Chinese Lehman Brothers? Days earlier, Beijing warned major Chinese banks that Evergande might not be able to repay loans and interest on its bonds - totaling more than $300 billion - and could, as a result, go bankrupt. The announcement caused turmoil: the real estate giant lost as much as 19% during the session, hitting its lowest level since June 2020. As a domino effect, several other real estate companies saw their share prices drop. Insurance giant Ping An, heavily exposed to real estate, dropped nearly 7%. It must be said that in recent months, the difficulties of the Chinese real estate sector have been exacerbated by Beijing's crackdown on developers to force them to get rid of their debts. In 2020, "three red lines" had been introduced, requiring compliance with certain financial ratios, while prohibiting the sale of properties before their completion, an important part of Evergrande's economic model. The group is said to have more than a million units prepaid by customers and not built, which added to the apprehension among investors. On Friday, September 17, the Chinese state newspaper Global Times headlined: Evergrande is not too big to fail.

Consequence: The VIX index soared, dropping very quickly from 19 to 25, and both European and US markets fell sharply in the wake of Hong Kong overnight from Sunday to Monday. Western operators, no doubt not used to seeing easy money from central banks solving all problems, suddenly seemed helpless in the face of this Evergrande problem that neither the Fed nor the ECB could control with billions of dollars. It will be China's decision whether or not to let this giant sink, with a potential domino effect on other sectors that remains, to this day, very difficult to quantify.

	Q3 2021	FY 2021	Close 30/09/21
DOW JONES	-1.91%	10.58%	33 843.92
S&P 500	0.23%	14.68%	4 307.54
FTSE 100	0.70%	9.69%	7 086.42
EUROST.50	-0.40%	13.95%	4 048.08
CAC 40	0.19%	17.45%	6 520.01
FTSE MIB	2.32%	15.52%	25 683.81
MSCI EM	-8.84%	-2.96%	1 253.10
CRUDE OIL	2.12%	54.64%	75.03
GOLD	-0.74%	-7.45%	1 756.95
EUR/USD			1.1580
EUR/CHF			1.0786
EUR/GBP			0.8593
EURIBOR 1M			-0.563%

After a brief lull of a few days, volatility resurfaced during the last week of the quarter with declines of between 2 and 3% on equity indices. Several reasons for this:

> A new development in the speech by J. Powell who warned last week that the rise in inflation could be prolonged, with bottlenecks in supply and difficulties in recruiting employers likely to prove to be "more sustainable than expected ". He added that if prices remained high, the FED "would be sure to respond."

> The continued rise in energy prices which is fueling the debate on inflationary pressures and causing some to fear a shock to household consumption. Under the combined effect of rising demand and tightening supply, the price of Brent last week crossed the $80 per barrel mark for the first time since October 2018. Supply problems thus remain while global economies rebound after periods of lockdown. Global gas prices have climbed further, rising 70% from August and more than 300% since January in Europe.

> The movement towards normalization of long term rates in Europe and the US following the integration by operators of the now slightly less accommodating position of the FED. With the result of clearances on values with the highest multiples.

> The American political situation where the negotiations concerning the second part of the stimulus plan are dragging on and therefore highlight the extent of the differences between Democrats and Republicans. One positive point, however: Congress finally managed to reach an agreement to extend state funding until early December and thus avoid a shutdown.

In this context, what do we expect for the next few months in the markets?

It seems fairly obvious that given the new clouds that have recently appeared on the horizon (Evergrande, energy crisis, rising inflation, rise in long term rates, etc.), the equity markets should retain some volatility in the coming months. By asserting a few days ago that the tapering could end in the middle of next year, Powell took investors by surprise by paving the way for a normalization process that could be faster than anticipated. Indeed, even if it ruled out a rate hike during the phase-out of monetary stimulus, and assuming that the tapering does not begin until next month at a rate of a decrease of $15 billion per month, this does not leave more than 8 months of respite when the consensus only counted on rate hikes at best in 2023. Now, convinced that growth will remain strong (2021 GDP at +5.9% and +3.8% in 2022) and that inflation will settle down (+4.2% in 2021 and +2.2% in 2022), the DOTS analysis shows that 9 out of 18 FED members expect an interest rate hike in 2022, followed by other movements in 2023 (3 increases) and in 2024 (3 increases).

That being said, we are still constructive on the equity markets, with perhaps a stronger focus on Europe and emerging markets, which are less highly valued than the US stock market. Even if long term rates have started to normalize, they still remain very low and for the long-term investor looking for yield, the equity markets remain an essential investment, especially if we include dividends, which are on the rise in some countries, for example in the banking sector. Admittedly, P/E are starting to be high, especially in the US, but the equity risk premium, which measures whether investors are well remunerated for the greatest risk in equities vs. the “risk-free” rate of government bonds, still suggests a potential for appreciation for the stock markets, especially since in terms of the economic cycle, we are barely entering the middle of the growth phase after the Covid shock of 2020. It is not as if we were already on the eve of a recession with already several years of rising FED funds behind us and an inverted yield curve …

However, we will remain very attentive in the coming weeks to publications from the companies on the results of the third quarter. Among other things, it will be necessary to observe whether the rise in raw materials and energy prices in particular will or will not have a significant impact on company margins (especially in the sector of industry) and what proportion of the quotation will be impacted. Selectivity should be the order of the day when it comes to stock-picking and with regard to our equity fund allocation, we are considering a slight rebalancing in favor of value funds to the detriment of the growth style, which is naturally more affected by rate hikes. We see no change on bonds, and are maintaining a stronger focus on flexible global funds with the possibility of positioning themselves short in terms of duration, and where applicable, on better quality bonds.

Christophe Carrafang

The Big Picture

For fear of deflation to inflation alert

It only took a few months for concern over low inflation, which has victimized the fragility of Western economy for the past decade, to be replaced by the fear of widespread price hikes. While the US CPI (consumer price index) ended 2020 at a level of 1.30%, the alert threshold of 5% has now been exceeded.

In the US, under the effect of generous government handouts, households were able to benefit from a 9.8% increase in their disposable income between December 2019 and July 2021 and from March 2021, consumer spending exceeded its trajectory of pre-crisis growth. But this return of the consumer has come about in dispersed order: on the one hand, the services sector which still shows a shortfall of 4.1% compared to its pre-Covid trend; on the other hand the durable goods sector, which usually represents only a tenth of American consumption, which grew by almost 40% between the end of 2019 and April 2021. This atypical growth has led to strong disruptions in supply chains, while triggering a sudden strain on costs.

Inflation is back almost everywhere in industrialized countries, with the notable exception of Japan. In September, consumer prices jumped to 4.1% in Germany, the highest level since 1993, and to 2.1% in France. The harmonized consumer price index in the Euro Zone, which serves as a basis for comparison at the European level, further accelerated in September to 3.4%, the highest since 2008 and well above the new target of the European Central Bank inflation at 2%. It is coherent and also consistent since activity picks up strongly as inflation rises. This is linked to a stronger than expected recovery, labor shortages, and shortages of raw materials. We could therefore believe that this burst of inflation is “cyclical” and therefore normal.

But inflation is like savings: some will disappear, as will forced savings due to the difficulty of consuming during lockdowns, and some will remain. Structural inflation has increased, as has precautionary savings, and they are unlikely to fall anytime soon. Some effects of the pandemic on prices may indeed be only transitory, but others not.

No one knows which bottlenecks will be able to unravel and when. Hence, complete uncertainty in the short term. In the long term, the rise in prices opens up major debates on household consumption. Faced with soaring prices for energy, food and durable goods, central banks are trying to reassure the public by hinting at a temporary increase. According to the OECD, on the other hand, inflation will continue to rise over the next two years.

Natural gas prices have jumped since the start of the year by more than 350% in Europe and by more than 120% in the United States. Oil shows an increase of almost 50%. Ditto for electricity: doubling the price. As winter approaches, this surge in prices creates a shock for businesses and household budgets. One of the factors that may have contributed to this bottleneck is to be found with V. Putin: the United States publicly suspects Russia of refusing to increase its gas deliveries to propel the finalization of the construction of the controversial gas pipeline North Stream 2.

Semiconductors have an impact on industry inconsistent with their magnitude. It now seems likely that the shortages will persist next year. Further price increases are to be expected and are likely to reach 20%, impacting the costs of consumer electronics as well as cars and mobile phones. With the rise of electric and autonomous vehicles, the general manager of Intel predicts that chips will represent 20% of the cost of manufacturing a car by 2030 against 4% in 2019. In China, where producer prices jumped 9.5% in August, power cuts are slowing production of many goods and raw materials, from cement to aluminum, fueling shortages in many sectors, such as the automotive industry.

(continued on page 4)

Macroéconomie

Context: Economic recovery on the landscape of inflationary supply shocks

Inflation: It's on everyone's lips

- **In the USA, it stabilized and went from +5.4% at the end of June to +5.3% at the end of the summer.**
- **Excluding cyclical items, food and energy, the rate fell from +4.5% to +4%.**
- **In Europe, with a three-month lag with the United States, inflation is accelerating, going from +1.9% to +3.4%. However, core inflation remains contained at +1.9%.**
- **The question that arises around the recent rise in prices is to know what part is cyclical, and therefore temporary, of the more structural part that could take hold over time.**

Manufacturing activity: Restrained slowdown

- **Manufacturing activity is declining but remains at high levels, bottlenecks in semiconductors, energy and transportation weigh heavily.**
- **In Europe, the indicator fell in September to 58.6.**
- **After two months of stabilization and against all odds, the ISM US manufacturing index rebounded to 61.1.**
- **With the improvement in the health crisis in Russia, India and Brazil, the indicators of emerging countries are regaining color.**
- **Manufacturing activity in China remains subdued, restrictive policies and the reform package are a drag.**

Services activity: reopening continues

- **In the US, employment figures are slowly improving, so much so that the number of job vacancies exceeds the number of unemployed.**
- **The services indicator for September, which was expected to be lower, is rising to 61.9.**
- **After a very robust summer, the services activity is decelerating in the Euro Zone, dropping from 59 to still a very decent level of 6.4.**
- **The first Chinese indicators point to a significant improvement in services in September, which after falling to 47.5 the previous month, rebounded to 53.2.**

Damien Liegeois

US CPI since 2004

Special Topic

China: The season for reform

It all probably started with a speech last year by Jack Ma condemning the lack of modernity of Chinese regulators. A bad move for him, costing the IPO of his financial gem Ant Group, several billion dollars and, as a bonus, a probable séjour in a "re-education" center.

For the government, this was an electric shock because, indeed, China was lagging behind in this area and was being overwhelmed by the speed and inventiveness of economic players who had become too powerful. By taking the bull by the horns, the government, taking advantage of a favorable macroeconomic window, in a few months shook up many sectors with announcements that revolved around 4 themes.

In the first place, it was a question of reducing the systemic risks in the sectors of finance and real estate, to avoid the crisis which the United States witnessed in 2008. For this, Pekin had already strongly reduced over the last years the impact of the famous shadow banking, and therefore recently brought Ant Financial, that was overlooking all banking controls, back in line. In real estate, red lines have been put in place; debt ratios not to be exceeded for developers: debt/assets, net debt/equity, cash/short-term debt, which put the sector's most vulnerable in difficulty, provoking the Evergrande crisis.

The authorities' second focus has been the establishment of tougher anti-trust laws in order to improve free competition and fight against abusive dominant positions. Companies such as Alibaba or Meituan have been particularly targeted.

The third axis is related to national data security. The trigger was Didi (the Chinese Uber), sanctioned the day after its initial public offering on the Nasdaq. The latter has indeed taken certain liberties with domestic data which has become available on American territory, a particularly sensitive subject in a geopolitical context of the quasi-cold war. This mishap has led to a strict reform of the processing of data by the Chinese internet giants.

Finally, in order to respond to growing social pressure and achieve their ambitious demographic goals, the authorities tackled issues of equal opportunities and the reduction of the cost of living, the symbols of which have been the sectors of private education and online games.

All these reforms are all quite logical and go in the same direction as those desired in the developed democratic countries, but it is the speed with which they were announced and implemented which surprised the observers, the investors and the protagonists of these sectors.

Earlier this year, Xi Jin Pin welcomed the fact that since the beginning of economic reforms in the 1970s, China has managed to lift 800 million people out of extreme poverty, while setting itself a new goal: social prosperity. The idea is to promote a better redistribution of wealth, provide a stronger social safety network and promote equal opportunities.

The pro-Chinese will say that these reforms should lead to more sustainable economic growth in the medium term and bring China definitively into the clan of developed countries; the skeptics see it more as a sign of extreme nervousness from a government that sees its power withering away. The future will be the only judge.

In the short term, however, the macroeconomic window is closing and we should see the easing of monetary policy and targeted stimulus announcements in the coming months, because the last quarters have nonetheless disrupted China's domestic economy.

Damien Liegeois

(The Big Picture: continuation & conclusion)

The prices of wood have soared, along with those of coffee, wheat, sugar. Global warming and the accidents it causes (droughts, floods, etc.) will regularly drive up the prices of raw food materials. The increase in world food prices reached 30% over one year in August according to the benchmark of the FAO, the United Nations food and agriculture organization. This acceleration is explained by the increase in the prices of agricultural raw materials but also because of the tensions created by the pandemic, which disrupted multiple logistics chains and caused transport prices to accelerate. In many emerging countries, food represents an important part of the reference basket used to calculate inflation, which results in increased pressure on monetary and budgetary authorities.

And finally, the subject of wage increases hits the charts. The mechanism is well known: when the rise in producer prices is reflected in consumer prices, it promotes wage demands.

In the United States, the increase in the average hourly wage reached 0.6% in August and consumer inflation expectations are moving around 3%. In the UK, in some sectors wages have increased by as much as 30% this year. In the Euro Zone, while labor costs fell in the second quarter, inflation expectations are now on the rise.

One possible scenario today is that of overheating at the onset of the cycle: growth will accelerate as supply bottlenecks are lifted, but inflation could remain higher than that recorded these past 20 years because its causes are not only temporary. With unspent savings and contained demand already high, the pursuit of ultra-accommodative monetary and fiscal policies further stimulates aggregate demand.

Are central bankers going to focus on growth and choose to be "a little behind the curve" or will they be more concerned about inflation and thus quickly withdraw support?

Costanza Corneri