QUARTERLY COMPASS

Q1 2022

KEY CALLS

Stick to a mild pro-cyclical asset allocation

The belly of the US curve is attractive

Long USD vs low yielders

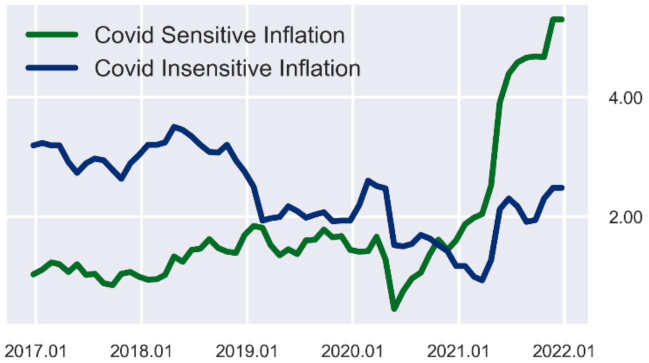
Favour "uncorrelated" hedge funds

GLOBAL MACRO AND ASSET ALLOCATION

World GDP growth has been rock solid in 2021, thanks to an easy base effect and the reduction of stringent Covid-19 measures. While we expect the economic cycle to normalise in 2022, world GDP growth should remain above trend, close to 5%. This should translate in companies delivering decent EPS growth. However, we see clouds gathering at the horizon with mounting headwinds. The fiscal impulse is fading and financial conditions are becoming less accommodative, while issues such as supply chain disruption, labour shortages and rising raw material could continue weighing on economic outlook. The slowing momentum of central banks balance sheet expansion (i.e. tapering) should be a headwind for risk assets next year. We expect the pace of the Fed's monetary policy normalization to be a key variable next year. All in all, risk assets will be torn between positive economic prospects and a tightening of monetary conditions. The economic recovery remains uneven between the US and Europe as the latter is expected to barely grow 0.7% in 4Q2021 against 5.2% in the US. Europe continues to suffer from more stringent restrictions to battle the pandemic, while in the US most economic indicators are solid. However, average growth expectations for 2022-2023 is marginally in favour of the Eurozone. The pandemic remains the wild card, and we foresee related uncertainties to prevail, with potential new mobility restrictions that could reignite negative consequences for labour market and production capacity.

Aside from growth, inflation will remain the key macro variable in 2022. The consensus outlook for inflation is becoming less transitory, even though the OECD still forecasts a deceleration as demand normalises, capacity expands, more people return to work, leading to supply-side constraints and shortages waning in 2022-23. Based on the studies from Fed San Francisco, the bulk of the rise in inflation is derived from Covid sensitive components while other components do not display price pressure, as the pandemic has evidenced a lack of supply elasticity. Freight prices are skyrocketing given the zero Covid policy adopted in Asia, European gas prices are surging given the green transition and issues with Russian Nordstream 2, and there is a global shortage in the semiconductor industry. As outbreaks will not disappear soon, we do not have any guarantee that all these issues will be resolved by next year, except for semiconductors, thanks to the huge ramp up in supply. Wage growth acceleration could also contribute more to inflation going forward as labour bargaining power in the US is intensifying, as evidenced by the highest quit rate over the last two decades and with significant job openings among businesses. In Europe, the current situation is different as the removal of many automatic wage indexation mechanisms and lower union memberships are structural disinflation forces. Hence the inflation outlook puts more pressure on the Fed to raise interest rates than on the ECB.

Covid Sensitive vs Covid Insensitive Inflation (SanFran Fed)



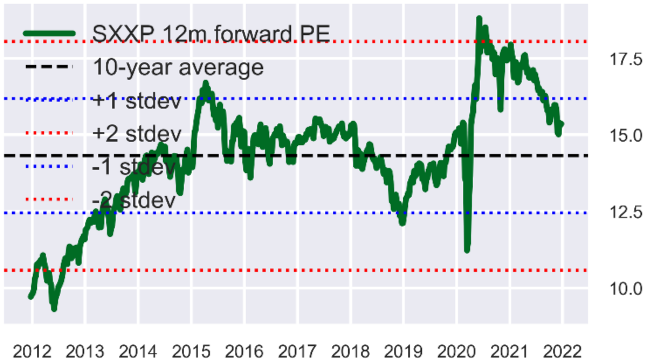
In China, the PBOC goes against the tide as it tries to support the economy (50bps RRR cut in December). The ongoing slowdown in the property sector due to government-led deleveraging likely means that more fiscal and monetary policies will be announced in the months ahead. As China has reduced money supply growth in the last few years, there is room for this to increase in a calibrated manner, thereby supporting Chinese assets. Given this backdrop, and while it is too early to drastically reduce risk within portfolios, we expect 2022 to be a challenging year. Being agile and selective will be key to cope with a mounting in cross-asset volatility.

EQUITIES

Europe earnings will likely increase by 72% in 2021, while US companies will grow earnings by 48%. We expect EPS growth to normalise in 2022 across regions, with Japan forecasted to display the strongest growth. Relative to bonds equities are still attractive with generous equity risk premia (ERP). Interestingly, Europe ERP is close to 7% and the gap is widening with the US, reinforcing the attractiveness of EU stocks. Moreover, European valuation (est fw P/E 12m) is moving closer to the 10-year average. Emerging markets are trading at a 35% P/E forward discount vs the MSCI world, mainly due to China and Brazil, and below the 1 sigma deviation from the 10-year average. Is the worst for EM close to being priced in?

We lift our 12-month targets based on sharp earnings upgrades. We foresee more potential in Europe than in the US. Will European equities finally catch-up after a 18% underperformance vs the US since December 2019? Our base case scenario derives from 1) P/E stability given depressed real rates; 2) EPS matching consensus for 2022 as solid GDP growth might mitigate headwinds such taxes, supply chain disruption, high raw materials costs and labor shortage.

Stoxx Europe 600 12-month forward PE



Given our outlook for rising cross-asset volatility next year, we recommend adding exposure to low volatility stocks. According to our research, the "low vol factor" tends to outperform during an economic slowdown, which is our baseline scenario for 2H2022. In Europe, our proprietary model indicates that a key number of the top low vol stocks are located in Switzerland. In the US, consumer staples, utilities and healthcare represent 60% of the top 40 names.

European basic resources are trading at a deep discount despite impressive EPS growth. China slowdown is probably the main culprit. Nevertheless, it represents a cheap optionality to be exposed to an eventual structural rise in commodities. Financials are still associated with high beta, however earnings have been much more resilient than usual in the last recession, hence increasing the valuation discount vs history. For the time being we maintain a barbell strategy between low volatility stocks, structural growth stocks (momentum), and some attractive deep value stocks (contrariant).

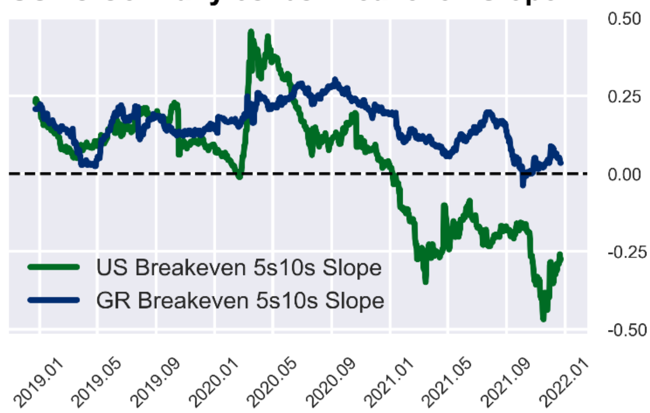
Sentiment indicators are now back into neutral territory after reaching borderline euphoria levels in 4Q2021. Some are even already flashing contrariant buy signals. Technicals are weakening in the short-term, most noticeably breadth, but the medium-term pictures still point to the continuation of the 2020 cyclical bull market into 2022.

FIXED INCOME

Despite some challenges ahead for risky assets, we think it is still time to keep a risk on positioning in the fixed income space. We maintain a preference for credit versus interest rate risk as core government yields are too low in our opinion, warranting a short duration stance. Moreover, fundamentals remain solid for credit assets and spreads are more attractive after the recent widening episode. However, we must keep in mind that credit usually leads equities in a downtrend, and we remain alert of signs of deteriorating conditions.

In 4Q2021, the US curve continued to flatten, driven by markedly rising short rate hikes expectations, and the belly (circa 5yrs) underperformed while long yields declined (monetary policy mistake pricing?). We feel the Fed's hawkishness may be tempered later in 2022 and believe there is now good value in the relatively short (3-5 years) maturities after the recent repricing. We are rebalancing some duration exposure from the very long end to the 5y sector, but still maintaining an underweight strategy in the government bonds space and a short duration bias. In Europe, we continue to see no value especially at current low yield levels, to the exception of peripheral countries whose risk premium has been rising recently. Inflation remains a key problem globally, and its "transitory" nature is being questioned even by the Fed. Still, the flat or inversed breakeven curve notably in the US is a sign that the market continues to see these pressures as a short-term phenomenon. Inflation-linked bonds have posted solid returns in 4Q2021, benefiting from rising inflation expectations, elevated inflation carry and decreasing real yields. We feel a lot is now priced-in and see possible headwinds on both the breakeven and real yields front going forward. We therefore keep an exposure to the asset class but with a short duration stance, to benefit essentially from the still high inflation carry.

US vs Germany 5s10s Breakeven Slope

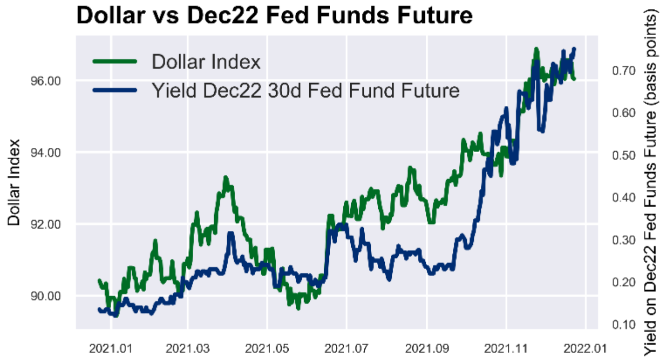


Despite Central Banks gradual liquidity tightening, financial conditions as well as the growth context remains supportive for investment grade corporate bonds. Even more so as the recent spread widening has brought back some value. The asset class will essentially be driven by the move of core yields, on which we have a defensive stance, to the exception of the 3-5 years segment in the US. We maintain a preference for the BBB signatures versus higher quality names. The High Yield segment can be quite volatile and sensitive to deterioration of both macro and liquidity factors, but we think it is not yet time to worry especially as company fundamentals remains sound and default rates are expected to be very low. We consider the sweet spot is in the BB segment and prefer to avoid the low-end of the credit spectrum. Current High Yield spreads offer some protection against a backdrop of rising yields. We remain overweight on High Yield with a preference for leveraged loans which have no rate duration exposure and would even benefit from rising monetary rates. We reiterate our strong preference for AT1 securities in the banking sector as banks fundamentals are solid and the sector benefits from rising yields. Also, most of these issuers' senior debt ratings are Investment Grade.

Emerging Markets bonds valuations have become cheap with spreads versus US High Yield being not only attractive but also markedly above the long-term average. However, they are facing many headwinds such as the China slowdown with its real estate sector crisis that will remain key to the whole EM complex, the rising US yields environment and associated USD strength, and inflationary pressures addressed by local Central Banks hawkishness. We maintain our tactically underweight strategy for now as the negative forces currently outweigh the appealing valuations.

FOREX

We expect relative monetary policy expectations to remain the key G10 FX driver in 1H2022, as the exit from ultra-loose monetary policy is not synchronised across G10. The FX market is now pricing at least two Fed hikes in 22 and two in 23, allowing the US to escape the interest rate zero-bound in 2022, and helping the Fed to leave ECB, SNB, and BoJ rates in its rear-view mirror. Surging inflation, and the debate on whether it is transitory or permanent, is particularly key in driving monetary policy expectations and short-end rates. Hence, we see leading inflation indicators as moving forces in the FX market next quarter.



In our view, the dollar is more sensitive to global growth in the current backdrop. Economic momentum peaked in 2Q2021, and global growth downward revisions have been a supportive macro factor for the dollar in 2H2021, despite relative GDP growth expectations having turned in favour of the EUR. We expect this to carry on in 1H2022. The dollar could also benefit from further downgrades of global growth in the wake of the new Omicron Covid variant and new lockdowns, particularly in Europe. In this context, we expect the dollar to fare well, supported by its anti-cyclical behavior. Despite long USD being now consensual from a positioning standpoint, we argue that there is still ample room to increase USD long positions, and even more so EUR short positions. Hence, we continue to see positioning as a mildly supportive factor for the dollar. Technicals also point to further dollar strength in 1H2022.

There is already a lot of good news, a lot of inflation concerns, and a lot of rate hikes now embedded in the dollar's value. Nonetheless, we believe there will be more dollar strength in 1H2022 going into the tightening cycle. We thus expect the dollar to outperform low yielders suffering from a still dovish central bank (CHF, JPY, EUR). The outlook vs cyclical currencies (AUD, NZD, NOK, CAD) is more mixed, depending on monetary policy expectations, covid policy, growth outlook, and sensitivity to specific commodities. In H2 the focus might shift away from the Fed somewhat to the global economic recovery, if the health crisis does not make a significant comeback. The main risk to this mildly bullish USD view is a shift in relative inflation surprises between the US and Europe, thereby shifting monetary policy expectations. As such, a potential ECB hawkish shift in H2 next year would put a floor on EURUSD.

CHF gained more than 5% vs the euro since mid-September and EURCHF briefly dipped below 1.04, the first time since 2015. The SNB reaction function has likely changed recently, probably because of higher inflation. Its new approach seems to be to fight only accelerations instead of the level. There is little doubt that 1.05 is an implicit floor, and the tolerance of the SNB for a strong CHF will be limited. Hence, we expect a weaker CHF in 1H2022.

HEDGE FUNDS

At the end of November 2021, hedge funds have performed rather well over 2 years, with an average return of +5.6% per annum. Equity hedge funds benefited the most from the impressive performance of equity markets with a return of 8.2% per annum, and macro/CTA funds benefited the least with an average return of 1.6%.
What is our outlook on hedge funds for 2022?
Among the four main hedge funds strategies, we avoid the equity hedge segment on average, because of its total dependence on global equities and a recurrent alpha drift. We keep a neutral stance on the macro/CTA strategy, which includes very heterogenous funds. We are positive on event-driven and relative value arbitrage strategies: the former should benefit from a large excess of liquidity ready to be deployed; the latter has historically provided good risk-adjusted performance in any interest rate environment.
If we go deeper into the different strategies, starting with equity hedge funds, we mainly avoid the most equity-sensitive fundamental strategies. We favour quantitative directional and multi-strategy funds as the ideal combination: the former should better adapt to a new market environment thanks to their systematic approach, the latter should benefit from the positive effect of diversification.
Within the macro/CTA category, selectivity is key. We avoid long-term trend-following strategies, namely currency, commodity, and CTAs hedge funds. Our preference is for discretionary and active trading strategies: top-down fundamental managers are more likely to identify opportunities and adapt to a new economic environment, and high-frequency funds should benefit from increased market volatility and dispersion.
Within the event-driven space, we avoid activist and distressed hedge funds, the former being entirely dependent on the behaviour of equities, the latter being too volatile in times of market stress. The environment seems favourable for merger arbitrage and credit arbitrage strategies, with activity likely to accelerate on expectations of higher interest rates and upcoming tax/ regulatory changes.
Finally, within the relative value arbitrage universe, we believe that interest rate volatility is likely to remain high and that credit spreads may increase, so we avoid convertible strategies. We prefer corporate arbitrage funds (ideally with a market neutral approach) and volatility funds that can take advantage of market dispersion and provide protection against tail risk events.

In conclusion, we continue to favour funds that are uncorrelated with traditional asset classes. Furthermore, in a context of increased volatility, uncertain markets and increased inherent risks, the sub-strategies we favour have at least one of the following characteristics: diversification, trading approach, focus on liquidity, relative value style, search for idiosyncratic opportunities, dispersion and convexity.

Nicolas Besson, Marco Bonaviri, Adel Chekir, Cédric Ozazman

Relative Positioning