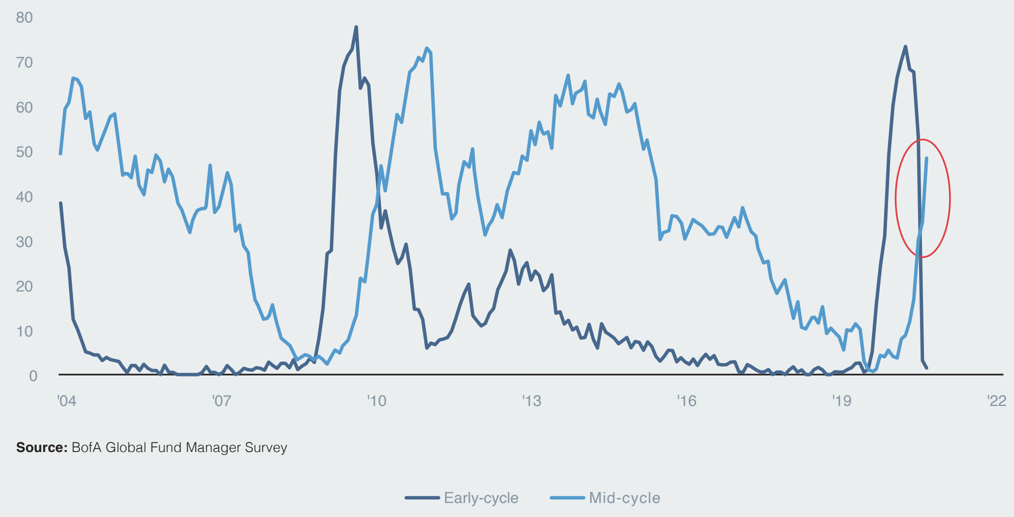
TELOMERE | Capital

Outlook 2021 – Q3

Our investment views

Summary of our investment views



Source: BofA Global Fund Manager Survey

Economy

After the strong economic recovery, activity should return to normal. The Fed should announce its normalisation plan by this autumn. However, the approach taken by central banks will remain accommodative and cautious, and favourable fiscal policies will continue to support growth.

Shares

The environment for shares remains positive. With the upcoming normalisation of economic activity, growth companies should attract greater investor interest compared with value and cyclical sectors.

Bonds

Sovereign bond yields have stabilised. Investment grade corporate bonds no longer have much upside potential. *Senior loans* and convertible bonds are interesting additional avenues to increase overall yield and portfolio performance.

Alternative investments

This asset class is having a more complicated year, with the imbalances observed following the “Wall Street Bets” phenomenon. However, this asset class is still very much of interest from a diversification and long-term yield perspective. We favour funds with a rigorous management style that prioritises maintaining low volatility and high decorrelation where equities and bonds are concerned.

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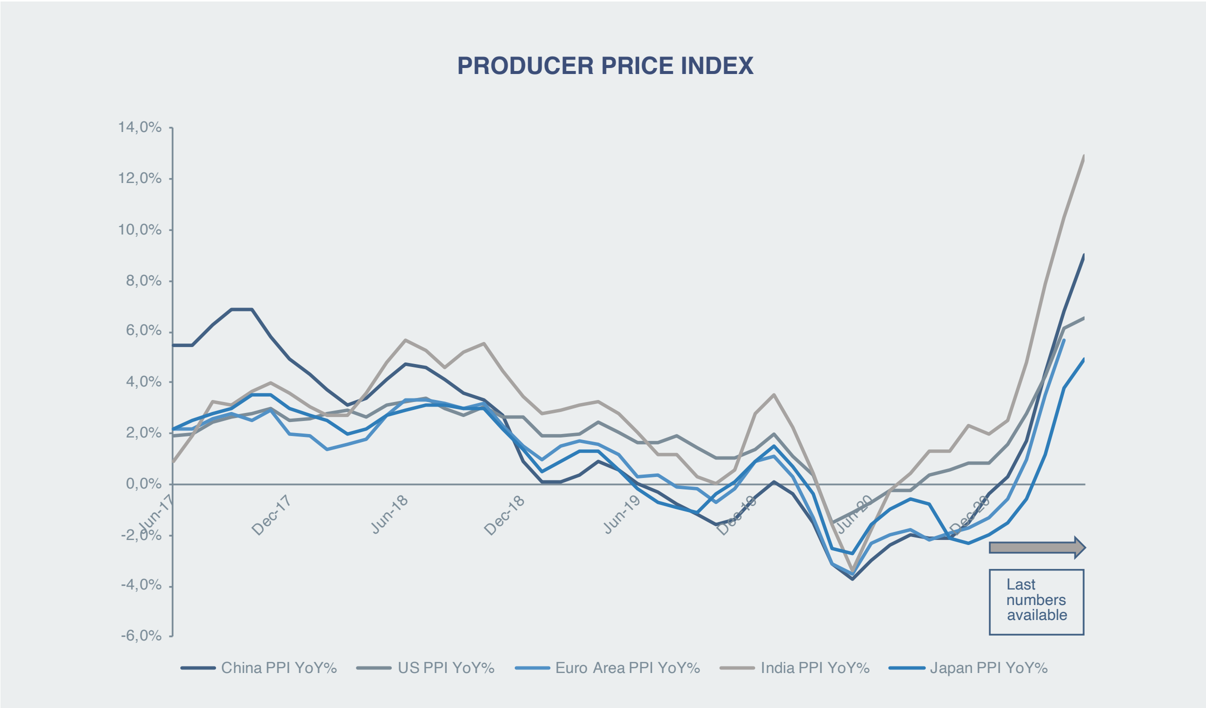


With this document, we are pleased to share with you our views and investment recommendations for the third quarter of 2021.

The second quarter of the year was marked by the gradual reopening of many economies and a recovery in activity that was stronger than expected. This recovery was driven by a demand shock and continued accommodative central bank policies, despite inflationary pressure caused by a delay in supply.

These dynamics are in sharp contrast with those observed during the two middle quarters of 2020, which were described as disinflationary periods, as they were characterised by a sharp reduction in demand.

Compared to other crises, the pandemic we are experiencing allows us in any case to measure one important aspect: the very rapid transition of economic and market regimes. This observation raises several questions. Which part of the cycle are we in? What impact is the current situation having on the dynamics of monetary policies, especially that of the Fed? What allocations should be made in this environment?

Where are we in the economic cycle?

In order to answer this question, we must take a step back, review the cycle, and take stock of the growth and inflation figures for the second quarter, as well as expectations for the coming quarters.

But before that, it is important to distinguish between actual economic growth and potential economic growth in order to understand the different phases of the economic cycle. While the former concept coincides with performance actually achieved, the latter estimates the value of goods and services produced by an economy if labour and capital are used at their maximum efficiency.

More specifically, we are talking about a period of steady growth that allows for stable inflation and supports full employment, and where demand does not exceed supply. Each economy has different levels of potential growth, which is defined by structural factors such as the number of working-age people, the labour force participation rate, or capital stock.

Actual growth can therefore be below or above this level. The role of central banks and governments in this regard is to adjust monetary and fiscal levers in order to smooth out cycles and avoid too much economic instability, which could have negative consequences on investment and employment.

If the actual economy is below the potential economy, this is known as a negative output gap. This is a regime that is intended to be disinflationary or even deflationary because supply is higher than demand, which tends to have a negative impact on prices. And since production is higher than demand, employment suffers, resulting in increased unemployment and job insecurity.

Conversely, if actual growth is higher than potential growth, this results in a positive output gap. Where demand is higher than supply, this is known as a reflationary or inflationary regime. Like the negative output gap, this regime can have negative effects in the long term if growth remains above its potential level for too long.

In the first case, the major negative effects are a structural increase in unemployment (which is difficult to reduce) and limited profits for companies, which may lead to a low level of investment and innovation.

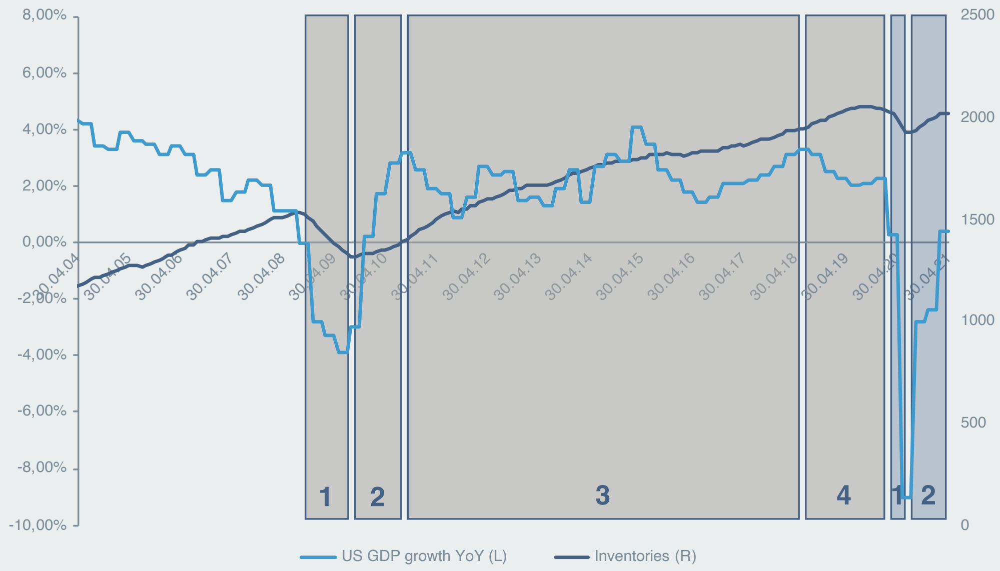
In the second case, if the positive output gap remains very high for a certain period, this could lead to strong inflationary pressure.

This is because demand will outstrip supply to the point where it will be difficult to find labour to meet such demand, leading to a mechanical rise in wages. Keeping the economy in a position that is neither “too cold” nor “too hot” is therefore essential.

> In practice, business cycles are defined by the dynamics created between actual activity and potential economic growth, despite the continuous smoothing effects provided by governments and central banks.

Now, in order to identify which phase of the cycle we are in and which way it will go, it is necessary to set out the different stages that make up this cycle. To do this, we will use the United States as an example. Through the impact of its activity on the dollar and its substantial contribution to global activity, the US economy represents a barometer for the world economy.

GDP AND INVENTORIES: MARKERS OF ECONOMIC CYCLES



1

Recession

Economic activity contracts, company profits decline. Credit becomes scarce for consumers and companies. Goods inventories reduce in size despite declining retail sales.
(Rectangle 1 on the chart).

2

Early recovery in activity

Activity rebounds, helped by monetary and fiscal stimuli. Access to credit improves. Inventories are low and momentum in retail sales picks up.
(Rectangle 2 on the chart).

3

Intermediate recovery (mid-cycle)

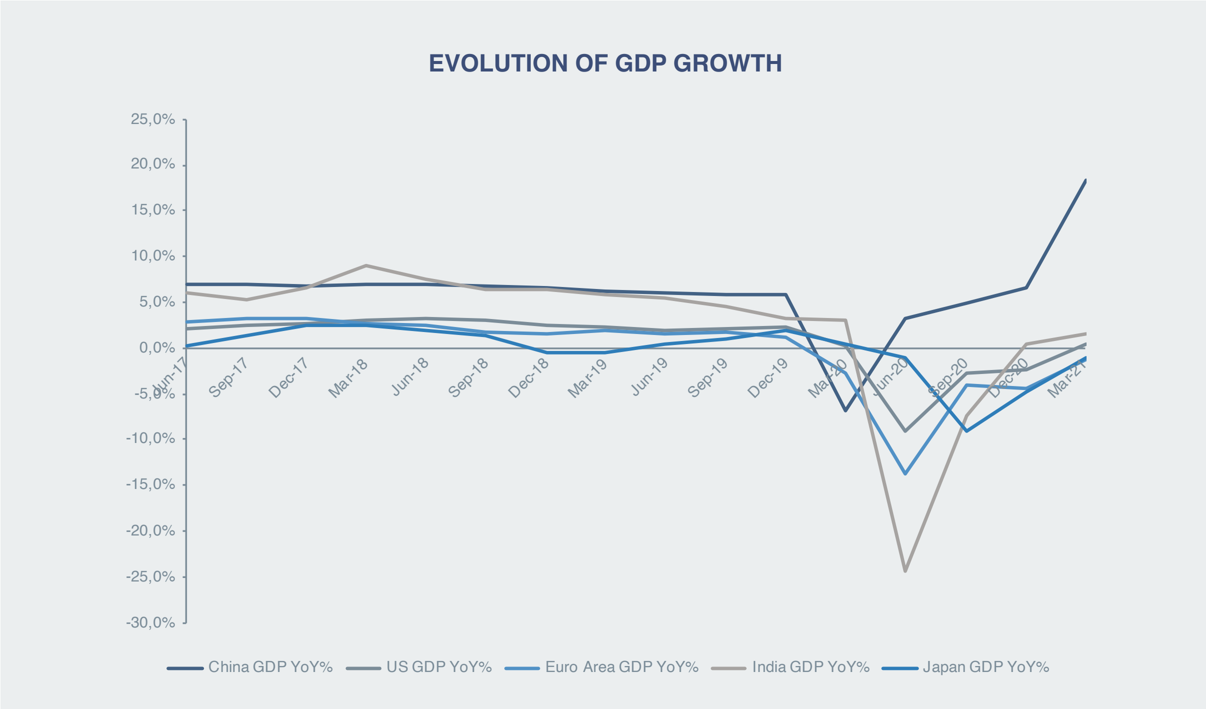
A prosperity phase commences, and is normally the longest of the four phases. Activity grows, but more slowly than in the previous phase. We are in a return-to-normal phase. Inventories and retail sales are in balance. Credit growth is solid and company profits are rising.

As the economy approaches full capacity, central banks adopt a neutral economic policy in the first part, followed by a slightly more restrictive one by raising rates to avoid overheating. However, they maintain a reassuring attitude regarding the solidity of the economy.
(Rectangle 3 on the chart).

4

Later phase of the cycle

This phase is characterised by rising inventories adjusted to retail sales, more timely rate hikes by central banks, and a rate curve that is beginning to flatten. Growth has peaked and is beginning to turn around, as are corporate profits. Inflationary pressures may begin to appear.
(Rectangle 4 on chart).



During transition periods, detecting which cycle we are in is sometimes more art than science. As each cycle is different, history 'rhymes' but does not repeat itself. If one cycle does not resemble the next, it is because of a change in the catalysts for its emergence. These catalysts include demographics, social development, and technological development.

For example, if we compare two intermediate recovery phases, one from 2001 to 2008 and the other from 2009 to 2020, the inflationary dynamics are not the same at all. In 2008, the economy began to overheat very strongly because of the explosive indebtedness of US households, which led to consumption exceeding supply.

While household debt accelerated the emergence of this cycle, it also ended economic expansion. The next cycle, from 2009 to 2020, was built on innovation in the technology industry. It was also based on the rise of China as a global manufacturing hub. These two elements reinforced globalisation and weighed on inflationary pressures.

The occurrence of COVID-19, unfortunately, did not allow us to see whether a smoothing by the Fed would have allowed a slowdown in activity as two of its former chairs had done so brilliantly: Ben Bernanke in 2012 and Janet Yellen in 2016. What is certain, however, is that the end of this cycle was caused by an exogenous event, rather than by a drifting of one of the cycle's catalysts. Therefore, if there had been inflationary pressures, we would not have had the opportunity to observe them.

The COVID-19 crisis, which put a severe brake on activity, pushed the US economy into recession

Compared with 2009 or other similar periods, this recession is notable for its suddenness and speed.

In this case, it is worth noting that the Fed and the US government reacted quickly to accelerate the transition by providing massive support to the economy in order to close the negative output gap. The result was a shift from a recession phase to an early recovery phase.

Other factors also allowed for a partial recovery, thanks in particular to the buoyant technological environment, which allowed a large proportion of employees to work from home. However, the combination of these factors illustrates that it is never easy to identify the phases of an economic cycle.

The recession phase was very fast. We have not yet reached the pre-COVID level of growth, but there has been a rebound, and it has been brutal.

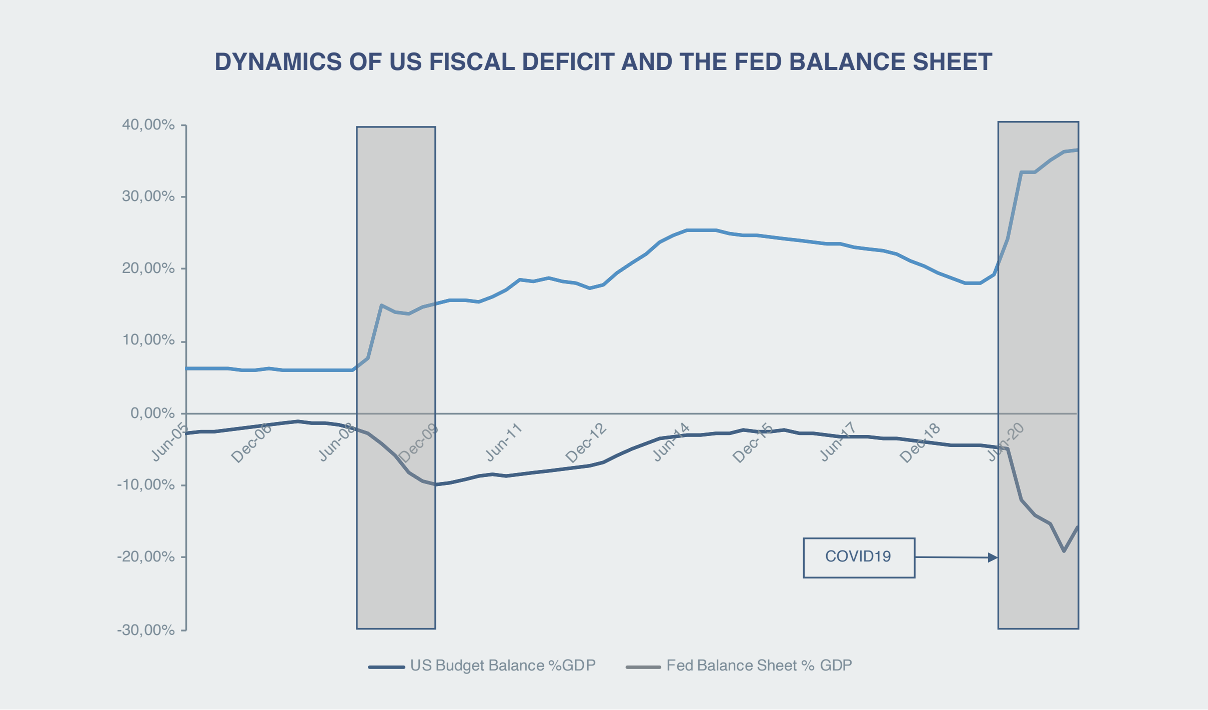
This proves to us that we have entered the early recovery phase for activity, where the declared growth rate is well above normal. Inventories are also low with demand rebounding strongly. The unemployment rate has fallen from 15% to 5.5% in one year, and credit conditions are improving again after having deteriorated significantly.

These elements also allow us to affirm that we have entered phase 2. The question now is how long this phase will last before we enter the next phase: intermediate recovery. It is difficult to answer this question with certainty, although there are signs that most of the recovery took place in the second quarter. The third quarter would then become a transitional period, heralding a phase of prosperity in the fourth quarter. As we have often explained, China was the first nation to be hit by the pandemic. The country experienced its first lockdown one quarter before other economies, with a rebound starting between the second and third quarters of 2020 and a strong acceleration of the recovery in the following two quarters. Figures for other countries, especially the US, do not yet show a similar trend; however, this trend should be confirmed when the results (GDP) are published for the second quarter of 2021.

Looking at the Purchasing Managers' Index (PMI) for the first five months of the year, there was indeed a good acceleration between April and May, which corresponds to the reopening and boosting of the inoculation campaign in the US. This confirms the start of a strong rebound in activity, which should continue during the summer and then become normalised.

This expected development will dictate a new change of regime that should have an impact on the Fed's policy.

What should we expect from the Fed in the coming months?



Exceptional circumstances call for exceptional measures. To combat the economic consequences of the pandemic, the Fed brought out the heavy artillery: its balance sheet rose from 18 % to 36 % of US GDP in just over a year, compared to 6% before the 2008 crisis to 25 % in 2014.

The huge stimulus, coupled with an immediate rate cut from 1.75 % to 0.25 % prevented a freeze in the financial system, helped close the output gap, and allowed long-term rates to fall in order to help finance the US fiscal deficit that had significantly worsened as a result of the government's stimulus plans. Now that the economy has rebounded, it will move towards normalisation for several months. In this context, what should we expect from the Fed?

At present, the economy is reopening fully, the number of people being inoculated is increasing, and the economy is returning to its growth trajectory. This means that, barring a worst-case scenario triggered by the emergence of a new, highly infectious, inoculant-resistant strain, it is far more likely that the Fed's monetary policy will normalise rather than loosen again. The question is how long this will take.

Theoretically, if we refer back to the last central bank normalisation cycle between 2014 and 2018, the Fed should follow the five steps:

1 Withdrawal ...
2 Preparation ...
3 Coming ...
4 Steadying ...
5 Policy ...

Phase 1
Withdrawal of excessive liquidity

For over a year, the Fed has been buying back USD 120 billion per month in assets (USD 80 billion in Treasury bonds and USD 40 billion in mortgage-backed bonds). Banks have been the main beneficiaries of these liquidity injections, and have now accumulated a large amount of liquidity.

However, as short-term bond yields are currently too low and unattractive in terms of remuneration for risk, banks have had no choice but to place this liquidity with the Fed through *reverse repo* transactions.

In total, more than USD 700 billion has been deposited since 5 April. These deposits take the form of a loan that the Fed carries out with the Treasury bonds it holds on its balance sheet. It thus agrees with the banks to sell them bonds that it will later buy back from them at a higher amount. In doing so, it removes liquidity from the market in order to prepare for the rest of the normalisation process.

Phase 2
Preparation of consensus and the markets

Thereafter, the Fed will announce the timing and magnitude of the normalisation process in a transparent manner. This is known as *forward guidance*. For normalisation to take place without any surprises, it is indeed necessary to prepare economic actors and financial markets, which is why central bankers are very careful with the terms used and the deadlines announced.

During this phase, we will learn more about the pace at which the institution will reduce its purchase programme, then reduce the number of assets held by not reinvesting the coupons received in order to achieve a reasonable balance sheet size. Then, much later and in a gradual manner, the first rate hike will occur.

Furthermore, at the June press briefing - the last before the traditional silence during summer - Jerome Powell announced that the start of the rate hike would not occur before 2023. It should also be noted that the amount of asset repurchases will not vary during the summer. We are therefore still at the beginning of the second phase of this process. The Fed should start announcing the next phase of its programme at the end of August, at the Jackson Hole conference, or during the autumn.

Phase 3
Coming out of the accommodation programme

This phase, which will see the Fed reduce the size of its balance sheet and continue its normalisation approach, should, in our view, start between the end of this year and the beginning of next year. This relatively long period will continue throughout the rate normalisation period.

Phase 4
Steadying the pace of normalisation

Once the balance sheet reduction programme is underway, the Fed is not expected to increase its pace of normalisation until the first rate hike is announced. Several months will pass before the actual date on which the Fed will raise key lending rates.

Phase 5
Policy rate hike

In the previous cycle, the first rate hike took place two years after the start of the balance sheet reduction. There is every indication that the Fed is planning to start a gradual process of rate hikes in 2023 that will last for several years.

In view of this, we are only at the beginning of the normalisation phase, which is why current policy remains extremely accommodative.

With the expected pace, risky assets should continue to be able to benefit from the potential for growth. Indeed, the previous cycle has shown us once again that the economy and markets can grow under a tight monetary policy regime. However, there is still one unknown factor in the equation: inflation. This could well generate an adverse scenario, but it we do not believe this is likely. Inflation has been making a comeback for several months now, as shown by the producer price index. As we mentioned in our previous publication, we are still convinced that this situation is a temporary one, as it is generated by factors that are cyclical, not structural. We do not believe that inflation will disrupt the Fed's programme and accelerate the pace of rate hikes. Once growth is normalising, it should indeed follow the same trajectory.

Now that we know a little more about the environment we are operating in, it is time for us to identify which asset classes we should opt for.

Which allocation should we opt for ?

While cycles come and go, they are not the same. As we explained earlier, several structural factors can transform the phases of a cycle by twisting some of their characteristics. However, the behaviour and dynamics of the major asset classes remain relatively similar from one cycle to the next. For example, in a recessionary phase, shares will suffer more than bonds, because after a sharp correction they will take longer to return to their initial level. Bonds, on the other hand, will be carried by duration as long rates fall to adjust to the new growth prospects.

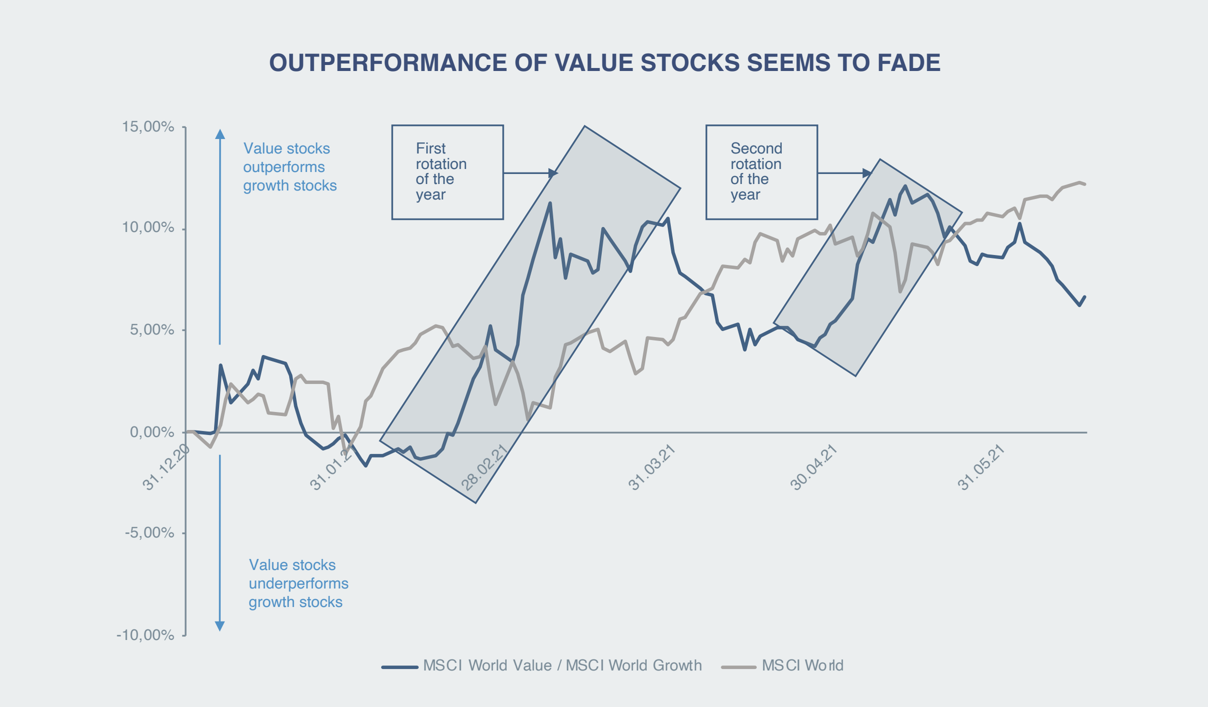
The default rate portion will be small compared to the total market, allowing bonds to quickly return to their pre-crisis levels. Conversely, in the early and mid-cycle recovery phases, shares will rebound strongly. The most cyclical segments will be the first to benefit during this recovery phase. Quality, growwth-oriented companies will be the ones expected to perform best in the longer part of the cycle. However, it is difficult to predict which particular sector will perform better than another.

In light of the foregoing, we believe in taking the following approach:

- Maintain an overweight in shares compared to bonds, as we believe their growth potential is promising.
- Do not anticipate a sharp rise in sovereign yields in the coming years, which will limit the potential for bond price appreciation when these same rates fall. Indeed, bond yields are low and are not expected to rise substantially. We are therefore reducing our strategic bond allocation. Furthermore, we do not hold developed country sovereign bonds.
- Increase allocation to alternative funds that have proven to be resilient over several years.

These convictions are the main guidelines for our medium- to long-term strategy, which we will set out below:

Equities



Stock markets have continued to rise during the second half of this year.

For the first half of the year, we can see that European shares are currently the best performers (+15%), closely followed by US shares (+13%) and Swiss shares (+11%). Swiss shares have caught up very well since 20 May 2021. Japan (+10%) and China (+2.4%) complete the picture.

It should be remembered that the strong recovery, combined with a rise in long-term interest rates, has favoured cyclical and *value* shares. This rotation has been difficult for quality and growth shares, which were slightly delayed this year. In this context, we had rebalanced our allocations to add cyclicality at the end of the year and during 2021.

In spite of this, we are still quite oriented towards quality and growth shares. These tend to smooth out cyclicals and generate long-term outperformance. We therefore expect them to outperform cyclical shares as soon as economic activity normalises.

Bonds

The rise in sovereign yields has paused this quarter

Indeed, 10 year US Treasuries fell from a high of 1.74 % in March 2021 to 1.5% on 15 June. German and Swiss 10 year sovereign rates also fell slightly, from -0.12% to -0.21%. As explained above, we expect bond yields to be lower in the coming months and quarters. Within our bond allocation, we have also reduced US credit in order to invest in convertible bonds. For the moment, we are maintaining our allocation in our Lyxor ETF, which is benefiting from rising inflationary expectations, and in *senior loans*, which generate returns of close to 5% without duration risk.

Strategically, the reduction in the bond allocation will allow us to increase the weight of our alternative investments.

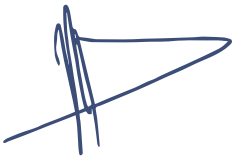
Alternative investments

Hedge fund strategies have suffered from rotation and the "Wall Street Bets" phenomenon (Graph XX); fortunately, this has had no impact on us, as we invest in funds with rigorous investment processes that have demonstrated their ability to outperform the market in the past. As a reminder, we are now mainly exposed to long/short strategies on global and European shares. We are also exposed to a particularly "decorrelated" strategy that feeds off the inefficiency of the energy markets. In the coming weeks we should also add a new strategy to our alternative investments, which will increase the allocation of this portion.

Conclusion

Given the probable phase change that we are likely to see, vigilance and caution remain essential, even more so if inflation causes anxiety about monetary policy. Far from following this scenario, we believe that the environment will nevertheless remain favourable for risky assets with interesting volatility periods to seize on opportunities.

Dominique De Riaz
Chief Executive Officer



Hugo Derny
Investment Strategist

Asset allocation

World Line Conservative

	UNDERWEIGHT	SLIGHTLY UNDERWEIGHT	NEUTRAL	SLIGHTLY OVERWEIGHT	OVERWEIGHT
EQUITY	○	○	○	○	●
Global equities	○	○	○	●	○
Emerging markets equities	○	○	○	●	○
Domestic equities	○	●	○	○	○
Small cap equities	○	○	●	○	○
FIXED INCOME	○	○	○	●	○
Government bonds	●	○	○	○	○
Inflation linked bonds	○	○	●	○	○
Corporate credit (US)	○	○	○	●	○
Emerging markets bonds	○	○	●	○	○
High yield bonds	○	○	●	○	○
Convertible bonds	○	○	●	○	○
ALTERNATIVE INVESTMENTS	○	●	○	○	○
Metals	○	○	●	○	○
Alternative funds	○	●	○	○	○
CASH	●	○	○	○	○

Based on 12-month forecasts

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