MFM

MIRANTE FUND MANAGEMENT

# Market Overview

NOVEMBER 2021

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# INFLATION AND MARGIN PRESSURE.

Investors' eyes remained focused on inflation and its impact on corporate earnings.

Numerous inflation measures continued to point to a robust acceleration. For example, the Eurozone is showing inflation of 4.1% year on year. As a result, central banks must acknowledge that price pressures are higher and more persistent than expected. Indeed, supply chain bottlenecks, soaring commodity prices, especially for energy, and labor shortages in some sectors could persist. However, most of these factors are transitory. Central bankers, therefore, continue to proclaim that inflation too should be temporary. More concretely, most central banks continue to announce a reduction in their purchasing programs, while some such as Norway, Brazil, Mexico, South Korea, and New Zealand have already started to raise interest rates.

At the corporate level, the third-quarter earnings season is already well underway. Early trends indicate that most companies report sensational sales figures, in line with the firm mid-year growth. However, analysts focus on margin pressures driven by raw material costs, rising wages and supply chain congestion. Wages, in particular, could be the transmission belt that turns the current inflationary phenomenon into something tenacious.

# INCREASED VOLATILITY FOR BONDS

With inflation rising sharply, investors have quickly advanced their expectations of when interest rates will increase. For their part, central bankers try to convince the market that a reduction in asset purchases is not synonymous with a rate hike.

Bond yield volatility has risen sharply, and yield curves have flattened. The very long durations (i.e. bonds with maturities of more than ten years) have seen their yields fall, thus presenting a positive performance. Conversely, the shortest maturities closed the month in negative territory in anticipation of potential rate hikes. Overall, high yield bonds were also under pressure. They suffered both the consequences of the Chinese real estate crisis and their short maturity. Inflation-linked bonds (known as TIPS) naturally benefited from the uncertainty associated with the latter. Despite their short duration, convertible bonds showed a robust performance by benefiting from their exposure to the good results of their underlying companies.

Positive results announced by companies drove stocks. Most benefited from strong global demand. The U.S. was the best region, led by the mammoths of its stock market indices, especially in the growth and financial sectors. Conversely, Japan ended the month in negative territory. The Japanese index suffered from profit-taking following the strong performance of the previous month due to the appointment of its new Prime Minister. At the sector level, consumer discretionary posted a spectacular performance led by Tesla, whose market capitalization exceeded $1 trillion. The energy and information technology sectors were also energetic. Energy companies continued to benefit from energy shortages around the world.

On the other hand, telecommunication services were the weakest sector due to Apple's new privacy policy. It allows users to decide whether they want to be tracked for advertising purposes. The revenues of several players in the field have fallen sharply due to the implementation of this policy.

The real estate asset class once again had a sensational performance. The sector benefited from both inflationary fears and the weakening of long-term interest rates. At the same time, real estate companies in industries such as data centers, logistics and self-storage benefited from investors' appetite for growth instruments.

Alternative strategies showed positive performance, mainly those benefiting from strong equity markets. Conversely, alternative strategies exposed to credit market beta were logically under pressure.

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# MACRO OUTLOOK.

The main macroeconomic uncertainty remains undoubtedly linked to the transitory nature of inflation. While the current surge still seems to have momentum (supply chain congestion and commodity prices), the first signs of a price peak already appear in some sectors. Wage growth will remain the central indicator for assessing inflation persistence.

Over the longer term, the major deflationary trends of the past few decades appear to be still present, including an ageing population and modest productivity gains. One of the challenges for asset allocators will be to mitigate these conflicting risks between the short and long term.

Beyond short-term inflationary risks, one of the themes of the coming months could be slowing demand. Companies confirm that it remains at extremely high levels. However, the effect of lockdowns and direct stimulus will likely fade, and demand should return to its steady state. However, even if global growth slows, the world is producing goods at an unprecedented rate. The World Trade Organization now expects world trade growth to exceed 10% this year. One of the relevant questions will be what happens to all this supply capacity when demand normalizes?

# POSITIONING OF OUR INVESTMENT STRATEGIES.

The downward movement in long-term rates combined with the appreciation of equities had an unexpected consequence. The correlation between stocks and bonds has become negative again. It means that bonds have significantly increased their diversification appeal despite the current low yields, providing a more tangible offset to equity risk exposure.

Our «World Equity Risk Premium» indicator has fallen significantly. Indeed, the fall in interest rates on long maturities did not compensate for the strength of the stock markets. This indicator measures the equity risk premium, the additional return that investors demand when investing in equities rather than government bonds. Even though the indicator has declined, it remains well above historical averages. This means that it makes sense to invest in equities, and more generally in growth assets, rather than in bonds over the long term.

The recent strong performance of some asset classes argues for maintaining a highly diversified portfolio. In equities, while valuations are high, so is the earnings growth of some innovative companies. The impact of these valuations represents a decline in expected long-term returns. Therefore, it is essential to remain humble in terms of expected returns to avoid exposure to disproportionate risks. In terms of bonds, despite their rise, rates remain modest in absolute terms. This is why we believe that exposure to convertibles and emerging market credit is appropriate, particularly in an environment of rising rates. A significant allocation to inflation-linked bonds (TIPS) and real estate remains essential to mitigate some of the risks associated with inflation.

The next market corrections could surprise by their magnitude, as the very definition of «defensive» assets is changing. However, genuine diversification and a robust portfolio construction should allow us to mitigate the impact of these declines and to benefit from potential market opportunities.

## NUMBER OF THE MONTH

# 21 years !

**CAC40 finally reached, at the beginning of November, its historical high, which it had last touched in September 2000.**

# MAIN DRIVERS.

*Main markets' drivers*

## GLOBAL GROWTH — neutral

- → Above average but gently converging to its equilibrium, the peak of recovery has been reached
- → Demand could moderate, supply still catching up
- → Lower growth ahead but probably more synchronized

## EARNINGS GROWTH — neutral

- → Peak earnings reached
- → Earnings growth will dictate performance of equities as multiple expansion is unlikely
- → Margins pressure on raw material prices, salaries, and supply chain congestion

## INFLATION — negative

- → Investors' patience tested
- → Beyond transitory factors, such as base effects and supply/demand imbalances, focus on durable sources of inflation, such as property prices and wages
- → Inflation could be a self-fulfilling prophecy

## INTEREST RATES — neutral

- → Key factor to push up long-term bond yields is the long-term inflation outlook
- → Is the decision to reduce quantitative easing synonymous with an imminent rate hike ?
- → Structurally low due to demographics & low productivity gains

*Main global risks*

## RECESSION RISK — low risk

- → New fiscal cycle: economic growth will be stimulated mainly by fiscal policies
- → Uneven recovery with divergences between regions and huge supply chains disruption (energy prices)

## FINANCIAL STABILITY — low risk

- → Fiscal and monetary stimulus has worked
- → Banks balance sheets are more robust than in the past
- → Combination of low liquidity and automatic trading (ETF & algorithmic) increase potential sharp drawdowns

SOURCE: MFM, October 2021

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# MONTHLY PERFORMANCE / OCTOBER 31 ST.

## Equities Market (Local currency)

| | |
|---|---|
| United States | 6.95 |
| World (all countries) | 5.50 |
| Europe | 4.50 |
| Switzerland | 4.07 |
| United Kingdom | 2.31 |
| Germany | 2.31 |
| Asia (ex-Japan) | 1.11 |
| Emerging Markets | 0.89 |
| Japan | -1.24 |

## Equities Sector (Local currency)

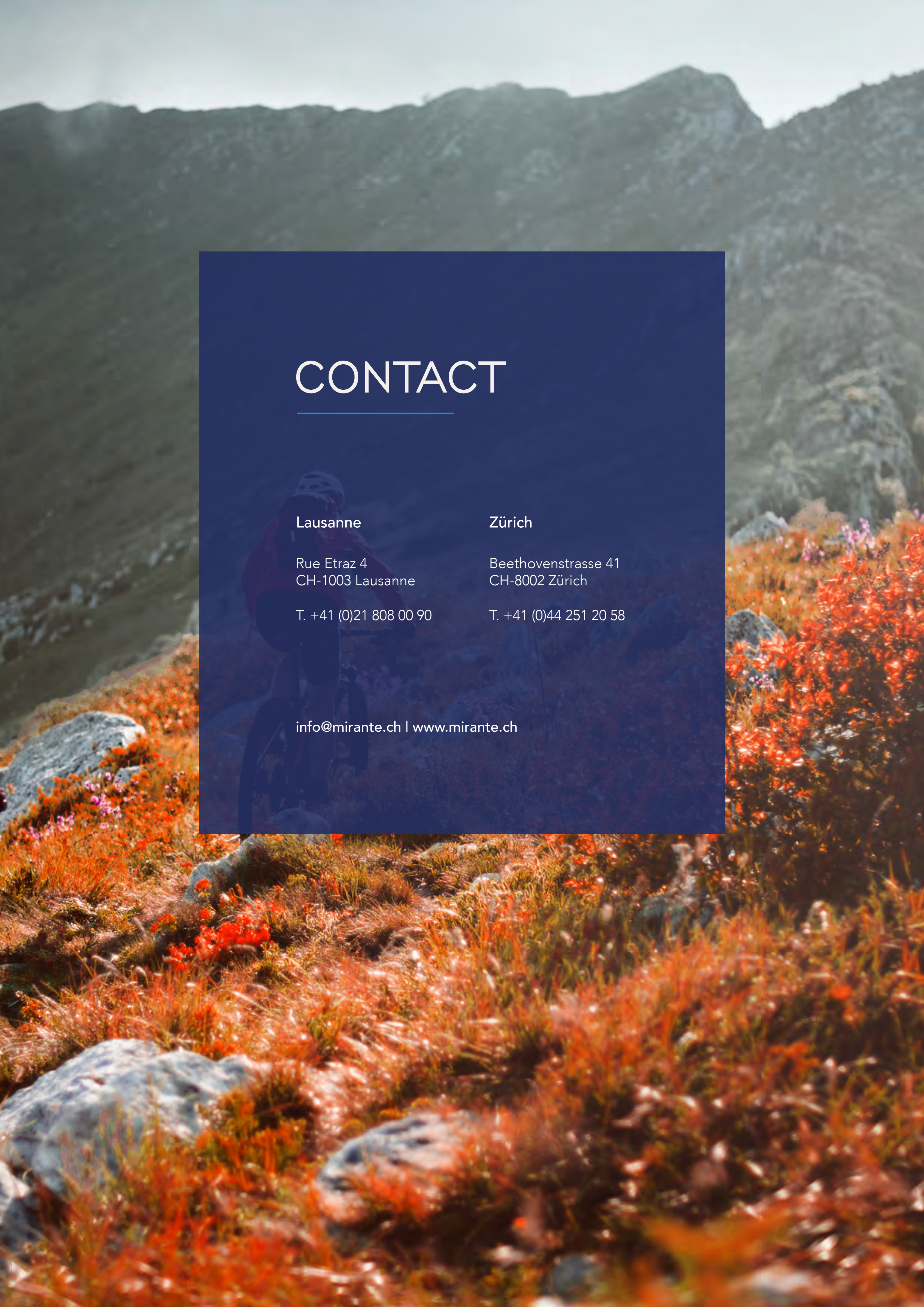
| | |
|---|---|
| Consumer Discretionary | 8.27 |
| Information Technologies | 7.57 |
| Energy | 7.36 |
| Financials | 5.81 |
| Utilities | 5.03 |
| Industrials | 4.62 |
| Materials | 4.13 |
| Health Care | 4.02 |
| Consumer Staples | 2.98 |
| Telecommunication Services | 1.33 |

## Fixed-Income (USD Hedged)

| | |
|---|---|
| US Treasury Long Duration | 1.86 |
| Global Convertibles | 1.58 |
| Global Aggregate Long Duration | 0.67 |
| Global Inflation-Linked Bonds | 0.50 |
| Global Corporate Credit | -0.08 |
| Global Aggregate | -0.26 |
| Global Treasury | -0.28 |
| Global Aggregate 1-3 Year | -0.29 |
| Emerging Market Hard Currency Aggregate | -0.48 |
| Global High-Yield | -0.53 |
| Global Aggregate 5-7 Year | -0.69 |
| Swiss Bond (SBI / AAA-BBB) - (CHF) | -0.78 |

## Others (USD)

| | |
|---|---|
| Real-Estate (FTSE NAREIT) | 7.60 |
| Commodities (BCOM) | 2.58 |
| Hedge Funds | 1.01 |



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