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Private Banking

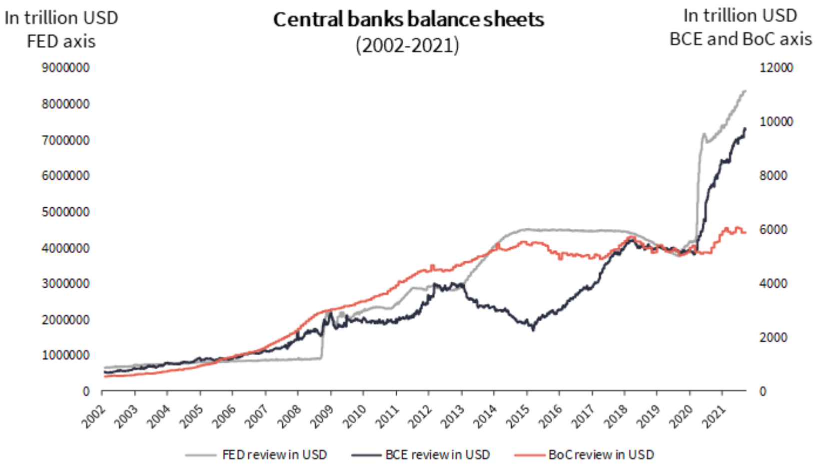
CIO VIEWS

After the recovery, what is the outlook for the economy and the markets?

Most major economies confirmed their recovery during the summer, proving that growth is indeed back. Driven by an improved global outlook, strong liquidity supply from central banks and the accumulation of excess savings, equity markets are showing exuberant health. Nevertheless, there is a certain heterogeneity in this recovery, reflecting the various public health strategies implemented to fight Covid.

After the restart though, tensions on the productive apparatus and in particular on supply chains are likely to constrain the recovery in some industries. Considering the sharp drop-in interest rates, central banks continue to use their balance sheets to stimulate recovery and avoid anchoring inflation expectations at too low levels. As asset allocation choices must accommodate for the lack of remuneration in interest rate markets, stocks providing healthy inflation protection and high-risk premiums are the default choice.

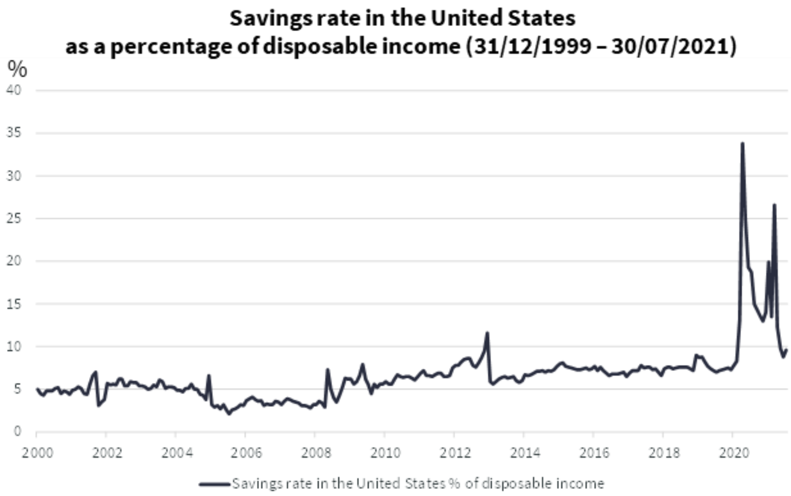
Chart 1: Central Banks stimuli [1]



[1] *Source chart 1: Société Générale Private Wealth Management, Bloomberg, September 2021*
Past performances are not a reliable indication of future performances

The recovery of economies, which began at the end of last year, has been especially robust. The supply-side policies implemented by governments have made it possible to effectively protect economies and ensure that they would be able to quickly rebound after the crisis. The IMF forecasts a global growth of 6% in 2021 and 4.9% in 2022, well above the level of +4.2% reached in 2010 after the great financial crisis. Consumption has been flourishing, which can partly be explained by the level of household savings accumulated over the past 18 months. Indeed, the savings rate had reached 35% of disposable income during the confinement and although it is normalizing, it remains relatively high at nearly 10%. The accumulated savings surplus combined to low household debt, particularly in the United States, are conducive to a strong recovery in real estate.

Chart 2: US personal savings [2]



The outlook remains positive for the manufacturing sector, but supply is likely to be affected by tensions in supply chains. It is already obvious in the semiconductor sector, where shortages led to plant closures in the automotive industry, for example. At their highest level in more than 20 years, leading indicators point to a very strong recovery landscape in Europe and the United States. The sequential decline in PMI indicators, which had reached a high point at the beginning of the summer, should therefore not be interpreted as a slowdown in activity, but rather as a sign that the pace of growth is normalising.

There is a certain desynchronization of growth between regions. The way governments define their public health strategies to combat the Covid epidemic clearly has an impact on growth. Asian countries often apply so-called "zero Covid" policies, which consist in implementing targeted containment measures as soon as the first cases of Covid are detected.

[2] *Source chart 2: Société Générale Private Wealth Management, Bloomberg, September 2021*
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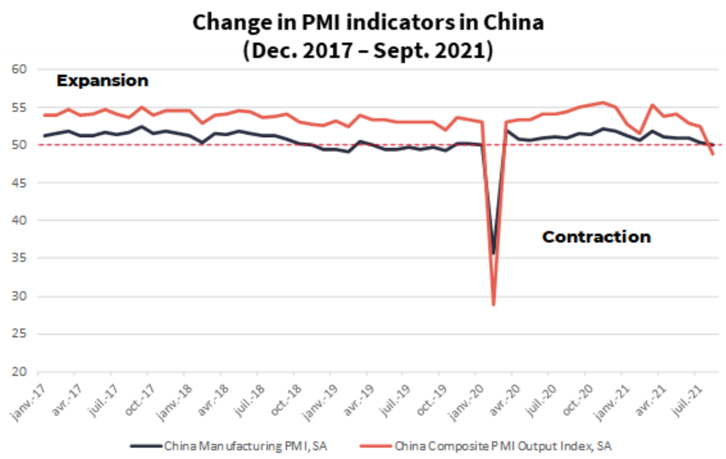
Thanks to high vaccination rates, Europe may consider relaxing distancing measures despite the high contagiousness of the delta variant. In August, China's manufacturing PMI came out in contraction zone for the first time since April 2020 due to the lockdown measures the country enforced over the summer. This desynchronization of growth is also linked to base effects. Indeed, China had emerged earlier from the Covid crisis in 2020 and its economy had suffered less over the whole year.

Chart 3: Chinese Manufacturing PMI Contraction [3]



Japan is also facing a slowdown in growth and the services PMI fell sharply in August in connection with the announcement of a state of emergency as the country battles its strongest wave of infection to date. This situation pushed the Prime Minister to resign when his approval rate had reached record lows. In Asia, India is probably a special case. As the country suffered the full brunt of a very strong wave of infection at the beginning of the year, we are now seeing a recovery primarily in the economy and in services.

Health strategies are only one part of the equation, and it must be recognized that economic policies have been much more accommodative in Europe and the United States than in the rest of the world both on the fiscal and monetary fronts. The United States voted in August a $1 trillion infrastructure spending plan to complement the *American Jobs Act* passed last March. The eurozone is not left behind with its joint recovery plan: *Next Generation EU.*

Developed countries are carrying out a new monetary policy doctrine based on average inflation targets. Faced with the steady decline in the neutral interest rate – the interest rate that allows full employment to be achieved without causing inflation – central bankers have faced new hurdles in the implementation of their monetary policy.

[3] *Source chart 3 : Société Générale Private Wealth Management, Bloomberg, September 2021*
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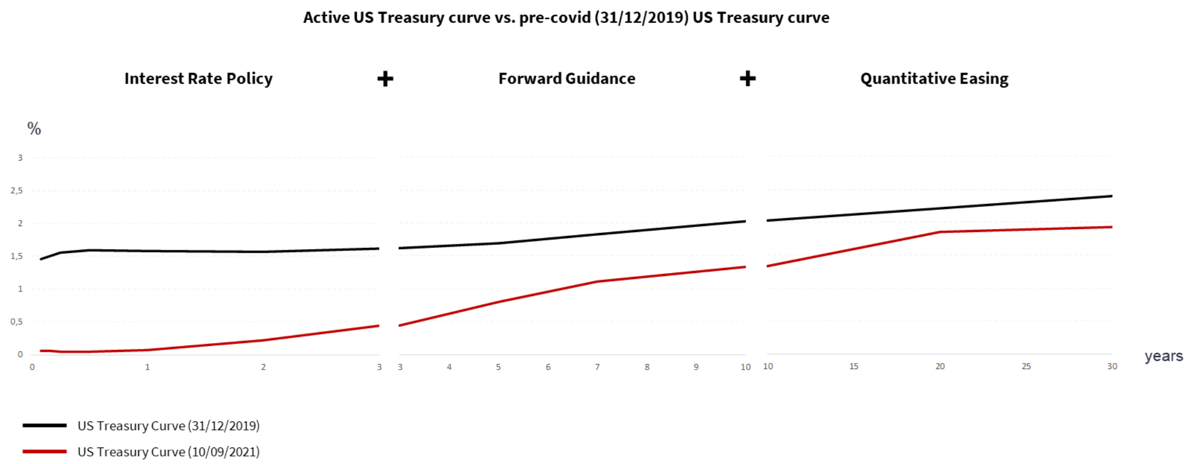
Indeed, the current situation, whereby monetary policy rates are at their lower bound (0% for the Fed and -0.50% for the ECB), prevents central banks from stimulating recovery through interest rate policy alone. This constraint poses the risk that economic agents will assume low inflation forecasts, leading inflation to be too low and even sub-optimal for the economy. It is within this framework of analysis that the Fed and more recently the ECB have set an average inflation target. The FAIT *(Flexible Average Inflation Targeting)* leads to the implementation of constant and pre-determined support measures when the economy is below its potential to prevent the decline in expected inflation from taking root.

Chart 4: F.A.I.T explained[4]



Therefore, the Fed and the ECB maintain an asset purchase amount of $120 billion and €85 billion respectively. Combined with large savings needs and a growing quest for risk-free assets, this monetary stimulus is driving real interest rates into negative territory. Deflated by the expected average inflation rate, US Treasury 10-year bonds show a yield of -1%. German government bonds of the same maturity even reached -1.8%. This ultra-accommodative monetary policy creates decidedly favourable conditions for asset markets. The influx of liquidity squeezes risk premiums and reduces volatility since any decline is used to buy assets cheaply. The beginning of the Fed's monetary policy normalisation could come at the end of the year but will remain intimately linked to the situation in the labour market. At 5.2%, the unemployment rate in the United States has fallen sharply since its high of 14.7% in April 2020. Nevertheless, the participation rate remains well below pre-crisis levels, which continues to confirm a rather deteriorating labour market situation. The Eurozone should follow suit and maintain a very accommodative bias. It is clear that central bankers have been unmoved by the recently published inflation data. In the United States, the inflation rate reached 5.4% in June and July. In the euro zone, inflation for the month of August has just come out at 3% and +1.6% for core inflation (excluding food and energy).

[4] *Source chart 4: Société Générale Private Wealth Management, Bloomberg, September 2021*
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However, reading these figures reveals important base effects on the one hand and effects related to the reopening of economies on the other hand. This reading, combined with the formulation of an average inflation target, implies that central bankers should remain fairly accommodating. More than the weapon of interest rates, we believe that central banks will rather rely on macro-prudential measures to curb any risk of a bubble in the credit market. It should be noted that they now have tools that allow them to measure the commitments of financial institutions.

In this environment of strong recovery and abundant liquidity, equity markets must continue to be privileged. Equity markets in developed countries now offer a credible alternative to yield-free bond markets. The entire German yield curve is now in negative territory and there is more than $1.8 trillion in negative-yielding bonds. This does not even consider the effects of monetary erosion that further reduces real returns. The pace of share buybacks and dividend payments are expected to pick up and support markets. At this stage of the cycle, we favour a fairly balanced approach from a style point of view, with a preference for quality stocks, nonetheless. Discounted securities were indeed highly sought after at the beginning of the year but have now made their catch-up. European equities are expected to do well compared to US equities in the coming months, as the high level of vaccination protects the European economy from the risk of re-confinement. Moreover, the sectoral composition of the European economy seems properly balanced.

Asia and emerging markets are lagging in terms of performance this year, reflecting a less robust economic momentum, but also a strong regulatory tightening in China in the technology sector. The Chinese Communist Party's goal of social welfare through a policy of "common prosperity" marks an important turning point. In the face of these regulatory uncertainties, the Chinese stock market has sharply corrected since its highs of last February and was down nearly 12% since the beginning of the year at the end of August. Emerging equity indices now trade at a significant discount to developed countries and could benefit from monetary and fiscal policy support measures by the end of the year. Many emerging markets have thus completed their monetary tightening policy, and in China, the PBOC could support liquidity by reducing the reserve requirement ratio.

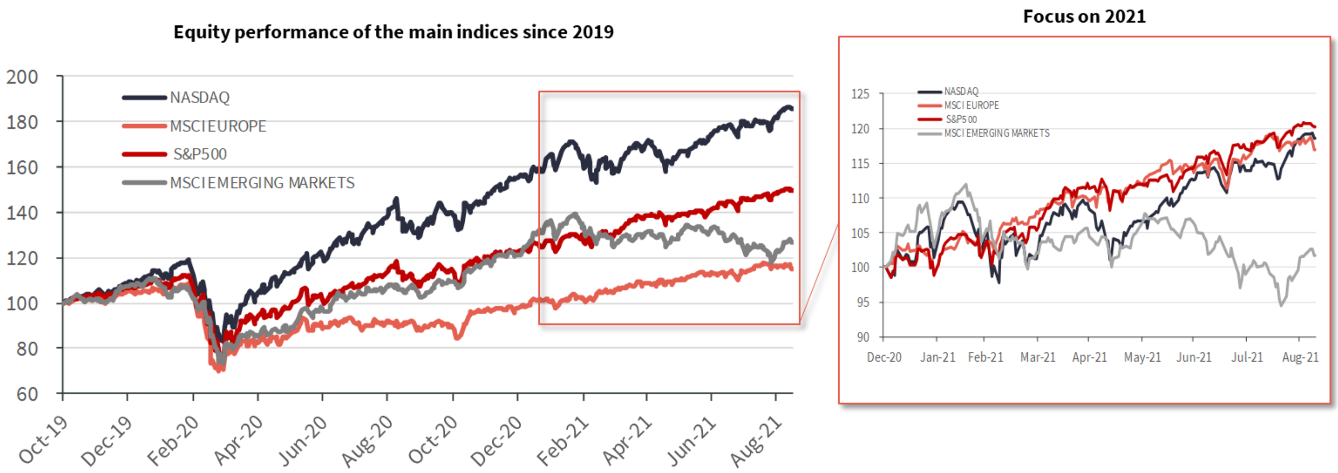
The energy transition remains a theme of strong growth and should continue to offer higher growth prospects. Taking these issues into account makes it possible to reduce risks for investors. We maintain a constructive view on these values for these reasons.

Among fixed income markets, the variable-rate bonds and inflation-linked bonds segments are the most appealing ones. In the euro area, Southern Europe continues to offer higher yields than German rates. Yields offered by emerging bond markets are more attractive and the segment should benefit from the monetary easing cycle that is starting. Gold continues to make sense in a diversified portfolio thanks to its haven status; it can effectively protect a portfolio in the event of extreme risk.

After a good start to the year, it may be tempting to take profits. However, the lack of investment opportunities on yield assets on the one hand and the prospects of renewed growth on the other hand led us to continue to favour equity markets, but also gold in our allocations.

Investors must learn to live with a new monetary policy doctrine whose effects are generally favourable to investment. Europe has real potential and, after a decline at the beginning of the year, emerging markets should benefit from renewed momentum. We also maintain a balanced approach from a management style point of view, preferring quality stocks. The energy transition and its challenges in terms of growth are significant, which warrants a central place in investment choices.

Chart 5: Equity Performance[5]



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[5] *Source chart 5 : Société Générale Private Wealth Management, Bloomberg, September 2021*
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