A turning point – yes or no?

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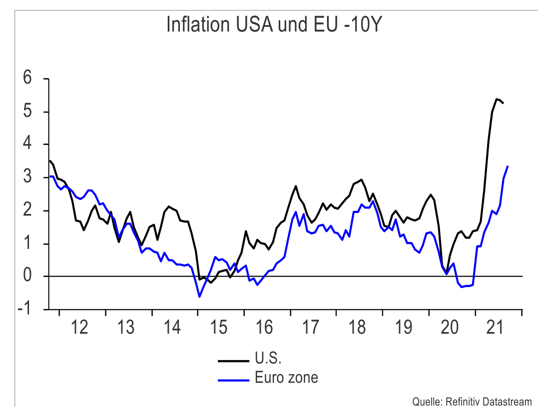
A plethora of problems unsettled the markets in the third quarter. For a long time, investors have been waiting expectantly to see how the change from an expansive monetary policy towards normality (tapering) will be achieved. Alongside this, we have inflation figures that have risen beyond all forecasts. But that's not all. In the third quarter, reports of the potential collapse of the Chinese real estate bubble did the rounds. And let's not forget: winter is coming. A time that may have surprising effects on the pandemic once again. On top of this, the investors' darlings of the last 10 years are no longer doing so well, including the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google). Not surprisingly, markets in the last weeks of September reacted mercilessly to this combined payload of pre-existing problems.

Many are justifiably asking themselves whether this is the start of a new era.

In assessing pandemic risks, it must be noted that global herd immunity has in no way yet been reached, as most developing countries will not have obtained sufficient numbers of vaccine doses until the end of 2022. And we still have to consider the potential mutation of the virus into a form that cannot be fought back by existing inoculation technologies. We also have to add that vaccine acceptance in many cases is insufficient in developed states, meaning a new wave could break out among the unvaccinated. We assume, however, that these risks will no longer lead to the closures of entire sectors or groups of countries, with a subsequent effect on investments.



Greater worry is caused by the unusually strong inflation in the USA and EU.

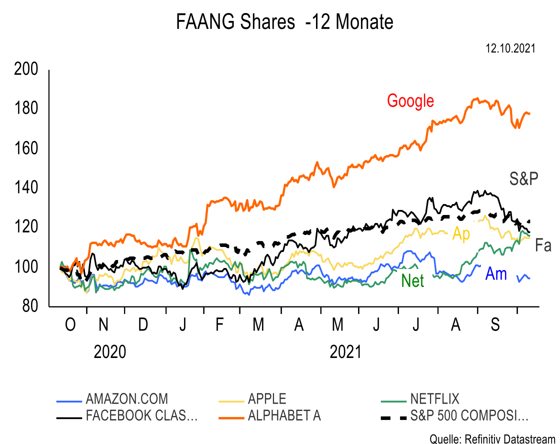
Such a development is not addressed by the latest central banking strategies. After years spent trying to bring inflation up to two percent, it has now been announced that inflation will be allowed to move towards three percent for a certain time in the future, in order to compensate for the failure to reach this benchmark. The latest shock development of the inflation rate has a problematic side. It is already having serious effects on the purchasing power of employees. This will lead at the latest by next year to widespread wage negotiations in an economic phase already marked by capacity bottlenecks. Employers will then be eager to pass on these wage rises to consumers. Because they are in no way the beneficiaries of the higher prices. They are elsewhere altogether: above all, in the raw material-producing countries. This suggests that the risk of a wage-price spiral should not be underestimated. Then in any case, it could take much longer to return to the target of two percent.

And another thing has to be considered: more than half of global financial wealth is in cash, bank deposits and bonds. With these investments barely having yielded for years, they will now be decimated by inflation. We are estimating – over a two-year period – real losses of 6% (EU) to 10% (US). Despite this bleak outlook, we do not expect central banks to apply the brakes as was usually the case in the seventies, eighties and nineties. Such an approach – based on high valuations – would have serious effects on the stock markets. The significant increase in short-term interest rates would also have an impact on long-term expectations and, among other things, would lead to considerable additional costs, which, in addition to corporate profit growth, would also have a very negative impact on government budgets in particular.

Such action on the part of the central banks would also not be justifiable in terms of economic policy, as the reasons for inflation are quite different today. Globalisation, new technologies, the heterogeneity of the labour market and low negotiating power of employees make a self-reinforcing wage-price spiral appear very unlikely. For that reason, we expect that the rash increase in prices of late is a transitory phenomenon, requiring no braking manoeuvres by the central banks. What remains, however, are large, real losses of value in nominal financial assets.

An exception to this assessment should be made for Great Britain. The shock departure from prior immigration policies has already led to serious disturbances in the economic cycle. Supply shortages and price increases will be the result. In addition, the shortages of labour will lead to marked increases in wages. If policy is not changed quickly, wage-price spirals could easily start up.

More concern is caused by the potential bankruptcy of Evergrande. This is the second-largest Chinese property developer with debts of around 300 billion US dollars. This situation is critical for two reasons. Firstly, the property market is the most important value-creating sector, with a share of over 20% of GDP; secondly, this sector has been out of control for a long time. The effects on the Chinese economy would certainly be significant. However, comparisons with the Lehmann Brothers collapse are misplaced, as the international interdependence of the Chinese property sector is low. It is primarily financed by domestic savings. Securitisation of mortgages, as was standard in the USA and brought the global financial system to its knees, is not usual in China. It must be added that Evergrande is largely a victim of the regulators. They demanded “red line” financing ratios that could not be fulfilled at short notice. This practically closed off access to the capital markets and banks at a stroke. If the schedule for fulfilling the requirements is not extended, bankruptcy will become unavoidable. However, we assume that the government will ensure the apartments that have been paid for are completed by other means, so the costs for the economy at large are kept low.



Overall, the Evergrande case will barely influence diversified portfolios.

The large US tech companies are living in uncertain times.

Because of their power on the market and their business models, they are coming under increasing pressure. In the last decade, they have ensured that growth stocks have markedly outperformed classic value stocks. For a year, this has no longer been the case. The five large FAANG tech companies (Facebook, Apple, Amazon, Netflix and Google) no longer match the S&P Index. Their underperformance also has serious effects on the entire American market, as they have grown to make up more than 20% of the entire market capitalisation.

There is no doubt that these growth stocks, with their above-average valuations, are exposed to increasing regulatory pressure. China has already started this process and accepted significant value corrections. For reasons of public order and social policy, the West will not be able to avoid introducing regulation. In addition, digitalisation is increasingly being applied in the traditional sectors of the economy. In this way, productivity growth is shifting ever further towards the traditional economy. It is therefore very possible that growth stocks have passed their prime and value stocks will gain greater prominence again.

Overall, we can say that the global economy has made up for much of the growth lost during the pandemic recession and is now on a calmer trajectory. Serious new risks have not arisen. Both the pandemic and Chinese property market risks are manageable.

We may have to prepare for bigger surprises in terms of inflation risks. The widely held conviction that this is a transitory problem could still be put to the test if certain shortages last longer than expected and the weather situation in regions that are key to global supply also remains exceptional. As long as the central banks do not take proactive action, however, this is not dangerous for investments.

We therefore believe that reducing the overweight in equities in the direction of a neutral positioning is most appropriate for the current situation, given the colourful bouquet of reasons described above. However, we would like to point out that equities and real assets will remain the only alternative to nominal assets in the longer term. We would, however, like to take account of the current inflation risk by an additional underweighting of bonds.

So much for the general trends.

You can find the details of asset allocation in the following table.

Strategic and tactical Asset Allocation for the 4th Quarter 2021

	Reference currency CHF			Reference currency EUR			Reference currency USD		
	Investment strategy Balanced			Investment strategy Balanced			Investment strategy Balanced		
Investment categories	SA	IC	C	SA	IC	C	SA	IC	C
Money market	**5**	**16**	**+8**	**5**	**16**	**+8**	**5**	**16**	**+8**
Bonds	**40**	**28**	**-4**	**40**	**28**	**-4**	**40**	**28**	**-4**
Home Country	24	18	-3	23	18	-2	3	4	-1
Rest of Europe	8	5		5	1	-1	5	2	
USA	4	2	-1	8	6	-1	28	19	-3
Rest of World	4	3		4	3		4	3	
Stocks and shares	**45**	**45**	**-5**	**45**	**45**	**-5**	**45**	**45**	**-5**
Home Country	9	9	-1	15	16	-2	7	9	-1
Rest of Europe	11	11	-2	6	5	-1	7	8	
USA	12	11	-1	15	11	-1	23	20	-3
Rest of World	13	14	-1	9	13	-1	8	8	-1
Alternative investments	**10**	**11**	**+1**	**10**	**11**	**+1**	**10**	**11**	**+1**
Commodities	4	6	+1	4	6	+1	4	6	+1
Various	6	5		6	5		6	5	
Total	**100**	**100**		**100**	**100**				

SA = Strategic Asset Allocation IC = Investment Committee C = Change

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