Investment Policy

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Key points

The end of an era?

When public **debt** reaches excessive levels, as is currently the case in most developed economies, it is vital that monetary and political authorities retain their credibility and continue to command confidence so as to avoid a run on the currency or an explosion in the cost of debt financing.

That being the case, the latest recovery plans – like the infrastructure package currently being negotiated in the US – are henceforth going to have to be backed by new sources of funding. And that is inevitably going to mean putting **taxes** up.

With the aim of reducing inequalities in US society, the Biden administration is planning to hike taxes on the most well-off households: through an orchestrated policy of redistribution, the government is going to try to succeed where trickle-down economics has failed. But an even bigger revolution looms: raising corporate taxes.

Also under the impetus of the US, without whom nothing would be possible anyway, the principle of a minimum **15%** business tax rate and, for the biggest companies with profit margins of over **20%**, payment of taxes in the countries where their customers are based, was agreed at the recent G7 summit. Although more countries will need to sign up if this is to become a reality, a genuine consensus does seem to be taking shape: the time has come for the winners at the globalisation game to make their contribution towards getting public finances back on track.

Initial estimates of the impact of these changes are not too alarming: the reduction in 2022 profits for S&P 500 companies would amount to no more than a few percent, with the tech and healthcare sectors likely to be hit hardest. Meanwhile, the impact in Europe looks set to be marginal – somewhere in the region of 2%.

One knock-on effect of the pandemic thus seems to be the end of a more or less uninterrupted **forty-year** decline in corporate tax rates (**Chart 1**).

Scenario and conclusions

- Growth set to **quicken** sharply in H2 except in China
- Contribution of credit to Chinese growth **dropping off**
- **Inflation** picking up
- Corporate **taxes** to be raised

→ **Equities**: neutral; continue rotating into more cyclical and value stocks

→ **Bonds**: preference for carry (high-yield segment; USD emerging sovereign debt and Chinese sovereign debt in RMB)

→ **Currencies**: unchanged

→ **Cash**: unchanged

	UW (-)		N (=)		OW (+)
Asset allocation					
Equities			■		
Sovereign bonds	■				
Credit		■			
Alternative investments				■	
Cash				■	
Equities					
US			■		
Europe			■		
Switzerland				■	
Japan		■			
Emerging markets				■	
Bonds					
Sovereign	■				
Corporate investment grade	■				
High-yield corporate					■
Emerging market sovereign (USD)				■	
Emerging market sovereign (local)				■	

Economy: *is inflation back?!*

Chart 1 | US: corporate tax rate set to rise

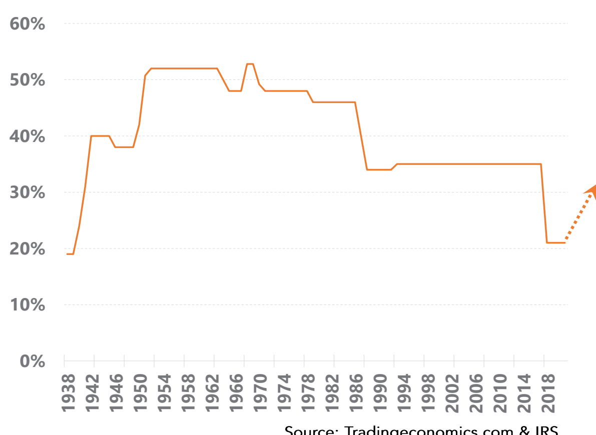
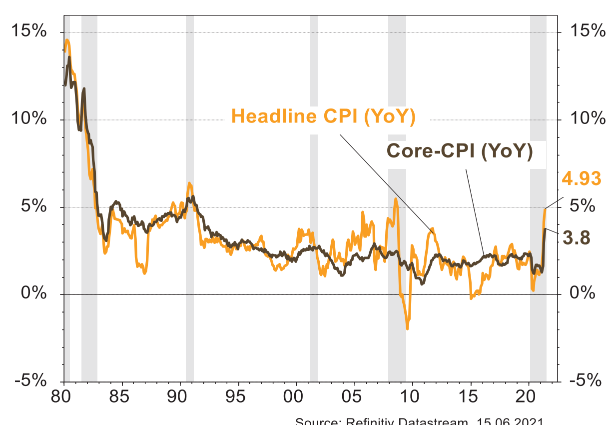


Chart 2 | US: price inflation quickening



Year-on-year US headline **inflation** came in at **5%** in May, its highest level since 2008, while core inflation excluding food and energy came in at **3.8%**, its highest since 1992. In China, producer prices have risen **9%** YoY; even in Germany, year-on-year consumer price inflation came in at 2.4% in May, compared with a mere 0.6% in Switzerland.

In light of these figures, it is no surprise that inflation has become the hot economic topic of the moment.

There are **two main opposing camps**. The **first**, which argues that this return of inflation is only temporary, is spearheaded by none other than the US Federal Reserve. The **second** thinks inflation is set to be a more permanent feature and that we are witnessing the dawn of a new regime after 40 years of disinflation (**Chart 2**).

Those who argue that the current upturn in inflation is a **temporary** phenomenon think the base effects working through at present, caused by the slump in prices in spring 2020, will gradually dissipate as lockdown restrictions are lifted. Similarly, current tensions in some areas of the economy (with bottlenecks in transport, semiconductors and some commodities, and even labour shortages in some sectors) are unlikely to persist once things get back to normal a few months down the line. Lastly, and most importantly, those in this camp believe the disinflationary forces that have held sway over the past few decades (globalisation, technological innovation, high levels of debt and demographic change) are not going to disappear and will once again put downward pressure on prices.

The arguments for **more permanent** inflation are just as relevant and compelling. In response to the argument that inflation is a temporary consequence of a surfeit of demand brought about by supply shortages, those who believe we are witnessing a shift in the inflation regime think demand, buoyed by government aid for households and planned investment for businesses, will exceed available supply long enough to send prices spiralling for quite some time to come. For that to happen, the quickening wage growth of the past few months – reflecting Americans' reluctance to go back to work given the generosity of pandemic-related unemployment benefits – would have to continue. Against this backdrop, the political will shown by various leaders

Financial markets

*) To 14.06.2021	Performance			Valuation			Earnings growth			
Equity markets	Price (local currency)	Quarter Q2*)	Since 31 Dec 2020	12-month P/EPS	Dividend yield	Price/ net assets	12-month EPS	2021 EPS	2022 EPS	2023 EPS
United States	4 132.56	7.20%	12.70%	21.70	1.9%	4.7	20%	36%	11%	11%
Europe	458.32	6.69%	14.90%	16.91	2.4%	2.1	25%	46%	12%	9%
Japan	1 959.75	0.29%	8.60%	15.62	2.0%	1.3	20%	25%	13%	9%
Switzerland	11 866.41	7.40%	11.00%	18.06	2.7%	3.2	9%	9%	10%	8%
United Kingdom	4 074.57	6.40%	11.00%	13.57	3.0%	1.8	30%	67%	8%	6%
Emerging Markets (USD)	1 383.19	5.07%	7.12%	14.22	2.3%	2.1	25%	49%	11%	10%
World (USD)	3 019.88	7.40%	12.30%	19.60	2.1%	3.2	21%	37%	11%	9%

Source: Datastream, IBES consensus

of the developed world to relocate production of essential goods will cause globalisation to slow and thus production costs to rise. Similarly, the need to reduce inequalities so as to limit social unrest and political polarisation will inevitably mean either raising taxes on the most well-off or lifting wages for the lowest-paid. Either way, the outcome will tend to be inflationary.

Similarly, the **energy and ecological transition** is not a free lunch, costing an estimated at c. $4trn a year. More generally, raising taxes, whether on consumers or the businesses that produce the goods they consume, will ultimately drive up costs and either lighten people's wallets or eat away at company profits.

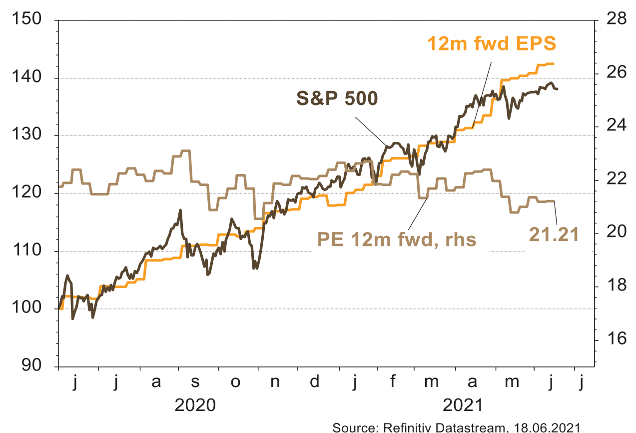
Although we do not, as some are predicting, believe there will be a return to 1970s-style inflation, we are of the view that highly expansionary economic policies – which, unlike in 2008, come on top of highly accommodative monetary policies – are likely to result in **longer-lasting** inflation. In the US, the amount shelled out by government and central banks combined equates to 30% of GDP, comparable to Second World War levels (!) and on a completely different scale to 2008 (less than 15% of GDP). Moreover, the Fed is happy to put up with inflation being higher than it has been over the past few years (averaging 1.8% over the past decade).

Despite significant upgrades to the growth and inflation outlook, the US and European central banks have maintained their highly accommodative bias. After testing their determination by pushing up long yields at the beginning of the year, markets seem resigned for the time being. They will have ample time to react if inflation does not slow and/or the economy heats up even faster than anticipated.

As regards **economic activity**, the recovery is continuing as economies emerge from lockdown. In the US, the ISM Manufacturing and Non-Manufacturing indices have probably already peaked. Activity data, particularly on consumption, has bounced back strongly, confirming this optimistic picture. Q1 GDP grew more than 6.4% QoQ annualised, and Q2 looks set to be even better. The **eurozone** is clearly lagging behind, with Q1 GDP declining slightly (down 1.3% QoQ annualised), albeit by less than expected. Similarly, **Swiss** GDP declined 2% QoQ annualised over the same period. Q2 will confirm the recovery as restrictions are lifted.

The contribution of credit to economic growth has been dropping off in **China**, signalling that, although the economic climate remains bright, growth in the country furthest ahead in the cycle is no longer quickening.

Chart 3 | Equities: growth in indices driven by EPS, not valuations



10-year sovereign bonds	Level at 14.06.2021	Change Q2*) (bps)	Change since 31 Dec 2020 (bps)
USD yields – United States	1.50%	-25	59
EUR yields – Germany	-0.25%	8	32
JPY yields – Japan	0.04%	-6	1
CHF yields – Switzerland	-0.23%	12	32
GBP yields – United Kingdom	0.78%	-10	54
Emerging markets (USD)	3.91%	-7	34
Emerging markets (local currency)	6.01%	-81	-2
Commodities	**Price**	**Quarter Q2*)**	**Since 31 Dec 2020**
Gold (USD/oz)	1 864.56	9.4%	-1.7%
Brent (USD/bl)	72.38	14.0%	39.0%

FX	Level at 14.06.2021	Change Q2*)	Change since 31 Dec 2020
EUR vs. CHF	1.0901	-1.45%	0.79%
EUR vs. USD	1.2109	3.04%	-1.36%
EUR vs. JPY	133.3513	2.68%	5.56%
EUR vs. NOK	10.0718	0.39%	-3.86%
GBP vs. EUR	1.1662	-0.66%	5.41%
GBP vs. USD	1.4120	2.34%	3.29%
USD vs. CHF	0.8991	-4.47%	1.71%
USD vs. CAD	1.2135	-3.45%	-4.75%
AUD vs. USD	0.7721	1.37%	0.05%

Source: Datastream

Monetary preferences

Rank 1	Rank 2	Rank 3
Appreciation expected	Stabilisation	Depreciation expected
USD	GBP | JPY | GOLD | NOK	CHF | EUR
▪ **USD**: benefits from monetary policy divergence	▪ **GBP**: attractive valuation and expected economic recovery (vaccination) ▪ **JPY**: attractively valued and a safe haven currency ▪ **GOLD**: a currency hedge and a diversifying asset ▪ **NOK**: stabilised now that oil prices have picked up	▪ **CHF**: high valuation; penalised by risk appetite ▪ **EUR**: penalised by a late restart and a more accommodative ECB

Investment conclusions

US equity valuations, as measured by the 12-month P/E ratio, have remained unchanged since June 2020. While that may appear surprising, gains posted by indices over the period – around 40% – have been driven entirely by the expected upturn in **earnings growth** (**Chart 3**).

While this trend is fairly healthy, since it is based on fundamentals (earnings), it also indicates that investors are unwilling to pay more for equities. It now seems that any further gains will be dependent on fresh upgrades to the growth outlook. While such upgrades are certainly a possibility, they will clearly be more **modest** than over the past few months. The upside therefore now looks more limited. While remaining exposed to equity markets, we have bought **protection** (put options) for all our strategies. The purpose is to lock in the gains we have accumulated so far this year at a time when positive surprises could become more of a rarity.

That said, there are few **alternatives** to equities. The surprising downtrend in interest rates in Q2 has not made life any easier for the most cautious investors. In an environment where the growth outlook remains more than satisfactory despite high absolute valuations, falling interest rates ultimately revive the appeal of… equities! We plan to increase our exposure as and when the opportunity arises. In the meantime, we remain active in the various asset classes: for example, we have taken profits on our holdings of equities linked to industrial metals and upped our exposure to Asian bonds. We have also been building up some new positions in hybrid corporate debt, which we think offers a more attractive risk/reward trade-off than investment-grade credit.

There has been little change in **currencies**. Our allocation, geared towards being anchored in the reference currency, remains unchanged, as does our allocation to gold, whose price has recovered nicely over the past quarter.

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