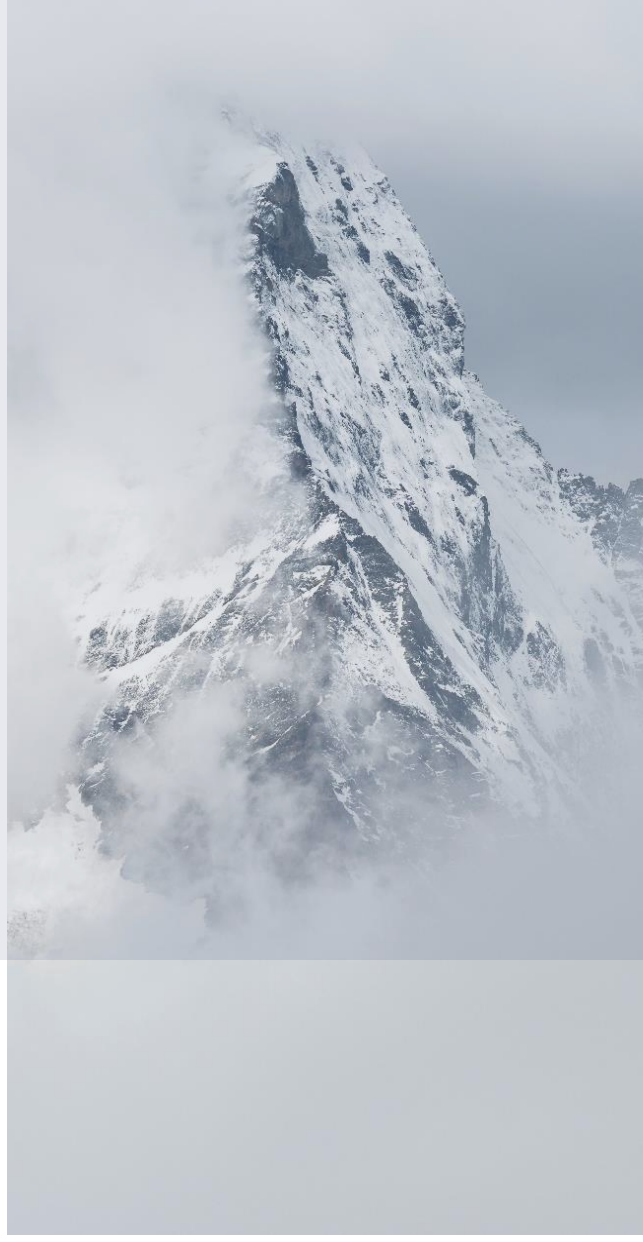
SUMUS' VERSION

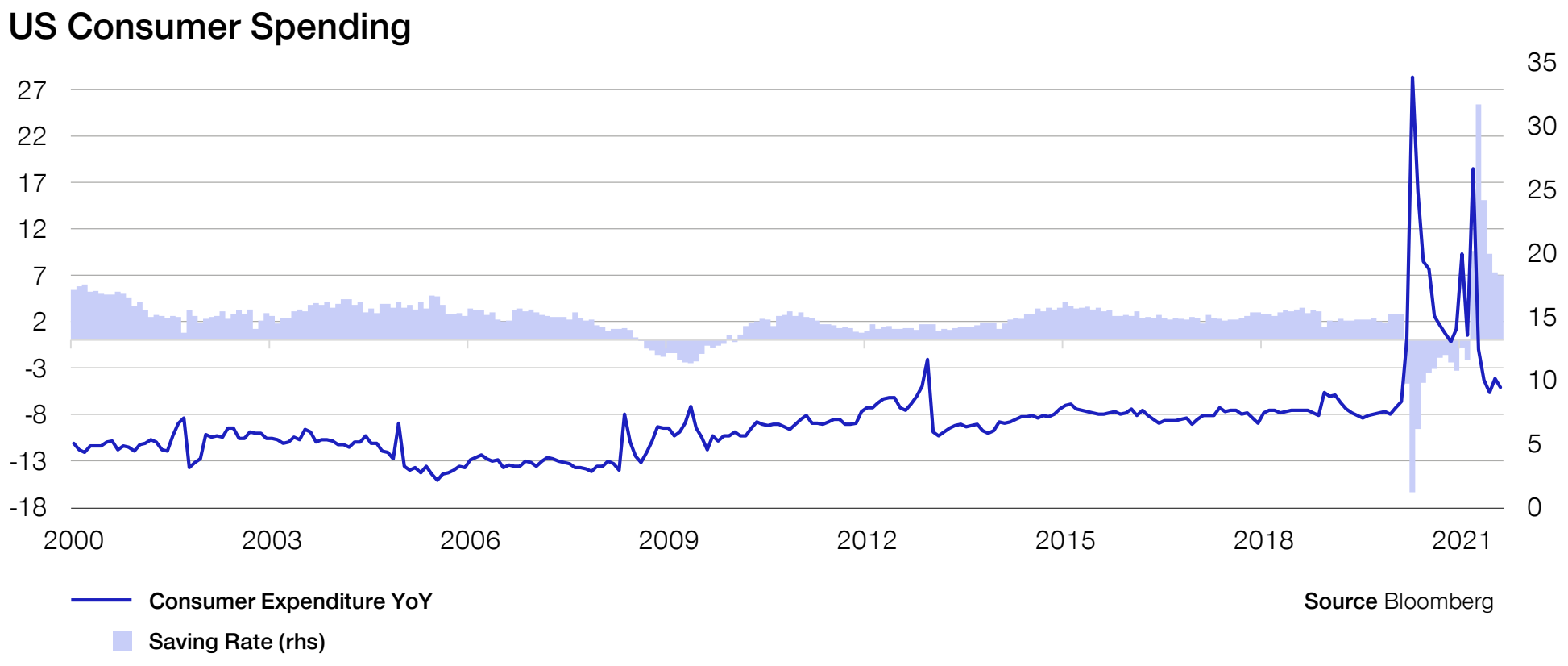
October 2021



After a strong recovery the economic cycle is starting to normalize. For the financial markets, the question is whether valuations are sustainable, and here a low interest rate environment is the key. Our view is of only a modest increase of long term rates, without a significant impact on other markets. High valuations mean low expected returns for the future and we favour better entry point to increase risky assets.

Growth Peak

The economic growth is starting to normalize after the recovery following economic reopening, with a reduction of the saving rate of American households to 9.4% (pre-Covid was 7.4%), and the end of a big jump in consumer spending approaching.



After the strong year-to-date performance of equities and credit spreads, a lot of attention is now dedicated to valuations. Spreads of US High Yield bonds are at the lowest level since 2007 and well below the historical average, while the P/E ratio is the highest since year 2001.
Valuations are more attractive when taking into account the risk-free rates.

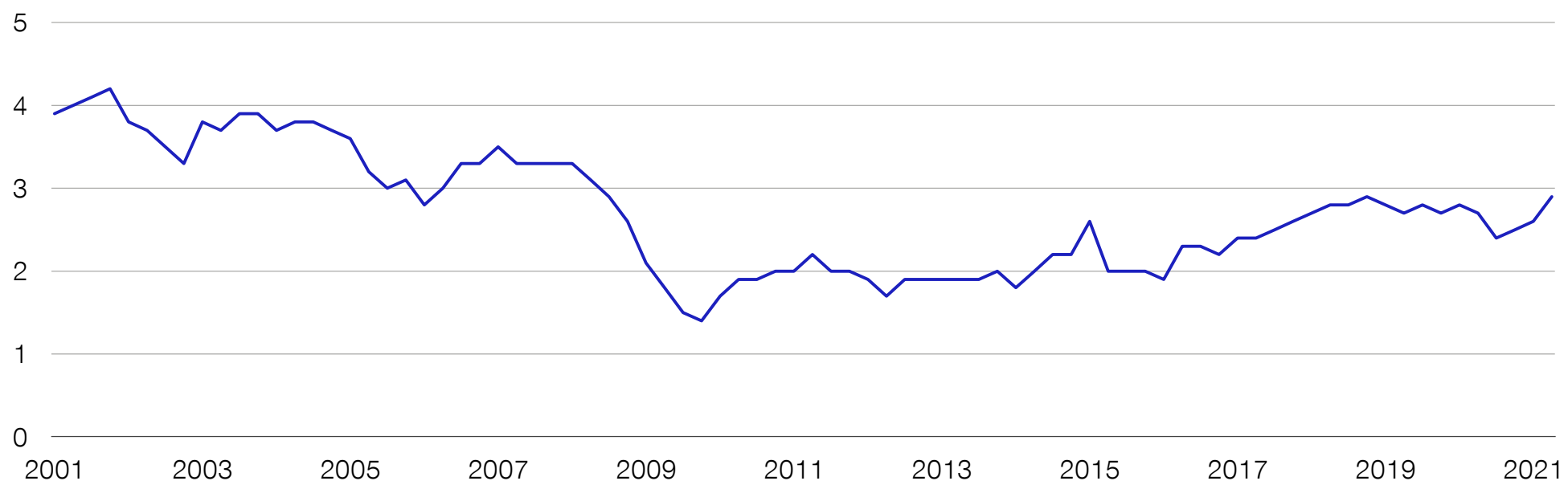
The High Yield market attracts investors trying to avoid negative interest rates (especially in BB issuers where the default risk is not too high), while for long-term investors the equity market is the only option to obtain significant gains.
The main risk lies in rates, and if they start to move higher the rationale for risky assets will vanish. This explains why, in recent days, every jump in rates is associated with an equity market correction.
A modest increase in long-term rates is highly probable given the low absolute level (for German 10 years bonds is negative) and will not change the global picture.

Inflation Risk

The real risk is a regime change for inflation, which will push interest rates much higher.
The Fed and ECB mantra is that inflation is temporary and will go down.
First we had a jump in inflation due to the reopening, with strong increases for hotels, airline tickets etc.
Now the risk is to have inflation remaining high due to many bottlenecks and logistic disruptions.

Again in principle these should give only a temporary boost to inflation, with the supply issues resolved in the next months.
A regime change (inflation remaining) can happen if, in a second round, wages and labour costs start to increase significantly. For the moment, the acceleration of the employment costs growth remains very limited and is fairly at the same level than 2018.

Employment Cost Index YoY



Source Bloomberg

Our view on inflation is in line with the Fed and we expect only a modest increase in long term rates.
In this scenario, portfolios can remain invested but excessive risks should be avoided because rich valuations mean low future returns and a better entry point could materialize in the future.

Chinese High Yield Bonds

In the bond markets, as we said, valuations are high but with a significant exception: Asian High Yield.
The collapse of Evergrande had an impact, especially for the Chinese property sector, for the fear of a systemic risk. The Asian Dollar High Yield corporate market has a yield to worst of 11.9% now, and it looks attractive even if other property market companies will default. The risk is a “Lehman moment” with a real collapse of the market, something we think the Chinese authorities want to avoid.

Sumus Investment Committee