BANQUE HAVILLAND

Q3 2021 OUTLOOK

JULY 2021

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TABLE OF CONTENTS

MARKET ENVIRONMENT

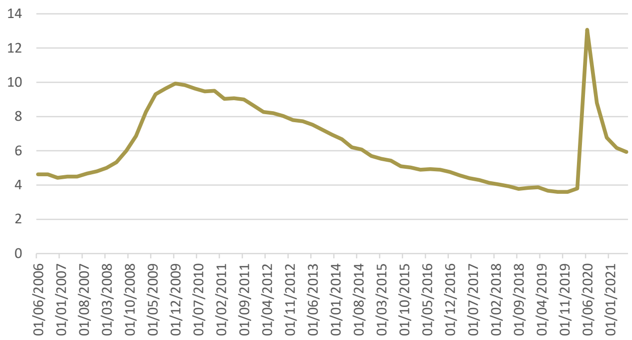
Whether or not global markets are now facing an inflection point, will of course be determined by the history books, but with certain trends and themes now having concluded there are plenty of uncertainties to ponder as investors position portfolios for the second-half of 2021 and beyond. The marked heightening of hawkish rhetoric at the June Federal Open Monetary Committee (FOMC) quite possibly signalled the beginning of the end of the era of extraordinary fiscal and monetary support that has underwritten financial markets and economic growth both prior to, and since 'in extremis' the Covid-19 pandemic. The government spending will most likely be paid for ostensibly in terms of taxation (and de facto via inflation), at a time when the easy gains of the past sixteen months have surely already been enjoyed, while policy makers are likely to scale back fiscal and monetary support – slowing economic growth.

"Some comfort can be taken from the muted reaction of the fixed income markets to the recent Federal Reserve meeting that surprised in its hawkish tone, especially in light of previous 'taper tantrums' and the spike in yields in February of this year – this suggests the markets have digested the inevitability of higher rates at some point in the future (...)"

On the other hand, the timescale of this scaling-back (or tapering) is so cautious, with rates in the US not expected to rise in 2023, that there is no apparent urgency for investors to exit either fixed income or equity positions, even though the part of the cycle which risk assets may be embraced with indiscriminate alacrity has passed. In short, it is difficult to conceive that equities will have gained another 10-15%, depending on which index you look at, by the end of the year. Likewise it is unlikely that US economic data in particular can continue on it's current trajectory, and key indicators such as the output and orders component of the US PMI appear to have peaked in May pointing to more measured growth from here, which in turn indicates a likelihood of corporate earnings also plateauing. Inflation has finally grabbed the attention of investors in general, with a great debate raging as to whether the current higher readings are indeed 'transitory' or symptomatic of a more sustained period of inflation. We have considered this at length in previous publications, so without wishing to cover familiar ground, it is prudent to assume that inflation will remain elevated for a longer period than many are expecting (not least as governments seek to alleviate their debt piles) and that investors position their portfolios accordingly. Some comfort can be taken from the muted reaction of the fixed income markets to the recent Federal Reserve meeting that surprised in its hawkish tone, especially in light of previous 'taper tantrums' and the spike in yields in February of this year – this suggests the markets have digested the inevitability of higher rates at some point in the future, as well as accepting inflation will be allowed to run hot at least while employment figures remain below pre-pandemic levels.

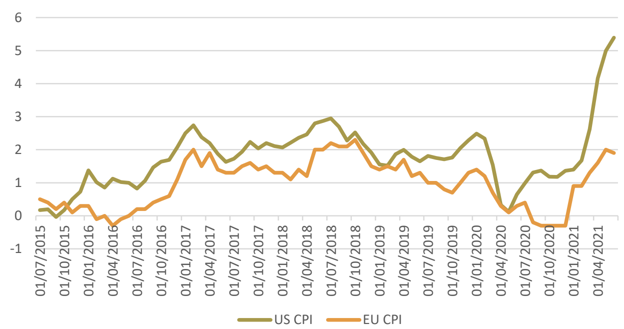
As such, the US employment data will be the key metric to watch in the coming months with any significant deviation causing ripples in the markets if the prevailing narrative of the time with respect to the Fed's inflation assumptions is put under strain.

US Unemployment Rate %



Employment has rebounded but the rate has slowed. The FED has stated it will wait for labour markets to fully recover before tightening, but with inflation elevated this is a nervous time for a policy misttep.

CPI: US and EU



Inflation has really spiked in the US, but has yet to significantly follow in Europe. If the current US CPI level is sustained the 'transitory' narrtaive will be questioned and the FED will come under pressure.

Forecasting which risk assets will perform well in the new phase of the market cycle is therefore a difficult prospect, particularly as the revival of value-orientated cyclical stocks came to an abrupt halt in June possibly due to fears that the post-Covid euphoria was fading and the appearance of a new coronavirus variant would postpone the lifting of social and economic restrictions once more. Equities in the US are expensive and the rebounding growth story is starting to mature, and while market leadership usually rests with the US, globally the recovery continues to expand with other regions that lagged now starting to pick up momentum -emphasising its uneven and increasingly multi-speed features investors can exploit. As mentioned earlier, global taxes are set to rise, which may have implications for the world's largest companies and, by proxy, the rest of the market. It is no coincidence that the new G7 Corporate tax agreement has assumed a greater urgency just as the Biden administration plans to spend $6 Trillion on public stimulus and infrastructure, at the same time as planning to raise the US corporate tax rate from 21% to 28% and raising extra taxes from the country's wealthiest individuals. The necessity for a more global approach to taxation has been on the cards for some time, with governments jealously eyeing globalised multi-nationals that choose where to book their profits, and the enhanced profits of mega-tech and e-commerce companies who disproportionately benefitted from the 'stay at home' trade over the past 16 months has accelerated this clampdown. Silicon Valley giants such as Facebook and Google have been criticised for years for paying minimal taxes in markets where they book billions of dollars in sales, so a move to level the tax rates comes as no great surprise.

For US equities the higher tax regime may well be a double-edged sword as global tech companies' tax burdens should increase, potentially catalysing the ongoing rotation of market leadership away from big tech, but the proceeds of the revenues should end up in infrastructure and economic growth – boosting other stocks. While reduced tax competition between national governments can hardly be healthy for equities, we note the lack of reaction on the affected (tech) companies' share price, as well as the fact that Amazon will actually not be troubled as its profit rate is less than the 10% threshold due to reinvestment! So while it may be that markets are sceptical that the G7 accord will pass through all the various national legislatures, the antipathy may be simply an expectation that other mega-caps will adopt the Amazon approach to minimize their tax burdens, reinvesting for future growth. Nevertheless, early OECD estimates suggest extra revenues of less than 4%, or $84bn from the global tax agreement, the biggest share of which would be paid by tech giants and other US multinationals to the US government – perhaps not that significant in the grand scheme but a near-term headwind for certain equities.

China Credit Impulse 12 Month Index

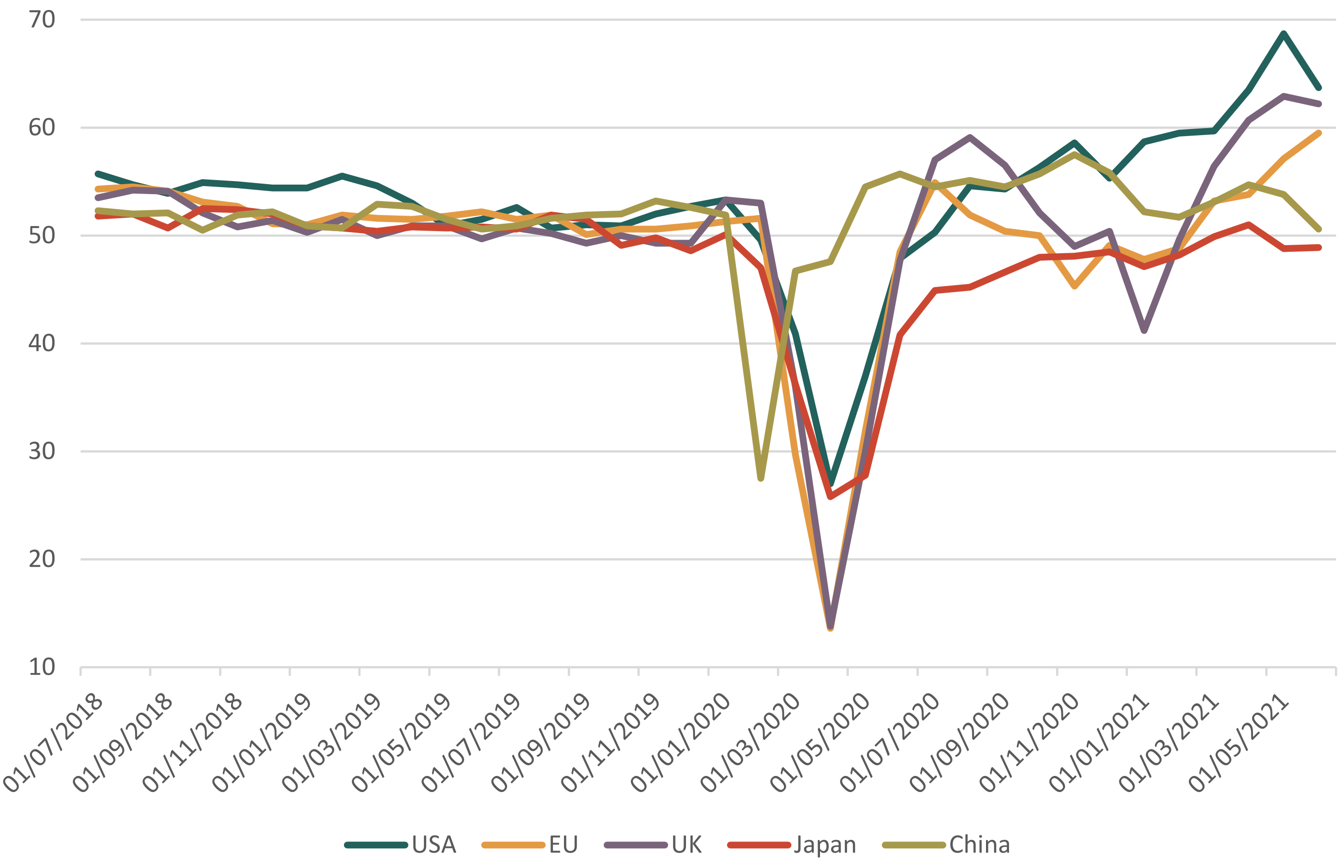
China has tightened its credit supply drastically this year, which could be a pecursor to a global contraction further down the line, with the country such a key player in world trade.

Outside the US, it is of course bad news for low-tax economies such as Ireland, Hungary and various Caribbean jurisdictions, but the effect on the wider market should be minimal – and really investors should be more fixated on the domestic US corporation threshold rise (should it make through a split congress). Higher corporation taxes of 28% could put a hole of 9% in corporate earnings in 2022 according to Goldman Sachs, but this of course could be offset in part by the infrastructure spending they are funding. The nature of the infrastructure is almost certainly set to be led by the trendy green and climate-change agendas, and the green transition is having the ironic effect of increasing demand for many commodities (eg. copper and metals for 5G, platinum for green hydrogen energy) and the cyclical industrials/materials companies involved. The green revolution looks inflationary then as is it set to be a long-term theme this rather adds weight to our suspicion that inflation will be supported way past the point that the pandemic rebound has peaked, suggesting value and cyclical stocks have further to run before this rotation can be confidently acknowledged as finished.

If the prevalence of global tech was one disinflationary force, then globalisation was certainly another and while it would be premature to suggest the latter has had its day the shifting relationship between the US and China would indicate it having peaked now that the US is no longer quite so willing to import cheap Chinese goods to the detriment of its own home industry, while border controls and the global free flow of labour look to be less porous in the post-pandemic era.

With all the focus on inflation, the importance of Chinese growth sometimes becomes lost in a global macro discussion and it is worth remembering the Q1 setback for equities as the PBOC once again looked to tighten credit conditions as growth looked to lurch too far forward. China was the only major economy to grow last year, despite the severe lockdowns and this was enabled by a very loose credit environment and debt bubble, but since January measures have been taken to curtail this, as well as efforts to cool the property market and draining liquidity from the equity and sovereign bond markets. As China was the first country both in and out of the Covid-19 crisis, and like Western economies turned to credit and stimulus to cope with the financial shock then it follows that China may be the first to end its credit cycle – and indeed the Credit Impulse has turned south already. If growth in China follows suit, then markets will notice and will put extra pressure on the central banks of the developed nations just as they are starting to taper and tighten. We think that most of the risks facing investors are further into the future, with fiscal and monetary policy currently very supportive with much of the world still to fully reopen and growth robust where vaccination programmes are advanced. Notwithstanding a vicious new variant, or some other geopolitical flare-up, we expect modest gains for risk assets in the second half of the year, though a recently flattening yield curve and relatively expensive US equity market indicates periods of choppy trading.

Composite PMI's



PMI's are in expansion territory but the rate of growth may have peaked now seen by the last readings from the US and China in particular. Risk assets cannot rely on rapid growth for much longer.

EQUITIES

As above the picture looks bright for many equity markets as investors continue to price in the maturing of the covid pandemic as more of an inconvenience to the economy rather than a full-blown threat, with most vaccination programmes progressing nicely and the Federal Reserve doing a good job of treading a fine line between reassuring investors and preparing for monetary tightening. Furthermore the past two quarters have seen earnings roar past expectations giving most indices a real boost, and for a period in the year of the policy response valuations were all but forgotten as the all-encompassing rebound lifted all markets. Eye-watering P/E ratios could be explained away by a monetary policy outlook of close-to-zero rates and the 'whatever it takes' attitudes of governments and central bankers - but now this will increasingly not be the case for much longer. Now profits are rebounding there are several major indices where P/Es have come down noticeably even as stock price gains remain robust, and that sort of healthy correction in valuations bodes well for longer-term outlooks. However, this is not the case in the US, where valuations remain very stretched and while the S&P 500 has come down from its record level of 23 in September it remains significantly higher than at any time outside of the dotcom bubble. The recovery and outperformance in European markets year to date means equities here are now above their pre-Covid range, with only Japan and the UK of the major regions looking attractive on a valuation basis. All the signals point towards a global equity allocation that needs to be less reliant on returns from the US market in the medium term, with even profit expectations far above historic norms which look vulnerable once the recovery euphoria has ended. Earnings momentum has predominantly been

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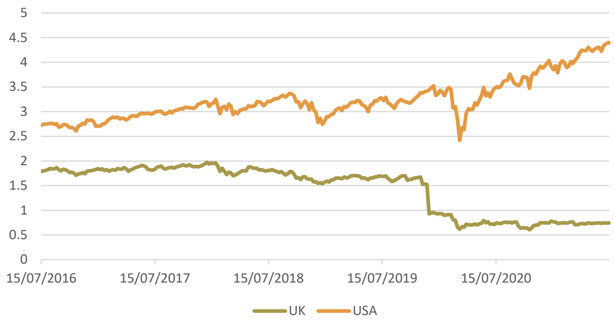
provided by the technology sector in the past decade, but with the dual headwinds of higher taxation and antitrust laws disproportionately targeting this area of the market it is quite likely this momentum may need to come from somewhere else. Earnings expectations for Europe and the UK are more grounded, so the potential for positive surprises are greater here at least, though it is foolhardy to presume any upward revisions will be to the same extent they have been over the past two quarters. Cyclicals are driving that superior European earnings growth with the region typifying the recovery story - Vaccination rates are picking up, infections dropping and travel starting to open up, although concerns remain. Miners, banks, energy and chemicals have posted some of the best 12-month forward EPS growth in the Stoxx 600 since the start of May, with utilities, tech, health care and food & beverage lagging, though of course some of this recovery stems from many cyclicals getting hit harder last year, and while these may well meet setbacks in the face of further virus restrictions or variant news-flow the overall narrative of vaccines accelerating a return to normality is intact.

Therefore we believe that a larger-than-average exposure to cyclicals and value-markets is still justified at the halfway point of the year. Our highest conviction position remains the UK stock market (though it is testing our patience), with the UK 100's price to book ratio at just 1.9 versus 4.7 for the US 500 while UK growth forecasts have been repeatedly upgraded this year, supported by encouraging economic data and one of the world's most successful vaccine campaigns.

UK Equities Price to book vs US Equities Price to book



Uk equities are cheaply valued versus their own recent historic levels, and especially compared with the US market, despite an advanced vaccine programme and decent economic outlook.

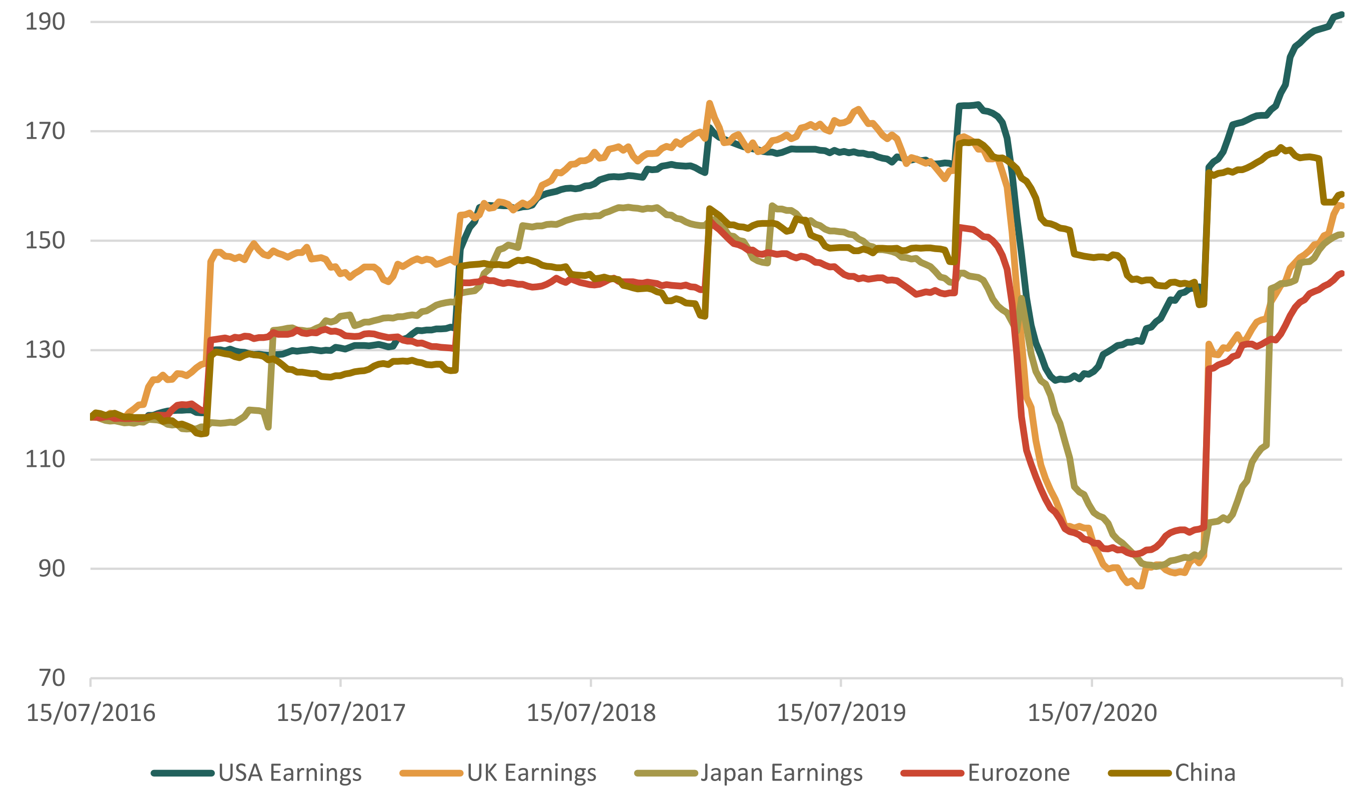
Equities rise with economic growth of course, and we wish to reiterate the opinion that over the long term this is best represented by emerging Asia – the world's fastest growing continental economy, which is rapidly embracing digitalisation alongside the well-known trends of demographic change and urbanization that should boost sectors such as e-commerce and semi-conductor manufacturing. We also believe that the region is more a diversified opportunity than historically, i.e. the export-focussed 'Asian Tiger' economies of the 1990's. China of course dominates the region and has displaced the US as the main trading partner of Europe, though has an increasingly demanding domestic consumer, while Korea and Taiwan are technologically advanced, open economies that are a key part of many global supply chains, and India has a changing corporate landscape where reforms looks poised to finally unleash the potential of its population. Significantly, the Asian continent seems to have capitalized on its fast emergence from the pandemic, stealing a march over the rest of the world in terms of future economic growth – a sizeable allocation to the region is essential for any long term investment portfolio.

IMF World Economic Outlook Projections (% change)

	YEAR OVER YEAR		
		PROJECTIONS	
	2020	2021	2022
WORLD OUTPUT	**–3.3**	**6.0**	**4.4**
Advanced Economies	**–4.7**	**5.1**	**3.6**
Emerging Market and Developing Economies	**–2.2**	**6.7**	**5.0**
Emerging and Developing Asia	–1.0	8.6	6.0

Developing Asian growth is projected to be stronger than all developed economies and other emerging markets, as it has passed the worst of the pandemic.

12M Fwd earnings estimates (rebased as of 07/16)



Earnings expectations in the US are far greater than elsewhere. Potentially this could lead to disappoiment for US stocks, but positive surprises for other markets by comparison.

	-			=	+			
EQUITIES								**The reflation narrative remains compelling for now, but it would appear to have a limited shelf-life, once the economic rebound has peaked and rotation from growth to value/cyclicals runs its course.**
US								A two-tone market. Growth/Tech seem to have topped out for now, but there is still more to come from value/cyclicals.
UK								British stocks are at their cheapest versus global stocks for many years, and should benefit from the catch-up/value rotation.
Eurozone								Continental European stocks are leading the rotation charge, though economic growth is lagging the US and UK.
Switzerland								Quality, defensive nature of the market may see the market lag more cyclical sectors as the economy recovers.
EM								We favour emerging Asia for the long term growth story with too much political risk elsewhere.
Japan								Attractive valuation for a developed market, and we like the safe-haven qualities of the currency. Vast BOJ asset-buying is underpinning market, and growth is returning.

FIXED INCOME

Since the last quarter global bonds staged something of a comeback, with yields on the US 10yr retreating from 1.7% at the end of March to 1.5% by the end of June, and the 30yr equivalent moving even further downwards. While much excitement immediately followed the FOMC meeting in late June, yields continued to compress further, confounding those who expected this to sound the starting bell of an inflation-fearing retreat for the bond markets: the taper was coming with the implied indication that the FED no longer believed their own narrative that the current spike in CPI data was truly transitory. Powell's subsequent press conference calmed nerves, however, and the bond markets probably concluded that two rate rises in 2023 (as implied by the dot plot) is still distant enough to justify shorter dated bonds' continued elevation. The reaction of the yield curve, flatting as it has with near-dated bonds anchored, suggests that most of the stress will occur at the far end of the curve that will incur volatility while investors chew over the inflation outlook – and therefore we stick with our emphasis on an overall short duration fixed income basket. It is important not to focus too much on the here and now, however, with supposedly large % moves in yields actually translating into very small increments for bond holder due to yields being so low (a big percentage move on a tiny percentage figure is still a small fraction) and we don't think that the latest drop in Treasury yields will continue for too long and are more likely to rise significantly in years to come. Quite simply, negative real yields at a time of rebounding economic growth and spiking (albeit 'transitory') inflation with the now-certain prospect of tapering and higher rates, is counter-intuitive and unsustainable

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over a longer period of time, and as such we remain underweight sovereign bonds and by progression the bond market in general. While we think Emerging market bonds with a short duration can offer investors a good yield/risk profile, alongside a small allocation to high yield credit, the wider corporate bond universe does not seem to be on the right side of the risk/reward ratio with spreads now close to their post financial crisis lows – with little stress apparently yet registered in the face of higher inflation or tapering. While we have made peace with the idea that bonds will not be returning meaningful income or capital in the coming years, we can at least hope that the decline will be slow-burning rather than especially sudden and violent, as suggested by the stifled reaction to the FOMC meeting. Nevertheless, the risk of a FED misstep in terms of communication persists as one of the more probable risks to the bond and wider financial markets.

2 Year Bond Yields

COUNTRY	MATURITY	YIELD
Switzerland	SWISS 4 02/11/23	-0.814
Netherlands	NETHER 1 3/4 07/15/23	-0.725
Finland	RFGB 1 1/2 04/15/23	-0.705
Belgium	BGB 2 1/4 06/22/23	-0.700
Austria	RAGB 0 07/15/23	-0.694
Germany	BKO 0 06/16/23	-0.682
France	FRTR 0 02/25/23	-0.660
Portugal	PGB 4.95 10/25/23	-0.628
Ireland	IRISH 3.9 03/20/23	-0.618
Denmark	DGB 0 1/4 11/15/22	-0.603
Spain	SPGB 0 04/30/23	-0.531
Greece	GGB 3 1/2 01/30/23	-0.493
Italy	BTPS 0.6 06/15/23	-0.412

COUNTRY	MATURITY	YIELD
Sweden	SGB 1 1/2 11/13/23	-0.324
Japan	JGB 0.005 07/01/23	-0.136
Hong Kong	HKGB 0.14 05/24/23	0.012
Australia	ACGB 2 3/4 04/21/24	0.048
United Kingdom	UKT 0 1/8 01/31/23	0.078
Israel	ILGOV 0.15 07/31/23	0.090
United States	T 0 1/8 06/30/23	0.231
Singapore	SIGB 1 3/4 02/01/23	0.360
Canada	CAN 0 1/4 05/01/23	0.485
Norway	NGB 2 05/24/23	0.617
New Zealand	NZGB 0 1/2 05/15/24	0.863
Iceland	ICEGB 1 1/2 05/15/23	2.400

Bond yields have moved lower again over the last quarter and are negative in many countries.

	-			=	+			
FIXED INCOME								**Headline yields are at record lows once more, and with economic recovery and inflation prevalent, bonds look too expensive.**
Sovereign Bonds								Sovereigns offer safe harbour in time of market stress, but have limited upside remaining and negative real yields long-term.
Corporate I.Grade Bonds								Central bank asset purchasing is supporting corprates for now, but tapering is on the horizon and spreads are very compressed.
High Yield Bonds								Yield pick-up is still relatively attractive, but low historically. Default risks are a concern.
E.M. Bonds								Local currency appreciation in an economic recovery, together with meaningful yield pickup make certain EM bonds relatively attractive. Short duration.

CURRENCIES AND COMMODITIES

The trajectory of the US Dollar and the price of commodities are closely linked and so it is that the sharp rebound in the dollar saw a reversal in many industrial metals that had been on a tear since the pandemic lows of March 2020, and the direction of the world's reserve currency will be hugely influential in determining the nature of the next phase of the global recovery. Our general expectation that economies such as the Eurozone and UK will 'catch-up' with the US, lends weigh to our view that the dollar looks set to decline over the long term despite the FED acknowledging the need to raise rates (in the distant future), but the nearer term outlook is murky. The government fiscal boost is building a US growth premium versus the rest of the world, suggesting that international capital inflows should stay anchored to dollar-denominated assets supporting the currency, though much could depend on the direction of bond yields. Strong growth is clouding the fact that huge liquidity injections are occurring and the fiscal situation therefore deteriorating which could come to light if other less-indebted countries do indeed catch up with the US.

FED US Treasury 10yr Real Yield Curve Rates

Real yields (rates after inflation) have plummeted again and are at crucial technical levels. Gold is a good hedge against a further lower move.

	-	=	+	
ALTERNATIVES				**An increasingly important allocation with equities expensive and bond yields so low. Ideally we like holdings that are genuinely uncorrelated to the main asset classes.**
Precious Metals				Gold and silver are moving in their own way as ever. Remains the most compelling long-term hedge agaist inflation.
Hedge Funds				Genuine alternative funds that behave in a different manner to traditional assets are a vital source of wealth preservation and diversification.
Oil/Commods				Commodities are booming in line with a recovering economy. Demand is currently outpacing supply, but signs of peaking in certain materials.

	-	=	+	
CURRENCIES				**Distant rate rises mean the Dollar will struggle to gain too much upwards momentum, and other developed nations are closing the growth gap. We expect the current USD strength to subside from here.**
U.S. Dollar (DXY)				Rising US yields may help and a huge stimulus bill will boost the economy but inflate the twin deficit pointing to a lower move long term.
Sterling (GBP)				The UK is on track to fully reopen this summer, and the strong economic data is buoying the pound accordingly. Bullish money-manager positioning.
Euro (EUR)				Central bank looks a little hamstrung, but will likely let inflation pick-up significantly before acting. Vaccine programme is back on track.
Japanese Yen (JPY)				JPY has fallen back in 2021, but only back to pre-Covid levels and broadly in line with its 5yr average. A nice currency for diversification in risk-off times.
Swiss Franc (CHF)				Virus fears and US monetary policy have seen CHF strength continue though has weakened v EUR. Nice diversifier, though global recovery could dampen demand.
EM				Many EM nations remain mired with Covid and Political setbacks. CNY looks strong, however though credit tightening could slow Chinese growth.

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Banque Havilland (Monaco) S.A.M., a subsidiary of Banque Havilland S.A., with registered office at Le Monte Carlo Palace, 3-7, Boulevard des Moulins, MC-98000 Monaco, is a credit institution regulated by the French regulator, *Autorité de Contrôle Prudentiel et de Résolution*, 61, rue Taibout 75436 Paris Cedex 09 and the local regulator, *Commission de Contrôle des Activités Financières* 4, rue des Iris BP540 98015 Monaco Cedex (www.ccaf.mc). Banque Havilland (Monaco) S.A.M. is also a member of a deposit guarantee scheme, the *Fonds de garantie des dépôts et de Résolution* (**FGDR**). Upon request, Banque Havilland (Monaco) S.A.M. can provide its clients with further information on the deposit guarantee scheme. In addition, relevant information can be found on www.garantiedesdepots.fr.

Banque Havilland (Liechtenstein) AG, a subsidiary of Banque Havilland S.A., is a public limited company (*Aktiengesellschaft*) with registered office at Austrasse 61, LI - 9490 Vaduz Liechtenstein, listed with the Liechtenstein Trade and Companies Registry under number FL-1.542.492-8, authorised by the Liechtenstein *Finanzmarktaufsicht* (**FMA**). Banque Havilland (Liechtenstein) AG is also a member of a deposit guarantee scheme, the Deposit Guarantee and Investor Compensation Foundation PCC (EAS Liechtenstein). Upon request, Banque Havilland (Liechtenstein) AG can provide its clients with further information on the deposit guarantee scheme. In addition, relevant information can be found on https://eas-liechtenstein.li/en/

Banque Havilland S.A. Representative Office, is a representative office of Banque Havilland S.A., with registered office at Aspin Commercial Tower, office # 4001, P.O. Box 414678, Dubai, UAE, registered with the Dubai Department of Economic Development under number 851121504. The Representative Office is licensed by the UAE Central Bank. Its permitted activities in the United Arab Emirates are limited to market and promote Banque Havilland's products and services. The information contained herein is exclusively addressed to the recipient. Any product referred to in this marketing communication may not be offered or sold in the United Arab Emirates except in circumstances permitted by the regulatory authorities. The distribution of this marketing communication by the recipient is prohibited.

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