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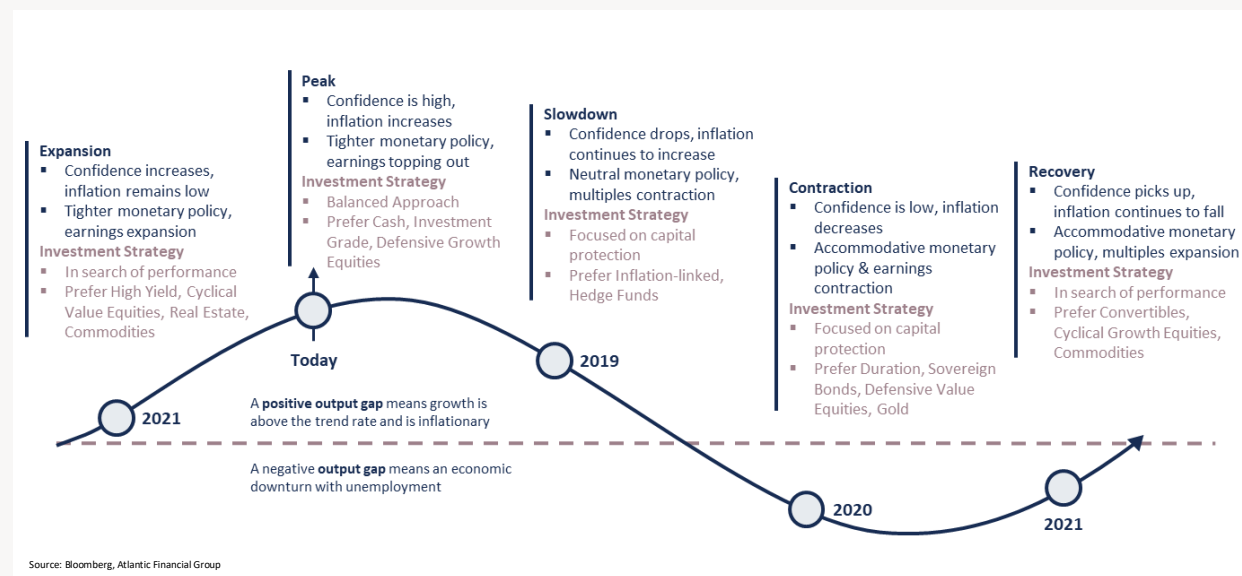
Weekly Investment Focus

2 August 2021

"BUSINESS CONFIDENCE: IF IT'S ROLLOVER, IT'S GAME OVER"

- ◆ The second quarter figures are excellent: GDP and corporate earnings
- ◆ However, excessive public interventionism has led to imbalances
- ◆ The top of the economic cycle may be much closer than it seems
- ◆ A rotation towards more defensive assets is to be preferred

CHART OF THE WEEK: "Asset allocation can be fine-tuned by matching the economic cycle"



FINANCIAL MARKETS ANALYSIS

Second quarter figures are gradually being released. In the wake of vaccination campaigns, the reopening of economies and continued support from central banks, **the global economic recovery has been strong.** US Gross Domestic Product (GDP) grew by 1.6% between April and June, the same pace as in the first quarter. Uncle Sam's economy is thus back to its pre-pandemic level of production (see Fig. 2). In China, the quarterly growth figure is similar, 1.3%, but it has been a long time since the Middle Kingdom exceeded its pre-crisis level. However, while the country seems to have almost got rid of Covid-19, domestic



consumption is slow to recover its dynamism and external trade is expected to weaken soon. Foreign demand for electronics (for remote working) and pharmaceuticals will decelerate as vaccination progresses. Europe's economy also recovered, with growth up by 2.0%, but it lagged significantly behind its two major partners. The nineteen countries sharing the single currency remain 3% below their pre-pandemic output levels. This is particularly the case for the southern European countries, which are the most affected by the collapse of tourism.

The earnings season shows that companies have taken full advantage of this growth, posting robust performances. In the US, where half of the companies have reported earnings, profits are beating expectations by 18%, well above historical norms of 3% to 5%. Wall Street analysts seem to be chasing reality: their estimates for the end of the year and 2022 keep being revised upwards. They are becoming as optimistic as they were during the dot-com bubble (see Fig. 3). **Overconfidence may end up being a risk, but margin erosion is an even greater danger.** Many companies have reported substantial increases in raw material and, in some cases, labour costs. In recent quarters, most companies have been able to pass on these higher costs to consumers because they have had plenty of cash. This pricing power is unfortunately weakening.

Fig. 2 - Economic activity (100 in 2019)

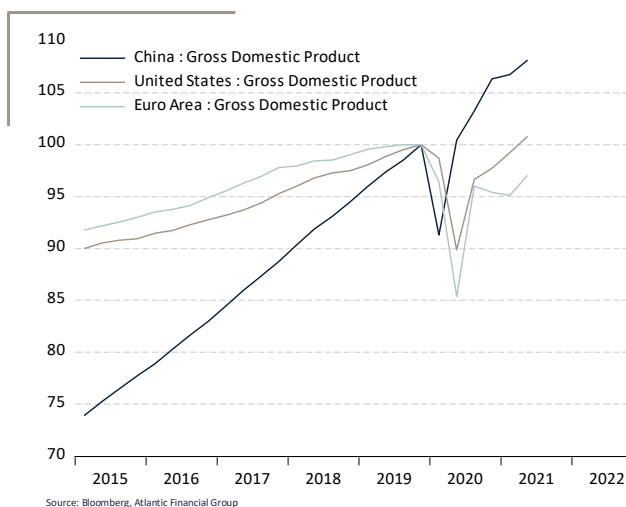


Fig. 3 - Sell-side analysts' buying advice (%)



Bear in mind that this recovery is unlike any other, not least because governments and central banks have acted swiftly and disproportionately. There are a number of factors that support this analysis. On the business side, capacity utilisation has rebounded strongly but remains historically low (see Fig. 4). Despite this, thanks to a very low interest rate environment and the willingness of banks to provide loans, companies have taken on debt to invest more and increase their production capacity. This over-investment was already visible since the previous crisis, in 2009, but it is now becoming more pronounced. **The risk is obviously that some investments have been mistakenly financed and that they will not be profitable in the long run.** Economic theory states that excess liquidity leads to a fall in profitability.



Fig. 4 - Production capacity and investment in the US

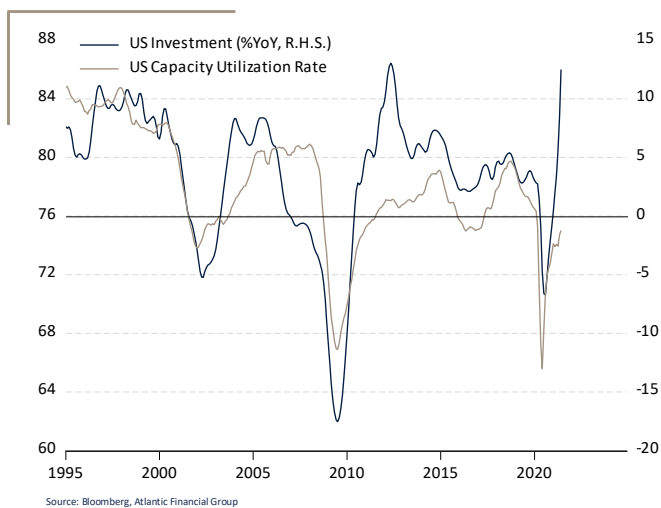
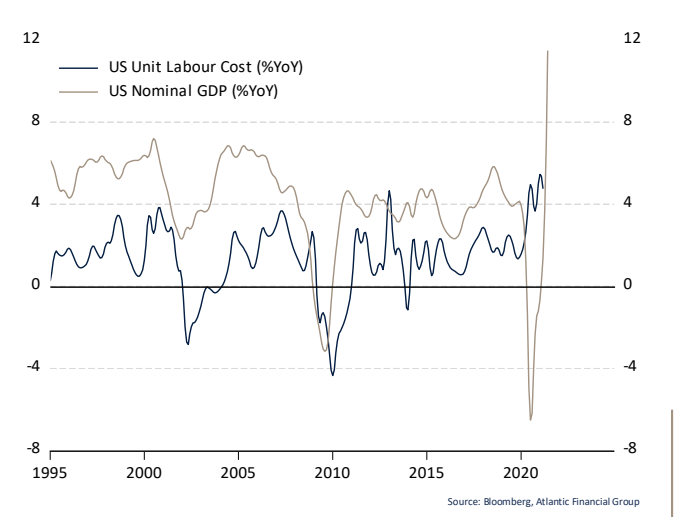


Fig. 5 - Labour costs and production in the US



Public support has also been felt in the labour market, to avoid layoffs. Thus, out of place, unit production costs have risen by 5% over the past 12 months, while activity has stalled (see Fig. 5). In concrete terms, this means that companies did not lay off enough people and did not adjust salaries downwards. Wages have even increased in some sectors due to a lack of available labour. Some Americans probably opted to stay out of the labour market when unemployment benefits were increased and checks for the more unfortunate households were distributed by the Biden administration. Once again, this is a first in US history: the household savings rate and retail sales have risen together (see Fig. 6). **It is only a short step to suggest that government support has been overdone and is creating unhealthy distortions in the labour market.**

Fig. 6 - Consumption and Savings in the US

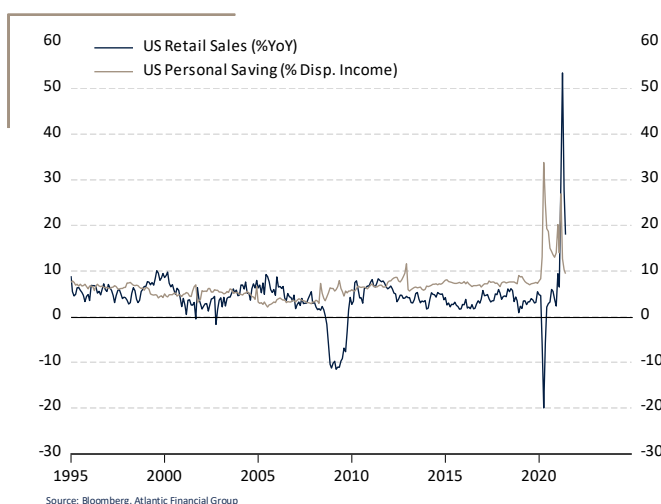
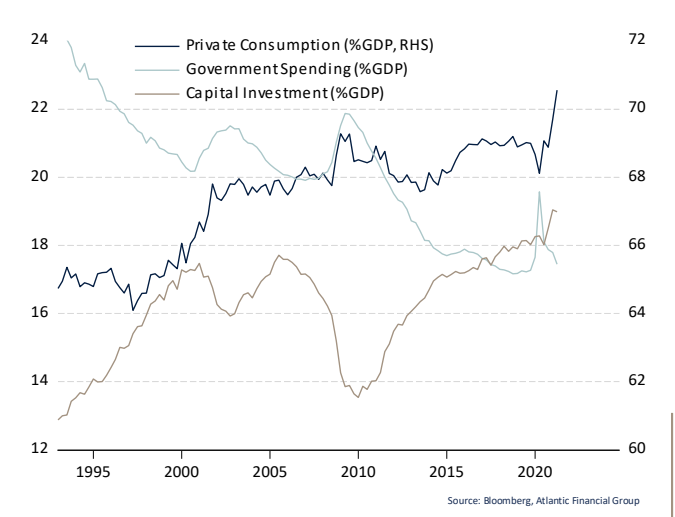


Fig. 7 - Weight of domestic demand in the US



These two elements, linked to companies and households, help explain why the weight of business investment and especially private consumption has never been so high in US GDP, respectively 19% and 70.6% (see Fig. 7).



The recovery will therefore have been strong in the first and second quarters of 2021. However, it seems that the peak of the economic cycle is coming. Signals that the momentum will soon fade are multiplying. Leading indicators such as purchasing managers' surveys are falling. Even more significant is the economic clock, which shows the cyclical relationship between industrial production and business expectations in a four-quadrant diagram (see Fig. 8).

Fig. 8 - US business cycle clock

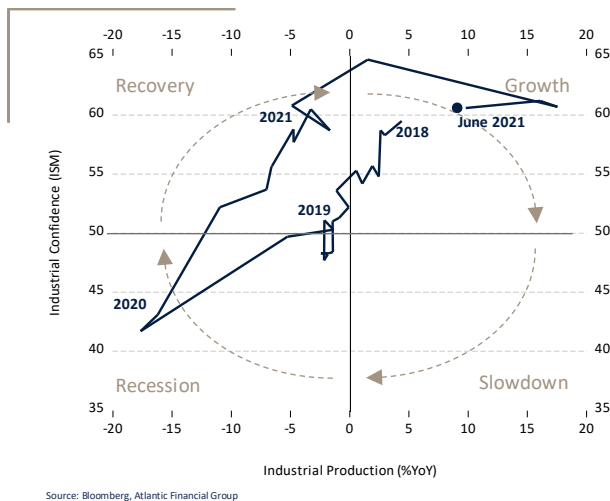
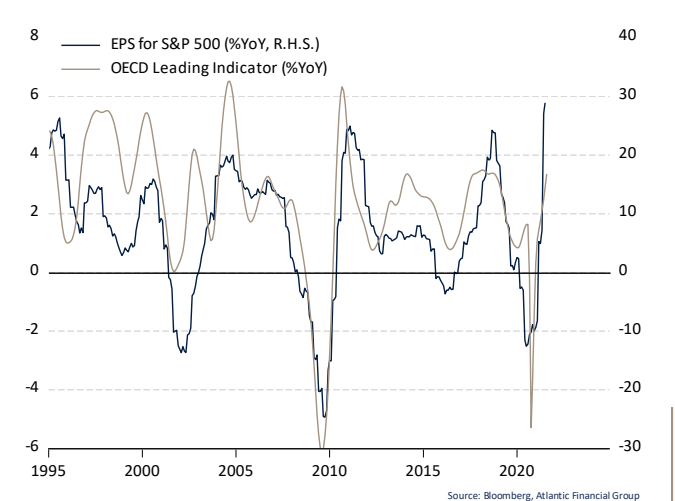


Fig. 9 - US earnings growth



In this diagram, economic activity goes through different phases, called recovery, growth, slowdown and recession. When both the current and future assessment of the situation are below their average, the indicator moves into the "recession" quadrant. As the purchasing managers' index rebounds, the indicator moves into the "recovery" quadrant. Gradually, as industrial production and expectations are both above their averages, the indicator moves into the "growth" quadrant. And finally, when purchasing managers' confidence falls back, the indicator slips into the "slowdown" quadrant. This last scenario is one to watch as it could materialise in the near future.

Anticipating the economic cycle allows investors to select the asset classes or sectors to invest in during each period. By nature, this analysis focuses on a rather long time horizon and not on trading opportunities. The performance of risky assets, such as equities, tends to be strongly positive during the initial phase of the economic cycle, when earnings growth increases with a strong momentum. This has been the case over the past 18 months (see Fig. 9 and 10). This performance then moderates during the other phases, until it becomes negative during a possible recession. **Typically, an ISM manufacturing index of 57 points is consistent with US equity growth of 20% over 12 months.** Given that the S&P 500 is already up 17% year to date, a normalisation of economic activity would leave little to capitalise on over the next five months. **The same is true for high-yield corporate bonds.** They tend to outperform high grade bonds during economic expansions. Conversely, **spreads widen during crises when volatility rises** (see Fig. 11).



Fig. 10 - S&P 500 12-month performance

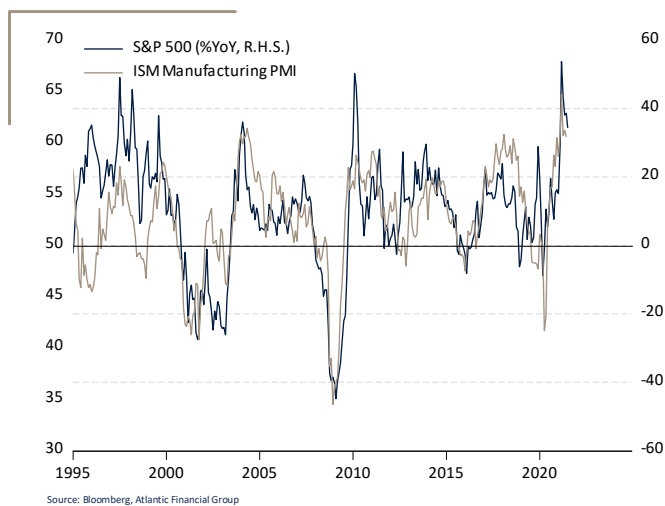
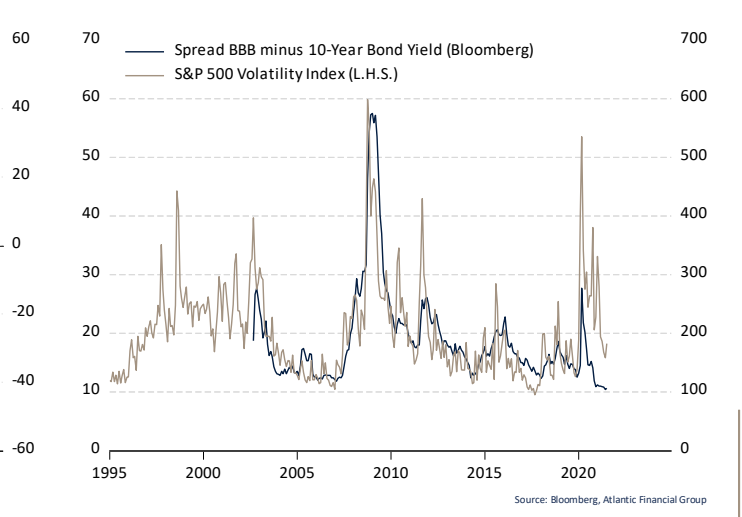


Fig. 11 - Corporate spread and equity volatility



Conclusion:

Economic analysis offers significant opportunities to leverage various asset classes over the cycle. As the probability of a phase shift increases, investors are able to adjust their exposure to those assets that will perform best in the next phase (see Chart of the Week). As the top of the cycle approaches, cyclical equities and high yield securities will lose their appeal to defensive sectors and investment grade bonds.





RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2021 Year-to-Date (%)	2020 (%)	2019 (%)
Equities							
World (MSCI)	724.2	53.01	-0.4%	0.7%	13.4%	16.9%	27.3%
USA (S&P 500)	4 395	58.49	-0.4%	2.4%	18.0%	18.4%	31.5%
USA (Dow Jones)	34 935	54.36	-0.4%	1.3%	15.3%	9.7%	25.3%
USA (Nasdaq)	14 673	55.64	-1.1%	1.2%	14.3%	45.1%	36.7%
Euro Area (DJ EuroStoxx)	458.1	54.55	-0.2%	1.5%	17.5%	0.8%	27.3%
UK (FTSE 100)	7 032	49.47	0.1%	0.1%	11.0%	-11.4%	17.2%
Switzerland (SMI)	12 117	58.93	-0.1%	1.5%	16.3%	4.3%	30.2%
Japan (Nikkei)	27 790	36.66	-1.0%	-5.2%	0.2%	18.3%	20.7%
Emerging (MSCI)	1 278	37.95	-2.5%	-6.7%	0.3%	18.8%	18.8%
Brasil (IBOVESPA)	121 801	36.90	-2.6%	-3.9%	2.3%	2.9%	31.6%
Russia (MOEX)	3 772	47.81	1.0%	-0.1%	19.3%	14.8%	38.4%
India (SENSEX)	52 910	50.73	-0.7%	0.4%	11.0%	17.2%	15.7%
China (CSI)	4 907	33.75	-5.4%	-7.3%	-6.4%	29.9%	39.2%
Communication Serv. (MSCI World)	115.11	48.95	-1.9%	-0.2%	15.2%	24.2%	25.1%
Consumer Discret. (MSCI World)	400.0	43.79	-2.2%	-2.3%	6.0%	37.0%	28.2%
Consumer Staples (MSCI World)	278.6	50.64	-0.2%	0.4%	5.6%	8.8%	22.4%
Energy (MSCI World)	171.5	43.04	1.5%	-5.9%	21.8%	-27.7%	13.9%
Financials (MSCI World)	143.5	49.13	0.6%	-0.6%	18.0%	-3.1%	24.1%
Health Care (MSCI World)	357.0	65.66	0.1%	3.0%	13.4%	15.4%	23.3%
Industrials (MSCI World)	325.5	51.77	-0.1%	0.7%	13.6%	11.8%	27.2%
Info. Tech. (MSCI World)	523.1	60.31	-0.6%	2.8%	15.7%	46.2%	47.5%
Materials (MSCI World)	374.8	58.55	2.5%	2.7%	16.1%	21.6%	20.8%
Real Estate (MSCI World)	225.3	49.24	-0.7%	1.6%	17.0%	-5.7%	24.0%
Utilities (MSCI World)	153.5	51.44	0.0%	2.8%	3.5%	4.8%	22.3%
Bonds (FTSE)							
USA (7-10 Yr)	1.22%	60.80	0.3%	1.7%	-1.5%	9.3%	7.4%
Euro Area (7-10 Yr)	-0.14%	76.78	0.2%	1.7%	-0.4%	4.5%	6.7%
Germany (7-10 Yr)	-0.46%	75.56	0.4%	2.0%	-0.9%	3.0%	3.0%
UK (7-10 Yr)	0.57%	61.57	0.2%	1.2%	-2.6%	5.4%	4.8%
Switzerland (7-10 Yr)	-0.37%	66.86	0.1%	1.2%	-0.2%	0.4%	2.0%
Japan (5-10 Yr)	0.02%	60.36	-0.1%	0.4%	0.3%	-0.1%	0.0%
Emerging (5-10 Yr)	4.34%	60.41	0.1%	0.6%	-0.9%	5.2%	13.3%
USA (IG Corp.)	1.93%	62.66	0.4%	1.2%	0.1%	9.9%	14.5%
Euro Area (IG Corp.)	0.16%	81.40	0.2%	1.0%	0.7%	2.8%	6.2%
Emerging (IG Corp.)	4.33%	23.88	-0.7%	-1.0%	-0.2%	8.1%	13.1%
USA (HY Corp.)	3.88%	63.13	0.0%	0.2%	4.0%	7.1%	14.3%
Euro Area (HY Corp.)	2.99%	77.86	0.2%	0.4%	3.5%	2.3%	11.3%
Emerging (HY Corp.)	6.53%	29.33	-0.4%	-0.6%	0.1%	4.3%	11.5%
World (Convertibles)	447.2	50.95	-0.2%	-1.0%	4.5%	38.8%	17.3%
USA (Convertibles)	604.7	51.81	-0.5%	-1.1%	5.1%	54.5%	22.8%
Euro Area (Convertibles)	4 178	50.34	-0.6%	0.3%	1.5%	6.1%	7.6%
Switzerland (Convertibles)	187.6	71.91	0.0%	0.4%	0.4%	0.5%	2.4%
Japan (Convertibles)	197.4	42.84	0.0%	-0.7%	1.5%	2.8%	2.6%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	711.4	75.70	-0.7%	0.4%	6.0%	2.5%	9.3%
Distressed	942.4	76.98	0.7%	2.2%	10.4%	1.5%	1.4%
Event Driven	787.9	73.25	0.6%	1.7%	10.2%	3.1%	8.2%
Fixed Income	388.6	76.94	-0.1%	0.4%	3.8%	2.2%	6.1%
Global Macro	1 200.7	70.19	-2.8%	-0.2%	6.2%	2.0%	10.4%
Long/Short	907.3	70.66	n.a.	-0.6%	5.3%	3.6%	12.2%
CTA's	337.4	53.68	-0.6%	1.2%	6.2%	-3.2%	9.0%
Market Neutral	284.4	61.83	-1.0%	-0.3%	3.0%	-0.1%	1.6%
Multi-Strategy	686.6	74.45	-0.9%	0.1%	4.4%	1.4%	7.3%
Volatility							
VIX	18.24	51.61	6.0%	15.2%	-19.8%	65.1%	-45.8%
VSTOXX	20.94	53.99	19.3%	15.1%	-10.4%	67.5%	-41.5%
Commodities							
Commodities (CRB)	562.2	n.a.	0.4%	1.1%	26.7%	10.5%	-1.9%
Gold (Troy Ounce)	1 811	50.43	0.7%	1.3%	-4.6%	24.9%	18.3%
Oil (WTI, Barrel)	73.95	57.27	2.8%	0.7%	52.4%	-20.5%	34.5%
Oil (Brent, Barrel)	74.78	53.74	2.3%	0.4%	47.3%	-23.0%	24.9%
Currencies (vs USD)							
USD (Dollar Index)	92.072	47.02	-0.6%	-0.2%	2.4%	-6.7%	0.2%
EUR	1.1872	51.46	0.6%	0.1%	-2.8%	9.7%	-2.2%
JPY	109.66	55.16	0.7%	1.3%	-5.8%	5.3%	0.9%
GBP	1.3908	54.11	0.7%	0.6%	1.7%	2.8%	3.9%
AUD	0.7348	37.44	-0.5%	-2.4%	-4.5%	9.5%	-0.4%
CAD	1.2472	50.44	0.6%	-1.2%	2.0%	1.8%	5.0%
CHF	0.9058	62.49	1.1%	1.7%	-2.3%	9.8%	1.4%
CNY	6.4635	51.83	0.3%	0.1%	1.0%	6.7%	-1.2%
MXN	19.869	55.40	0.8%	-0.5%	0.2%	-4.9%	3.8%
EM (Emerging Index)	1 729.9	51.10	0.3%	-0.5%	0.6%	3.3%	3.1%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)



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