INSIGHT

QUARTERLY MARKET REVIEW

Q3 2021

Click to listen
PODCAST

OVERVIEW

The best of times, the worst of times

SWITZERLAND

The tricky task of reforming pensions

LATIN AMERICA

Getting riskier

SPECIAL FOCUS

Financial disruption

After one of the worst years for global economic growth in 2020, this year looks set to be one of the best. Indeed, the bounce in activity is greater than many expected just a few months ago.

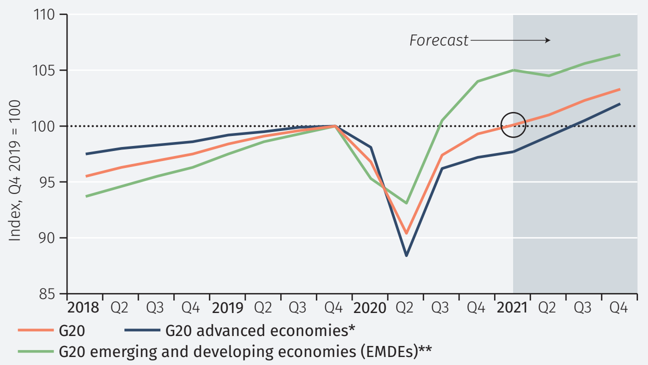
Global recovery: a bigger bounce

"It was the best of times; it was the worst of times"[1] is an apt summary of global economic developments this year and last.

This year, the World Bank forecasts the strongest post-recession recovery for the world economy in over eighty years.[2] The Fed has revised its forecast of US GDP growth up to 7% (from 4.2% just seven months ago).[3]

Last year, the contraction of US real GDP was the largest recorded in the post-war period; for the eurozone, the drop was the biggest since its launch in 1999; and for the UK, 2020's decline was the biggest since 1706, when the UK was at war with France.

1. G20 GDP: back above pre-crisis level



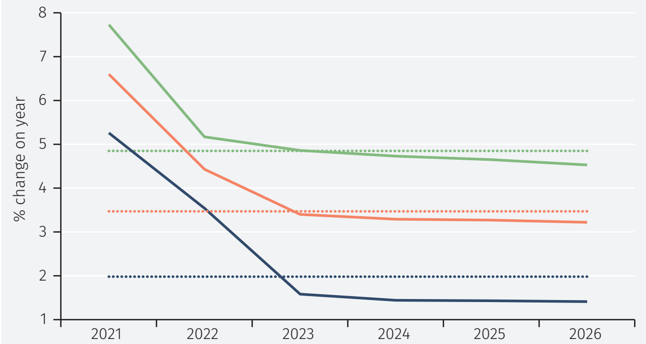
*Australia, Canada, France, Germany, Italy, Japan, South Korea, UK and USA.
**Argentina, Brazil, China,India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa and Turkey.
Source: OECD, IMF, Refinitiv and EFGAM calculations. Data as at 1 July 2021.

For the G20 economies in aggregate, real GDP was already above its pre-Covid level in the first quarter of 2021 (see Figure 1). That recovery was led by China; but South Korea and Australia were also above their pre-Covid levels. The US is set to pass a similar milestone in the second quarter; and most European economies will be close to their pre-pandemic GDP levels by late 2021/early 2022. Whereas the fiscal response to support the US economy was quick and substantial, the eurozone's response, whilst still large, is more 'slow burn' – focusing on longer-term priorities such as curbing carbon emissions and the take-up of digital technologies.

Fast growth rates will not be sustained

After pre-Covid activity levels are regained, what can we expect? Growth rates may remain elevated for a while as pent-up demand, especially for travel, holidays and entertainment, gradually recovers. But, looking ahead to 2023 and beyond, many (notably the IMF, whose forecasts are shown in Figure 2) are concerned that there will be a slowing

2. G20 growth: returning to 'normal'?



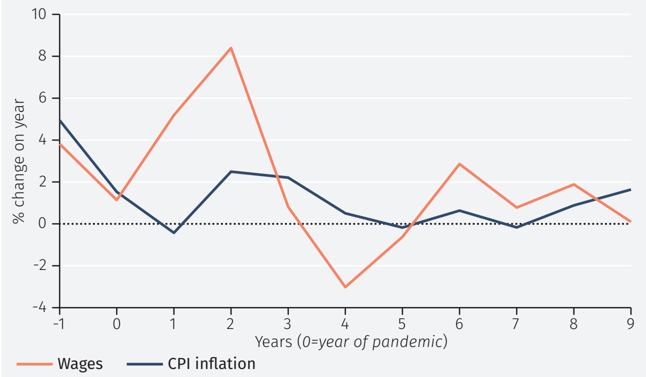
Real GDP growth (*average 2015-2019 shown as dotted line*):
G20 — G20 advanced economies — G20 emerging economies
Source: IMF (actual and forecast data) and EFGAM calculations. Data as at 1 July 2021.

to rates below those of the pre-Covid world. The concerns are on a number of fronts. Slower population and workforce growth are a feature of many advanced economies, as well as China. Weak productivity trends remain a concern and as Paul Krugman quipped, "productivity isn't everything but, in the long run, it is almost everything". That is, a country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker. The quality of the infrastructure needed to facilitate that – both of the 'old school' variety (transport, power, water and sanitation) and that of the digital world – varies enormously. Improving it is a priority everywhere.

Inflation pressures set to recede

The other major economic uncertainty for the months ahead relates to inflation. A rebound in inflation has been seen in many economies, notably the US. There are concerns that this may herald the start of a new, more inflationary period for

3. Pandemics, inflation and wages



Experience of 10 UK pandemics from the 1348 Black Death onwards.
Source: Bank of England Millennium database and EFGAM calculations. Data as at 1 July 2021.

[1] The opening line of Charles Dickens' *A Tale of Two Cities*.
[2] World Bank *Global Economic Prospects* June 2021. https://tinyurl.com/yz35efjr
[3] Fed *Summary of Economic Projections*. Measured as growth between the fourth quarter of the current year and the fourth quarter of the previous year.

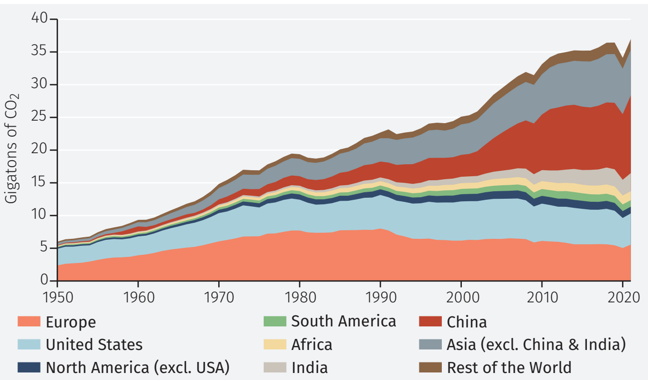
the world economy; but most central banks, as well as many private sector forecasters, see this as temporary. For now, we are probably at a time of 'peak inflation noise': discerning the underlying trend is much more difficult than usual.

There are two main concerns relating to the consumer price inflation trend. The first is that it may be pushed up by higher wages. From bar staff in Britain to stevedores in San Francisco, labour shortages are seen around the world. A broad sweep of UK economic history shows that wages, driven higher by labour shortages, have typically risen sharply in the aftermath of pandemics (see Figure 3). However, the rise in wages tends to be temporary; and the general trend for several years after the pandemic is for lower, not higher, consumer price inflation. The reason, broadly, is that subdued demand tends to be a more important factor than supply shortages.

That suggests that the second inflationary force – supply shortages of semiconductors, new cars and building materials, etc. – may also not be long-lasting. Indeed, there are already signs of these shortages being corrected in the US, the advanced economy which has opened up the fastest. On balance, therefore, we tend to be sanguine about inflation prospects, a message which the US bond market also seems to have accepted.

The "three Cs": climate change, cars and copper
One welcome side-effect of the drop in activity in 2020 was the decline in carbon dioxide emissions. But that has not lasted. Data for the first four months of 2021 show a marked rebound (see Figure 4). A similar pattern was seen after the Global Financial Crisis: the reduction in carbon emissions at that time now appears as a temporary blip.

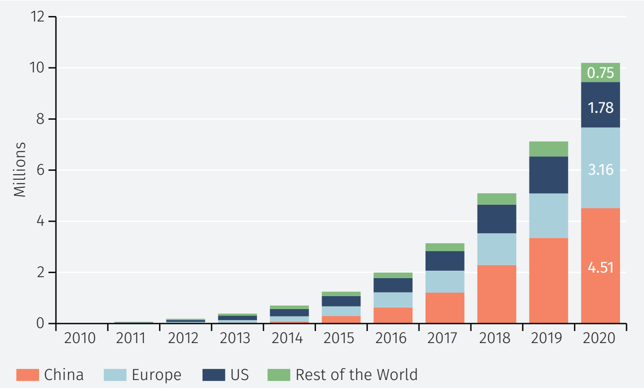
4. Global CO2 emissions



Source: *Our World in Data*, Nature.com.
https://www.nature.com/articles/d41586-021-00090-3 and www.carbonmonitor.org. Data as at 1 July 2021.

What is clear, however, is that there is a more determined focus on environmental issues and a greater co-ordinated international commitment to act. There has been a rapid growth in installed solar and wind power and plans for much more. Electric cars, a rarity just a few years ago, are now more common. But on all these fronts more needs to be done. Of

5. Global stock of electric cars

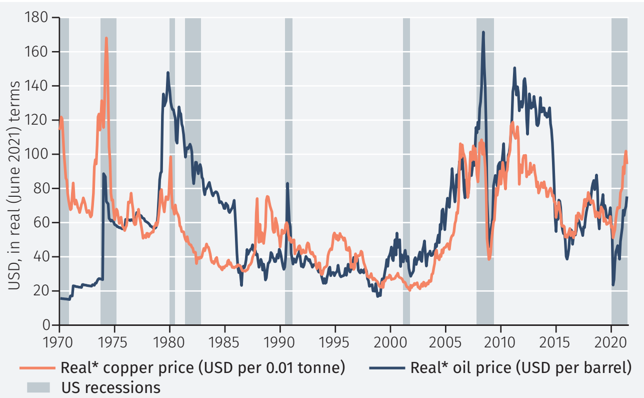


Note: Data includes plug-in hybrids. Source: International Energy Agency. Data as at 1 July 2021.

the 1.4 billion cars on the road around the world, for example, only 10 million are electric vehicles (see Figure 5).

Electrification of the economy extends to many other areas. But that trend, in itself, will lead to greatly increased demand for some commodities (notably copper, aluminium, nickel and zinc). Although the copper price has risen sharply in recent months, in real terms it is still below previous peaks (see Figure 6). In that market, contrary to the general trend, strong demand may dominate a poor supply response.

6. Copper and oil prices in real terms



*Deflated by US CPI index. Source: Refinitiv and EFGAM calculations. Data as at 1 July 2021.

Some are concerned that capital markets may struggle to finance the move to a new, greener infrastructure. To curb global warming to 2.0°C above pre-industrial levels, one estimate suggests US$50tr over the next 30 years will be needed.[4] But given that there has been a shift in the priorities of many investors to favour climate-focused investing, we doubt that there will be a problem in attracting the required finance. And some context is provided by the global fiscal response to the Covid pandemic: US$16 trillion so far.[5] After paying that bill, the cost of mitigating climate change may seem much more acceptable.

[4] Morgan Stanley estimates. See https://tinyurl.com/4yr48et5
[5] IMF *Fiscal Monitor* April 2021.

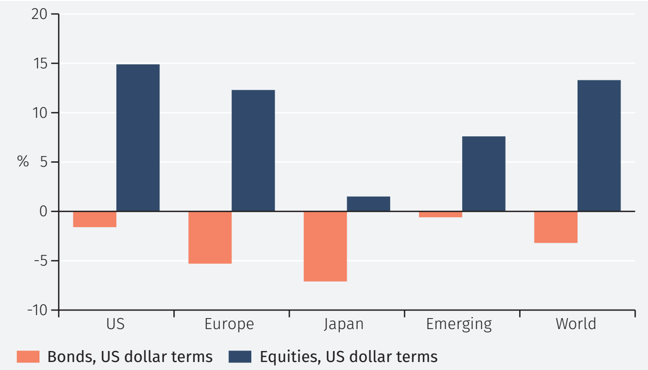
ASSET MARKET PERFORMANCE

The first half of 2021 saw a broad rise in global equity markets, led by the US. Bond markets were under pressure from a rise in yields, reflecting concerns about inflation, but these eased towards the end of the period.

Asset market performance

World equity markets saw gains of 13.3% in the first half of 2021 (see Figure 7) on the basis of the total return from the MSCI World Index in US dollar terms. Global bond market returns, in contrast, were negative, at -3.2% on the basis of the Bloomberg Barclays Global Aggregate Index.[6] In several of the larger markets (notably Japan, Switzerland and the eurozone) returns were undermined, in US dollar terms, by currency depreciation.

7. Asset market returns

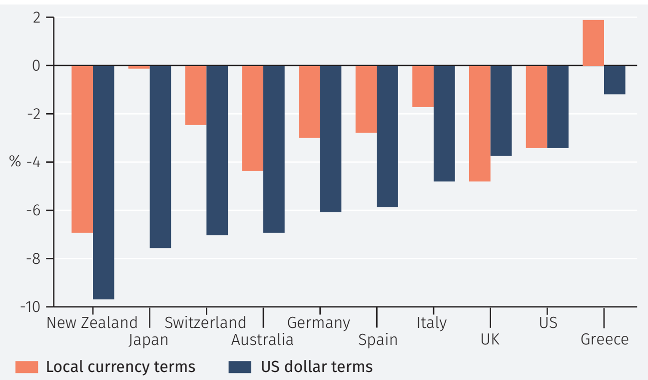


Sources: Barclays Bloomberg (bonds); MSCI (equities). Data for six months to 30 June 2021.
Past performance is not necessarily a guide to the future.

Bond markets

In bond markets, there was a general rise in longer-dated yields (and a consequent decline in prices) in the first quarter of the year, but a large part of this was reversed in the second quarter, as inflation concerns started to ease. In the US market, the total return from 10-year government bonds for the first six months of the year (shown in Figure 8) was -3.2%. In Australia and New Zealand, local currency returns were even more negative than in the US. In both economies, rising bond yields reflected growing confidence in economic recovery but despite this both currencies weakened against the US dollar. Concerns about the economy and the Olympics undermined the Japanese yen, resulting in sharply negative bond returns in US dollar terms.

8. Bond market returns



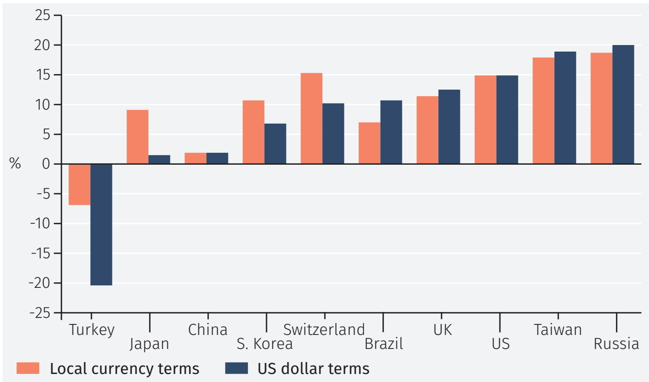
Source: Refinitiv. 10-year benchmark bond total returns. Data for six months to 30 June 2021.
Past performance is not necessarily a guide to the future.

In the eurozone, Greek 10-year bonds produced the strongest returns. Yields were stable at around 1% and the high coupon rate on Greek bonds added to returns. However, across all eurozone bond markets and, to an even greater extent in Switzerland, returns in US dollar terms were undermined by local currency weakness. In the UK, 10-year gilt yields rose modestly, resulting in capital losses and negative local currency returns, but sterling was one of the few currencies to gain against the US dollar during the first half of the year.

Equity markets

The US equity market produced returns in the first half of the year of almost 15% (see Figure 9). Returns were higher in two smaller markets: Taiwan, which benefitted from continued strong performance of technology companies; and Russia, benefitting from higher oil prices. Concerns about the management of the economy weighed on Turkish equities and the Turkish lira. Although returns from Japanese equities were over 9% in yen terms, the yen's weakness meant these were reduced to just 1.5% in US dollar terms.

9. Equity market returns



Source: MSCI. Data for six months to 30 June 2021.
Past performance is not necessarily a guide to the future.

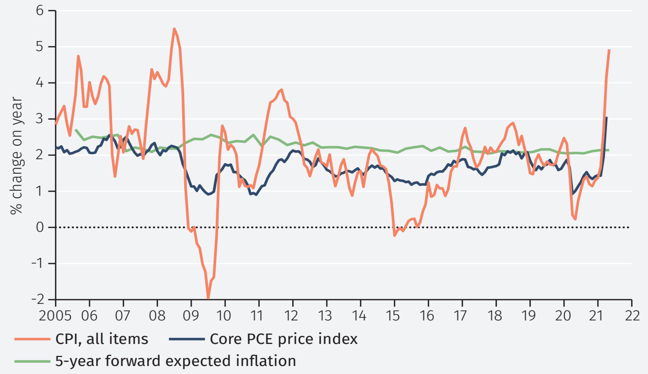
[6] The Bloomberg Barclays Global Aggregate Bond Index is a benchmark of government and investment grade corporate debt from developed and emerging markets issuers in 24 countries.

The Fed faces a dilemma: growth is strong – suggesting monetary policy should be tightened sooner rather than later – but inflation is seen as only temporarily elevated – suggesting caution. The bond market signals are, perhaps, reassuring.

The Fed's dilemma

The Fed, and many financial market participants, are clearly pleased that the US economy is growing so strongly this year. The Fed has ratcheted up its projections for real GDP growth this year to 7% but forecasts for 2022 and 2023 have not been changed. On that basis, the boost to the economy is seen as temporary – and more short-lived than many outside forecasters expect.

10. US inflation: CPI, core PCE and long-term forecasts



Source: Refinitiv. Data as at 1 July 2021.

Similarly, the rise in inflation is also seen by the Fed as temporary. It does seem likely that the headline CPI inflation rate, which rose to 4.9% in May (see Figure 10), will come down later in the year. The Fed's preferred measure of inflation (the core PCE price index) is already lower than that (3.4%) and 5-year forward inflation expectations have scarcely moved, suggesting that markets are not too concerned about longer-term prospects. However, there have been some big swings in bond prices so far this year, partly reflecting the difficulty financial markets have had in ascertaining the inflation outlook.

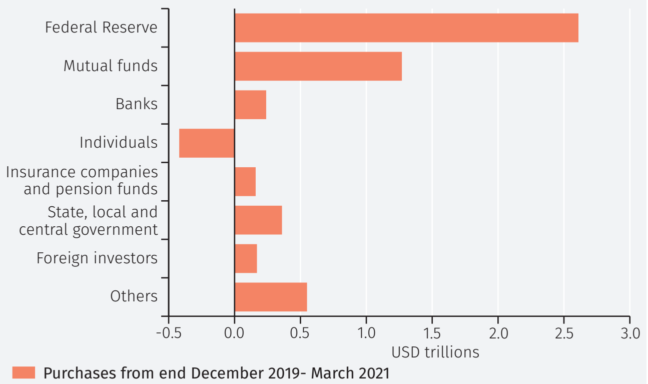
11. US 30-year Treasury bond

Source: Refinitiv. Data as at 1 July 2021.

Message from bond markets

The price of the benchmark US 30-year Treasury bond fell by 17% between the start of the year and mid-March, before recovering (see Figure 11). That meant that on 1 July 2021 30-year yields stood at 2.1%. That is perhaps the soundest endorsement that financial markets could give of the credibility of the Fed's 2% inflation target in the long-term.[7]

12. Who buys US Treasuries?



Source: Refinitiv. Data as at 1 July 2021.

Of course, many will not trust such a signal coming, as it does come from the notoriously fickle and volatile bond market. Moreover, it can be argued, the Treasury bond market is distorted by the Fed's large purchases: it has been the biggest buyer since the start of the pandemic as individual investors have been sellers and foreign investors have seemingly lost interest (see Figure 12).

The second half of 2021 will see these big themes play out. By the end of the year, a much clearer picture should emerge of post-pandemic economic developments. We think that the Fed's view will be proved generally correct: a temporary burst of inflation and temporarily higher growth to be followed by something close to the low and stable growth and inflation which characterised the pre-pandemic world.

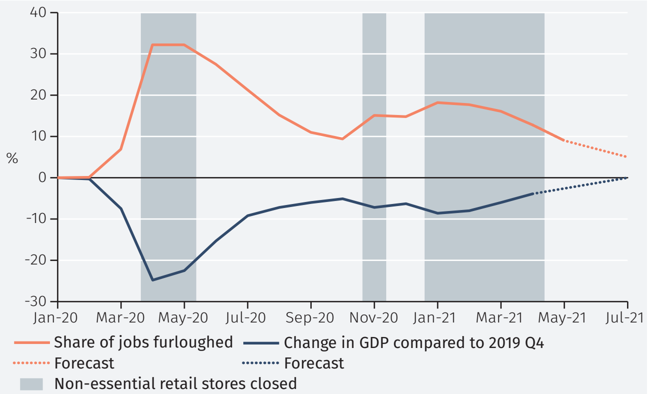
[7] Assuming real rates average close to zero over that time period.

The UK is on a path back to regaining pre-Covid levels of activity, but expectations of a rapid recovery in consumer spending look misplaced. Concern about inflation and gilt yields remains.

The path back

The UK economy is on a path to regaining pre-Covid levels of GDP, probably in the third quarter of the year (see Figure 13). The main factor propelling growth in the short-term is a rebound in consumer spending. But the substantial 'coiled spring' rebound which some expect, based on a rapid rundown of 'excess savings', seems unlikely. Indeed, after an initial surge in retail sales after lockdown restrictions were eased in April, trends have been somewhat disappointing. Although households saved a fifth of their disposable income in the first quarter of 2021 and accumulated savings are more than £200bn above what would be typical, we think it is inappropriate to see these as likely to be quickly run down for two main reasons.[8]

13. UK: employees furloughed and GDP



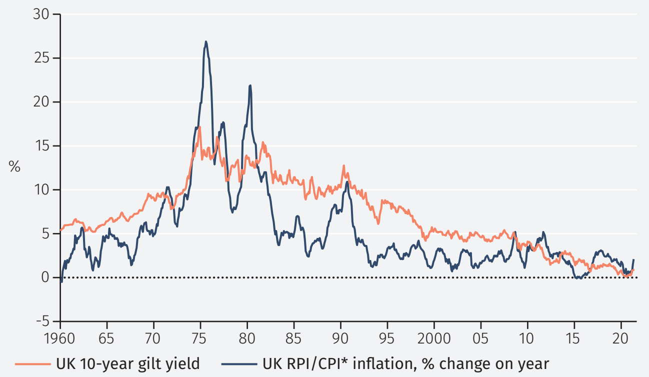
Source: Refinitiv and HMRC. Data as at 1 July 2021.

First, the labour market has lagged behind the recovery in output. Although the number of jobs furloughed has fallen from a peak of over 30% in April/May 2020, it is still 9%. For many workers, job insecurity has increased; others have reappraised their work patterns; some have left the country. Second, there is a hesitancy to spend on some activities, especially given the rapid spread of the Covid Delta variant. Although, by 1 July, 85% of the population over 18 had received a first vaccine and 62% had received a second, caution about engaging in many pre-pandemic activities is still evident. Furthermore, the ability of some sectors to respond to increased consumer spending is still constrained by capacity restrictions and staff shortages. Additionally, prices for many services (hotel accommodation and restaurant meals, for example) have increased, sometimes sharply. Even though consumers may have more money to spend, they are still price sensitive.

Rising inflation and UK financial markets

Indeed, rising inflation is becoming a broader concern. The Bank of England expects the headline consumer price inflation rate to rise to 3% later in 2021. Even so, an increase in the main policy interest rate seems unlikely soon and the Bank intends to continue with its asset purchase scheme. That has helped keep 10-year government bond yields at just 0.7%, less than half the rate in the US. The UK has seen a trend decline in inflation and gilt yields for many years (see Figure 14) but markets may be too sanguine about the prospects of both remaining low.

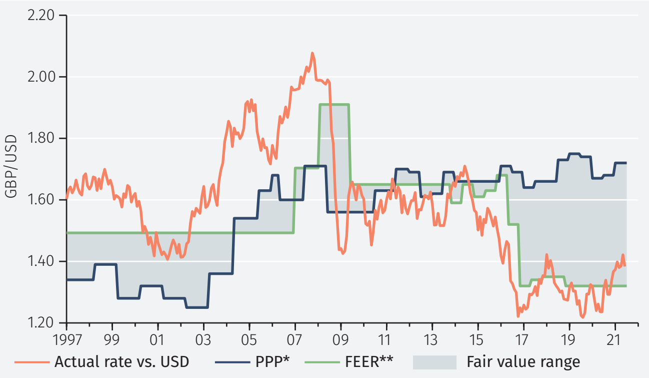
14. UK gilt yields and inflation



*RPI inflation up to December 2003; CPI after that date reflecting the change in the Bank of England's targeted measure. Source: Refinitiv and EFGAM calculations. Data as at 1 July 2021.

Sterling has recovered against the US dollar to trade at USD1.38/GBP on 1 July. That is still towards the low end of the range that we would consider 'fair value' (see Figure 15). But lingering uncertainties about UK growth, policy and the new trading arrangements remain, limiting the upside.

15. Sterling undervalued



*Purchasing Power Parity rate (The *Economist*) **Fundamental Equilibrium Exchange Rate (Peterson Institute for International Economics). Source: Refinitiv and EFGAM calculations. Data as at 1 July 2021.

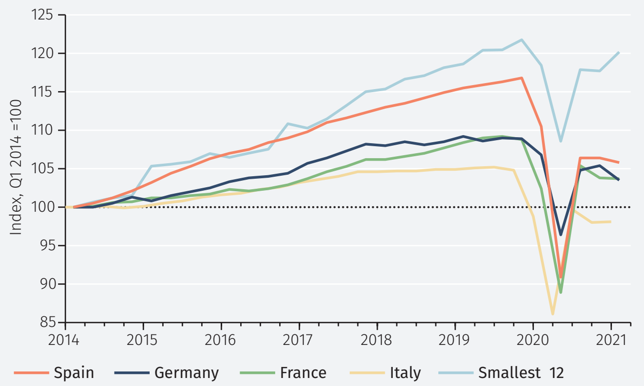
[8] See our *Infocus* publication *'Excess' savings and the outlook for consumption*, June 2021.

The eurozone recovery, which has been slower than in many other economies, is starting to pick up pace. It should broaden out as 2021 progresses. Policy support will continue, but longer-term growth challenges remain.

Larger economies, slower recovery

The eurozone economic recovery has been slower than that in the US and China although services activity – which had lagged the manufacturing sector – now shows more encouraging signs of recovery. However, real GDP levels in some of larger economies (see Figure 16) are still well below pre-pandemic levels. Italy, in particular, is making a slow recovery. Germany and the smaller and more flexible eurozone economies are seeing more of a rebound.

16. Eurozone real GDP recovery: Smaller countries lead



Source: Refinitiv. Data as at 1 July 2021.

In the second half of 2021 and into 2022, the eurozone economy will benefit indirectly from the Biden administration's fiscal stimulus in the USA and from growth in China, helping demand for the eurozone's exports. Funds from the Recovery and Resilience Plan will also start to be released in the second half of the year.

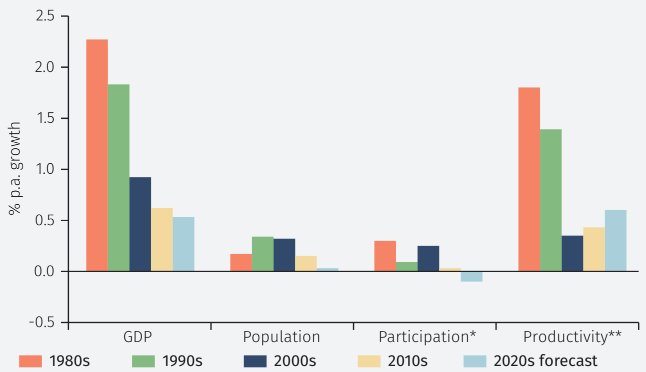
Although the inflation rate in the eurozone has risen, the extent has been much less marked than in the US. It seems likely that any move above the ECB's 'less than, but close to, 2%' target will not be significant or sustained. Indeed, the rate dropped from 2% in May to 1.9% in June.

In that light, policy support looks set to continue. Notably, the ECB's asset purchases are set to be sustained through the summer.[9] And, for another year, the Stability and Growth Pact's restraints on fiscal stimulus will remain suspended.

Future constraints on growth

Looking further ahead, demographic trends will constrain growth. Population growth in the three largest economies is set to be close to zero in the 2020s and participation rates are expected to fall (see Figure 17). That puts the emphasis on productivity in sustaining growth. One encouraging sign is that

17. France, Germany and Italy: growth trends

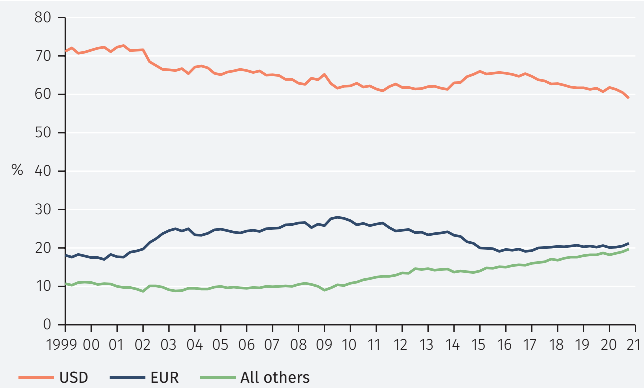


*Participation = workers/population **Productivity = GDP/worker
Source: Refinitiv and Oxford Economics. Data as at 1 July 2021.

the eurozone is ahead of many economies in the transition to green technologies and in reducing carbon emissions. Given the risk to growth posed by climate change, that may put future eurozone growth on a firmer footing, although climate change does not respect geographic borders.

In the financial markets, the eurozone has also become the leader in the issuance of green bonds. That may increase international demand for the euro. However, the European Council's ambition of increasing the use of the euro as a reserve currency is still hampered by zero or negative interest rates. The eurozone's share of global foreign exchange reserves is stable, but at a relatively low level (see Figure 18).

18. Share of global foreign exchange reserves



Source: IMF COFER database via Refinitiv. Data as at 1 July 2021.

Many challenges, but some great opportunities, face the eurozone.

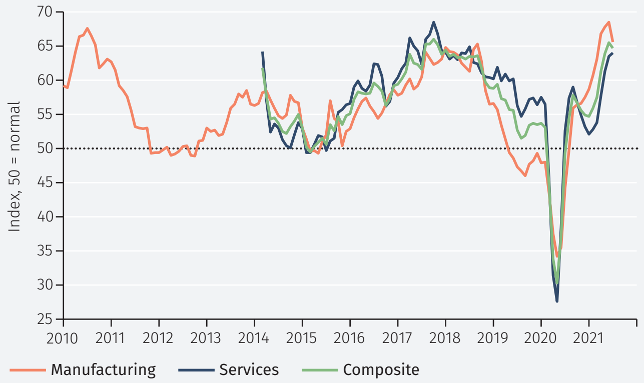
[9] The PEPP (Pandemic Emergency Purchase Programme) is the asset purchase scheme launched by the ECB in March 2020. The initial EUR 750bn amount was increased by EUR 600bn on 4 June 2020 and by EUR 500bn on 10 December, for a total of EUR 1,850bn.

With the Swiss economy back on track and monetary policy on autopilot, attention has turned to fiscal policy – particularly the generous public pension scheme. Reform would benefit the economy, but will be difficult to achieve.

Switzerland: back on track

As measures against the pandemic have eased, survey data indicate that the Swiss economy has rebounded strongly after the first quarter contraction (see Figure 19). Domestic demand growth, driven by the services sector, is catching up with the manufacturing sector, which is benefiting from the normalisation in international trade. Inflation has risen to be within the SNB's 0-2% target range (although this has been largely due to base effects and the strong Swiss franc remains a deflationary force). The SNB has confirmed that it is in no hurry to tighten policy: negative interest rates and foreign exchange intervention to curtail the franc's strength can be expected to continue.

19. Swiss PMI surveys



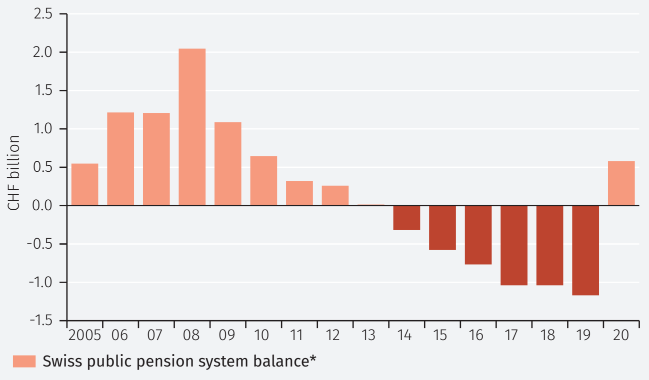
Source: SECO, Refinitiv, and EFGAM calculations. Data as at 1 July 2021.

Public pension reform

With monetary policy on autopilot, the public debate has shifted to fiscal policy and, in particular, the public pension system. The Federal Council has proposed reform of the public Old Age and Survivor's Insurance (OASI) programme: increasing the female retirement age to 65, the same as for men; and raising revenue for the programme by increasing the Swiss VAT rate are the key proposals. Both Houses of Parliament voted for the reform. But this is unlikely to come into force: public opinion polls suggest it would be rejected if put to a referendum. This may not be bad news.

The proposed reform merely contains the financial costs for a few years while the adverse demographic trends affecting OASI will unfold over decades. According to Swiss Upper House projections, in 2031 the OASI deficit will rise to CHF4.4 billion (four times its recent level – see Figure 20). Subsequently, population ageing would further widen the

20. Swiss public pension system balance

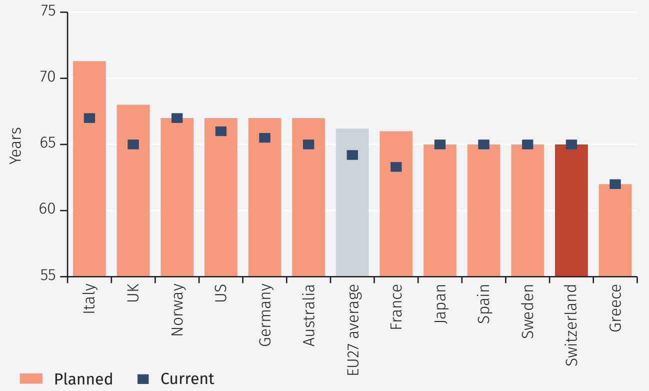


*Data refer to the difference between incoming contributions and pensions paid.
Source: Compenswiss. Data as at 1 July 2021.

deficit, making new measures, including cuts to pension benefits or higher taxation, inevitable. A fairer solution would be a universal increase in the retirement age. Since the OASI was created in 1948, the Swiss male retirement age has remained at 65 years even though life expectancy at birth has risen by more than 15 years.

Over the years, the retirement age has been raised in most OECD countries, including in Germany and Italy where it is already higher than in Switzerland (and is planned to rise further, see Figure 21). Raising the retirement age in Switzerland would enhance the pension benefits that are provided, reduce the need for higher taxes and benefit the competitiveness of Swiss corporates. It remains to be seen whether such inherently difficult steps will be taken.

21. Normal retirement ages: current and planned



Source: Refinitiv. Data as at 1 July 2021.

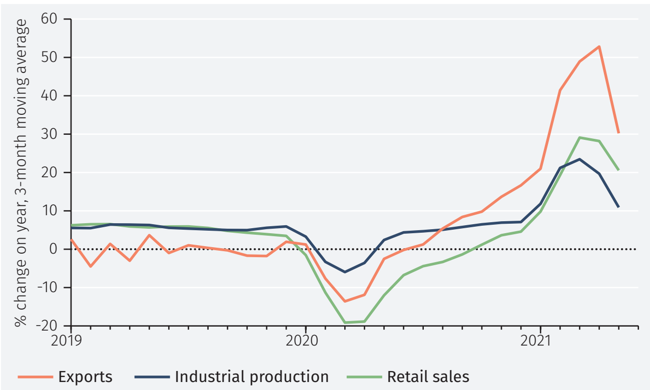
China's plans for capital market liberalisation build on the progress already made with economic development. Much, of course, still needs to be done and it would be surprising if progress was completely smooth.

China: slowing after a swift recovery

One good thing about a centrally-planned economy is that a credible, well-executed plan can produce great results. In practice, few such planned economies have been successful. But China's economic management in recent years must surely be judged a success.

Most recently, China made a swift recovery from the Covid pandemic. The rebound was driven by exports and industrial production (see Figure 22) and consumer spending followed. That recovery was achieved without a big fiscal stimulus or an easing of credit – measures which characterised its response after the global financial crisis. That policy response was well-judged at the time. Now, with concern about the high level of credit and the authorities apparently satisfied with a slower, more sustainable rate of growth, the approach has been different. Measures to restrain credit are in place. Interest rates, in sharp contrast to the advanced economies, have not been cut. There has been no massive fiscal stimulus.

22. China: exports, production and retail sales



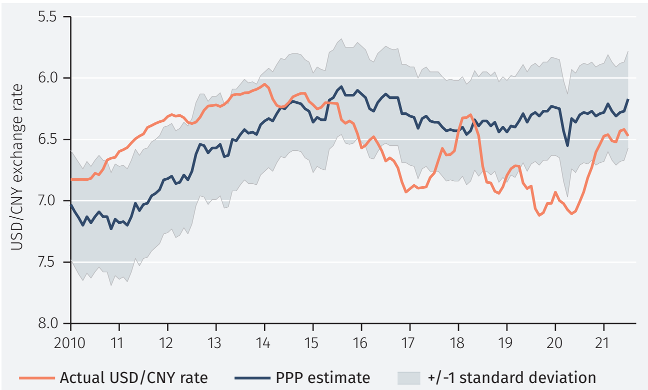
Source: Refinitiv. Data as at 1 July 2021.

The fact that interest rates are higher than in the west partly explains the appreciation of the renminbi (see Figure 23). This will help to contain import prices, provide a buffer for future depreciation if US-China trade tensions were to escalate and could help in rebalancing the economy to one which is more consumer-driven.[10]

Wealth Connect

The next step in China's development will be an easing of capital controls and greater internationalisation of the renminbi. China plans a Wealth Connect programme, which will allow up to Rmb150bn (US$23bn) to be invested in either direction between Hong Kong and mainland China. The

23. Chinese renminbi exchange rate and PPP



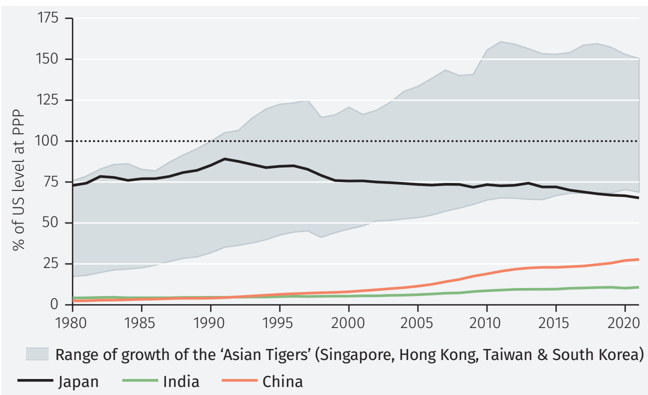
Source: Refinitiv and EFGAM calculations. Data as at 1 July 2021.

scheme will add to existing programmes that connect stock and bond markets. Meanwhile, the internationalisation of the renminbi continues. Although still small (2.3%), its share of international foreign exchange reserves has doubled in the last three years.

Still a lot of catch up needed

Building on successful economic reform, financial market reform should help propel China towards higher standards of prosperity. Even after China's great progress, incomes per head are still only one quarter of those in the US (see Figure 24). India is much further behind. But both countries have much further to go if they are to emulate the success of the Asian Tigers; and Japan's experience shows that even highly successful economies can find continued growth difficult. The most difficult tests of the efficacy of China's approach to economic and financial market development lie ahead.

24. Asian prosperity: GDP per head as a % of US level



Source: Maddison Project Database (2020) and IMF via Refinitiv. Data as at 1 July 2021.

[10] See *The economic and social effects of real exchange rate – Evidence from the Chinese provinces*, Ping Hua, OECD 2011.
https://www.oecd.org/dev/pgd/46838088.pdf

There have been important shifts, in various directions, in Latin American politics. Overall, risks in the region have increased. Whether progress with economic reform and development can be sustained is, in some countries, questionable.

Changing political landscape

There has clearly been a shift in politics in Latin America. Although the common causes of change have been Covid and the deleterious effects on growth, public finances and (in some cases) inflation, politics has moved in different directions in different countries.

In Ecuador, the new president is more conservative than his predecessor.

In Peru, Pedro Castillo, the new president campaigned on a platform of nationalisation, increased government intervention and tax hikes for the rich. Although that stance has seemingly moderated, the formerly market-friendly policy stance is clearly being questioned.

In Mexico, President López Obrador has lost his two-thirds majority in Congress, hampering reforms (notably tax reform) which, it is widely regarded, have been too slow.

It could well be that, in some cases, the worst is behind us. Rising industrial metals prices (especially copper) will help Peru and Chile (the world's top two producers); Colombia will benefit from higher oil prices. Eventually, the Covid pandemic will be brought under control. And US stimulus will provide a general (albeit modest) boost for the entire region.

Risks increase

However, overall, our assessments of Latin American country risk (see Figure 25) have deteriorated and are now high in all countries apart from Chile. The main reasons for the greater risk are a worsening of fiscal positions and slower real growth. The bond markets, of course, are forward looking and should be expected to price in such risks. We are concerned, however, that this has not been the case and are wary of exposure to fixed income in the region. Brazil, where the central bank has acted forcefully to contain inflation, is one exception. 10-year local currency bond yields are 9.5%, surely well above the likely long-term inflation rate; and similar maturity US dollar denominated yields are 3.1%, a reasonable yield spread over the US.

Although risk may be lowest in Chile, even there uncertainty about constitutional reform will remain for some time and cracks in what was considered a well-constructed pension scheme have emerged. Under political pressure, withdrawals from accumulated pensions funds have been allowed, potentially undermining the future viability of the system.

Going sideways

Chile was at the forefront of reforms in Latin America in the 1980s. At that time, the reforms of the 'Chicago Boys' echoed those of President Reagan in the US and Margaret Thatcher in the UK: deregulation and privatisation; monetary control to bring down inflation; tax cuts and the promotion of private enterprise. That enabled Chile to grow strongly from the mid-1980s onwards, but progress has now been reversed. Other Latin American economies have made only hesitant progress in moving towards US living standards (see Figure 26). In some economies, the current political and policy uncertainty is unlikely to push the region in the right direction. A highly selective approach to exposure is warranted.

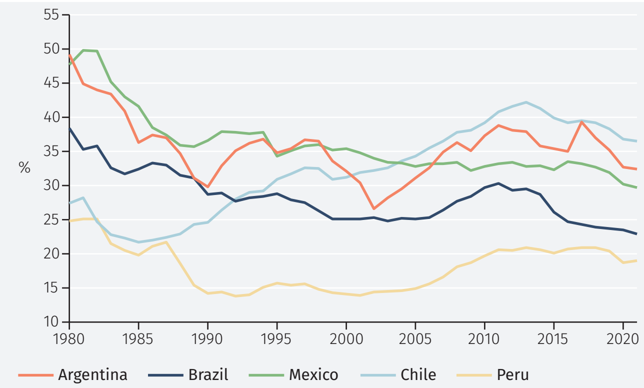
25. LatAm: risk scores

	1997	2013	2021
Argentina	8	14	18
Brazil	10	16	12
Chile	11	8	11
Colombia	9	7	13
Mexico	13	8	12
Peru	10	6	13

Key: Low, Medium, High

Risk scores are based on a selection of economic indicators: current account balance, government budget balance, gross government debt, inflation, GDP growth and the change in GDP growth, external debt, net foreign assets, foreign exchange reserves, credit growth and the change in credit growth.
Source: IMF, Refinitiv and EFGAM calculations. Data as at 1 July 2021.

26. LatAm prosperity: GDP per head as a % of US level



Source: Refinitiv. Data as at 1 July 2021.

Many industries were being disrupted even before the accelerant provided by the Covid pandemic. The financial services sector is one industry which we think is now ripe for substantial disruption.

A shift from established to new business models – 'disruption', in short – has been seen across many industries. In many cases it has been accelerated by the pandemic. From doctor's visits and healthcare diagnostics to education and retail trade, traditional approaches have been replaced by new, typically digital solutions.

The financial sector is one in which disruption has already started, but where we think it could go much further in coming years.

Why disruption? Three ingredients

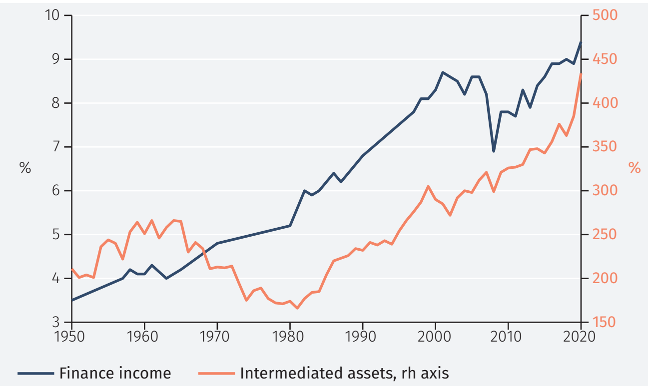
Three key ingredients make an industry prone to disruption. First, where the industry has not changed much for a long time but where the customer experience is poor. Second, where high returns are made by incumbents, providing the potential for a disruptor to be successful. Third, where a catalyst – such as technology, regulation or demographics – exists for the disruption to take place.

Why finance? Three forces

Assessed against that checklist, the financial services industry appears ripe for disruption. On the first point, the structure of the industry has not changed much for a long time: central banks as lenders of last resort; banks and insurance companies as the main intermediaries; and cash, bonds and equities as the primary assets have been the key features for more than a century. The median age of the ten largest companies in the US MSCI financials index is 151 years.[11]

Second, margins have stayed high. The value added by US finance companies as a share of GDP has grown along with intermediated financial assets (the stock of debt and equity)

27. US finance income and intermediated assets (% of GDP)



Source: Refinitiv. Data as at 1 July 2021.

for a long time. Figure 27 shows the trend since 1950, but it has been seen, broadly, since the late nineteenth century.[12] That means that financial intermediation (value added divided by intermediated assets) has had broadly constant returns to scale of 1.5-2% of intermediated assets for more than 130 years (although there are some concerns about the precise way in which value added is measured). Third, new technology means that established business models are increasingly being challenged.

Old networks vs. new technology

Long-established banks typically have a branch network, centralised data storage and 'siloed' offerings – deposit, saving, mortgage and wealth management are provided separately. Challenger financial institutions typically provide online, app-based solutions with cloud storage. Some have grown rapidly. One app-based payments company, has acquired 70 million US customers in 11 years; it took one banking giant 222 years to reach 60 million customers.

Others provide a range of solutions, including wealth management. That is particularly important as the US millennial generation, many of which have a high degree of comfort and familiarity with app-based technology, has seen its wealth increase tenfold over the last ten years, to US$5.9tr.[13] Moreover, their investment preferences (for example, with more emphasis on sustainability) may well be different to those of older generations.

For the insurance industry, one new disruptor uses chatbots and artificial intelligence to process applications and claims while giving a proportion of underwriting profits to charitable organisations. That package clearly appeals to many.

Of course, there are risks to this new disruptive approach. Indeed, for both traditional and new financial companies, cybersecurity is an important issue. Accenture estimate around US$5trillion of assets are at risk of some form of cyberattack and annual spending on cybersecurity now amounts to US$150bn.[14]

In practice, of course, the challenge to the entrenched position of long-established financial institutions will not be easy; and new technology can certainly be embraced by incumbent organisations.

[11] Sources: MSCI; company information.
[12] 'Has the US Finance Industry Become Less efficient? On the Theory and Measurement of Financial Intermediation', Thomas Philippon, *American Economic Review* 2015. https://www.aeaweb.org/articles?id=10.1257/aer.20120578
[13] Source: Federal Reserve. https://tinyurl.com/3sthve8n
[14] Accenture *Cybersecurity Report*, 2020.

Important Information

The value of investments and the income derived from them can fall as well as rise, and past performance is no indicator of future performance. Investment products may be subject to investment risks involving, but not limited to, possible loss of all or part of the principal invested.

This document does not constitute and shall not be construed as a prospectus, advertisement, public offering or placement of, nor a recommendation to buy, sell, hold or solicit, any investment, security, other financial instrument or other product or service. It is not intended to be a final representation of the terms and conditions of any investment, security, other financial instrument or other product or service. This document is for general information only and is not intended as investment advice or any other specific recommendation as to any particular course of action or inaction. The information in this document does not take into account the specific investment objectives, financial situation or particular needs of the recipient. You should seek your own professional advice suitable to your particular circumstances prior to making any investment or if you are in doubt as to the information in this document.

Although information in this document has been obtained from sources believed to be reliable, no member of the EFG group represents or warrants its accuracy, and such information may be incomplete or condensed. Any opinions in this document are subject to change without notice. This document may contain personal opinions which do not necessarily reflect the position of any member of the EFG group. To the fullest extent permissible by law, no member of the EFG group shall be responsible for the consequences of any errors or omissions herein, or reliance upon any opinion or statement contained herein, and each member of the EFG group expressly disclaims any liability, including (without limitation) liability for incidental or consequential damages, arising from the same or resulting from any action or inaction on the part of the recipient in reliance on this document.

The availability of this document in any jurisdiction or country may be contrary to local law or regulation and persons who come into possession of this document should inform themselves of and observe any restrictions. This document may not be reproduced, disclosed or distributed (in whole or in part) to any other person without prior written permission from an authorised member of the EFG group.

This document has been produced by EFG Asset Management (UK) Limited for use by the EFG group and the worldwide subsidiaries and affiliates within the EFG group. EFG Asset Management (UK) Limited is authorised and regulated by the UK Financial Conduct Authority, registered no. 7389746. Registered address: EFG Asset Management (UK) Limited, Leconfield House, Curzon Street, London W1J 5JB, United Kingdom, telephone +44 (0)20 7491 9111.

If you have received this document from any affiliate or branch referred to below, please note the following:

Bahamas: EFG Bank & Trust (Bahamas) Ltd. is licensed by the Securities Commission of The Bahamas pursuant to the Securities Industry Act, 2011 and Securities Industry Regulations, 2012 and is authorised to conduct securities business in and from The Bahamas including dealing in securities, arranging deals in securities, managing securities and advising on securities. EFG Bank & Trust (Bahamas) Ltd. is also licensed by the Central Bank of The Bahamas pursuant to the Banks and Trust Companies Regulation Act, 2000 as a Bank and Trust company.

Bahrain: EFG AG Bahrain Branch is regulated by the Central Bank of Bahrain with registered office at Bahrain Financial Harbour, West Tower – 14th Floor, Kingdom of Bahrain.

Bermuda: EFG Wealth Management (Bermuda) Ltd. is an exempted company incorporated in Bermuda with limited liability. Registered address: Thistle House, 2nd Floor, 4 Burnaby Street, Hamilton HM 11, Bermuda.

Cayman Islands: EFG Bank is licensed by the Cayman Islands Monetary Authority for the conduct of banking business pursuant to the Banks and Trust Companies Law of the Cayman Islands. EFG Wealth Management (Cayman) Ltd. is licensed by the Cayman Islands Monetary Authority for the conduct of trust business pursuant to the Banks and Trust Companies Law of the Cayman Islands, and for the conduct of securities investment business pursuant to the Securities Investment Business Law of the Cayman Islands.

Chile: EFG Corredores de Bolsa SpA is licensed by the Comisión para el Mercado Financiero ("Ex SVS") as a stock broker authorised to conduct securities brokerage transactions in Chile and ancillary regulated activities including discretionary securities portfolio management, arranging deals in securities and investment advice. Registration No: 215. Registered address: Avenida Isidora Goyenechea 2800 Of. 2901, Las Condes, Santiago.

Cyprus: EFG Cyprus Limited is an investment firm established in Cyprus with company No. HE408062, having its registered address at Kennedy 23, Globe House, 6th Floor, 1075, Nicosia, Cyprus. EFG Cyprus Limited is authorised and regulated by the Cyprus Securities and Exchange Commission (CySEC).

Dubai: EFG (Middle East) Limited is regulated by the Dubai Financial Services Authority with a registered address of level 15, Gate Building, Dubai International Financial Centre, Dubai, UAE.

Guernsey: EFG Private Bank (Channel Islands) Limited is licensed by the Guernsey Financial Services Commission.

Hong Kong: EFG Bank AG is authorised as a licensed bank by the Hong Kong Monetary Authority pursuant to the Banking Ordinance (Cap. 155, Laws of Hong Kong) and is authorised to carry out Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activity in Hong Kong.

Jersey: EFG Wealth Solutions (Jersey) Limited is regulated by the Jersey Financial Services Commission in the conduct of investment business under the Financial Services (Jersey) Law 1998.

Liechtenstein: EFG Bank von Ernst AG is regulated by the Financial Market Authority Liechtenstein, Landstrasse 109, P.O. Box 279, 9490 Vaduz, Liechtenstein.

Luxembourg: EFG Bank (Luxembourg) S.A. is listed on the official list of banks established in Luxembourg in accordance with the Luxembourg law of 5 April 1993 on the financial sector (as amended) (the "Law of 1993"), held by the Luxembourg supervisory authority (Commission de Surveillance du Secteur Financier), as a public limited company under Luxembourg law (société anonyme) authorised to carry on its activities pursuant to Article 2 of the Law of 1993. Luxembourg residents should exclusively contact EFG Bank (Luxembourg) S.A., 56 Grand Rue, Luxembourg 2013 Luxembourg, telephone +352 264541, for any information regarding the services of EFG Bank (Luxembourg) S.A.

Monaco: EFG Bank (Monaco) SAM is a Monegasque Public Limited Company with a company registration no. 90 S 02647 (Registre du Commerce et de l'Industrie de la Principauté de Monaco). EFG Bank (Monaco) SAM is a bank with financial activities authorised and regulated by the French Prudential Supervision and Resolution Authority and by the Monegasque Commission for the Control of Financial Activities. Registered address: EFG Bank (Monaco) SAM, Villa les Aigles, 15, avenue d'Ostende – BP 37 – 98001 Monaco (Principauté de Monaco), telephone: +377 93 15 11 11. The recipient of this document is perfectly fluent in English and waives the possibility to obtain a French version of this publication.

People's Republic of China ("PRC"): EFG Bank AG Shanghai Representative Office is approved by China Banking Regulatory Commission and registered with the Shanghai Administration for Industry and Commerce in accordance with the Regulations of the People's Republic of China for the Administration of Foreign-invested Banks and the related implementing rules. Registration No: 310000500424509. Registered address: Room 65T10, 65 F, Shanghai World Financial Center, No. 100, Century Avenue, Pudong New Area, Shanghai. The business scope of EFG Bank AG Shanghai Representative Office is limited to non-profit making activities only including liaison, market research and consultancy.

Portugal: The Portugal branch of EFG Bank (Luxembourg) S.A. is registered with the Portuguese Securities Market Commission under registration number 393 and with the Bank of Portugal under registration number 280. Taxpayer and commercial registration number: 980649439. Registered address: Av. da Liberdade, No 131, 6o Dto – 1250-140 Lisbon, Portugal.

Singapore: The Singapore branch of EFG Bank AG (UEN No. T03FC6371J) is licensed by the Monetary Authority of Singapore as a wholesale bank to conduct banking business and is an Exempt Financial Adviser as defined in the Financial Advisers Act and Exempt Capital Markets Services Licensee as defined in the Securities and Futures Act.

Switzerland: EFG Bank AG, Zurich, including its Geneva and Lugano branches, is authorised and regulated by the Swiss Financial Market Supervisory Authority (FINMA). Registered address: EFG Bank AG, Bleicherweg 8, 8001 Zurich, Switzerland. Swiss Branches: EFG Bank SA, 24 quai du Seujet, 1211 Geneva 2 and EFG Bank SA, Via Magatti 2 6900 Lugano.

United Kingdom: EFG Private Bank Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority, registered no. 144036. EFG Private Bank Limited is a member of the London Stock Exchange. Registered company no. 2321802. Registered address: EFG Private Bank Limited, Leconfield House, Curzon Street, London W1J 5JB, United Kingdom, telephone +44 (0)20 7491 9111. In relation to EFG Asset Management (UK) Limited please note the status disclosure appearing above.

United States: EFG Asset Management (UK) Limited is an affiliate of EFG Capital, a U.S. Securities and Exchange Commission ("SEC") registered broker-dealer and member of the Financial Industry Regulatory Authority ("FINRA") and the Securities Investor Protection Corporation ("SIPC"). None of the SEC, FINRA or SIPC, have endorsed this document or the services and products provided by EFG Capital or its U.S. based affiliate, EFGAM Americas. EFGAM Americas is registered with the SEC as an investment adviser. Securities products and brokerage services are provided by EFG Capital, and asset management services are provided by EFGAM Americas. EFG Capital and EFGAM Americas are affiliated by common ownership and may maintain mutually associated personnel. This document is not intended for distribution to U.S. persons or for the accounts of U.S. persons except to persons who are "qualified purchasers" (as defined in the United States Investment Company Act of 1940, as amended (the "Investment Company Act")) and "accredited investors" (as defined in Rule 501(a) under the Securities Act). Any securities referred to in this document will not be registered under the Securities Act or qualified under any applicable state securities statutes. Any funds referred to in this document will not be registered as investment companies under the Investment Company Act. Analysts located outside of the United States are employed by non-US affiliates that are not subject to FINRA regulations.