Investment Strategy Update

23rd November 2020

CURMI & PARTNERS

Curmi & Partners Research

- The US election outcome has confirmed the broad-based expectations of a Biden victory, however, the Republicans are expected to retain control of the Senate.
- The COVID vaccine news by Pfizer and BioNTech led triggered a sharp rally in global stock markets led by a rotation into value and cyclical stocks.
- Despite the positive vaccine news, the resurgence in cases across major economies is expected to slow down activity and in some cases lead to economic contraction.
- Economic data and survey-based indices released in recent weeks confirm the fading economic momentum and the marked downturn that is expected to hit services sectors.
- Manufacturing remains remarkably strong given the improving business and demand conditions and the uptick in export orders.
- Given the light-touch approach adopted in the US to combat the resurgence in cases, the slowdown in economic activity is expected to be less severe compared to other advanced economies.
- The weakening consumer demand and the impact on labour markets is expected to push inflation rates lower across major economies.
- A high degree of fiscal and monetary accommodation remains warranted in order to avoid scarring effects on the economy as we enter into another phase of poor economic performance.
- Whilst current economic conditions are weak, business and economic growth prospects remain highly supportive for 2021 given the anticipated launch and distribution of a COVID vaccine.
- Financial markets are looking beyond the current economic slowdown as risky assets continue to recover strongly from mid-March lows.
- Despite the generally optimistic outlook, inflation expectations have remained relatively subdued reflecting concerns of economic slack and risks of hysteresis as economic output continues to rebound next year.
- Given the weak inflation outlook and the purchase programmes of central banks, we expect benchmark bond yields to continue to trade at low levels with limited risk of a volatile move upwards in yields.
- We expect a reflationary market environment to be more pronounced in US markets when economic activity starts to recover given the high level of fiscal and monetary coordination and the substantial spending pipeline.
- The benign credit environment and abating macro risks have led us to increase credit risk in our portfolios by increasing our allocation to high yield bonds.
- Given our constructive outlook for 2021, we are looking to increase exposure to lower-rated high yield bonds in order to benefit from more pronounced compression in spreads.
- We continue to seek opportunities to enhance our exposure to value and cyclical stocks as we gradually reduce the underweight equity allocation, whilst maintaining our current selection in growth and defensive equities.

November has been an eventful month with notable market reactions uncovering important dynamics across financial markets which will shape investor flows and preferences in the various asset classes as economies face another battle with the virus.

The US election at the start of the month confirmed the broad-based expectations that Joe Biden will take the presidency. The ensuing lawsuits by the Trump campaign alleging voting fraud and the failure by Donald Trump to concede victory, has resulted in a disorderly transition of power increasing political uncertainty and casting doubts on the timing and size of the highly anticipated phase 4 stimulus package. The race for the Senate is expected to come to a close in January. However, the baseline assumption is that the Republicans will retain control of the upper house.

The dividend government outcome comes short of expectations for those eyeing a Democratic sweep. The general consensus is that a massive stimulus bill will fail to go through Congress given the pushback by a Republican-lead Senate. While such political hurdles on government spending are generally viewed as negative for financial markets, the likelihood that the planned tax increases make it through Congress are equally unlikely.

The announcement by Pfizer and BioNTech on 9th November on the development of an effective vaccine to combat the virus, stole the limelight shortly after the US election. The positive news resulted in a strong market rotation into cyclical sectors, particularly favouring companies that have been severely hit by the virus lockdowns. The optimism which drove market sentiment was echoed a week later when AstraZeneca announced comparably positive results on their version of the vaccine.

While the economic reality today remains dire in most countries given the reintroduction of high-impact measures, the growth prospects for economic output and corporate earnings in 2021 have remained highly supportive and in most cases revised upwards in view of the vaccine optimism.

Having said that, a high level of fiscal and monetary accommodation remains crucial to support economic players through the current slowdown which will likely result in contraction in output across major economies.

Given the heightened downside risks in the near term and the softer economic and survey-based data, we anticipate another phase of dislocation where valuations remain supported and risk premia continue to compress. This is primarily underpinned by the improving business prospects for the second quarter and the second half of 2021.

Therefore, while we acknowledge that the next few months will be challenging for businesses, we view this weak period as a bump in the road for the world economy and which will mark the start of a more resilient economic recovery in 2021.

Given our constructive outlook, we have been looking to increase exposure to cyclical sectors in fixed income markets in order to take advantage of the generally higher yields and the potential upside from further spread tightening. Moreover, we are identifying opportunities to improve our exposure to value stocks in cyclical sectors across Europe and North America.

At the same time, given our outlook on rates and inflation, we will maintain a long duration position in investment grade corporate and sovereign bonds which will also act as a hedge against the higher cyclical risk in our portfolio strategy.

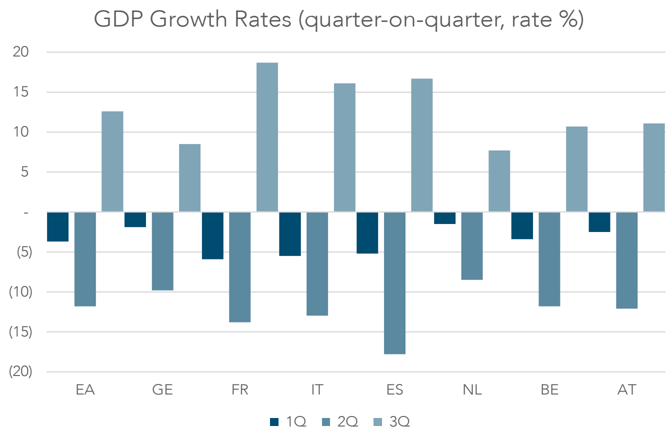
MACRO

Euro Area

The Eurozone economy expanded by 12.60% during the third quarter following a contraction of 11.80% in the second quarter. The rate of growth came in higher than market expectations pointing at a 9.4% growth. Whilst the level of output is still 4.4% below 4Q 2019, the rebound has been surprisingly fast when considering the sudden shock to the economy as a result of the COVID-19 impact on economic activity. Looking at individual countries, Netherlands has so far shown the most resilient economic growth path since Q4 2019 followed by France and Germany, while Italy, Portugal and Spain are lagging the Eurozone average.

In view of the downside risks in the near term, analyst expectations are pointing towards a partial reversal of the third quarter growth during the last quarter of the year. This is already evidenced in economic activity data showing a slowdown in industrial production and retail sales as well as mobility data, indicating lower activity across European countries.

Survey-based indices, particularly Purchasing Manager's Indices for the month of November have declined substantially showing increasing concerns in the private sector as more countries introduced stringent measures



Source: Bloomberg

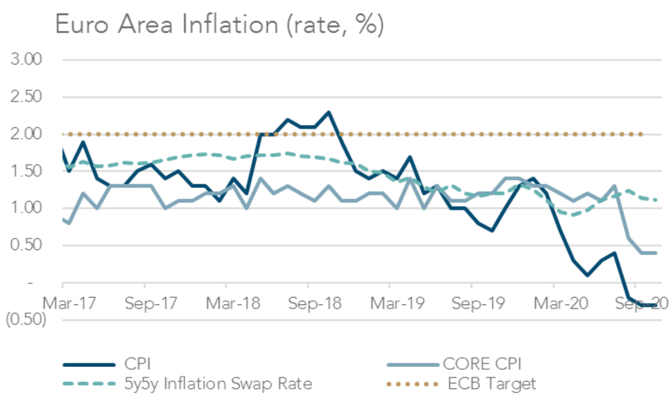
to combat the resurgence in the virus. The Composite PMI Index for the Euro Area came in at 45.1 in November down from 50.0—the first time the index has indicated contraction since May—as businesses see a decline in new orders, slowdown in input price inflation and output prices continue to fall, while the rate of layoffs remained unchanged. The decline in the composite flash estimate was mainly driven by the fall in the Services PMI data falling to 41.3 in November from 46.9 in October, as a result of the decline in activity primarily in hospitality, travel and consumer-facing businesses.

Manufacturing, on the other hand, remains somewhat resilient. The Eurozone Manufacturing PMI flash estimate shows a marginal decline to 53.6 in November from 54.8 in October, thus still showing expansion in manufacturing sectors.

It is worth noting that industrial production remains particularly strong in Germany with capital goods, consumer goods and intermediate goods all showing month-on-month increases. Manufacturing in the auto sector continues to grow, whilst energy production is on the decline. German Manufacturing PMI came in at 57.9 in November, marginally down from 58.2 in October, showing sustained growth in factory activity driven by domestic and foreign demand (particularly rising sales in Asia).

As containment measures are reintroduced across countries, economic activity is expected to slow down, although the magnitude of the downturn is not expected to be as severe as that seen in April. Similar to what we have seen during the first wave of the pandemic, countries with a higher orientation towards services industries are again likely to be worst affected during the winter months.

Consensus estimates are pointing towards a 3% contraction during the 4th quarter, though the margin of error around such estimates remains wide and highly dependent on the path of the virus and the reaction by health authorities and governments.



Source: Bloomberg

Euro area headline inflation and core inflation were unchanged in October at -0.3% and 0.2% respectively. The outlook for inflation has worsened when considering that the impact from the German VAT cut, the delay in clothing sales in summer and low energy prices is only partially explaining the weakness in prices, while the slowdown in the services sector is expected to be the main driver for weak price pressures.

Current price dynamics and weakening economic outlook will likely lead to lower inflation rates in the coming months. The key concerns here are the weak demand and the drag in tourism and travel-related sectors, the low pass-through effects on internal spending given the decline in employment and the strengthening of the Euro currency

The unevenness of the economic impact across member states highlights the challenges that the European economy will face as the recovery resumes given the fragmented fiscal system. The effective launch of the European recovery fund, which is estimated to be circa 5% of Eurozone GDP, will be crucial to assist the restart of the recovery following a weak quarter, especially in economies such as Spain and Italy, where additional national government support is limited.

Such pan-European fiscal plans go some way in addressing these concerns by allowing fiscal transfers across member states. However, the risk that the modalities of the recovery fund are watered down in order to get approved at national level places doubt on the effectiveness of the programme in assisting the weaker states, thus decreasing the probability of a concerted recovery across Europe.

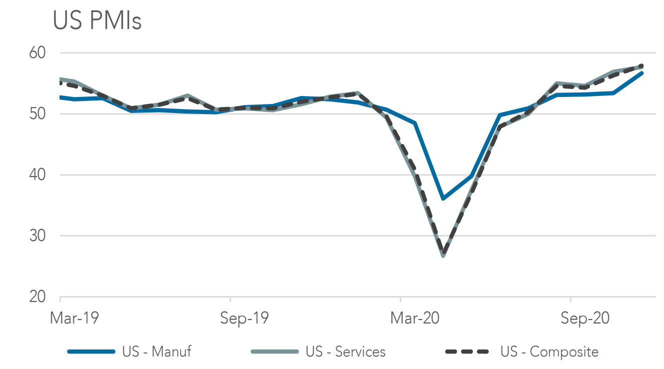
While the pandemic is expected to eventually fade, and demand to gradually recover, we expect inflation to eventually gain some traction and accelerate in line with economic activity. However, the strength of a reflationary economic environment is not expected to be as pronounced as other economic regions (such as the US) given major economies are expected to lag the recovery. As a result, we expect inflation to possibly improve towards the 1% in 2021, while the risks of a spike in inflation remain highly unlikely.

United States

The release of third quarter GDP data in the US revealed a surprising 33.1% annualised growth rate following the contraction of 31.40% experienced in the second quarter. On a year-on-year basis, the US economy has contracted by -2.9%, whilst the level of output remains at -3.5% compared to 4Q 2019/

The rebound in GDP was primarily driven by the surge in personal spending, as household income was sustained through unemployment insurance payments, whilst services spending remained subdued due to the ongoing restrictions. Business investments, exports and residential and non-residential fixed investment also contributed to the growth in output

While economic growth forecasts for the US have generally been optimistic, further expansion in output is expected to be slower given the record surge in cases in the US and renewed lockdown measures.

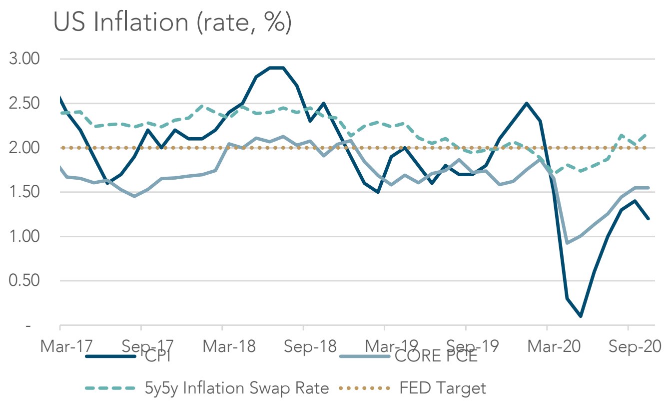


Source: Bloomberg

The risk that the economy stalls in the coming months poses a threat to the recovery, as latest economic data shows that the rate of job gains has slowed and growth in retail sales has decelerated. Simultaneously, hospitalisations have increased substantially, as confirmed cases are almost double the peak seen in August. High frequency data is similarly starting to show declines in shopping mall footfall and restaurant diners, which are expected to lead to a reversal in hiring for such businesses.

Having said that, the economic impact in the fourth quarter is expected to be less severe compared to Europe and the UK, primarily given the softer approach adopted in the US to contain the virus, which predominantly involves emphasising the use of masks and localised restrictions as opposed to widespread lockdowns.

Personal incomes have remained supported by the introduction of additional programmes following the expiry of the famous $600 weekly unemployment insurance payments in July. Whilst the new programmes, which are a fraction of the first programme, are expected to expire in December, the impact on consumption and spending is expected to be limited. This is because households, in general, are in much stronger financial position given that personal incomes and savings patterns have been boosted substantially by the unemployment benefit programmes. Moreover, the likelihood of additional fiscal support early next year is expected to soften the impact on personal income and expenditure.



Source: Bloomberg

Given the slowdown in activity, US headline inflation rate fell to 1.2% in October from 1.4% in September as medical care costs, energy prices and transport costs fell while inflation for food and shelter was steady and apparel deflation softened. Notably, prices for cars and trucks continued to increase at a fast pace.

As we have noted in previous updates, the rate of inflation is expected to follow closely the economic growth path as the economy rebounds from the slump in activity and closes the gap in terms of output to pre-pandemic levels. The decline in inflation earlier this year was mainly driven by a drop in prices in the worst-hit sectors whilst the subsequent rebound came as restrictions were lifted.

While we have seen inflation breakeven rates moving upwards in recent months when positive economic data (actual inflation or jobs reports) was released, suggesting that investors are anticipating a reflationary environment, the movement in traded inflation following the recent vaccine news has been surprising muted.

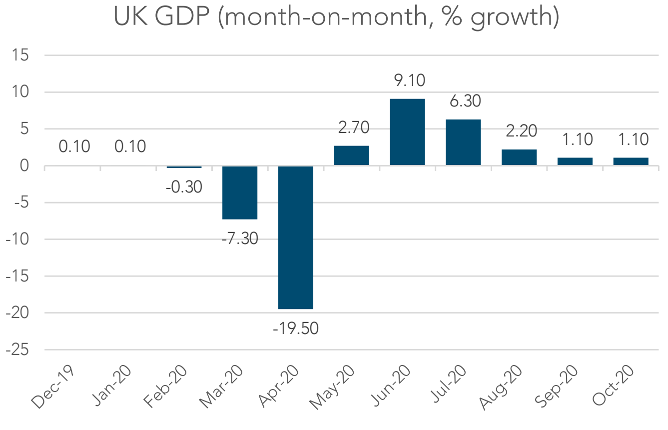
The expectation is that the near-term downside risks, at least until the number of cases and hospitalizations are back under control, will continue to weigh on prices while the rebound in consumption is expected to decelerate. In any case, the risk of deflation in the US remains low.

As the economic recovery is expected to resume in the first quarter of 2021, unemployment is expected to continue to gradually decline whilst additional government stimulus will continue to sustain the growth in spending and investment. As a result , we expect inflation to pick up in 2021 and gradually increase towards the Fed's 2% target level.

United Kingdom

Similar to the outcome seen in other advanced economies, the UK has seen a sharp expansion of 15.5% in the third quarter following the contraction of 19.8% in the second quarter. However, the monthly GDP data shows that the growth momentum has slowed down in September and, given the progression of the COVID-19 virus and the tighter restrictions imposed in the UK, we expect the fourth quarter to be a contractionary period for the economy.

The rebound in economic output during the third quarter was primarily driven by household consumption increasing by 18.3% and by fixed investment increasing by 15.1%. The latter was primarily boosted by housing investment (+46%) while business investment grew at a more modest pace (8.8%). The increase in imports during this period outpaced the increase in exports resulting in a net trade reduction of 2.1%. Public spending, on the other hand, rose by 7.8%.



Source: Bloomberg

As at September, the UK economic output remained 8.2% smaller than February 2020 (pre-COVID) – with the services sector remaining at 8.8% lower compared to February, production at 5.6% lower and construction 7.3% lower.

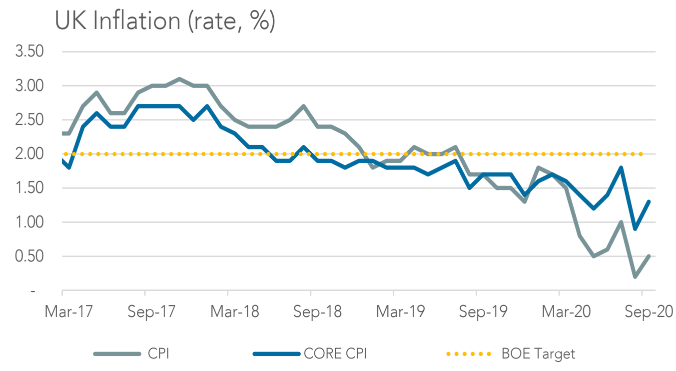
Preliminary estimates of the Manufacturing PMI index points towards continued expansion in the sector, coming in at 55.2 in November, up from 53.7 in October. The growth in factory activity is driven by strong demand in output and new orders both domestic and foreign. Employment has declined due redundancies, recruitment freezes and cost-cutting strategies. The Services PMI data on the other hand declined to 45.8 in November from 51.4 in October, falling for the fifth consecutive month. Given the restrictions on hospitality, travel and other consumer-facing businesses, it is expected that services will be severely impacted in the months of November and December.

In view of the more aggressive measures being adopted as a result of the resurgence in virus cases, expectations are pointing at a contraction of 3.5% in fourth quarter, primarily driven by the slowdown in the services sector.

Unemployment has continued to increase from 4.5% to 4.8% for the three month period ending September in comparison to the three month ending August. Since the start of the pandemic the UK employment rate has been decreasing whilst the unemployment rate and level of redundancies has increased in recent periods.

The extended and new government job schemes are expected to limit the impact of weaker economic activity on unemployment, though increased labour market slack over the medium term seems to be unavoidable. The Bank of England expects unemployment to peak to 7.75% in 2Q 2021, at which point, economic slack will gradually dissipate as activity picks up.

Inflation in the UK has increased further to 0.7% in October from 0.5% in September driven primarily by price increases in transport, as a result of the shift in demand from public to private transport, clothing, food and furniture, furnishings and carpets. Core inflation (excluding food and energy) rose from 1.3% to 1.5%.



Source: Bloomberg

Even though demand for food is expected to increase due to the lockdown, the impact on clothing and other discretionary items will be deflationary, especially when considering that footfall dropped to circa 75% following the new restrictions.

Headline inflation is set to weaken and decline back towards 0.5% over the near term. Having said that, positive vaccine headlines are increasing the likelihood for inflation to trail towards fresh highs as the economy recovers in 2021. The risk to the inflation outlook is a no-

RATES

Euro Area Rates

In line with broad market expectations, the ECB left interest rates unchanged during its October monetary policy meeting, and maintained the ultra-accommodative pandemic purchase emergency programme ("PEPP") to continue until at least the end of June 2021.

Lagarde did mention however, that the mix and size of policy tools will be reassessed in December when the updated staff macroeconomic projections are produced. Given that the balance of risks has clearly tilted to the downside, it is highly anticipated that the central bank will take further action and boost monetary accommodation to sustain the flow of credit to the real economy, whilst maintaining borrowing rates at low levels. Given the current level of policy rates and money market rates in the Euro Area, cutting rates further into negative territory is viewed to be the less effective course of action.

The viable options seem to be to enhance the modalities and the duration of the Pandemic Emergency Purchase Programme ("PEPP") and improve the terms under the funding for loans programme, namely the Targeted Long-Term Refinancing Opterations ("TLTRO").

The recent streak of positive news related to the vaccine is unlikely to influence monetary policy decision for the time being given that inflation is expected to remain subdued over the medium term and financing conditions need to remain accommodative throughout the recovery.

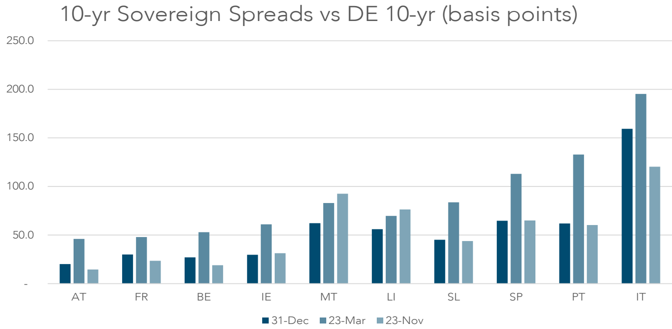
Financing conditions remain easy today given the improvement of short-term financing measures, as can be seen in the continued spread tightening across money-markets, with Libor-OIS spreads trading negative. In view of the weak inflation outlook, interest rates are expected to continue to trade at very low levels with monetary policy expected to remain highly accommodative for the foreseeable future.

The positive vaccine news in recent weeks has supported market sentiment resulting in an uptick in long-end German sovereign bond yields and a steepening in the benchmark yield curve.

However, the challenging economic realities in the near term across Euro area economy have kept the sovereign bond market supportive, primarily due to:

- Increased virus concerns and containment measures as the number of cases surge;
- Increasing expectations of economic contraction in the fourth quarter;
- The persisting deflationary environment;
- Increasing probability that the ECB will step up monetary accommodation measures in December.

In view of the weak economic demand and growth outlook, the general decline in employment which will require substantial time to recover from, low inflationary expectations and substantial increase in debt burden (both public and private debt), the risk of volatile spikes in benchmark bond yields seems highly unlikely.



Source: Bloomberg

Spreads across Euro Area sovereign bonds have continued to tighten despite the renewed virus fears which have deteriorated growth prospects for the fiscally-weaker nations and economies with a higher economic dependency on services. In fact, sovereign spreads are trading tighter than pre-pandemic levels in view of pan-European fiscal plans and continued market intervention by the ECB.

As we have noted in previous updates, whilst we expect the virus situation to worsen and that the fourth quarter is expected to result in another (relatively milder) dip in economic performance, the (1) ECB backstop, the (2) impending launch of the recovery fund, and the (3) prospects of abating macro risks in the first half of 2021 provide a constructive outlook for stable to tighter spreads across euro area sovereigns.

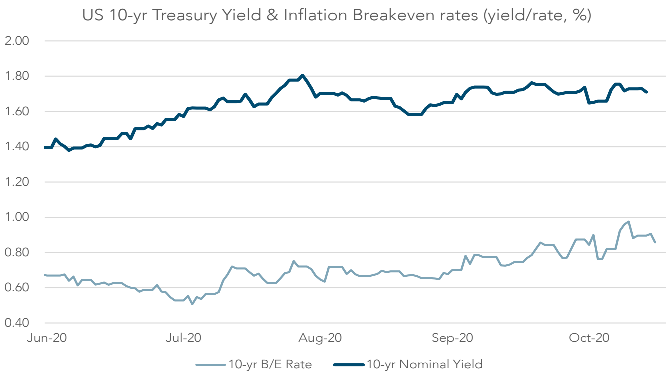
In any case, given the significant downward movement in sovereign bond yields since mid-March, we reiterate that, at this point, the risk/return trade-off for further spread tightening is less attractive, with the exception of specific instances.

US Rates

Whilst no new major policy measures have been announced at the last monetary policy meeting held on 5th November, the Fed reiterated its commitment to maintain a highly accommodative stance throughout the recovery.

Financing conditions remain loose and the emergency lending facilities introduced earlier this year to support businesses and municipalities are expected to be extended into next year despite the pushback by the outgoing Treasury Secretary Steve Mnuchin.

At the monetary policy press conference held on 5th November, Chairman Jerome Powell stated that it will maintain the current pace of treasury purchases for the time being. As a result, any upward movement in long-end treasury yields was quickly reversed while expectations of additional issuance in view of a new fiscal stimulus package have been pushed back, and likely scaled down, given the outcome of the election.



Source: Bloomberg

US treasury yields traded higher on the announcement by Pfizer and BioNTech on their progress in the development of a vaccine. Driven by the positive market sentiment, the 10-yr treasury yield peaked at 0.97% on 9th November after declining to 0.71% following the inconclusive outcome of the election. The movement in inflation breakeven rates following this announcement was surprisingly muted with the 10-yr B/E rate trading in a tight 10bp range. In any case, the uptick in long-end treasury yields was subsequently reversed, with the 10-yr Treasury yield trading back down towards 0.83% shortly after.

Whilst many analysts, (including ourselves) would have expected that a Biden victory and positive vaccine news would be clear catalysts for treasury yields to trend higher, a number of factors explain the reversion in the benchmark yield and the lack of traction in the reflationary trade following these events:

- The disputed election outcome resulting in a disorderly transition and delaying timing of additional fiscal stimulus;
- The likelihood of a divided government reducing the probability of a massive stimulus package;
- The pandemic resurgence threatening the economic growth trajectory and weakening the momentum in the labour market recovery.

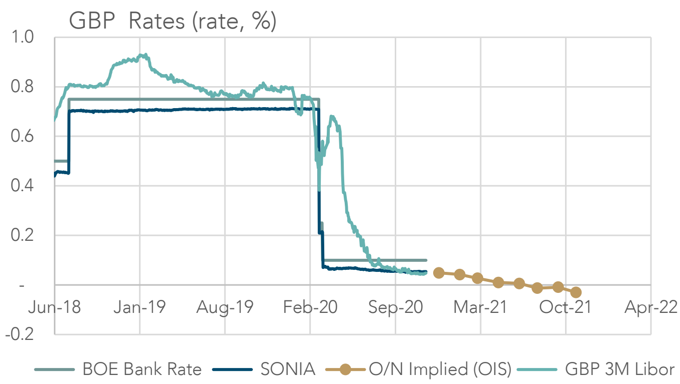
As a result of these factors, inflation is expected to lose momentum in the near term whilst the Fed will remain committed to a highly accommodative approach for the time being. The increased political uncertainty has reversed the steepening in the US treasury yield curve that we have seen prior to the election in anticipation of a Democratic sweep.

We still maintain that the conditions remain for the uptick in (traded) inflation to be cyclical rather than structural – in other words, inflation is expected to follow the growth path to a certain extent, but more permanent structural issues on productive capacity and demand are expected to cap the rise in actual inflation over the longer term.

Whilst acknowledging that the heightened downside risks in the short term and Fed Intervention will keep long-end yields capped for the time being, the US curve is likely to continue to gradually steepen over the next quarters, as long-end yields trade higher given the buoyant growth expectations for 2021. Similarly, given the fiscal stimulus pipeline and the Fed's average inflation targeting mechanism, the long-end can move higher, although short-end will likely remain anchored. Having said that, we do not expect a sharp sell-off in the long-end (similar to the Taper-Tantrum situation in 2013).

UK Rates

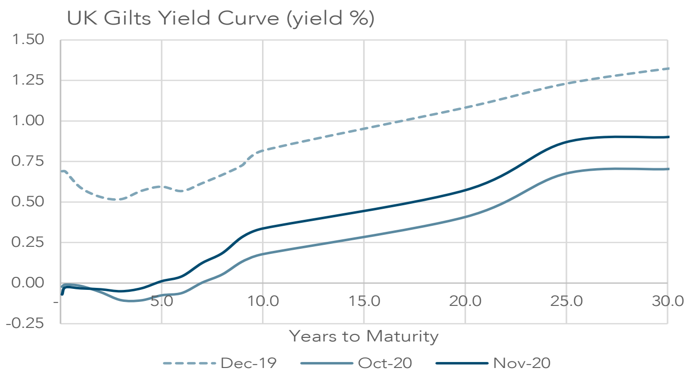
As we have been expecting, the BOE has decided on 5th November to increase the targeted size of its bond-purchase programme by GBP 150bn, to GBP 875bn, while the bank rate was left unchanged at 0.1%. The decision came as a result of the increased downside risks to the economic recovery path, which continue to warrant ultra-easy financial conditions in view of the weakening momentum and the likelihood of a double-dip recession.



Source: Bloomberg

Money market spreads continued to tighten given the increased liquidity in the system, with OIS swap rates implying negative overnight rates in 2021.

Gilt yields at the long-end of the curve have moved upwards on the positive news of a vaccine, indicating the generally supportive outlook for growth and inflation beyond the current period of weakness.



Source: Bloomberg

The upward movement in the UK 10-year Gilt yield was more pronounced compared to other benchmark bond yields, resulting in a notable steepening in the UK sovereign curve. The movement in the curve highlights the sensitivity of the UK economic growth prospects to vaccine optimism as a result of substantially higher reliance on the services sectors.

The extension in furlough schemes and fiscal plans also led to higher expectations of bond issuance by HM Treasury. The prospects of increased supply is seen to have outweighed the announcement by the BOE to increase bond purchases given the prolonged timeline attached to the targeted bond purchases.

The net supply of Gilts, combined with inflation dynamics in the UK, has supported the steepening in the yield curve over recent weeks despite the weakening economic momentum in the near term.

The UK economic recovery remains highly dependent on the continued fiscal and monetary policy support as well as a favorable Brexit outcome. With a substantially weaker growth and inflation outlook, elevated uncertainty and the BOE's focus on bond buying programmes as its main policy tool, our preferred positioning is a long duration position in Sterling-denominated bonds for the time being. However, the expectations of more issuance by the UK treasury may continue to counteract QE-driven flattening in the gilt curve.

CREDIT

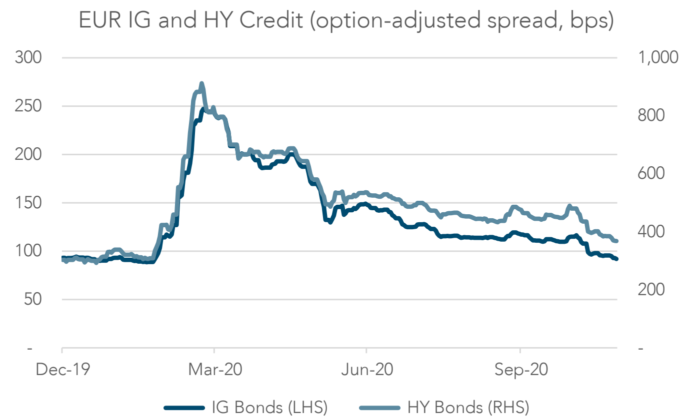
Credit markets performed positively across the board during the past month as markets turned bullish and uncertainty abated following announcements from pharmaceutical companies on the vaccine front.

Corporate credit spreads tightened in both the investment grade and the high yield corporate bond markets. Bond yields within the corporate credit space declined following Joe Biden's victory in the U.S. Presidential election held on the 3rd of November and also on the news that a potential vaccine has reached the final stages of trials with more than 90% efficacy seeking FDA approval in the coming weeks.

Given the risk-on market sentiment, the high yield bond market outperformed the investment grade bond market as a result of the stronger compression in credit spreads. Uncertainty within credit markets has also seemed to have been quelled during the past month as a result of the positive news cycle with credit default swaps declining within both the investment grade and high yield markets.

Cyclical sectors across European corporate bond markets have rallied the most in view of the supportive growth prospects, with energy, transportation and cyclical names tightening the most over recent weeks. Similarly, sub-investment grade financials, energy and transportation were the strongest performing sectors in US corporate bond markets.

We expect that many of the negative catalysts that have been hanging over the market – the second wave, the US elections, and the EU-UK trade negotiations – will



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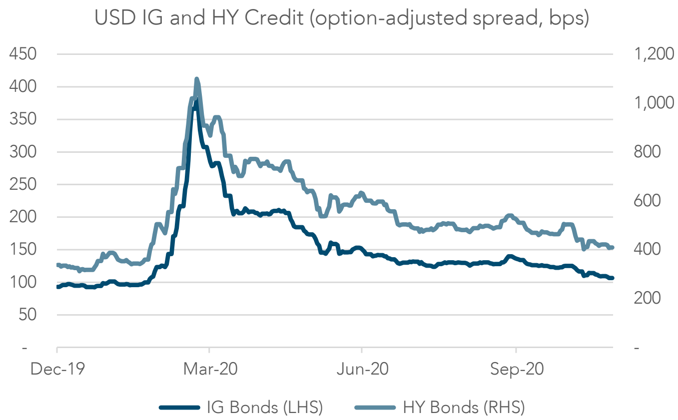


Source: Bloomberg

be largely behind us as we progress through the first half of next year. We believe that investors will focus on the roll out of vaccine programmes, which should hopefully allow for a gradual normalization in pandemic-affected industries by next summer. Going into 2021 we expect compression to remain the driving theme in the market with high yield outperforming as economic activity improves, fiscal stimulus is deployed and default rates subside.

We expect volumes in primary markets to be relatively light next year for Investment grade bonds. Corporates raised huge precautionary cash balances in the months immediately following the first wave of lockdowns, with this year marking a record for both gross and net issuance. For many businesses, most of this cash remains on balance sheets, which is inefficient even with coupons at near zero. As a vaccine is rolled out and business sentiment recovers, companies will be comfortable to gradually reduce their liquidity cushions. Within the High Yield space, there remains scope for additional issuance into 2021 as a growing market and a renewed 'refi wave' could set the scene for additional gross supply next year.

We continue to think that the flexibility of the ECB PEPP significantly increases the impact compared with its predecessor program. Effectively, they can increase the pace of purchases to an unlimited extent at any time in order to combat volatility. For the time being, there is no reason to expect the general level of monetary support to change next year. In her last press conference, Lagarde effectively pre-announced a new stimulus package, saying that they will "recalibrate their instruments" at the next Governing Council meeting in order to offset the economic drag from the reimposition of lockdowns across much of the Euro Area this month. However, we do expect the net pace of purchases to moderate slightly to €8bn/month, as it may become a little harder for them to source volumes.

Given a strong technical picture, the principal risk in high yield issuers is that credit losses continue to climb due to short term fundamental or structural issues. The resurgence in infections that has taken hold over recent months is a reminder that we can't take the benign default environment as a given. The narrative around a vaccine is encouraging, and has allowed investors to look through the current flare-up in cases. Nevertheless default rates may continue to increase in the short term over the next few months, only to subside over the second half of 2021.

We think lower-rated bonds will outperform in 2021 given greater scope for spread compression, and are better isolated from interest rate risk should we see volatility on that front. However, we see ratings as less important than the sector rotation theme for the time being. The ECB continues to deplete the pool of investment grade corporate bonds, buying at a pace of c€10bn per month. Euro high grade bond yields average 0.5%, close to all-time lows, making HY credits look like an attractive source of carry.

EQUITY

In our last month's report, we stressed the importance for equity markets that a vaccine is approved before the end of the year. This became more apparent as investors welcomed Pfizer's announcement some days ago, looking through the surging COVID-19 cases and hospitalisations in the process.

Until now, the global economy has fared well following the significant hit at the start of 2020. Despite the huge economic shock, the global economy recovered over the summer, as governments eased containment measures and the number of registered COVID-19 cases stabilised.

The lack of any apparent scarring bodes well for sentiment going into 2021. We think government actions have served to limit any negative long term impact on the economy, especially those measures aimed at supporting the labour market, such as wage subsidies, unemployment benefits etc. Had these measures not been implemented, it is reasonable to assume that unemployment would have skyrocketed, consequentially leading to lower consumer spending, further delaying the economic recovery. We expect government support to continue over the coming months, possibly extending to 2021, before the long road to normalisation starts. Finally, we can see a clear path to normalisation of sorts, though risks to the recovery remain. Nationwide lockdowns have been implemented in a number of countries to help curb the case growth, and we could see the expected recovery being delayed unless the spread is controlled.

Global equities rallied in the first week of November, as the probability of a vaccine being approved before year-end increased. Global equities have delivered a total return (in USD) of 7.0% to the 13th November, the strongest performance seen since 2011.

In our last equity strategy report we noted that "The US election and the COVID-19 vaccine will be key market movers during 4Q20". Indeed, the conclusion of the US election has provided some comfort for US equities while the recent news flow around the vaccine has been a key catalyst for global stocks.

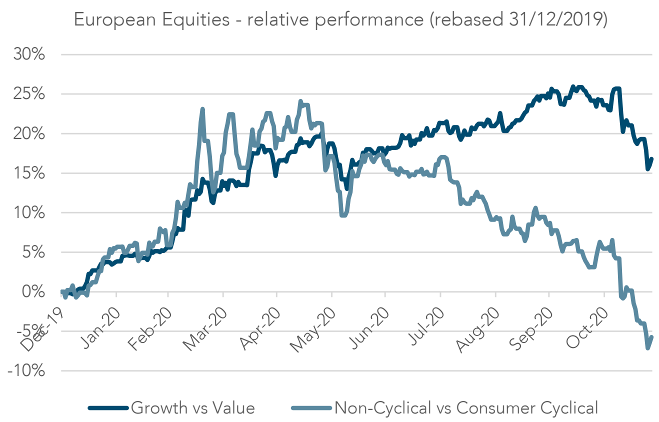
The US election was held on 3rd November with Democratic candidate Joe Biden exceeding the required 270 electoral college votes. The election has been tainted by various voting fraud allegations, as Republicans disputed the election results in the swing states. We do not anticipate any significant changes to the voting outcome. Putting aside the impact on US equites, the implication of a Democratic victory in the Presidential race is lower trade disputes. This should be a welcome development for EU and EM equities.

Trump's "America First" policy disturbed the push to globalisation. US companies had for years sought cheaper labour to reduce unit costs, which in general led to a higher income inequality, as less blue collar jobs were available and the higher profits generated by corporations were generally to the benefit of individuals in the higher income brackets. That said, the actions taken by the President to bring jobs back to the US were a big source of uncertainty for the global economy. The US/China trade talks were complicated with no agreement in sight. Additionally, the EU (which ironically imposes tariffs on trade from outside the bloc) was also getting hit by tariffs. Any easing on the trade tariff front would be a positive for the global economy.

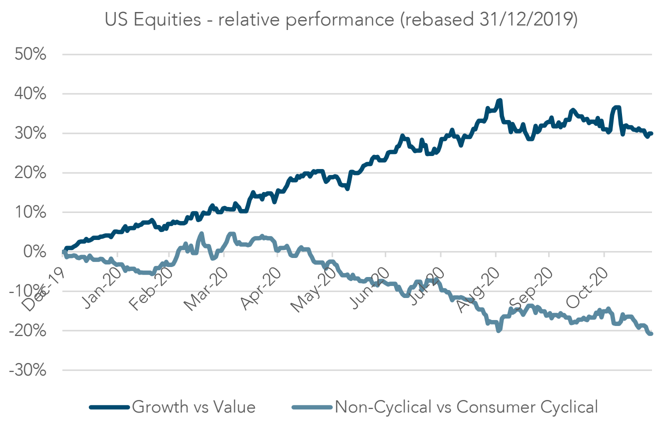
On 9th November, Pfizer announced that its "Vaccine candidate was found to be more than 90% effective in preventing COVID-19 in participants". On 18th November, Pfizer announced that "Primary efficacy analysis demonstrates BNT162b2 to be 95% effective against COVID-19 beginning 28 days after the first dose. 170 confirmed cases of COVID-19 were evaluated, with 162 observed in the placebo group versus 8 in the vaccine group". We expected investors would look through any surge in cases as long as a vaccine was approved before year end. The price movement so far seems to back our view.

The approval and distribution of a vaccine in the coming weeks is expected to be the first step towards normalisation. Until then, economic activity will remain depressed as major economies have announced a number of containment measures. This comes after a surge in hospitalisations, particularly in Europe. The current base case is for the global economy to recover strongly in the second half of 2021. Any delay in the vaccine could see this pushed to later, with a higher risk of scarring effects on the global economy.

The current consensus estimates point to growth of 5.2% in 2021 and 3.7% in 2022 for the global economy, however these forecasts could be revised lower if countries lose control of the virus and/or if governments cease fiscal support measures to their respective economies (wage subsidies, unemployment benefits etc). If the base case materialises, we see scope for equities to perform well in 2021, especially cyclical stocks that have been beaten up in 2020. Our preference to maintain a diversified equity portfolio with exposure to both growth and value names remains unchanged. A skew to value names as a tactical strategy would be preferable in the current scenario, even though there is little evidence that inflation will pick up sufficiently to warrant a rate hike any time soon. On the other hand, our long term preference for growth remains intact.



Source: Bloomberg



Source: Bloomberg

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Sovereign Bonds	Stable	U/W	Benchmark bond yields benefitted mainly from central banks' policies and the generally weak expectations of economic growth and inflation., despite the determination of governments to intervene with substantial supportive measures. Outlook for periphery credits is well supported, but as noted in previous updates, the strong rally seems to be showing some signs of fatigue at current levels. However, the agreement on the Recovery Fund and additional monetary stimulus could add further momentum going forward. In addition to maintaining exposures as hedge, this could offer marginal tactical opportunities. We maintain an underweight stance to sovereign credit given the predominantly negative yield on offer for the asset class in absolute terms. Underweight exposure in held through tactical long positions where investors still stand to benefit from spread compression whilst also maintaining absolute returns above 0% in yield terms.
Investment Grade Corporate Bonds	Positive	O/W	Investment grade bonds remain attractive, however, at a lower level conviction, given the notable rally in corporate bond markets and the tighter spreads. Strong central bank support is expected to continue to sustain the current levels in spreads which underpins the benefits of maintaining a long duration exposure within this space, with the aim to carry a relatively higher yield, particularly in view of the low interest rates and low inflation outlook. The risk of downgrades remains prevalent and requires close monitoring in view of the challenging business conditions and general sentiment in credit markets even though economic conditions have continued to stabilise.
High Yield Corporate Bonds	Neutral to Positive	O/W	High yield markets have rallied considerably from the mid-March lows. Having said that, improved market conditions may provide scope to pro-actively seek opportunities on a selective basis. Investors are increasingly able to assess the impact of COVID-19 more specifically with the release of earnings updates. This could allow for more scope to seek opportunities on an individual basis, whilst acknowledging that the wider market has already pulled back from March lows. Particularly referring to Euro HY, the renewed deterioration of Covid-19 situation has not had notable negative impact; any cheapening of market would be seen as opportunity
Emerging Markets Corporate Bonds	Neutral	N	Recent developments have increased investor confidence in this space, as market yet not fully recovered and the opening up of the global economy should be improving prospects (with US yields remaining "capped"). Still, whilst most exposures are centred on conservative financial profiles, de-risking on individual exposures could be required for a selection of names.
Equities	Negative To Neutral	U/W	We still retain an overall underweight allocation in equities combined with an overarching factor tilt towards quality stocks and growth stocks. However, we have adjusted our positioning to include exposure to renewable energy as well as luxury goods in selected stocks given the strong ability of companies to grow cash flows and retain a strong balance sheet position. Given the positive news around the vaccine supporting earnings prospects for next year, we are gradually reducing our underweight allocation and looking at opportunities to enhance our exposure to value stocks and cyclical industries. As noted in our previous update, the approval of a vaccine is expected to have a strong positive impact on sentiment, and consequentially, once it is widely distributed, on the macro-economic backdrop. We could see a re-rating of cyclical/value stocks in this environment and we are positioning our portfolios to benefit from such a move.

N = Neutral O/W = Overweight U/W = Underweight

DISCLAIMER