Investment Strategy Update

30th December 2020

CURMI & PARTNERS

Curmi & Partners Research

- The surge in COVID-19 cases and the tighter restrictive measures which have intensified in December are the main dragging factors for economic activity across the main economic regions.
- High frequency data shows that spending and consumption is been slowing down in November and December as a result of the tighter measures.
- Employment in the Euro Area and the UK is expected to decline given the renewed virus pressures on service sectors.
- Similarly, the rate of job gains in the US has been declining, while jobless claims are on the rise, indicating that the recovery in the labour market is faltering.
- Inflation across economic regions has lost traction in November and is expected to remain low in December and in early 2021.
- Health authorities in the US, the UK and the Euro Area have authorized the first COVID-19 vaccines and started its rollout in December.
- PMI data across economic regions came in broadly stronger than expected in December, despite the generally disappointing economic data, given the improving business prospects in 2021.
- The US Congress agreed on a USD 900 billion stimulus package, which was subsequently signed by President Trump late in December, which is boosting expectations of a strong economic recovery next year.
- The UK and the EU have finally agreed on post-Brexit terms thus removing the risks of a no-deal outcome.
- Whilst no tariffs or quotas will be applied to the trading of goods, the ramifications for the UK leaving the customs union and the single market are yet to be assessed.
- Given the base effects and the strong cyclical upturn expected next year, inflation is expect trail higher in line with the rebound in economic activity.
- Consensus expectations forecast the economic recovery to pick up pace in 2Q 2021 when authorities are expected to lift essentially all containment measures as the vaccine rollout reaches a critical scale.
- Despite the short-term economic weakness, risky assets continue to trade strongly given the substantial central bank support and the improving outlook.
- We expect a reflationary environment on the back of a recovery in economic activity to be more pronounced in the US given that the risks of hysteresis is more prevalent in the Euro Area.
- We prefer holding interest rate risk in Euro fixed income markets given our outlook on Euro yields and the scope of divergence in US-DE benchmark curves.
- We continue to increase exposure to lower-rated high yield bonds to benefit from a more pronounced compression in spreads given the benign default environment and positive business prospects.
- We continue to increase our exposure to value and cyclical stocks given the improving growth-policy mix, as we gradually reduce the underweight equity allocation whilst maintaining our current selection in growth and defensive equities.

When considering the extreme conditions that took hold of the global economy for most of 2020, we are ending the year on a relatively positive note which strengthens prospects for 2021.

December saw three key developments which have serious implications on the future of major economic regions and the path of recovery.

The first is the approval of the vaccine by health authorities and the start of inoculations in the UK, US and the Euro Area. At the time of writing, two vaccines have been authorised for use in both the US and the UK and, so far, one vaccine has been approved in the Euro Area. The rollout of the vaccine is currently underway across most countries and is expected to reach a critical scale in the second quarter of next year which will allow governments to lift containment measures.

The second key development is the US fiscal stimulus package. Following weeks of debate on the size and scope of the latest stimulus package, the USD 900 billion spending bill has received overwhelming support

by both the House and the Senate and was ultimately signed by President Trump on 27th December. The bill will see a much needed extension in the unemployment benefits, direct payments to individuals and assistance to small businesses.

Thirdly, the UK and the EU have finally reached some sort of agreement on post-Brexit terms of business thus avoiding the increased uncertainty and higher trade tariffs of a no-deal outcome.

In the meantime, at their December monetary policy meetings, the ECB, the Federal Reserve and the Bank of England have reiterated their commitment to maintain a highly accommodative stance for as long as necessary to ensure easy financial conditions throughout the economic recovery. The ECB has gone one step further and increased its bond buying programme by another EUR 500 billion in order to maintain borrowing costs low, as governments are expected to continue running unusually high deficits in 2021, while the European Union will raise capital and deploy funds across member states under the newly established recovery fund.

Despite these positive developments, current economic data has been deteriorating as a result of the rise in cases and the restrictive measures which have been in place for a large part of the fourth quarter of the year. Labour market conditions and inflation data have weakened in the Euro Area and the UK, job gains in the US have slowed down, while consumption and spending is seen to be declining across all the economic regions.

Given that the rate of contagion has been on the rise, it is expected that the first quarter of 2021 will be similarly weak. However, markets are looking beyond this short-term weakness and are drawing on the relatively positive survey based data indicating improving business prospects and the expectations that the economies will rebound strongly from the second quarter onwards.

In view of the constructive outlook, we have increased risk in our investment strategy primarily by increasing our exposure to high yield bonds and reduced our underweight allocation in developed and emerging market equities.

We expect the easy financing conditions combined with the improving growth outlook to continue to sustain the compression in credit spreads particularly in lower rated corporate bonds. Moreover, we expect the improving growth-policy mix on the back of vaccine optimism and sustained government spending to be a strong catalyst for cyclical and value stocks. On this basis, we have increased exposure to autos, basic materials and banks.

Concurrently, we continue to maintain a long duration position in investment grade corporate bonds given our view of stable benchmark yields, predominantly in Euro, and stable to tighter credit spreads.

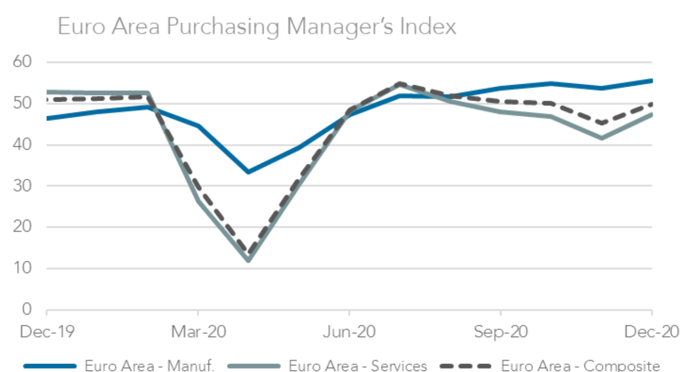
MACRO

Euro Area

The surge in cases across the Euro Area is the main braking force in the economic recovery which is expected to reverse the momentum built during the summer months resulting in a weak fourth quarter for the year. The Euro Area economy is expected to contract in the fourth quarter with consensus expectations looking at a 3% contraction.

Given current data relating to the contagion of the virus, the restrictive measures which have been introduced across countries are expected to remain in place at the start of 2021. This means that the Euro Area economy will kick off the year on a weak footing. Having said that, it is expected that the economic impact from these measures will be substantially less severe compared to the contraction experienced earlier in 2020.

Despite this short-term weakness, the expectations for 2021 have remained positive given that the rollout of the vaccine is expected to gain critical mass in the second quarter of the year allowing authorities to lift restrictive measures. In fact, PMI data continued to improve in December, broadly exceeding expectations, despite the surge in cases and the stalling economic activity, reflecting the fact that businesses are becoming more optimistic on the economic outlook.

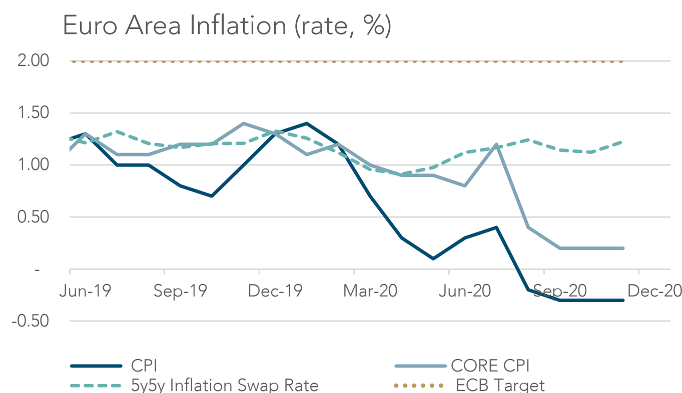


Source: Bloomberg

The improving growth-policy mix in the Euro Area will be a key catalyst to sustain a strong recovery next year. The EU has finally agreed on the Recovery Fund with the first disbursements of funds expected to occur in the second half of next year.

Inflation data released in December shows that Euro

Area headline inflation and core inflation were unchanged in November at -0.3% and 0.2% respectively compared to the previous month. As we had noted in our earlier updates, disinflationary effects from weakness in demand, particularly in the service sectors, has continued to outweigh any inflationary effects from the supply side.



Source: Bloomberg

Headline and core inflation rates are expected to increase next year from the current low levels, mainly because of base effects, which are expected to kick-in in the second quarter, and the resumption in economic recovery as restrictions are gradually lifted with the rollout of the vaccine.

Nevertheless, inflation in the Euro Area is still expected to remain relatively weak, possibly stabilizing at around 1%, and remain well below the ECB target of close-to-but-below 2% over the medium term. This is primarily due to the output gap that has emerged as a result of the pandemic and the limited wage pressures given the weakening labour market conditions which will continue to weigh on price inflation.

Unemployment in the Euro Area has marginally declined to 8.4% in October from 8.5% in September. However, the statistic does not fully capture the impact of the pandemic given the decline in individuals who are actively seeking work. Tension in labour markets is set to increase as the services sector is expected to go through another phase of weakness given the resurgence of the pandemic.

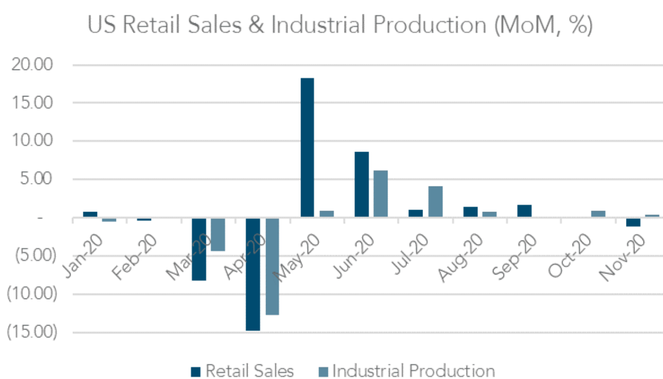
Government short-term job retention schemes have cushioned the fallout in labour markets for the time being when considering that unemployment rate was at 7.2% pre-pandemic. However, extending such programmes further will be limited by the governments ability to ensure sustainable public financing and the aid provided at EU level.

Labour market conditions are expected to continue to worsen over the near term, mainly given the current weakness in the service sectors, before starting to normalise. Labour force participation is expected to increase as economic activity starts picking up again while governments eventually wind down work retention schemes. As a result, headline unemployment in the Euro Area is expected to continue to grind higher and peak around mid-2021.

United States

The US economic recovery seems to be faltering in December despite the approval of the vaccine as the near-term risks remain tilted to the downside. The economic impact from the surge in virus cases seems to be intensifying in December, primarily driven by a decline in consumption, whilst the vaccine rollout is still in its early days.

The decline in retail sales in November of -1.1% (month-on-month) was worse than the consensus expectations of -0.3%. The weakness is primarily due to the surge in cases and the reimposition of lockdowns by a number of states. Sales are also expected to be slower in December given the current virus data and tighter controls. December will probably see a larger decline since high frequency data is showing continued decline in activity, particularly in restaurant diners, air travel and hotel occupancy.



Source: Bloomberg

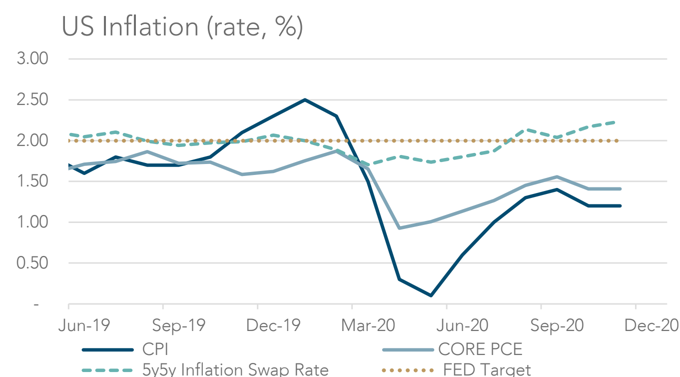
The increase in manufacturing output, despite the decline in sales, is the lagged effect of the acceleration in sales in previous months resulting in the depletion of inventory levels which require replenishing. This is particularly prevalent in the auto sector. Industrial production is expected to continue to grow in December as manufacturing is expected to remain strong, mining output has been trending higher as oil prices rebounded, and output in utilities is seasonally stronger in the winter months.

Nevertheless, coincidental and lagging economic data is expected to continue to disappoint in the near term, however, given that we are late in the quarter, the current weakness will have limited impact on 4Q GDP data.

The USD 900 billion fiscal stimulus package which has

just been signed off by President Trump will be crucial to extend unemployment benefit programmes beyond year-end particularly as the employment-intensive sectors are facing renewed challenges and payrolls are likely to decline.

US 2021 growth forecasts remain supportive on the basis of this additional fiscal spending, the vaccine approval and its distribution which is currently underway. Expectations point to 2Q 2020 when the vaccine inoculation reaches a critical point where restrictions can be eased, and the economy can recover strongly.



Source: Bloomberg

In the meantime, US headline inflation was unchanged at 1.2% in November from the previous month while Core PCE was also unchanged at 1.41%. Over recent months, price levels have been supported primarily by the rebound in the prices of goods and services that have been mostly impacted earlier on during the pandemic.

As noted in previous updates, given the current economic dynamics, primarily the output gap and slowing recovery in labour market, inflation is expected to continue to closely follow the economic recovery path.

In the near term, inflation is set to slow given the decline in activity. However, given the base effects and the strong cyclical upturn expected next year, inflation is expected to rise strongly in the second quarter of next year. Market-implied inflation measures are trading higher on this basis.

Over the longer-term, the risk hysteresis in the US economy and persisting output gap may result in a decline in inflation towards more moderate levels. However, such risks may be avoided through the continued sustenance of fiscal stimulus measures to continue to support economic players.

Headline unemployment continued to decline to 6.7% in November compared to 6.9% in October, coming in better than market expectations of 6.8%. However, the improvement in the headline rate came as fewer people are looking for work with the effect that the participation rate declined to 61.5% from 61.7% in October.

Weekly jobless claims continued to climb showing the weakening momentum in the labour market recovery as a result of the economic slowdown and increased restrictions weighing on consumer-facing business. The slower growth in payroll numbers and the current weakness in high frequency data (slowing activity in service sectors, increasing virus infections and tougher restrictions) suggest that unemployment may increase in the coming months.

However, despite the short-term weakness it is unlikely that the labour market recovery will deteriorate substantially given the strong expectations for 2021 and the generally improving survey data.

United Kingdom

Similar to the other economic regions, the UK economic recovery is seen to be stalling in the last months of the year. However, markets continue to envisage strong prospects in 2021 which primarily hinge on an effective vaccine roll-out process and the Brexit deal.

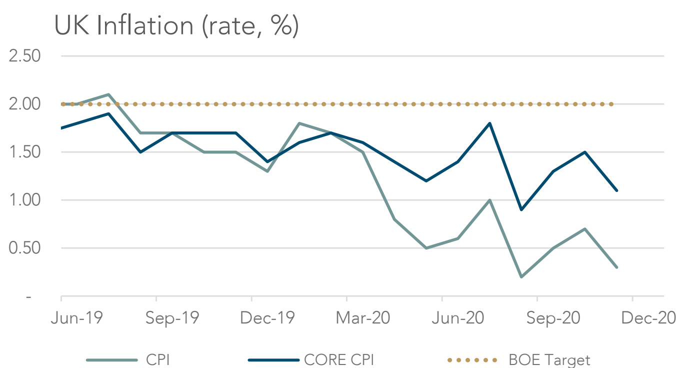
Economic growth slowed down in October with output rising by just 0.4% on a month-on-month basis. Given the UK's higher sensitivity to the pandemic, the economy is expected to contract in the fourth quarter given that COVID restrictions have been introduced in October, relatively early in the quarter, and will likely remain in place for the time being.

Manufacturing and construction, however, continued to grow at a solid pace in October at 1.7% and 1.0% month-on-month respectively. Services on the other hand only grew by 0.2%.

Fiscal discretionary spending and government guarantees are expected to be extended next year in a smaller, but still sizeable fiscal programme aimed at limiting lingering damage to the economy and support small businesses post-Brexit.

The prospects of economic growth beyond the first quarter are strong given the expectations that the vaccine rollout will support an accelerated recovery in the service sectors which make up 80% of UK GDP. December Manufacturing and Services PMI data ticked higher on the basis of such expectations. Moreover, the agreement reached between the UK and the EU has removed the risks of a no-deal Brexit. The resulting disorderly outcome in a no-deal scenario would have had negative repercussions on UK purchasing power given the weakness in the pound. Whilst the UK has secured a trading line with the EU at zero tariffs or quotas, the costs of leaving the customs union and the single market still need to be evaluated.

The fall in inflation came as a surprise in November with the headline rate dropping to 0.3% in November from



Source: Bloomberg

0.7% in October and core inflation declining to 1.1% from 1.5% in the previous month. General market forecasts expect inflation to gradually increase, possibly exceeding the 2% target next year. These expectations have been strengthened by the last minute agreement reached on post-Brexit trading terms.

Given the economic slack that has been created as a result of the pandemic, with output only expected to reach pre-pandemic levels in 2022, it is unlikely that inflation can be sustained above the 2% level. Therefore, the longer-term expectation is that inflation will gradually lose ground to settle close to the 1.5% area.

Unemployment has continued to increase from 4.8% to 4.9% for the three-month period ending October beating expectations of 5.1%. 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. In the next months, job losses are expected to continue to increase gradually given the economic slowdown and, in fact, survey data also indicates that lay-offs are on the rise.

The tapering of the government furlough scheme whereby employers are now required to foot around 20% of wages, is seen to have led businesses to shed more jobs in recent weeks, but the full impact of the pandemic on the labour market has certainly been softened substantially resulting in a slower and more gradual deterioration in unemployment. When furlough schemes come to an end in March, the unemployment rate is expected to rise markedly towards 7%.

RATES

Euro Rates

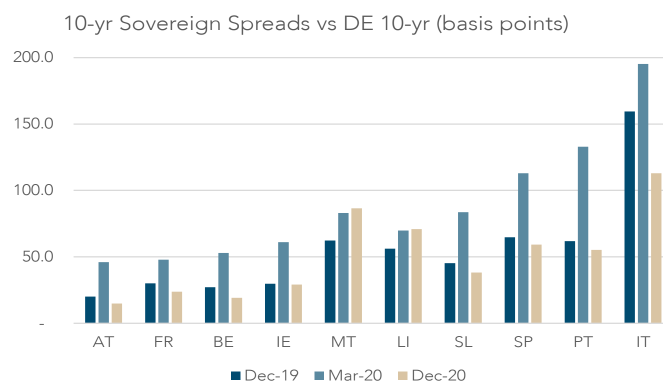
Money market rates continue to trade at substantially low levels with the Libor-OIS spreads trending further down into negative territory indicating a high degree of financing availability in the Euro Area.

At its December monetary policy meeting, the ECB has reinforced its already highly accommodative stance primarily by expanding its Pandemic Emergence Purchase Programme ("PEPP") by a further EUR 500 billion and extending its timeline until at least March 2022. Moreover, the ECB announced that it will hold another three rounds of TLTRO enabling banks to access cheap funding to offer loans to the real economy.

These accommodative policy decisions were in line with broad market expectations primarily given the recent deterioration in economic conditions, decline in inflation rates and intensification of downside risk factors. The current favourable financing conditions in the Euro Area economy are expected to be preserved given the strong commitment by the central bank to maintain cheap access to credit.

The stalling Brexit talks during December and the expectations of a QE boost were the main forces driving the shift lower in the German sovereign yield curve. Markets seem to have shunned the positive news around the agreement of the recovery fund and the approval of the vaccine which has buoyed growth expectations in 2021. On the other hand, the increase in QE raises concerns around scarcity of German bonds since the scheduled purchases exceed the net supply in 2021.

Whilst intraday movements in the German 10-yr Bund have been correlated with the US 10-yr Treasury, the disparity between the two benchmark yields has been growing reflecting the economic divergence and the evolution of reflationary expectations which are becoming stronger in the US.



Source: Bloomberg

Although we have seen Euro Area sovereign yields traded higher on the announcement that an effective vaccine has been found, the move was quickly reversed given the changes announced by the ECB. Moreover, even though episodes of risk-on sentiment generally lifts safe-haven bond yields, non-core and peripheral sovereign spreads have cushioned some of the upward movement in the German benchmark curve.

Looking ahead, additional central bank bond buying, the agreement on the recovery fund and improving growth outlook continue to support tighter country spreads across the Euro Area sovereign bond market.

Debt sustainability issues do not seem to be worrying investors for the time being, despite the higher deficit levels expected in 2021 (albeit less than 2020) – as long as the economy can grow at a healthy pace (which is higher than the level of interest rates), the debt burden may be normalised over time without the need to resort to austerity measures.

Current market conditions, boosted by the expansion in the PEPP envelope, as well as the short to medium term economic expectations, remain conducive to low and flat yield curves in Euro. We therefore expect benchmark yields to remain stable at low levels for the time being with a low risk of potential market sell-off.

Inflation is expected to pick up next year, probably after the first quarter, however we still expect inflation to remain well below the ECB target over the medium term. As a result, the strong central bank bid throughout a period of substantial issuance is expected to continue to keep Euro benchmark yield curves under control. Whilst the risk of a sell-off in sovereign bonds remains low, given the substantial decline in yields and compression in spreads seen in 2020, we do not expect similar strong returns in the sovereign bond market in 2021.

Our preference to maintain a pronounced long duration position has somewhat moderated while the scope to continue to favour carry trades in EUR remains. In the absence of an additional rate cut (which is improbable), the current level of yields compared to the effective lower bound (or the ECB policy rates) indicates limited scope for Euro Area core sovereign bond yields to trade much lower. As a result the risk/reward of the core-sovereign bond market has deteriorated.

US Rates

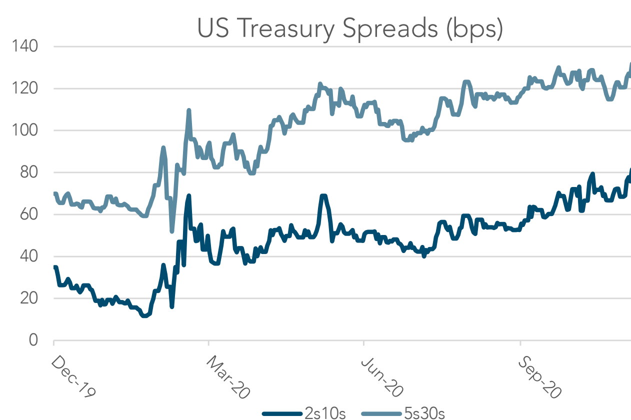
US financing conditions remain substantially loose given the zero-policy rate regime and the tight money market spreads suggesting ample liquidity.

At the December FOMC meeting, the Fed reiterated its commitment to keep policy rates unchanged for the time being and tweaked the language around its bond buying programme suggesting that such purchases are expected to continue for longer than previously anticipated. Powell said that the Fed would continue to buy at least USD 120 billion of bonds a month "until substantial further progress has been made" towards achieving maximum employment and price stability.

On this basis, the smooth functioning of markets, funding conditions and the flow of credit to households and business is expected to remain highly supportive.

Whilst the central bank is committed to maintain a highly accommodative stance until the economic recovery is complete, it is noted that no additional monetary measures have been added at this stage and that fiscal stimulus is the more appropriate policy tool to stimulate the economy in the current situation.

The upward movement in long-end treasury yields over the recent month is driven by reflationary market expectations as the economic recovery is expected to accelerate in 2021. This has resulted in a steepening of the curve with the 2s10s (differential between 10-yr and 2-yr treasury yields) and 5s30s (differential between 30-yr and



Source: Bloomberg

5-yr treasury yields) continuing to trail higher as the Fed's forward guidance and the new "average-inflation-target" regime continues to anchor short-term rates.

Despite the growing consensus of a strong economic recovery and rising inflation, the market has not priced in the possibility of a reassessment in monetary policy by the Fed sometime in 2021. This seems to be justified for the time being given that the Fed remains committed to keep a dovish stance for a number of years.

The improving balance of risks, which could be boosted by additional fiscal stimulus, over the coming months is expected to outweigh the weaker economic data, particularly labour data and retail sales data, and the near-term downside risks brought about by the resurgence of the virus. The view that yields are expected to move higher next year is primarily attached to the expectations that inflation will rise while the economy recovers strongly as the vaccine rollout progresses and the virus risks abate.

Whilst acknowledging that the downside risks to the economy in the short term and the intervention by the Fed will keep long-end yields capped for the time being, the US curve is likely to continue to gradually steepen as long-end yields trade higher given the buoyant growth

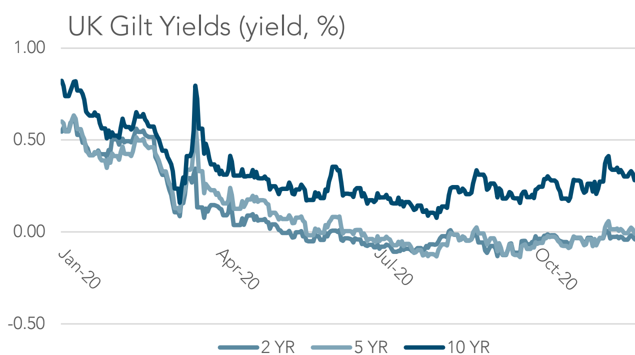
expectations for 2021, the fiscal stimulus pipeline and the Fed's average inflation targeting whereby long-end yields can move higher but short-end yields will remain anchored.

UK Rates

Easy financing conditions are maintained given the copious monetary accommodation by the BOE providing ample liquidity and keeping borrowing rates low.

As was broadly expected, the BOE has decided on 16th December to keep its monetary policy unchanged despite the decline in UK inflation rates. It stated that its outlook for the UK economy remains intact in spite of the unusually uncertain prospects particularly around Brexit. BOE's underlying assumption at the time of the meeting was that a free-trade agreement with the EU will be reached before 1st January.

However, the intensification of Brexit risks in December so close to the deadline of the transition period saw the UK gilts moving higher, reversing the downward movement in prices and uptick in yields following the positive vaccine announcement. The ongoing Brexit discussions and the recent increase in the targeted bond purchases by the BOE have provided a strong technical factor supporting gilt prices.



Source: Bloomberg

The outlook for the UK economy has improved substantially as the health authorities were the first to approve a COVID vaccine and initiate its rollout. Given the relatively higher sensitivity of the UK economy to the virus risks, the scope of a stronger rebound next year has pushed inflation expectations higher.

Whilst the improving inflation and growth outlook over the medium-term lessens the scope to retain a long duration position in GBP, the strong central bank support reduces the risk of sharp market sell-off in UK gilts. On this basis, we see limited attraction from extending duration further for the time being.

CREDIT

Credit markets across sectors, regions, and ratings were stronger over the last month, with a combination of factors driving performance. The continued spread tightening coming off the back of the vaccine-related optimism that began in early November has continued to compress spreads for lower rated corporate credit. Simultaneously, the expectations of prolonged and increased central bank support has kept benchmark rates at record lows. Within credit markets, investors are largely looking through the recently rising case numbers, and are expecting a return to normality in 2021 as a vaccine becomes widely available.

Euro investment grade ("IG") credit markets continued to trade strongly during the month despite some volatility around Brexit negotiations and the EU recovery fund, and remain above pre-pandemic levels on a total return basis. As a result of the recent strength, the Bloomberg Barclays Euro IG index closed the period at an option-adjusted spread ("OAS") of +93bp versus the sovereign curve, just 4bp wide of levels seen in mid-February at the start of the pandemic, and largely inline with FY19 spread levels. Whilst the move higher in IG credit markets was largely indiscriminate, the strongest mover within the recent rally has been the transportation sector as investors grow more confident that a vaccine rollout will soon lead to increased travel and commercial activity.

Since the start of November, the Markit IBOXX high yield ("HY") market index has rallied 4.74%, to now trade largely in line with pre-pandemic levels. In spread terms, the index currently trades at an OAS of +355bp at the time of writing, which remains roughly 60bp wider to the levels seen at the start of the year. Whilst a large part of the move was driven by recent vaccine-related optimism, we have also seen strong support for subordinated financial credit that is expected to continue to be a major beneficiary of unprecedented asset purchasing by central banks.

Despite the overall strength in credit markets in recent weeks, the resurgence of Brexit-related headline risk had more recently been the cause for some marginal softness, particularly within GBP HY markets. Trade deal negotiators had agreed to push back the deadline for a firm decision on a deal, which was taken positively by the market as a sign that there may be scope for some middle ground to be achieved through further discussion. Now that a trade deal has been reached, the drag on high yield Sterling credit is likely to subside.

Despite the increased tension around Brexit negotiations over recent weeks, within Sterling IG, the noise from the uncertainty was largely outweighed by recent positive IHS data and ongoing central bank support as, similar to the broader European space, Transport and Industrials sectors led the charge for performance. Following the moves in the last month, Sterling IG is now the only market that we follow which trades tighter than pre-pandemic levels on an option-adjusted spread basis, at +116.8bp as of the end of the review period versus +126.7bp at the start of the year.

In the US corporate credit space, the story is largely the same, as investors look through the recent spike in COVID cases whilst leaning on the expectation of mass vaccine rollouts and further details on the US stimulus plan. Early signals of IG-rated corporates pivoting back to their pre-pandemic, shareholder friendly, capital allocation priorities have emerged in recent weeks, with firms across a range of sectors having increased or reinstated their quarterly dividends or authorizing new share buyback programs.

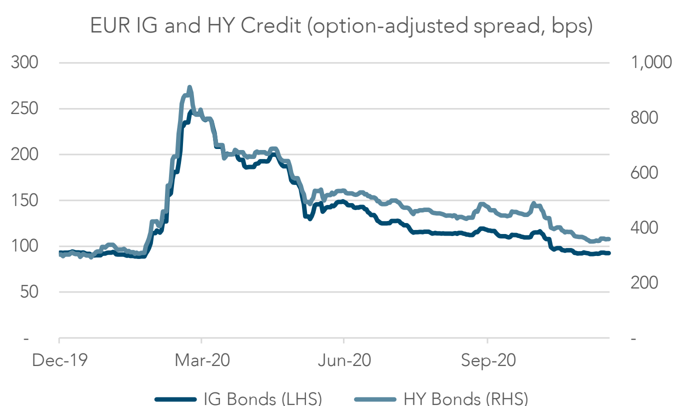
Within the IG space, the best performing sectors over the review period were energy and industrials, posting gains of +2.9% and +3.0% on a total return basis on the expectation of a ramp up in activity. Within HY, Energy was again the best performer, giving +6.7% in total returns over the period.

Looking to the spread breakdown by rating and currency, we again see a continuation of the spread compression theme discussed previously, with lower rated names providing the most room for further compression. Following the moves in the last month, a number of key markets now trade at spreads tighter than those seen prior to the pandemic, most notable of which would be BBB and CCC bonds in Euros. Despite this move, we would note that the monetary policy backdrop today is far different than what it was this time a year ago, and as such, we feel investors should be more comfortable with spreads at current levels today.

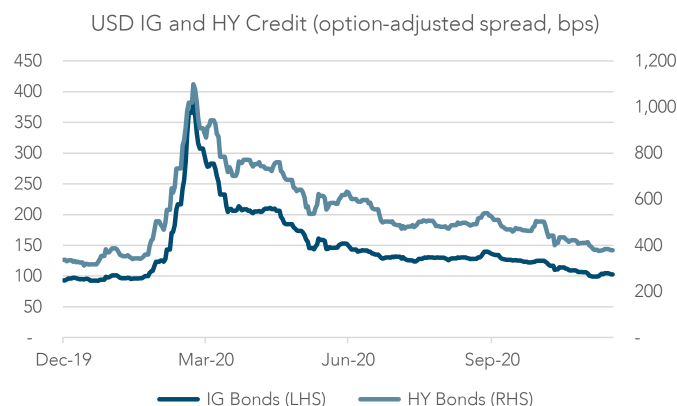
We expect that many of the negative catalysts that have been hanging over the market – the second wave, the US elections, and the EU-UK trade negotiations – will be largely behind us as we progress through the first half of next year. We believe that investors will focus on the roll out of vaccine programs, 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 IG 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. At the last ECB Governing Council meeting, the size of the PEPP was upsized by €500bn (to €1.85tn) and extended by nine months to March 2022. We expect the ECB to continue monitoring inflation and financing conditions closely and deploying this capital as necessary. As expected, the net pace of purchases has moderated slightly in December as primary supply declines into year end and



Source: Bloomberg



Source: Bloomberg

it may become harder for the ECB to source volumes.

Given a strong technical picture, the principal risk to high yield 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 not 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 2H 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. EUR 10 billion per month, despite a recent moderation to roughly EUR 7 billion per month. Euro high grade bond yields average 0.35%, close to all-time lows, making HY credits look like an attractive source of carry.

Our view is that positive cyclical developments are conducive towards a more pronounced reflationary environment in the US, implying an increased risk that the US treasury curve will continue to gradually steepen. Whilst our outlook on US credit spreads remains stable, our opinion is that the risk-return trade-off of holding US dollar duration at this stage has weakened. Given our shifting outlook on a steepening treasury curve, we continue to prefer reducing exposure to dollar bonds and rotating exposure into Euro assets.

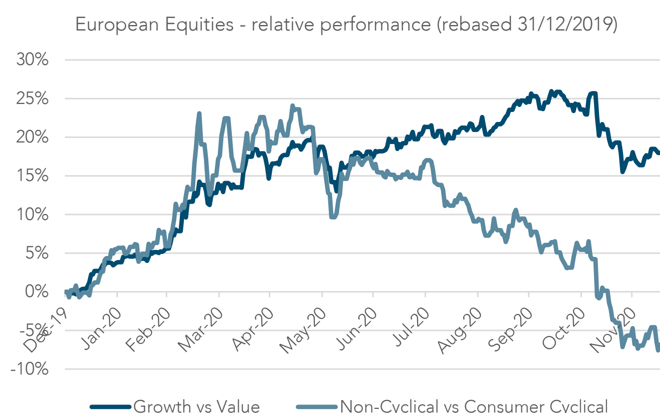
EQUITY

The momentum in equity market performance built up in November was hit by an uptick in uncertainty from surging cases in Europe, as well as the lack of any sort of trade agreement between the EU and UK as the deadline approaches. This led to a sell-off in the week ending 11/12, but most of these losses were recovered in the following week. The quick reversal to us highlights the change in investor sentiment following the vaccine related announcement early in November.

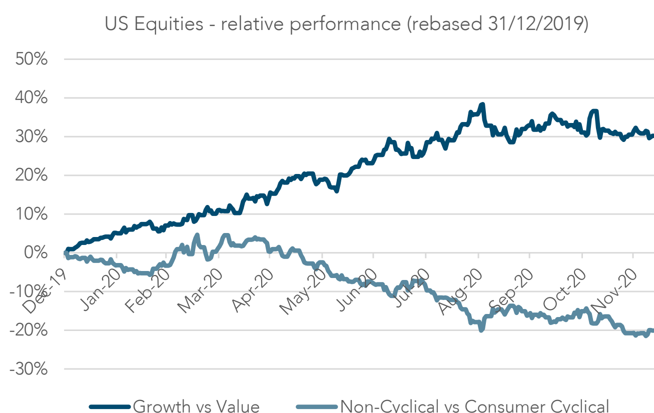
Our outlook for 2021 remains unchanged, we believe that equities will perform well assuming the strong economic recovery currently being expected materialises. Value stocks should outperform growth stocks as conditions improve, although the road ahead in the coming weeks could be bumpy as cases growth will probably accelerate over the Christmas period. The conditions supporting this value rally are not expected to persist. On average, value rotations have lasted circa four months since the global financial crisis, and this rotation should not be any different. Growth, inflation and interest rates are expected to remain supportive for growth names, at least in the medium term. Earnings growth will be another important theme for the equity market in 2021. With interest rates so low, we see little scope for additional valuation expansion in the coming years. Therefore, returns are expected to be driven by earnings growth as opposed to valuation expansion. Valuation expansion has been the key driver of returns for the equity market since the global financial crises.

Global equities rallied 12.8% (in Euro terms) during November, boosted by the positive news-flow around the COVID-19 vaccine. However, equites suffered a minor pullback in December, as investors weighed the impact on the global economy from the surging COVID-19 cases, as well as the rising risk around a no-deal Brexit.

Global COVID-19 cases have now reached circa 72million, with a death rate of circa 2.3%. The number of cases rose throughout the year as countries increased their



Source: Bloomberg



Source: Bloomberg

testing rates, but the death rate has been falling steadily from the 8.1% monthly peak recorded in April to the current 1.8% in December. Italy, Spain and the UK were hardly hit earlier in the year, but Germany has seen a significant increase in November and December. During the first 10 months of the year, Germany recorded c.513k cases in total. Things took a turn for the worse in November however, as 535k cases were recorded followed by 283k so far in December. Worryingly, the death rate has increased to 2.0% in December, up from 1.1% in November and 0.4% in October.

The expectation was always that the winter months will be the toughest in terms of virus hit. There are a finite number of beds available to treat virus victims, and as hospitalisations increase, resources will become stretched. This explains the containment measures announced recently across Europe. This will impact the global economy, as the holiday season is one of the more important spending seasons. However, in the long run, managing this period will be very important for the respective governments and for the health of the global economy as a whole.

The approval and distribution of a vaccine should be the first step towards normalisation. The current base case scenario is for the global economy to recover strongly in 2H 2021. Any delay in the vaccine or containment measures that are enforced for longer than expected, could see this pushed further out, with a higher risk of scarring effects on the global economy.

Over the past decade investors have benefited from valuation expansion, i.e. rising valuation levels, mainly due to the low interest rate environment, against a backdrop of falling earnings. We believe that the current valuation levels leave little room for further valuation expansions, with focus turning swiftly to earnings growth. This will undoubtedly be made easier the quicker we return to some sort of normality, and emphasise the need for a vaccine to be widely distributed in a short space of time. The prospects of an interest rate hike in the medium term appears to be very low.

The divergence in performance between the EU and US equity markets has been subject to much debate. The last time European stocks outperformed their US counterparts was in 2017 (in Euro terms). However, this has been a rare occurrence, with US outperforming 8 times over the period 2010 to 2019. The index composition, especially the skew to growth over value has been one of the key drivers of this outperformance. However, we see that the strong macro-economic recovery expected in 2021, the EU recovery plan and the Green deal to provide are expected to provide a boost to EU stocks. It is no coincidence that the EU stocks outperformed in 2017, following the Trump tax cuts and in a period where economic expectations were improving.

Looking at emerging economies, given the strong exposure to commodities and to global trade, emerging markets generally do well in periods of strong economic growth. The high growth expectations in 2021 and the softer foreign policy approach that is expected to be adopted by the US under a Biden administration is expected to bode well for emerging economies. To this end, we expect laggards such as Latin America to outperform in 2021.

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. 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, on a relative basis, we are becoming more comfortable with maintaining a high exposure given the spread differentials versus sovereigns bonds and the view for stable to 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, in order to earn a higher carry, 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. The scope to remain selective in carrying high yield positions remains while the scope to opportunistically identify unjustifiably discounted bonds is starting to emerge. We continue to seek opportunities on a name-by-name basis. In line with our view last month, we view the minor spread decompression between high yield and investment grade as an opportunity to pick up additional exposure in the space.
Emerging Markets Corporate Bonds	Neutral	N	Confidence to add exposure in emerging market corporate bonds is starting to increase given signs of stabilisation and the reopening of the global economy. This should improve return prospects from emerging market bonds particularly given that US yields continue to trade at relatively low levels while the EM bond market has not yet recovered to the same extent as other bond markets. While our selection remains tilted towards more conservative financial profiles, the scope to continue to de-risk specific positions may be considered on an individual name basis.
Equities	Negative To Neutral	U/W	Our defensive stance in equities due the widening dislocation in valuations against the deteriorating company fundamentals and a challenging economic outlook offered some protection against the pullback in equity markets in June as fears of a second wave started increasing. We prefer to 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. We are turning more bullish on cyclical industries in view of the potential for a vaccine to be approved before the end of 2020 and the impact this would have on sentiment, and consequentially, once it is widely distributed, on the macroeconomic backdrop. We could see a re-rating of cyclical/value stocks if this happens and we are positioning our portfolios to benefit from such a move.

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

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