Investment Strategy Update

January 2021

Curmi & Partners Research

- The surge in COVID-19 cases and deaths continues as major economies fall behind their vaccine roll-out plans increasing the chances of a prolonged lockdown period in 2021.
- Hard economic data released in recent weeks has generally been disappointing, reflecting the weaker economic position at the start of the year.
- Economic activity has slowed in December and will likely remain low in the first few months of the year given the lockdown measures.
- Employment in the UK and Euro Area continues to decline as conditions in service sectors remain weak.
- The improvement of labour market conditions has lost traction in the US as a result of the wave of cases over the winter months resulting in job losses.
- Highly accommodative monetary policy measures and fiscal spending remain in place as authorities continue to sustain economic players during what is hoped to be the last leg of the pandemic.
- The Democratic win in the US Senate gives President Biden the political support to propose a massive fiscal stimulus package, although uncertainty remains on the quantum and timing of the bill.
- Inflation across economic regions remains weak, however, a spike in inflation, namely in the US and the UK, is expected given one-off factors as well as the cyclical economic upturn when economies reopen.
- Breakeven inflation rates trade higher on the back of improving inflation dynamics, leading to a steepening of the US treasury curve and the UK gilt curve.
- Euro Area benchmark yields remain at very low and negative levels, despite the positive market risk sentiment, given the lower growth and inflation expectations compared to other advanced economies.
- Credit markets continue to remain supported by the ongoing central bank accommodative policy through bond buying programmes, the continued access to credit and capital markets, the favourable financing conditions and the improving business prospects.
- The high public and private debt levels do not seem to be of concern to investors given the expectations of a strong recovery and the backstop provided by major central banks in keeping borrowing costs low.
- Our preference is to maintain an overweight allocation in corporate credit given our view on benchmark bond yields and spreads.
- The expectations that we will transition into an early cycle type of environment when economies reopen is underpinning our preference to maintain a tilt towards lower rated bonds within the investment grade and high yield bond markets.
- Our medium term outlook for equities is positive, however we remain cautious in the near term given the high market complacency and the risk of a correction following the strong rally since November.
- We continue to gradually increase our equity exposure at the opportune time, in order to enhance our sensitivity to the cyclical and value rotation trade through selected positions in key sectors.

Whilst markets have generally maintained an upbeat tone in the first few trading weeks of the year, the harsh ongoing reality of lockdowns on businesses and consumers is being reflected in the string of disappointing hard economic data across major economies.

The baseline expectations that containment measures will be lifted in the second quarter, thus allowing economies to rebound strongly, is coming under serious doubt given the experience so far with the roll-out of the vaccine. The UK, after being the worst hit by the pandemic, is seen to be outpacing other economic areas in the rate of inoculations. The story in Europe is sadly much worse, with inoculations in the largest economies going at a snail's pace.

In any case, markets remain optimistic on the eventual economic recovery, eyeing strong growth in economic output in the second half of the year. Risky assets, particularly high yield bonds and equities of entities operating in cyclical sectors, have been in favour on the expectation that the hardest hit sectors will benefit from the strongest upswing when economies reopen.

The prolongment of lockdown measures means that economic performance in the first quarter of the year will most likely be worse than previously expected. This, combined with indications that actual GDP data for Q4 2020 will also be weak, shows that the economy will take a longer period of recovery to reach pre-pandemic levels of activity and output.

Whilst our baseline thinking is that we are in the process of coming out of the crisis, the challenges with the deployment of the vaccine will be the main source of uncertainty for the time being. This will keep a lid on possible selling pressure build-up in safe haven assets.

Beyond that, however, the scope for advanced economies to see a rapid pace of recovery propelled by the unusually high and coordinated fiscal and monetary stimulus can quickly take us in an early cycle type of environment which is more favourable for risky assets.

Given the stronger reflationary dynamics in the US and the grand fiscal stimulus plan of President Biden are expected to lead to another period of economic divergence between the US and the Euro Area. Expectations of such conditions are already reflected in the widening differential between the US treasury curve and the German sovereign curve, particularly at the longer-end. We believe that the divergence is expected to continue to grow and the US curve to steepen throughout the year. On this basis, we prefer to reduce our duration exposure in USD-denominated bonds in favour of EUR-denominated bonds where the conditions for low benchmark yields remains.

Moreover, we continue to favour maintaining a higher sensitivity to spread movements by increasing exposure to longer-dated investment grade bonds and high yield bonds in cyclical sectors. We expect such bonds to continue to benefit from a benign credit environment, favourable financing conditions and the strong growth prospects.

The downside risks to our overall positive equity outlook are the elevated market complacency, when considering the ongoing economic challenges, and the risk of negative surprises in the process of flushing out the virus. Whilst we remain cautious in increasing our beta position, we continue to identify pockets of value and select stocks in sectors which we believe are likely to rebound strongly during the impending economic expansion. Our higher sensitivity to the cyclical rotation is balanced by the positions we continue to hold in Tech stocks and the long duration exposure in bonds.

MACRO

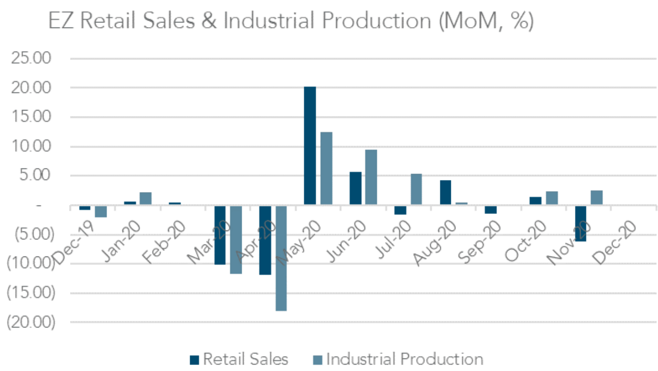
Euro Area

The forecasted contraction in the last quarter of 2020 was revised up to 2.4% quarter-on-quarter from earlier expectations of a 3.0% quarter-on-quarter contraction. The upward revision came despite the expected decline in retail sales over the December festive period.

Fourth quarter retail sales dropped drastically as governments implemented new measures amidst rising COVID-19 cases and deaths. Some major EU economies introduced stricter measures or even implemented lockdowns towards the end of Q4, causing a slump in what was expected to be a month of recovery in retail sales due to the festive season.

Initial news regarding vaccine roll-outs pushed economic sentiment indicators higher in December, however remain below pre-pandemic levels. Since then, economic sentiment is expected to have dropped further given the disappointing vaccine roll-outs across the Euro Area, including in major economies, mainly Germany and France where roll-outs were particularly slow. That said, the Euro Area increased its confirmed purchases from 1.8 vaccines per person to 2, which should increase the pace of inoculations.

Industrial production saw an increase of 2.5% in November almost entirely due to Ireland which rose by c. 50% month-on-month. Business surveys are suggesting a further increase in December due to expected increases in industrial production. In fact, Manufacturing PMI stood at 55.2 in December compared to November's 53.8.



Source: Bloomberg

It is expected that the Euro Area would start 2021 on a weak note as virus infections and deaths continue to increase further into the new year, with economies implementing stricter measures and extended lockdowns.

The new lockdowns and measures are less likely to result in the significant impact seen in the first round of lockdowns of April. There is however an increasing chance that the economy will stagnate or even contract should lockdowns be extended even further.

That said, the markets remain cautiously optimistic that the vaccine roll-outs will allow governments to lift restrictions during 2Q2021, resulting in a slow but gradual sustainable recovery during 2H2021. In all Euro Area economies, the future Composite PMI increased, suggesting that firms were becoming more optimistic vaccine roll-outs will boost activity. However, this boost is highly dependent on the pick-up in the pace of vaccinations. Therefore, given the current slow pace, the expected boost may be seen later than wanted.

Inflation remained weak at end 4Q2020, with both core and headline inflation remaining unchanged, at 0.2% and –0.3% respectively from around September levels. Core inflation is anticipated to increase in 2021 with the reversal of Germany's VAT cut, together with the gradual rise in clothing and holiday prices, however will remain below 1%. Both core and headline inflation rates are expected to remain below the ECB target of 2%.

Meanwhile, investors' long-term inflation expectations remain low as seen in December's 5y5y forward rates of 1.26% and 10-year EUR German yield of -0.57%.

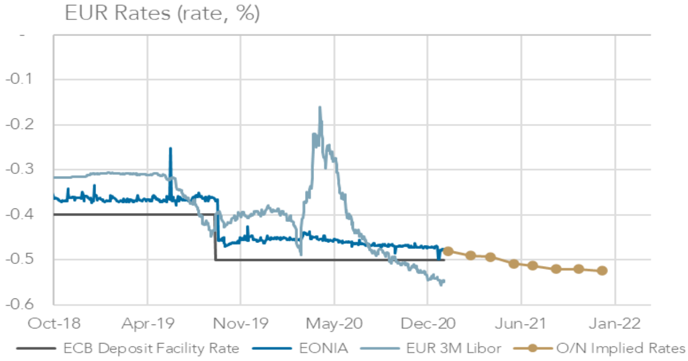
The unemployment rate saw a reduction in December to 8.3% from prior month's 8.4%. This occurred even though there was a rise in inactivity, with short-time work schemes helping to maintain the levels across the Euro Area. The number of persons entitled to these benefits would have increased during the recent lockdowns given the closure of non-essential stores and other industries, however remaining below first lockdown levels.

It is expected that unemployment will continue to rise in 2021 and will unlikely regain 4Q2019 7.3% levels until 2022. It is more than likely that governments will keep a lid on unemployment during 1Q2021. However, as the economy reopens on the easing of restrictions, governments will reduce said schemes, with the number of jobless persons increasing as a consequence.

The recent lockdowns did not cause a surge in bank lending to firms. Consumers once again took the opportunity to deleverage, causing consumer credit to fall sharply. Firms might need to take advantage of government-guaranteed loans to replace lost revenues should lockdowns get extended further.

The TLTRO's improved terms include an increase in bank borrowing amounts which should help keep credit flowing. Policymakers approved more long-term loans on cheap terms for another year until June 2022 and announced four additional pandemic emergency longer-term refinancing operations to be offered in 2021.

The ECB has reduced its bond-buying in December in line with previous years, however is still higher than pre-pandemic levels. The strong pace of asset purchases is viewed to continue in 2021.



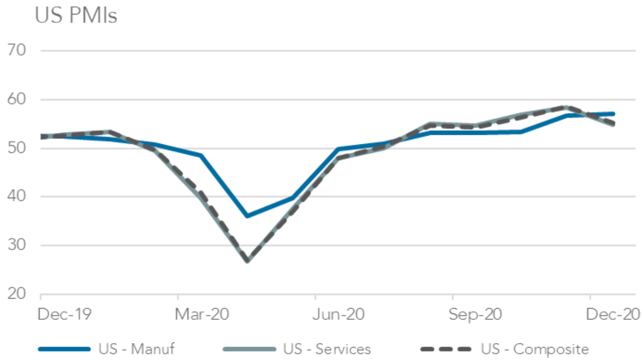
Source: Bloomberg

Extended lockdowns further indicate larger budget deficits for 2021 than previously expected due to the €1 trillion bonds issued by the Euro-zone government. The ECB will continue to indirectly finance this borrowing throughout 2021.

Furthermore, an agreement was reached over the EU's multiannual budget, making way for the EU to begin disbursing its Next Generation EU funds later this year, with southern Euro Area countries benefitting the most.

United States

The surge in virus cases and increased measures is weighing on the economy, with GDP growth expected to slow down during Q4. In fact, forecast figures show an annualised quarter-on-quarter GDP growth of 4.3% in Q4 compared to actual annualised 33.4% quarter-on-quarter growth in Q3.



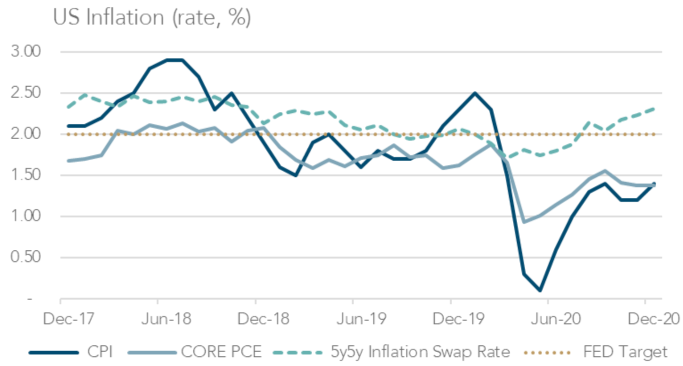
Source: Bloomberg

This sentiment is expected to continue into the first quarter, despite the optimism of the fiscal stimulus news as nationwide vaccine roll-outs are slower than anticipated. In fact, Composite PMI for December was of 55.3, a decrease from the 58.6 November 68-month high level, further signalling the slowest upturn in business activity.

Towards the end of Q4, retail sales experienced an even further slump due to nationwide restrictions. In contrast, industrial production figures show a continuing increase in manufacturing output, namely in utilities due to the cold months and despite a decline in autos production.

The recovery in production is behind the rebound seen in consumption, with goods consumption about 10% above February levels, while production levels are 2.6% below February levels. This discrepancy indicates that consumer goods output has fully recovered but production of business equipment and materials is still lagging.

It is anticipated that production will continue to expand over the early months of 2021, rebuilding inventory to more 'normal' levels. Furthermore, the December increase in the ISM manufacturing index to 60.7 from 57.5 indicates that the manufacturing sector will remain resilient to the continued increase in virus cases, with the factory sector escaping relatively unscathed during 2021.



Source: Bloomberg

Inflation remained low at the end of 4Q2020, with headline CPI inflation increasing to 1.4% in December, while core inflation remained unchanged at 1.6%. However the rebound in energy prices and strong base effects are expected to push inflation briefly above 3% during 2Q2021, with further expectations that both headline and core inflation to remain at c. 2% during 2H2021. The expectations of 2H2021 are dependent on the assumption that vaccination roll-outs are a success and the easing of restrictions occurs by summer months, returning to the 'norm' by 2H2021.

The US labour market experienced a stagnation in recovery during December, with the unemployment rate remaining unchanged at 6.7% as a result of further measures against the continually increasing outbreak.

Payrolls took a plunge as the leisure and hospitality sector closed across the country. With virus cases rising, payrolls could fall further in January, however most indicators suggest that the economy is still holding up.

Jobless claims increased amid new restrictions, with the 4-week moving average increasing to 834.25 thousand in the second week of January compared to the previously week's level of 816.0 thousand. Moreover, c. 284 thousand persons (previously c. 161 thousand) applied for the Pandemic Unemployment Assistance scheme.

During the final weeks of December, Congress agreed to a stimulus package of $900 billion, due to expire in March 2021. Incoming President Joe Biden proposed an additional fiscal stimulus of c. 9% of GDP ($1.9 trillion) just a few days prior to his inauguration. This will include $1,400 cheques (making a cumulative of $2,000) and an increase in unemployment benefits to $400 a week, with this scheme running until at least September 2021. It is however still uncertain whether the Senate will support the entire proposed plan.

Biden is also pushing to raise the minimum wage to $15 an hour from the current $7.25. This sudden increase may cause dire problems for some states.

Biden's major legislative priorities including a large Green New Deal-style infrastructure package partly funded by higher taxes on high-income individuals and corporations are still unlikely to become a reality, with analysts not adjusting for this event in their forecasts.

The Fed continues to signal that ultra-loose monetary policy is here to stay, with no rush to offset further fiscal stimulus through monetary tightening. Analysts view economic growth forecasts to be more dependent on the rate of vaccinations than on the fiscal spending plans given the doubt that the full package will be backed by the Congress.

United Kingdom

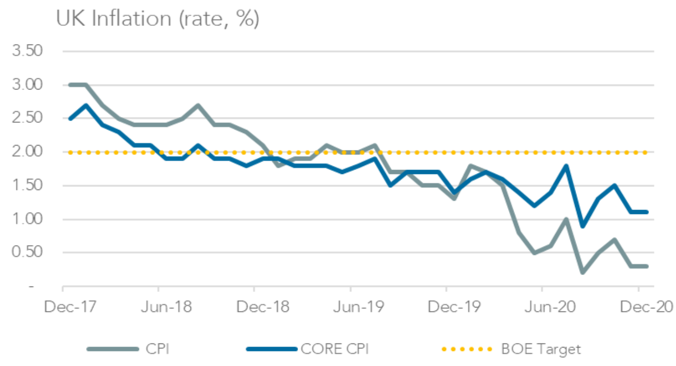
The United Kingdom GDP growth followed suit, with 4Q2020 not contracting to the severe levels previously anticipated. The forecasted quarter-on-quarter contraction was of 1.5% compared to survey results showing expectations of a contraction of 2.7%. In fact, November levels fell by 2.6% month-on-month compared to the market consensus of 5.7% month-on-month.

This indicates that the double dip recession expected as a result of the second lockdown at end Q4 will probably be avoided as the drop was not as severe as in the first lockdown where the economy contracted by 18.8%.

Although the third lockdown implemented at the start of 1Q2021 will likely take GDP to even lower levels as schools are forced to close, further slowing down recovery, the contraction will still not fall as significantly as feared since the only differing aspect from the second lockdown is that of the closure of schools.

Retail sales during November fell overall by 3.8% with the closure of non-essential retail stores, however still remaining at 2.7% above pre-pandemic levels. Consumer confidence indicators and surveys fared better during December, and Services and Manufacturing PMI ticking higher for the month. These factors further iterate that the contraction will not be so severe.

The UK is amongst the top countries with the fastest vaccine roll-out pace, having (as at document date) vaccinated c. 6% of the population. This pace has kept the economy optimistic that economic recovery should start during 2H2021. This rebound is likely to return the economy to pre-pandemic levels by c. 2Q2022.



Source: Bloomberg

The UK's departure from the EU Single Market in December will increase border costs, weighing on net exports going forward, further weighing on GDP recovery.

CPI is expected to rise quite sharply towards the target 2.0% inflation in the Spring months as the VAT cut comes to an end and the large fall in energy prices seen in early 2020 drops out of the annual comparison.

The number of unemployed persons increased during November, with c. 2.7 million persons claiming for unemployment benefits (an increase of 2.5% over October and 114.8% over March). The unemployment rate is expected to increase further, with the 4Q2020 forecast at 5.4% compared to the 3-month rate (ending October) of 4.9%, even though the Coronavirus Job Retention Scheme continues to support employment. According to OECD, the unemployment rate is projected to be on average 7.4% during 2021, this figure being contingent on the country's health going forward.

The BOE voted unanimously to maintain the Bank Rate at a record low of 0.1% and the size of the bond-buying programme at £875 billion during its December meeting, as policymakers took a wait-and-see approach amidst uncertainty surrounding a post-Brexit trade deal and concerns over the pandemic situation.

The third lockdown may prompt the BOE to loosen monetary policy further with markets pricing in a greater chance of the BOE cutting interest rates from +0.1% to below zero within the next two years which contributed to the fall in the 2-year gilt yields from –0.05% to –0.15% in December and in the 10-year gilt yields from +0.30% to +0.19% over the same period. The BOE is however resistant to negative interest rates as it believes banks are not operationally ready, with there being more likelihood of an increase in quantitative easing. The BOE has yet to move forward on the extra £150 billion quantitative easing announced in November.

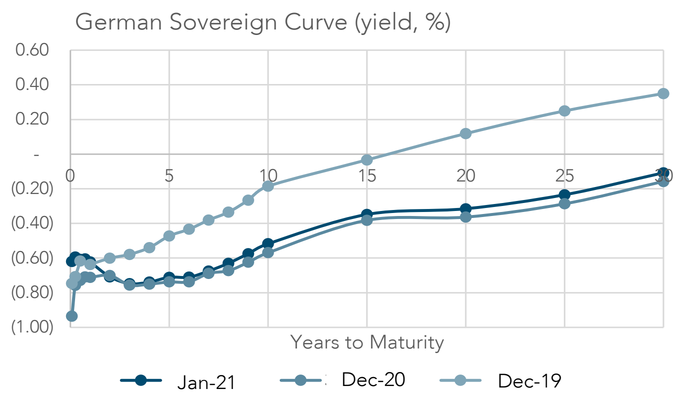
The £31.6 billion (c. 50% month-on-month increase) of public sector net borrowing (exc. banking groups) in November was the third highest on record. Government current expenditure rose to £80.6 billion in November, with an additional £5.9 billion spent on furlough schemes. Government spending will likely remain high in Q1 given increased restrictions.

RATES

Euro Rates

German bund yields have moved in tandem with the sharper changes seen in the US 10-yr treasury in the month of January but resulted in a more modest steepening in the German curve. The widening differential in US-DE 10-yr yields remains driven by the weaker inflation dynamics in the Euro Area, the fiscal policy efforts in the US outpacing Euro Area initiatives and the growth outlook in the Euro Area implying a slower rate of recovery. Moreover, the ECB is expected to keep rates unchanged and the quantitative easing ("QE") programmes in place for longer.

The latest ECB minutes show an element of disagreement around the December decision to expand the pandemic emergency purchase programme ("PEPP") by an additional EUR 500 billion. This is partly stemming from the fact that the previous target of purchases had not yet been fully utilised. Overall the communication is consistent with the changing view that the ECB is becoming more focused on yield levels in order to maintain easy financial conditions as opposed to the quantities of bond buying.



Source: Bloomberg

This is also consistent with our earlier assessment that further monetary injection (through bond buying programmes) is losing effectiveness given the high amounts of liquidity in the system and the tight, and in some cases negative, money market spreads.

Some widening in country spreads since the start of the year is partly explained by the rising political tensions in Italy with Italian government bonds showing a more pronounced widening. The downward force on benchmark bond yields and tighter sovereign spreads coming from the ECB action seems to have peaked at this stage. The recent policy adjustments are viewed as having over-delivered on what is required at this stage to protect (not enhance) the easy financial conditions in the Euro Area.

The first quarter is seasonally a strong period for supply in the euro sovereign bond market (around 30% of gross annual issuance generally is done in the first three months of the year). This front-loading is expected to be more pronounced this year given the spending requirements of governments to combat the virus crisis. It is expected that the ECB will step up the pace of purchases (following the Christmas period lull), due to the increased issuance.

Given the capital-key guidance in the distribution of purchases across countries, it is expected that the ECB take up of net-issuance may vary to a greater degree given the differing budget requirements (Germany expected to run smaller deficits compared to peers this year) – this implies that the required private sector take up of net-issuance is higher for Spain, Italy and France. This further underscores the limited further upside in the European government bond market coming directly from ECB action.

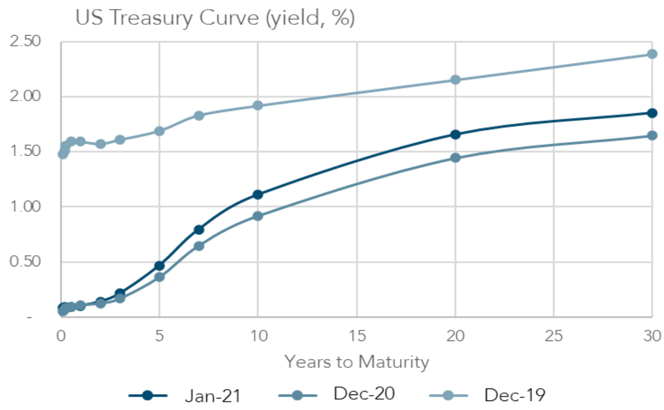
As a result, we expect investor focus to gradually shift more towards the progress in economic data and the roll-out of the vaccines across Euro Area countries.

In conclusion, we see limited scope for further curve returns for the time being. At the same time, current economic conditions and inflation expectations in the Euro Area are expected to continue to support flat benchmark curves, with little risk of sell-off in long-end yields. The scope for stable, possible tighter spreads remains. On this basis, our preference to maintain a pronounced long duration position has substantially moderated while the scope to favour carry trades in EUR remains.

US Rates

Reflationary forces gained traction with the sizeable stimulus package plans announced by the new Biden administration. However, the sharp upward movement in long-end treasury yields since the start of the year so far seems to have calmed.

The near-term risks to the reflationary trade are two-fold: (1) uncertainty on the size of the fiscal package and (2) the downbeat market tone, reinforced by dovish Fed communication and the worsening COVID situation in the US.



Source: Bloomberg

Over the medium-term, the higher degree of policy response and coordination bode for a stronger rate of recovery in the US which increases the scope for market anticipation of an earlier policy normalisation by the Fed. Expectations of an inflation spike this year is driven by base-effects and the basis for an accelerated recovery in economic activity as COVID-19 restrictions are wound down. However, we need to assess whether this is true inflation build-up or the result of short-term imbalances in demand-supply dynamics that leads to a temporary shock in prices.

In the meantime, discouraging economic data in the US increases concerns that the economic momentum is fading, particularly when looking at the rise in unemployment benefit claims and the weak retail sales data showing a decline in spending.

The basis for long-end yields to continue to move higher this year are primarily attached to the expectations of an increase in inflation driven by the strong growth expectations. In turn, the latter assumption is principally dependent on government spending and a successful roll-out of the vaccine.

The downside risks to the economy in the short term, which include the fading economic momentum and worsening health trajectory, and the dovish stance of the Fed will continue to hamper any sharp movements higher in long-end treasury yields for the time being. Having said that, the scope for further steepening in the curve over the medium term remains intact, primarily given the:

1. Evidence of early cycle dynamics building up supported by easy fiscal (and monetary) policy stance;

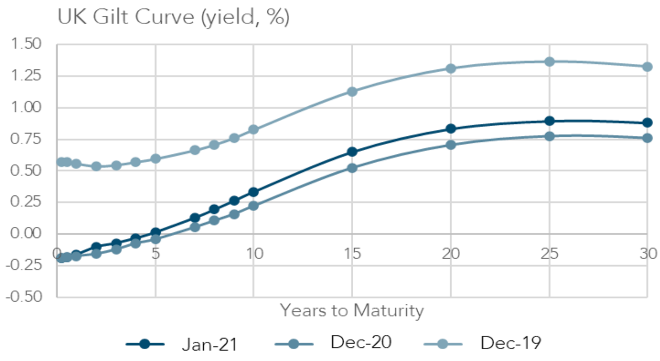
2. Expectations of strong growth and inflation data from 2Q onwards;
3. Abating health risks on the back of a successful vaccine roll-out and a corresponding unwind of containment measures;
4. Potential for growing anticipation of early policy normalization by the Fed (so far unlikely and highly dependent on the other factors mentioned above).

UK Rates

Long-end gilt yields have traded higher given the positive risk sentiment at the start of the year as the generally faster vaccine roll-out in the UK is underpinning expectations of a strong rebound later this year outpacing other advanced economies.

The rise in breakeven inflation rates in December on the back of the growing Brexit fears have subsided once a deal was struck with the EU since the risks of substantial weakening in the pound leading to a sharp rise in inflation have largely been quelled. In January, breakeven rates given the vaccine optimism and strong growth prospects which generally resulted in the steepening of the curve.

Short-end yields remain fairly anchored in view of the Bank of England's commitment to maintain rates at the current low levels as well as the on-going gyrations on the pros and cons of the introduction of negative interest rates. The market has reduced the expectations of a rate cut at the next MPC meeting following Governor Bailey's comment on negative rates, highlighting a growing focus on quantitative easing measures as the main policy tool of the central bank.



Source: Bloomberg

Assuming that the current pace of purchases is maintained during first quarter and then reduced to half in the second quarter, the QE purchases are expected to outpace the net guilt supply leaving an unutilized portion of circa GBP 25bn of the targeted purchases for the second half of the year. The BOE will communicate the pace and target size of purchases in the February meeting. In the unlikely scenario that the pace of purchases is stepped up, the current pace of purchases is expected to continue to support the gilt market in the first quarter.

Central bank action continues to hamper any sustained upward movement in long-end yields driven by improving growth and inflation expectations whilst front-end yields remain firmly anchored. Given the short-term downside risks and uncertainty in growth forecasts, the scope for further steepening in the gilt curve is more likely to happen once the economic recovery gains traction.

CREDIT

Corporate credit markets experienced a contraction in spreads as yields have continued to tighten over the last few weeks of December and in early January. Central banks have continued to offer their support to corporate bond markets, particularly within the investment grade segment of the market, with highly accommodative monetary policy through asset purchase programmes and historically low rates.

Notwithstanding the slowdown in the rally in the final days of 2020, Q4 has generally seen a sharp return to risk-on trading, with risky assets in high demand despite the discovery of new strains of the virus found in different parts of the globe.

Our expectations on the vaccine recovery trade remains unchanged. Further, we expect that investors will remain focused on the pace of the global roll-out of the vaccine, which will eventually allow for a normalisation in pandemic-affected industries. Whilst the timing of the roll-out remains uncertain following global delays in distribution, we expect that as the strain on healthcare systems eases and some degree of normalcy returns, a boost to consumer spending will likely follow.

We expect spread compression to remain the driving theme in the corporate credit market for the time being with HY continuing to outperform as economic activity improves and fiscal stimulus is deployed. Whilst this remains our base case, we note that a large amount of optimism is already priced into credit markets, implying a lower scope for outperformance than we noted prior to the 4Q2020 risk-on rally, underlining our preference for HY credit over IG and the focus on credit selection.

We expect volumes in primary markets to be relatively light in 2021 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 HY 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.

Given a strong technical picture, the principal risk to HY is that credit losses continue to climb due to short-term fundamental or structural issues. The resurgence in infections over the recent months acts as a reminder that the benign default environment cannot be taken as a given. The initial positive narrative surrounding the vaccine roll-outs has changed given the slower pace in roll-outs than originally anticipated. This implies that default rates may continue to increase in the short term, only to subside over 2H2021, meaning that idiosyncratic risks will remain a crucial driver of both risk and return for the time being.

The number of corporate defaults globally totalled 209 in 2020, nearly double the count from 2019, with the oil and gas, business services and retail sectors accounting for most of the defaults. The trailing 12-month global speculative-grade default rate was 6.6% at end December and will climb to 7.3% in March before falling to 4.7% at end 2021 under baseline Moody's forecasts.

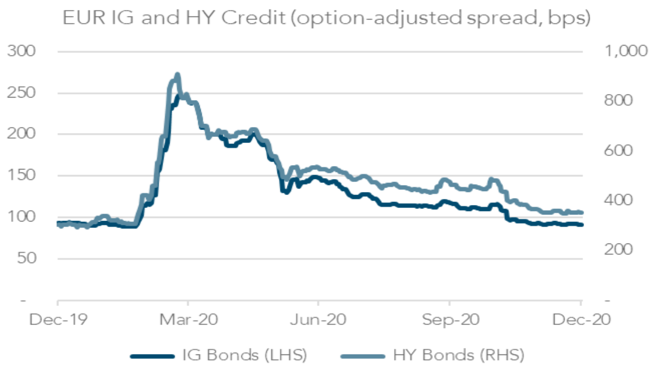
Despite the possibility of a short term rise in default rates given the expectation of a prolonged vaccine roll-out period, we expect that demand for HY debt will likely remain high given accommodative monetary and fiscal stimulus, while IG debt with a return close to zero is relatively less attractive. We therefore expect lower-rated bonds will continue to outperform in 2021 given greater scope for spread compression, and remain better isolated from interest rate risk should there be volatility in benchmark rates.

Within the HY space, we see scope for the harder hit sectors to outperform and would have a preference for services, entertainment and leisure issuers with ample access to liquidity to meet the needs of the business over a prolonged recovery period if necessary.

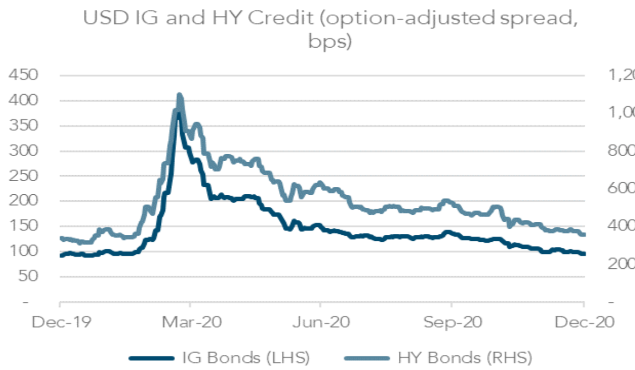
At this stage, any rise in uncertainty over future accommodative monetary policy is the major fear for fixed income investors and possibly the greatest risk to the fragile recovery over the coming year. That said, for the time being, there is no reason to expect the general level of monetary support to change during 2021. During the December ECB Governing Council meeting, the size of the PEPP was upsized by €500 billion (to €1.85 trillion) 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 with a focus on maintaining low yields to maintain accommodative financial conditions rather than hitting target purchase numbers. Similarly, in a recent statement aimed at easing investor concerns, Fed Chairman Powell reiterated that the bank is far from considering an exit from its ultra– loose monetary policies.

We expect 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 opinions 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 EUR assets.

With inflation currently running at very low levels, 2021 looks set to see a reasonable recovery, albeit to remain below long-term targets for the time being. Typically, periods of rising inflation are costly for fixed income investors, leading to higher interest rates that place pressure on bind pricing. However, central banks appear committed to limiting any increases in nominal benchmark yields even as inflation picks up, so as to prevent an unwanted tightening of financial conditions. Counterintuitively, if increases in inflation are fairly modest and central banks are successful in mitigating rising benchmark rates, a resultant tightening in credit spreads could theoretically be positive across higher risky fixed income assets currently trading at wider premiums.



Source: Bloomberg



Source: Bloomberg

EQUITY

Equity markets have rallied strongly since the Pfizer announcement in November, with the 4Q2020 being the strongest last quarter for global equities since 2005. Further, 4Q2020 was the best fourth quarter for global value stocks since 2016, as investors started to price in their expectations for a global economic recovery from the pandemic shock in 2021.

European value stock fared even better, with the level of performance for value stocks during the fourth quarter only being exceeded by the fourth quarter results of 1999. Value stocks have lagged for most years since the financial crisis with growth stocks having established a clear market leadership for many years.

The powerful rotation to value in November saw an outperformance of European value stocks over growth stocks of 11.0%, which is thought to last longer. The main drivers for this outperformance include falling economic growth expectations, higher uncertainty and falling interest rates and bond yields.

In view of the falling long-term growth expectations, investors were prepared to pay a higher premium for stocks that they believed could grow at a faster pace than the market. Value stocks, with their high economic beta, perform better when economic growth is accelerating and vice versa. The higher uncertainty over the near-term economic growth was a key factor for investors to opt for stocks that could grow earnings notwithstanding the economic backdrop. Additionally, falling bond yields led to a higher risk of deflation. This resulted in long-duration equities being more valuable on a relative basis. The lower interest rate environment has weighed on traditional value sectors like banks and insurance companies. This meant that investors require a higher return to invest in the asset class.

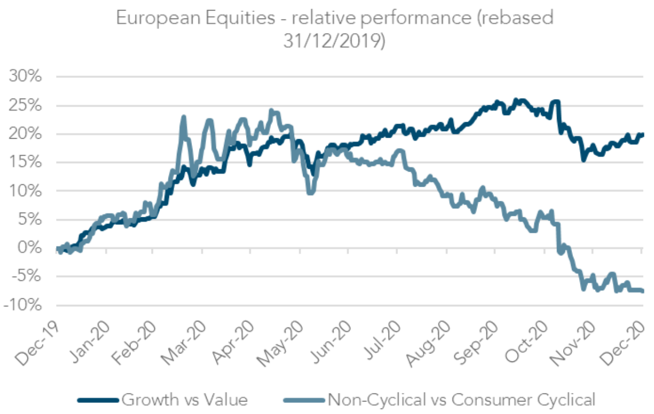
This outperformance infers a very high bar in terms of investor expectations and downside risk should the much-hyped economic recovery fail to materialise. We expect there is a good reason for this optimism, assuming that the news around the vaccine is accurate.

The valuation gap between growth and value is currently at extreme levels, following the outperformance (in growth) seen over the past 12 years. It is important to caution that extreme valuation is rarely a trigger for a major rotation. Global growth stocks are currently trading at a 91.7% premium to value, compared to a 10-year median of 26.6%. The valuation premium has been expanding at a faster pace since 2018, during the trade spat between the US and China (investors paid a premium for stocks that could grow notwithstanding the headwinds for global trade), and continued to pick up pace this year due to the outperformance of the "stay-at-home" stocks. Although we do not expect the valuation gap to fall to median levels, it is reasonable to expect that the conditions in the near term will result in a lower valuation premium that is currently the case.

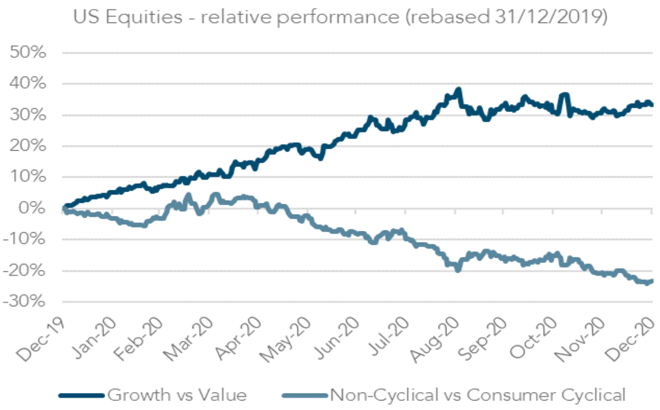
There is room for certain value stocks to rally as they have lagged the rally due to the continued impact of the pandemic. If the vaccine is as effective as the regulators are announcing, and if the vaccine roll-out is effective, there is no reason to believe that these sectors will not recover. It is becoming clear that risks for the equity market are starting to subside, which should bring about a fall in the equity risk premium, a positive for equities. At this stage, we do not anticipate a multi-year rotation in stocks.

European equities remain unloved with outflows reported for most of 2020. The region is considered to have a value tilt, which means that the conditions mentioned previously should boost performance. A number of risks faced by the EU have subsided, with the EU Recovery Fund being a significant step forward, Brexit now finalised and with an unusually light political agenda (election in the Netherlands in March and German federal election in November).

Over the near term, we continue to believe that developments over the vaccine and the implication on wheth-



Source: Bloomberg



Source: Bloomberg

er curtailment measures will persist for longer than expected will remain key drivers of performance for the equity market. The risk of a correction in the near term is increasing as some complacency has creeped in, but we remain positive on the asset class for the full year.

We are entering a period that should see strong synchronized global economic and profit growth. The measures taken by governments and central banks will help, but the expected pick-up in personal consumption should be a significant contributor to economic growth, especially when looking at the high consumer savings ratio. This should be supportive for sectors with a high economic beta.

With the Democratic party in the US winning control of both the House and the Senate, it is very likely that there will be another round of fiscal stimulus in the US. Additionally, the EU seems to have softened its stance on budget deficits in view of the COVID-19 impact, with several measures announced during 2020. The current expectation is that fiscal support within the EU (and the UK) will remain strong during 2021. This marks a significant change from what happened after the financial crisis, when the EU persisted on the tough balanced budget targets, eroding any possibility of economic growth for a number of EU member states, especially the Southern European countries.

The financial conditions index remains remarkably easy. There are no signs that central banks will shift their stance in the near term s inflation remains very low. The combination of loose monetary and fiscal policy should, in theory, lead to higher inflation in the near term. However, we are starting off from a very low base.

The outperformance of growth versus value appears more likely when considering that we should be entering a period of synchronized global economic and profit growth while interest rates are at or below zero, fiscal policy is supportive and financial conditions are loose with commodity prices rising.

Key risks over our view mainly include: (1) the new virus variants that have emerged in the UK, South Africa and Japan, which appear to be more transmissible, represents a threat to near term growth in the form of longer/stricter curtailment measure; and (2) structural issues such as low inflation, falling growth expectations and high debt, may still act as a headwind for equities.

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Sovereign Bonds	Negative	U/W	Investments in Sovereign credit have diminished, with the vast majority of benchmark issues pushing deeply into negative yielding territory. The outlook for periphery credits remains well supported, but as noted in previous updates, the strong rally seems to be showing some signs of fatigue at current levels. However, following the launch of the EU Recovery Fund in January and additional monetary stimulus could add momentum going forward. We maintain an underweight stance in sovereigns given the predominantly negative yield on offer for the asset class in absolute terms. We see a risk of higher inflation in the medium term, and on that basis, we remain tactically underweight.
Investment Grade Corporate Bonds	Neutral to Positive	O/W	Investment Grade Corporate bonds remain attractive, however, on a relative basis, we are becoming more comfortable with maintaining a high exposure given the spread differentials versus sovereigns and the view for stable to tighter spreads. Central bank programmes are offering strong support and this is expected to continue to sustain the current levels of 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 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 stabilize. Whilst we are comfortable with holding high cash balances, it is relevant to seek yield opportunities.
High Yield Corporate Bonds	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	There is increased confidence in the EM corporate bonds, as the market as at current has 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	Neutral to Positive	N	We still retain an overall underweight allocation in equities combined with an overarching factor tilt towards quality stocks and growth stocks. However, we 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 believe there is good reason for optimism of an economic recovery, assuming that the news around the vaccine is accurate. We believe also that there is room for lagged pandemic-effected value stocks will rally should the vaccine roll-out be as effective as expected. Over the near term, we continue to believe that developments over the vaccine and the implication on whether curtailment measures will persist for longer than currently expected will remain a key driver of performance for the equity market. The risk of a correction in the near term is increasing as some complacency has creeped in, but we remain positive on the asset class. 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