Investment Strategy Update

February 2021

Curmi & Partners Research

- COVID-19 cases and case growth rates have been declining since the start of the year given the recent round of lockdown measures.
- Economic data releases have been mixed, with the US showing marginally positive activity trends compared to the Euro Area and the UK.
- Survey data releases remain mostly optimistic in the US given the relatively fast vaccination rate and the substantial fiscal spending plans compared to other advanced economies.
- Inflation in the US has so far been subdued but it is expected to rise sharply as base-effects kick in and economic momentum gains traction.
- Euro Area inflation surprised to the upside in January with core CPI reaching 1.40% primarily due to one-off factors.
- Inflation data across advanced economies is expected to rise sharply in the near term given the expectations of a surge in demand and spending, as economies lift containment measures, compounded by strong base effects on year-on-year comparisons.
- Central banks are not expected to communicate a change in stance for the time being, despite the rising inflationary expectations given that underlying economic conditions have not yet normalised.
- We remain optimistic on growth expectations particularly in the US and the UK where the vaccine roll-out was more successful, while the expectations of a recovery in the Euro Area have been pushed out due to the vaccination delays.
- We expect market sentiment to remain positive given the growing evidence that economies are heading into an early-cycle type of environment.
- The US treasury curve is expected to continue to steepen given the strong inflation expectations and the scope for markets to expect an earlier normalisation of monetary policy by the Fed.
- Benchmark yield curves in Euro Area and the UK may steepen further as a result of the improving cyclical developments and the unlikelihood that the ECB and BOE introduce new stimulus measures any time soon, but the risk of a sustained sell-off in benchmark bonds remains low.
- We prefer reducing duration risk for the time being and maintaining higher cash allocations with the scope of adding back duration at better yield levels.
- Our outlook on credit spreads remains positive and we continue to prefer lower-rated IG and high yield bonds in order to boost spread returns.
- We continue to gradually increase our equity exposure given the expectations on growth and business conditions by selecting quality companies that are expected to outperform during the recovery.

The gradual decline in new cases and the tapering off of case growth rates following the recent round of lockdowns is boding well for global economies. At the same time, vaccination programmes are underway with some countries, namely Israel, UAE, UK and US showing success in achieving faster inoculation rates. Supply shortages and public hesitation is slowing down the process in other regions, particularly in the Euro Area, with France and Germany achieving very low vaccination rates.

In any case, it is still early to assess the positive economic benefits from the vaccines in advanced economies. Governments and health authorities do not yet have the confidence to lift restrictive measures given that the number of inoculated individuals has not yet reached a critical scale.

However, economic expectations are favouring those economies showing greater success with the vaccine roll-outs. The US, in particular, is reporting sequentially improving growth data which is expected to garner further support from the substantial fiscal stimulus package which has been put forward by the Biden administration. The size of the stimulus package of $1.9trn, in addition to the previous programmes launched in 2020, far outpaces the fiscal efforts of other advanced economies. Should the full package be agreed upon by the US government, we see high scope of stronger economic divergence when compared to UK and the Euro Area.

Inflation developments will remain of key concern for investors. Several one-off technical factors as well as the base effects on year-on-year comparisons will result in high inflation rates, all else constant. Moreover, we could very well see an inflation overshoot, over-and-above the high inflation expectations for the short-term, coming from a shock in prices as a result of temporary demand-supply imbalances given a surge in spending as a result of the release in pent-up demand and high household savings when economies reopen.

Volatile inflation and growth data can give wrong signals about the underlying economic advancements. As a result of this "noise" in data releases, we can equally expect erratic movements in financial markets, particularly in fixed income markets, which are high driven by the market's assessment of future policy adjustments.

Central banks have clearly indicated a higher tolerance to increasing inflation rates if, in their assessment, the economic conditions have not yet fully recovered. On this basis, we turn to labour market developments to assess the economic output gap and the risk of hysteresis as a result of longer-lasting effects on employment and productivity.

Economic dynamics favour more persistent inflationary trends in the US and possibly a sooner normalisation of policy rates. Because of this, we see scope for more pronounced steepening in US yield curves. Conversely, while the Euro Area and UK benchmark yields could rise further, the risk of a substantial steepening remains low.

We see low potential for further curve returns at the current juncture, despite the commitment from central banks to maintain a high level of market intervention. We have been gradually reducing the duration of our investment strategy and allocating capital in fixed income opportunities which offer adequate compensation for interest rate risk.

Given that expectations on cyclical developments remain positive, we continue to add credit and equity risk with a tilt towards those sectors that are expected to rebound more sharply when economic conditions normalise.

MACRO

Euro Area

Euro Area GDP contracted by 0.7% quarter-on-quarter during Q4 2020, compared to market expectations of a 1% quarter-on-quarter contraction. Overall, GDP for the full year 2020 contracted by 6.8%. The resilience to the downside in Q4 suggests that businesses and households are increasingly adapting to life in a pandemic. Therefore, it is expected that any fallout from further lockdowns may be less than during March levels.

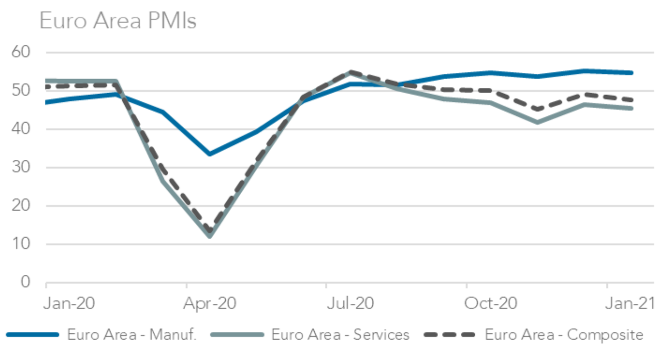
The economic recovery in the Euro Area is now expected to begin later and more gradual than anticipated given the rise of cases at the start of the year and the increased lockdown measures. Economic output may contract further in Q1, with increasing concern that output in Q2 and possibly even Q3 will fall short of expectations due to the following reasons:

- The Euro Area has fallen behind in inoculations, having only vaccinated c.5% of the population, compared to the US and UK (c.16% and 23% respectively) as at 14th February. In some countries, the roll-out programme has been put on pause due to supply shortfalls, while other countries are experiencing vaccine "hesitancy";
- It is unclear how long immunity will last and the percentage of the population required to be inoculated to reach herd immunity is still unknown; and
- New virus variants have surfaced in many Euro Area countries, these variants being more transmissible, with concerns that the vaccines are less effective. These variants are discouraging governments from lifting restrictions in the near term, particularly on cross-border travel.

Countries where the travel and leisure industry is an important driver for GDP growth during the summer months are at risk of a delayed recovery when compared with other countries should economies not open in time.

Looking at survey data, January's Composite PMI declined, reiterating that the tighter measures imposed are taking their toll on the economy. January's Services PMI declined from December for the fifth consecutive month, showing that December's month on month increase of 2.0% in retail sales will be short-lived. Manufacturing PMI also declined despite factory activity expanding for the seventh successive month.

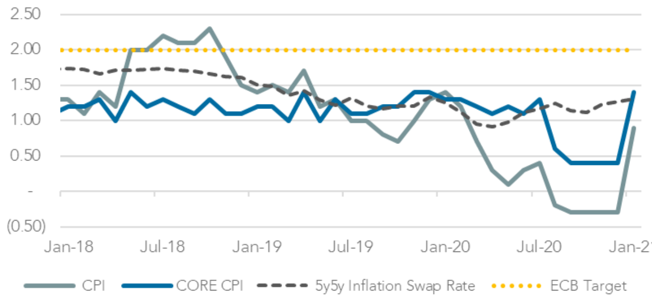
PMI data suggests that while input prices continued to rise, services sector firms in particular felt unable to pass on higher costs to their customers, decreasing the pressure to lift consumer price inflation.



Source: Bloomberg

The annual flash HICP inflation of 0.9% for January 2021, whilst coming in substantially above market expectations of 0.5%, was driven by a combination of one-off factors rather than a revival in underlying demand. January's annual flash core inflation was at 1.4% versus market consensus of 0.9% and December's level of 0.2%. It is expected that inflation will rise in the near term but is still expected to settle below the ECB's December forecast, which shows a price growth from 0.3% in 1Q2021 to 1.5% in 4Q2021, declining to 1.2% a year later. Some factors contributing to the January inflation surprise include the reversal of the temporary German VAT cut and the delay in store sales given that shops remained closed which pushed clothing and footwear prices upwards compared to last year. Additionally, in line with yearly adjustments, new weights will be applied to HICP items in 2021 which will have a bigger movement compared to prior years given the large change in consumption patterns in 2020, pushing inflation upwards.

Inflation is expected to remain elevated in the near term given the positive energy price inflation expected between February and April. Furthermore, when governments eventually ease restrictions, services inflation should pick up in line with the return in activity.



Source: Bloomberg

Over the medium-term, Euro Area inflation is expected to decline again as these one-off factors drop out of the year on year comparison and the short-term demand-supply imbalances are cleared. Following the ECB policy statement and press release, it is evident that the central bank will not change course for the time being despite acknowledging that inflation will remain weak. Moreover, the continued strengthening of the euro is expected to add to disinflationary pressures.

December's unemployment rate remained unchanged at 8.3%, in line with market expectations, highlighting that government work schemes have protected jobs during the recent lockdowns. Unemployment rates are expected to rise minimally as government furlough schemes will continue to support jobs in 2021. It is anticipated that vaccine roll-outs will allow governments to lift restrictions towards the end of the first half of the year, which is expected to boost labour demand allowing work schemes to be tapered off as growth in activity picks up.

In the meantime, the ECB reiterated that it did not see the urgency to adjust financial conditions in its recent policy statement and press conference. The ECB reaffirmed markets that it stands ready to adjust all its instruments should the need arise and that the PEPP "envelope" does not all need to be used but could be increased again should it be required. The ECB could eventually be forced to do more, possibly making the terms of their financing-for-lending programme, the "TLTROs", even more generous.

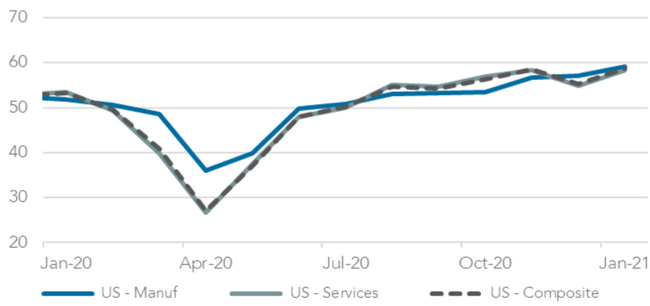
According to the latest Bank Lending Survey, Euro Area banks tightened credit standards slightly in Q4 last year to the tightest level since the debt crisis, as bank's perceptions of risk rose. It is expected that credit standards will be tightened further in 1Q2021 given that economic activity is still weak. The Q4 survey revealed that the demand for bank credit fell at the end of last year. Firms again took advantage of government-guaranteed loans to replace revenues lost during recent lockdowns, however these were not as large as during 1H2020.

United States

The US economy expanded by an annualised quarter-on-quarter growth of 4% in 4Q2020, marginally below the consensus estimate of 4.3%. This showed a slow-down from the Q3 growth of 33.4% as virus cases continued to rise and restrictions on activity moderated consumer spending, causing some temporary weakness in consumption. Overall, for the full year of 2020 GDP contracted by 3.5%.

Market sentiment remained upbeat since December as vaccine roll-outs have begun and Biden's $1.9 trillion stimulus plan was announced. The expected quarter-on-quarter annualised GDP growth for 1Q2021 is 2.3%.

Around 1.2 million vaccine shots are being administered each day. Should the current pace hold up, Biden's target of 100 million doses within his first 100 days looks achievable. With the additional purchase of 200 million doses together with the roll-out pace, it is possible that the entire population will be vaccinated by the end of summer, auguring well for strong economic recover in the second half of the year.

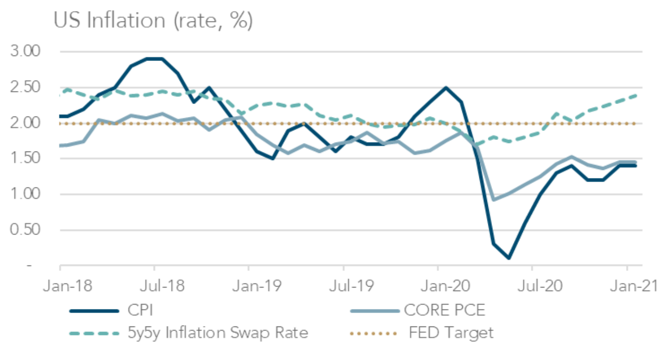


Source: Bloomberg

January's Composite PMI increased from December levels, despite the decline in Services PMI. The constituent for this increase was the Manufacturing PMI, which rose as factory growth reached new record highs due to accelerated expansions in output and new orders.

Although manufacturing output initially lagged the broader economic recovery, continued gains in recent months have brough it to c. 2.5% below pre-pandemic levels. The remaining gap is expected to close within the next few months given that domestic demand is set to be boosted by declining virus cases and the recent fiscal stimulus announcement, moreover, the weaker dollar is expected to continue to support foreign demand.

In the near team, inflation is expected rise sharply, primarily due to the base effects given the drop in prices last year as well as the expected rise in spending given the high accumulated household savings as well as the strong fiscal and monetary stimulus which will continue to sustain business and consumer confidence. The combination of improving growth and base effects could push inflation well above Fed target in the near term. However, structural deflationary factors (primarily the low level of employment, globalisation and technology) are expected to moderate inflation rates in the medium term.



Source: Bloomberg

The recovery in the labour market is expected to resume given the recently announced fiscal support which is expected to boost activity as well as the decline in new virus cases since the start of the year. Headline unemployment dropped to 6.3% in January, with the number of unemployed persons decreasing to 10.1 million from 10.7 million. It is forecast that unemployment will increase to 6.6% during Q1, falling thereafter to 6.1% in Q2.

The pace of increase in initial jobless claims now appears to be easing will little risk that claims will return to the levels seen during in 2020. The count of jobless claimants has been declining since the start of the year after reaching the highest initial jobless claims level in October 2020. January's non-farm payrolls increased by 49k compared to the prior month's decline of 227k (revised down by 87k). Whilst the increase in payrolls is a step in the right direction, the economy is still left with c. 10 million jobs short of February 2020 levels.

Looking at financing conditions, the Fed's Senior Loan Officer Survey reveals that access to credit is improving for consumers, which will support an acceleration in consumption growth this year. Although the survey shows a small net share of banks continuing to tighten standards on business loans, standards are now being relaxed for all major categories of consumer lending. Banks expect to continue to relax consumer credit standards over 2021, reiterating the expectation of a rebound in consumption growth.

The Fed left the target range for its federal funds rate unchanged at 0% to 0.25% at its meeting held at the start of 2021. The quantitative easing programme was also maintained at the current pace of monthly purchases of $80 billion of Treasuries and $40 billion of Mortgage-Backed Securities. The Fed will most likely maintain its current ultra-loose policy stance throughout 2021, even as economic growth accelerates.

Democrats passed a budget resolution which sets the reconciliation process in motion to pass the $1.9 trillion stimulus package. There are still doubts on whether all the Senate Democrats will support the full plan set out by President Biden. It is however possible that a substantial portion of the originally announced $1.9 trillion will be passed.

United Kingdom

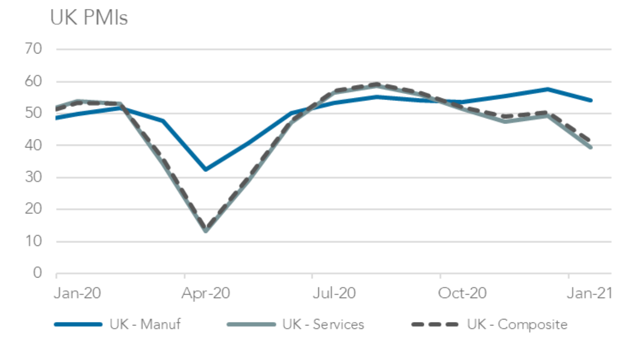
The revised forecast for Q4 quarter-on-quarter contraction was of 1.2% resulting in a upward revision from December's forecast of –1.5%. The forecasted quarter-on-quarter contraction for 1Q2021 is that of 2.5% according to Bloomberg estimates, while the BOE forecast a quarter-on-quarter contraction of 4.0%.

The festive period did not bring about a surge in retail sales as usual, with only a small rise seen in December figures. This came about as retailers were allowed to reopen in early December and then forced to close again on 20th December due to the imposition of tighter restrictions. However, the latest retail sales level is still 2.7% above pre-pandemic levels. Moreover, January's third lockdown is expected to result in a further decline despite it being the month of store discounts.

January's Composite PMI declined drastically from 50.4 to 41.2 but remained above market expectations of 40.6. The main drivers behind this decline were:

- the sharpest contraction in services activity since May due to restrictions on trade and temporary business closures during the third lockdown; and
- output growth declined and new order numbers fell slightly as producers faced weaker inflows of new ex-

port work and temporary supply-chain disruptions caused by restrictions and transport delays following the end of the Brexit transition period.

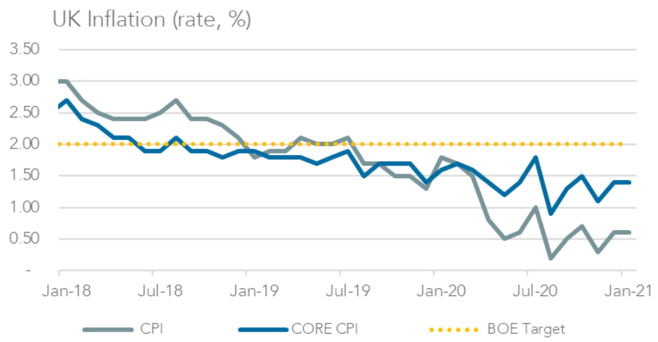


Source: Bloomberg

Vaccination efforts so far covered c. 23% of the population, implying that the government's goal to administer c. 14 million first doses by mid– to late–February will likely be met. Should vaccines be resistant to new virus variants and policymakers not tighten fiscal policy prematurely, GDP could be on track to return to pre-pandemic levels by 1Q2022.

CPI inflation rose to 0.6% in December from 0.3% in November as some measures were eased. A corresponding movement was seen in core inflation rising to 1.4% from 1.1%. The main drivers were:

- an increase in transport inflation mainly due to year on year increases in airfares and fuel prices;
- an increase in recreation and culture inflation mainly driven by a rise in IT equipment inflation as more people worked from home; and
- an increase in clothing inflation as the traditional December discounts were disrupted by the pandemic.



Source: Bloomberg

CPI inflation is expected to rise more sharply from April when the temporary VAT cut for the hospitality sector is reversed and the downward drag from the previous plunge in fuel prices is adjusted for. Inflation may creep higher should authorities keep monetary and fiscal policy loose after all the spare capacity in the economy has been absorbed. Inflation may possibly exceed the BOE target of 2.0% in 2021 as a result of the strong upswing but it is expected to fall back down towards 1.5% by year end.

The unemployment rate for the 3-month period ending November 2020 was 5.0%, this being the fifth consecutive increase bringing the rate to a new high in the last five years. Headline unemployment is only 1% above February levels, showing the success of government furlough schemes in protecting jobs throughout the year. The number of persons entitled to unemployment benefits increased by 7 thousand in December to 2.6 million, pushing the claimant count rate up 0.1% to 7.4%.

It is expected that unemployment will start to rise more quickly once furlough schemes are reduced and firms have to start paying wages in full. In fact, unemployment is forecast to increase to 6.2% by end Q1 and reach 6.6% by end 2021. Once economic activity starts to recover, unemployment should fall back given the eventual recovery in labour demand.

Up to mid-January, the BOE has completed £16 billion of purchases out of the £150 billion of the quantitative easing it announced in November. At the current pace of purchases of £4.4 billion a week, the central bank is expected to have reached the full target in September 2021. Historically, the MPC has always waited for all announced purchases to be completed before announcing further quantitative easing. Given the substantial headroom that remains, we do not expect further increases in QE purchases to be announced for the time being. This expectation is further strengthen by the assumption that economic output is expected to recover in 2H2021 with inflation rebounding slightly higher towards the target 2%, thus reducing the scope for the MPC to add stimulus.

On 4th February, the BOE maintained its Bank Rate unchanged at 0.1% and left the size of its total asset purchase programme at £895 billion. The BOE said that it kept its stimulus programme on hold with hopes that the economic recovery will occur later this year. The BOE said that Britain's banks require at least 6 months to complete the technical preparations required to introduce a negative interest rate regime. However, Governor Bailey has reinforced the BOE's communication that these technical preparations not be interpreted as a signal of forward policy rate adjustments but merely a fail safe should they be required to introduce negative rates.

RATES

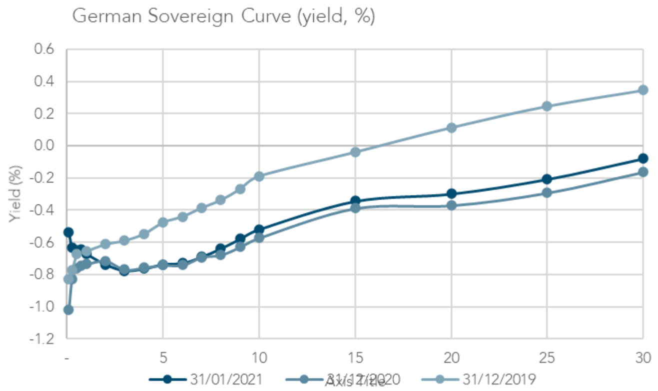
Euro Rates

The latest ECB minutes show an element of disagreement around the December decision to expand the PEPP programme by an additional €500 billion. This is partly stemming from the fact that the previous target of purchases had not yet been fully utilised when the additional increase was announced. 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. This has been strengthened by President Lagarde's comments in the latest press conference where she highlighted on multiple occasions that the priority now is to maintain (and not enhance) easy financing conditions.

This is also consistent with our earlier assessment that further monetary injection through bond buying programmes is losing effectiveness, in terms of the its real economic impact, given the high amounts of liquidity in the system and the tight/negative money market spreads. At the same time, peripheral bond spreads contracted substantially following the surprising news that Mario Draghi was asked to form a new Italian government. Markets are eyeing the 90 bps spread level on the 10-year benchmark bonds, which is the lowest spread level since 2010.

The upwards movement in long-end German sovereign yields has so far been more muted than the steepening seen in the US and UK curves. This is primarily explained by relatively smaller increases in inflation expectations (+12 bps), and a minor decline in expected short-term real yields. The lack of traction in the expected trajectory in short-term real yields is explained by the fact that:

- although the change in inflation expectations is slightly positive, the absolute level of inflation expectations is still substantially low; and
- The ECB is expected to keep rates unchanged or lower for longer, thus keeping downward pressure on real yields.



Source: Bloomberg

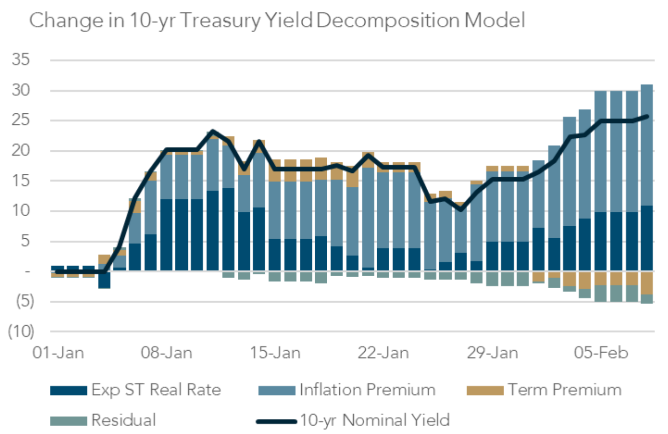
Despite the high degree of monetary accommodation, we believe that the downward force on benchmark bond yields and tighter sovereign spreads coming from the ECB action seems to have peaked at this stage. The recent policy adjustments are viewed as having over-delivered on what is required at this stage to protect and not enhance the easy financial conditions in the Euro Area.

As noted in our previous update, we expect investor focus to shift towards the progress in economic data and in vaccine roll-outs across the Euro Area. This has been reinforced by the messaging given by the ECB at their last meeting where essentially Lagarde indicated that no additional policy action is expected. This suggests a greater tolerance for higher yield levels by the ECB, unless such a move is driven by a deterioration in underlying economic fundamentals.

In conclusion, we see scope for negative curve returns in the near term even though the risk of substantial sell-off in benchmark bonds remains low. The scope for long-end yields to continue to gradually move higher remains (particularly at the very long-end) given the expectation that growth and inflation data will sequentially improve due to base effects and that eventually the cyclical recovery is expected to gain momentum. The scope for stable and 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

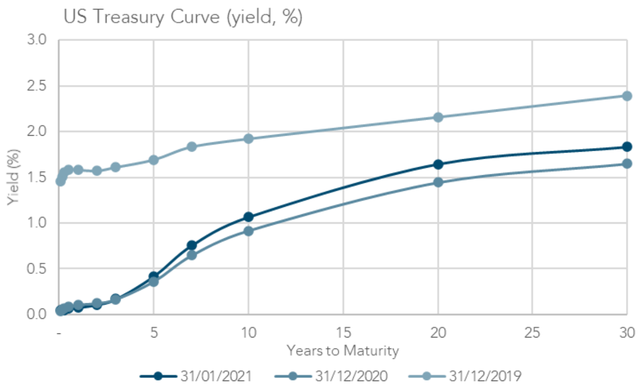
The move higher in long-end yields steepened the US treasury curve in January. The 30bp jump in the 10-year treasury yield was primarily driven by increasing inflationary expectations (+20 bps) and market pricing of eventual policy adjustments by the Fed (+10 bps).



Source: Curmi and Partners, Bloomberg

Markets are looking through the recent soft patch of economic data and focusing on the stronger economic data expected in the Q2 as economic activity continues to recover and which, optically, will be supported by strong base effects in year-on-year comparisons.

Whilst the strong base effects on data is a "given" and should be priced in, expectations on policy normalisation by the Fed, which has explicitly tied policy response to realised/actual inflation, have heightened the implications of an overshoot in inflation (even if it is temporary). This is increasing the risk of further widening in breakeven inflation rates and, as a consequence, further steepening in the curve. Steepening has so far come from 5s30s primarily. An inflation overshoot increases the scope for markets to expect an earlier normalisation path in short-term policy rates which increases the risks of steepening in the 3s10s area of the curve.



Source: Bloomberg

The 10-year breakeven rate has breached the 2% level in mid-December. Since then, the inflation swap market is showing higher levels of expected inflation implied at the shorter-end of the inflation curve which is now more consistent with the market-implied rate hike trajectory. In other words, swap markets are implying inflation will reach and exceed the Fed target before the policy rate increases.

As a result, given that traded inflation is now reflective of an accelerated inflation trajectory, it is becoming increasingly less likely that further steepening in the yield curve continues to be driven by additional inflation premium. Whilst this may still be the case, particularly in the case of an inflation overshoot, higher yields will have to be driven by higher real returns over the medium term. Real yields are in fact looking very rich when considering the strong growth outlook of the economy.

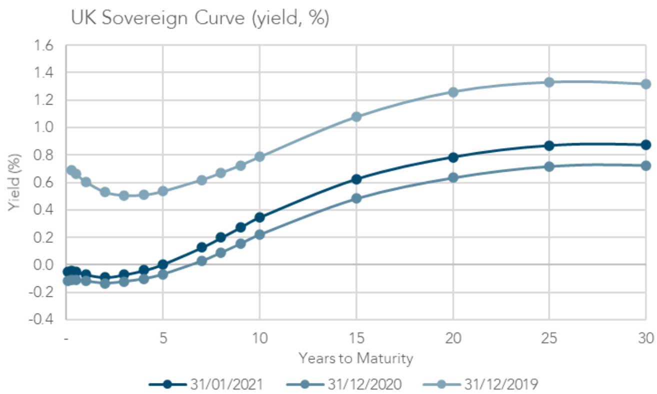
The basis for long-end yields to continue to move higher this year are primarily attached to the expectations of an increase in inflation driven by the strong growth expectations as well as base effects. The strong growth outlook remains principally dependent on government spending and a successful roll-out of the vaccine.

The dovish stance of the Fed, the safe haven buying in periods of weak sentiment and increasing foreign demand will continue to soften any sharp upward movements in long-end treasury yields for the time being. Having said that, the scope for the US treasury curve to continue to steepen over the medium-term remains high, 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 Q2 onwards, supported by increased activity and base effects;
3. Abating health risks as COVID cases decline and the vaccine roll-out continues, leading to a corresponding unwind of containment measures; and
4. High potential for growing anticipation of early policy normalisation by the Fed — so far this remains unlikely and highly dependent on the above mentioned factors.

UK Rates

Similar to the movement in the US treasury curve, the UK gilt curve steepened with long-end yields rising primarily due to the increase in inflation expectations (+15 bps) and a rise in expected short-term real yields (+14 bps). The latter reflects growing expectations of eventual policy rate adjustments by the BOE. The short-end saw some minor upward repricing given the communication by the BOE that they will certainly not adopt a negative interest rate policy in the next six months of preparation, and that, even when the preparatory window elapses, the committee remains divided on the effectiveness of a negative interest rate regime with most members opposing the idea of cutting rates into negative territory.



Source: Bloomberg

Despite the lower probability of further rate cuts, the short-end of the OIS curve remains inverted showing at least some market-implied probability of that rates will go negative in the UK. Market pricing also shows no expectations that the BOE will change course for the time being despite the improving inflation data for December and, more importantly, the expectation of improving growth and inflation data as earlier as Q2 given the progress on the vaccine roll-out. In view of the relatively faster pace in vaccine roll-outs compared to other advanced economies, the UK remains on track to be one of the first economies to see the highly anticipated unwinding of containment measures possibly by April, and the subsequent return to economic growth in 2Q2021.

The BOE adopted a positive tone at the latest MPC meeting citing the strong results achieved on the vaccine programme and indicated that UK GDP is set to recover strongly in 2021 due to the lifting of COVID-related restrictions with the level of output expected to reach pre-pandemic levels in early 2022.

Given that short-end rates remain firmly anchored by the messaging of the BOE, improving growth and inflation data releases in the coming months are expected to continue to drive further steepening in the sovereign curve. Having said that, the risk of a substantial sell-off is unlikely given technical flows (QE purchases).

CREDIT

January largely began with a continuation of the optimism seen towards the end of 2020 following the positive news around the vaccine development in the ongoing battle against the pandemic. The early wins for corporate credit in January were driven by the expectations of significant further financial support for markets coming out of the US as a result of the Georgia senate race, which ended in a "Blue wave" win for the Biden administration. The rally nevertheless began to stall toward the latter part of the month following the discovery of a new, more contagious strain of the COVID-19 virus and the reimposition of lockdowns that followed, coupled with downward revisions to economic forecasts across multiple regions. Overall, Investment Grade ("IG") credit had a dull start to 2021 with most sectors posting minor losses.

We continue to expect that as issues around logistics and distribution are ultimately solved, the roll-out gathers pace and lockdowns are lifted, we should see an economic revival, particularly for service sectors that were more badly hit in this latest round of lockdown measures. Therefore, we expect to see continued ultra-accommodative policy from the central bank, and credit spreads will likely stay compressed. In the search for yield, we think many investors will look to central Europe and to lower credit quality as carry will be a larger component of fixed income returns going forward, highlighted by lower breakeven rates.

With IG yields at 26 bps in absolute terms, rising benchmark rates have become more of a concern for investors. After the recent rally towards end 2020, IG breakeven rates are below 5 bps, implying minimal cushion against rising rates before negative total returns within IG credit. Such low breakeven rates are a post-QE record, so this spread cushion is low on both a historical and absolute basis. The current extremes within IG credit spreads and the lacklustre returns within IG during January highlight the need to manage benchmark rate risk within the context of an IG portfolio today. Whilst the trajectory has been similar within High Yield ("HY") credit, the breakeven rates still remain above multi-year lows seen back in 2017, and current levels continue to provide some buffer to be able to withstand interim weakness in benchmark rates.

ECB total bond buying dropped in January compared to December, which likely contributed, at least partially, to some of the added volatility seen in markets towards the latter part of January. Total QE dropped to €71 billion from the prior €78 billion across both the PEPP and the asset purchase programme ("APP") combined. Despite this drop, the ECB bought €6 billion in net credit, leading to an 8.4% credit share in net QE purchases, the most in four months. In fact, corporates are the only sector that increased in the APP in January. The €6 billion of net credit buying translated to €10 billion of gross due to a record €4 billion in CSPP redemptions. We can reasonably expect €8-9 billion of monthly net credit buying in 2021, maintaining an 8% share within total QE. January was roughly in line, and a similar February level implies larger net buying, which should better support credit spreads.

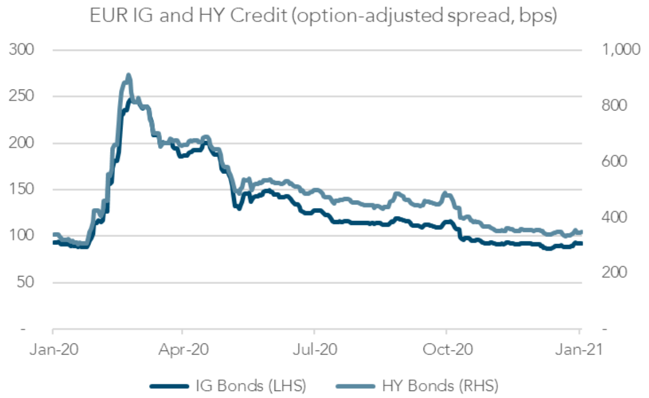
Our view on the vaccine recovery trade has not changed, and we continue to believe that the focus for investors will remain on the pace of the global roll-out of the vaccine, which will eventually allow for a normalisation in pandemic-affected industries. Whilst the timing of the roll-out remains uncertain following global delays in the distribution of the vaccine, 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.

In Europe, we are coming off a strong year in terms of supply across both IG and HY credit as companies moved to recapitalise balance sheets in light of the pandemic. So far in 2021, the pace of issuance has moderated relative to 2020's strong start, but still remains within the context of the past few years. We are beginning to see a larger share of issuance earmarked for ESG purposes and expect this to be a growing feature for this year despite our expectations of overall lower issuance in 2021 compared to 2020. Within the EUR HY space, and similar to the pattern in the USD HY market, the share of CCC-rated debt issuance has also increased. Approximately 12% of the year-to-date EUR HY deals have been CCC-rated, well above the 2-6% share of the past several years.

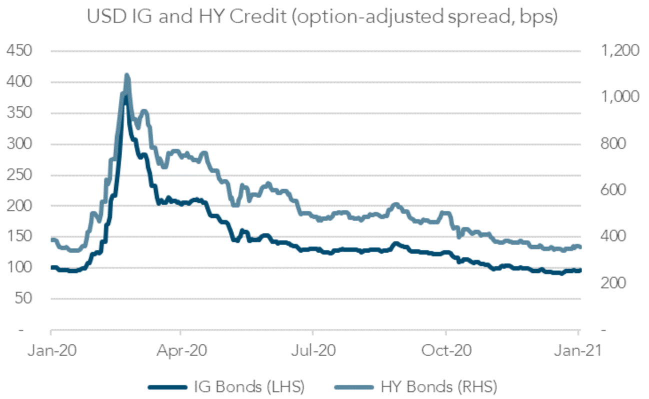
Given a strong technical picture, the principal risk to high yield is that credit losses continue to climb due to short term fundamental or structural issues. The resurgence in infections that has taken hold over recent months is a reminder that we cannot take the benign default environment as a given. The positive narrative around a vaccine towards the end of 2020 has recently turned, with the pace of initial roll-outs being slower than initially anticipated and implying that default rates may continue to increase in the short term, only to subside over 2H21, 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 the most defaults. The trailing 12-month global speculative-grade default rate was 6.6% at the end of December and will likely climb to 7.3% in March before falling to c. 4.7% at the end of 2021 under baseline Moody's forecasts.

Despite the possibility of a short term rise in default rates given the expectation of a prolonged vaccine rollout period, we think that demand for high yield debt will likely remain high, given accommodative monetary and fiscal stimulus, while investment grade debt with a yield close to zero is relatively less attractive. We therefore think lower-rated bonds will continue to outperform in 2021 given greater scope for spread compression, and remain better isolated from interest rate risk should we see volatility in benchmark rates. Within the high yield space, we see scope for sectors harder hit by the pandemic 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.

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.



Source: Bloomberg



Source: Bloomberg

EQUITY

Global equities rallied during the first half of January, as investors were buoyed by hopes of a strong economic recovery in 2021. Positive news-flow around the vaccine and a new round of fiscal stimulus in the US were key market movers throughout the period. Both the vaccine and fiscal stimulus bode well for the global economic recovery in 2021 and is therefore a key positive for the equity market. The strong rotation into value stocks that started in November however hit a snag in the last week of January.

The Euro Area's slow vaccination roll-out pace could have serious implications for the region's economy, as curtailment measures could remain for longer than expected. At this stage, we remain positive on the Bloc's economic outlook for 2021, but risks are rising.

Now that the vaccine roll-out has started, investors will start to look at different data points in order to get a better feel on the vaccine's effectiveness. Hospitalisations have slowed down recently, but this has been partly driven by curtailment measures like lockdowns. In order to get a better understanding of the vaccine, it would be best to look at Israel where c. 74.5% of the population have been immunised as at 14 February.

The Maccabi's Research and Innovation Centre is tracking 132,015 Maccabi members over the age of 60, who received the first vaccine dose between 20 and 29 December. The study suggests that protection begins roughly two weeks after the first dose is administered. The study noted that average daily infections fell 55% between peak point (day 14) and day 21. At the same time, a 14% increase in COVID-19 infections was observed in the general population. An additional 25% decrease was seen between day 21 and day 28, with a respective 18% increase in the general population. As for hospitalisations, compared to peak day, an 80% decrease is seen on days 27 and 28. It must be noted that while data is encouraging, the sample size is small.

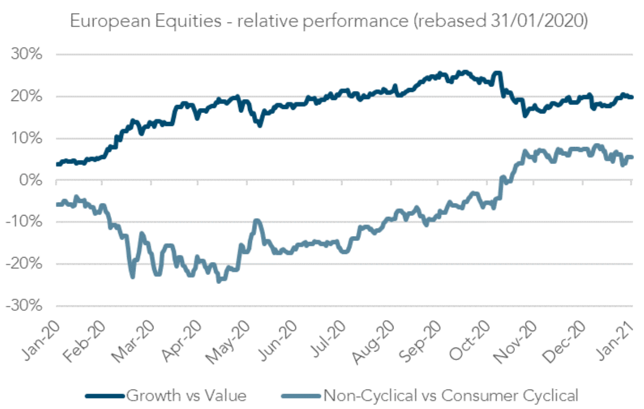
In the second half of January, sentiment shifted sharply as investors digested the news of a possible delay of roll-outs in Europe, while across the pond, retail investors caused havoc for short-sellers with bulk buying in stocks with a high short interest. Whilst this has hit returns in January we remain positive on the outlook for the asset class in 2021.

As we had explained in last month's report, valuations are quite high (some of which are explained by low interest rates) and lofty expectations have been priced-in. Equities are now in a new bull market cycle, following the COVID-19 bear market that ended in March 2020. Compared to the previous bull market, we think there is less room for high returns when considering:

- Higher valuations out of the bear market, with the forward PE at c. 12.0x in 2020 compared to 8.9x in 2009;
- Interest rate levels, with much more room for interest rate cuts or a fall in bond yields (which boosts valuations) in 2009 than it is today when interest rates and bond yields are at record lows; and
- Higher government debt levels which suggests less room for additional government support and introduces the risk of higher taxes.

Although we currently see no reason to change our positive outlook for equities in 2021, we warn that volatility should be expected in the near term, at least until investors are comfortable on the success of the roll-outs.

We use the Global Economic Policy Uncertainty Index ("EPU") as a measure of risks for the equity market. The EPU peaked in May 2020 (412.7) but has been falling steadily (226.5 at end 2020), albeit still above the 10-year median (156.1). Despite the surge in volatility during 2020, the volatility index remains largely unchanged (15.4 at end 2020) and is currently below the 10-year median (16.3). This supports the claims we made last month, that some complacency could be creeping in, and that investors are ignoring risks.



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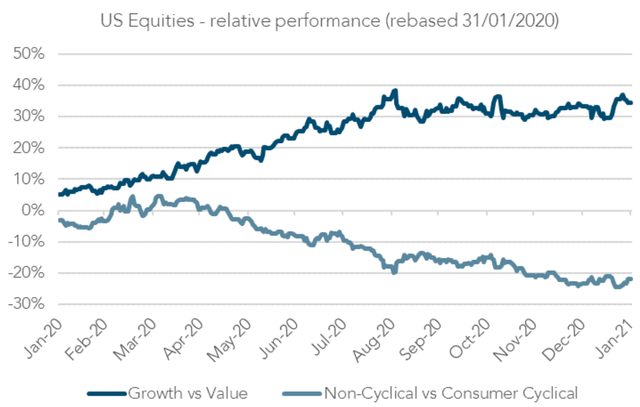

Source: Bloomberg

The expected synchronized global economic rebound supported by a strong pick-up in consumer expenditure, coupled with loose fiscal and monetary policy should lead to higher inflation. Rising inflation can be both a positive and a negative for equities, depending on the current level (low) and the speed at which inflation picks up. Any sudden surge in inflation would be a negative for the asset class, but the possibility of this happening currently appears to be low.

Despite the possibility of investor complacency, we highlight that conditions remain favourable for equity investors with yields still very low and financial conditions still extremely loose. This should support the high equity market valuations, but we caution that performance in 2021 will probably be driven by earnings growth as opposed to valuation expansion. For this to materialise, the economic backdrop will need to improve substantially and a fast vaccine roll-out is key.

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Developed Market 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	N	We believe that high grade returns will depend on German Bund movements, stimulus and vaccine success. We expect the ECB to step up purchases in February, which would be supportive for spreads, however, unlike 2020, there is currently no cushion against Bund movements within IG corporate credit, and hedging rates is becoming a critical factor within IG performance. 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	Positive	O/W	We adjusted our positioning to include exposure to construction in selected stocks which pushed our asset class into an overweight position. Over view on the asset class remains positive despite the volatility seen at end January. In our opinion, we are in the early stages of a new bull market and drawdowns are very common at this stage. We expect returns at an index level during this bull market to be lower than the previous one, bearing in mind the starting high valuations, level of interest rates and Government debt levels. This highlights the importance of stock/sector picking to generate alpha going forward. The prospects for the equity market seem positive assuming a successful vaccine roll-out leading to the end of curtailment measures. It seems that there will be a divergence in the roll-out speed across the major economies, with the UK and US currently leading the race, while Europe is falling behind. The developments over the coming weeks will be key for Europe, as any delays that could put in doubt the economic recovery in 2H21 could weigh on the European equities and the value rotation. Recent data coming out of Europe, US and Japan indicates that case growth has slowed down significantly over the past weeks. This is most probably related to curtailment measures and in some cases, herd immunity. It is too early for the vaccine to have any impact on case growth, which is positive when considering that case growth has already started to slow down.

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

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