Investment Strategy Update

March 2021

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Curmi & Partners Research

- Retail Sales in the Euro Area and the UK have taken a sizeable knock in January due to the recent round of lockdowns.
- The US saw sustained increases in spending and manufacturing boosted by the December stimulus cheques, and the improving economic activity as more states scaled down containment measures.
- Labour market conditions in the Euro Area and the UK continue to deteriorate as a result of the poor business environment and weak demand, with most governments extending programmes to support job retention.
- Whilst the employment gap that has been created in the US as a result of the pandemic remains fairly wide, latest data releases show marginal but positive improvement in labour market conditions.
- The USD 1.9 trillion stimulus programme ratified by Congress will provide an additional fiscal boost to the US economy.
- Vaccine roll-out programmes in the UK and the US maintain a solid pace of inoculation, reinforcing expectations of a more considerable scale-back of containment measures relatively early on, allowing the economy to recover strongly in 2Q2021.
- The rate of vaccination in the Euro Area is poor, putting in doubt the optimisic growth and inflation forecasts for 2021.
- Benchmark bond yields saw a relentless rise in February fuelled by a rebound in real rates as markets anticipate earlier hikes in policy rates by central banks.
- The sell-off in bonds saw a substantial decline in sovereign and investment grade corporate bond prices whilst high yield bonds and equity markets outperformed.
- The rise in real yields however dented the positive momentum in equity markets given the impact on equity valuations. Nevertheless the strong earnings growth outlook and reduced uncertainly is expected to sustain tighter equity risk premia which will overcompensate for the rise in discount rates.
- At this stage, we remain cautious on rates and maintain higher exposures in credit and equity markets.

The narrative in financial markets has shifted from the strong risk-on momentum in January on the back of high expectations of a swift economic recovery to one dominated by the sharp rise in bond yields and what this means for asset valuations. Moreover, as more data releases show stark divergences in economic activity across advanced nations, the attention remains on the rates of inoculations across countries as forecasters recalibrate their expectations on the start and the speed of the economic recovery following the last bout of lockdowns.

Economic conditions continue to favour a pronounced divergence in economic performance in the US versus other countries. This is supported by the streak of positive economic data out of the US reflecting a strong increase in sales and production, survey data pointing towards sustained expansion of both services and manufacturing and, finally, an additional fiscal boost from the USD 1.9 trillion programme which was finally agreed upon under Biden's administration.

Coincidental and lagging data in the UK and Europe continues to reflect the ongoing struggle to generate economic activity primarily due to the challenging conditions in service sectors. As we have previously noted, labour market data has continued to incrementally deteriorate in these economic areas given that business are scaling down capacity in view of the poor demand whilst government have broadly sought to maintain job retention schemes to limit the fallout in labour markets.

Conversely, the US has seen a sharp drop-off in the number of people employed early on in the crisis, and is now registering small, but positive increases in payrolls.

There is no doubt that, even though we expect to see a spike in activity as countries scale back restrictions, countries will struggle for longer to close the economic slack that has been created because of the pandemic.

Central banks are ignoring the strong impulse for higher inflation in the near-term as they acknowledge that economic conditions remain fragile for the time being and that the primary objective is the recovery in labour market and economic productivity levels. A return towards

full employment is crucial to sustain healthy levels of aggregate demand which in turn provides resilience to higher price levels towards the central banks' inflation target.

In order to move onto boosting economic activity, the first step is a successful vaccine roll-out plan. The UK and the US are outpacing other European nations on this front, achieving a much faster rate of inoculations. The "vaccine gap" has led to upward revisions in economic growth for the US and the UK and a downward revision in growth for the Euro Area.

Despite the short term pains that are primarily felt in the Euro Area and the UK, markets continue to look out towards a sharp and strong cyclical recovery combined with a rise in inflation in 2021. Sovereign and high-quality corporate bond markets have fallen victims to a sharp sell-off in February. The initial rise in benchmark bond yields was driven by higher inflation expectations. However in mid-February we have seen a shift in the underlying drivers, with the move higher in yields being primarily driven by a revival in real rates. These in turn reflect growing market expectations of earlier action by central banks towards normalizing monetary policy and hike policy rates.

Whilst we believe that markets are assuming an overly hawkish reaction by central banks to the expected rise in inflation, we have maintained a reduced exposure to interest rate risk for the time being in order to protect portfolios against the sharp rise in yields and the increased volatility in investment grade bond markets. Whilst we continue to eye a sustained, but less volatile, rise in US long-end yields, we expect rates in the Euro Area to stabilize possibly offering some opportunities to add back duration. This preference is backed by our assessment that a weaker policy-growth mix in the Euro Area is less conducive towards the strong reflationary pressures which we are seeing elsewhere.

At the same time, the expectations of a strong cyclical upturn underpins our positive outlook in riskier asset classes. We continue to maintain an overweight allocation to high yield credit given the generally lower duration exposure of this bond class, the favourable financing conditions and the improving business prospects which will allow corporates in selected industries to restore their financial strength as activity picks up.

We also maintain a tilt in our equity risk towards cyclical sectors, selecting business profiles with earnings that are highly correlated to economic expansion. In particular we continue to hold higher exposures to retail, travel and leisure, banks, basic resources, autos and construction and materials.

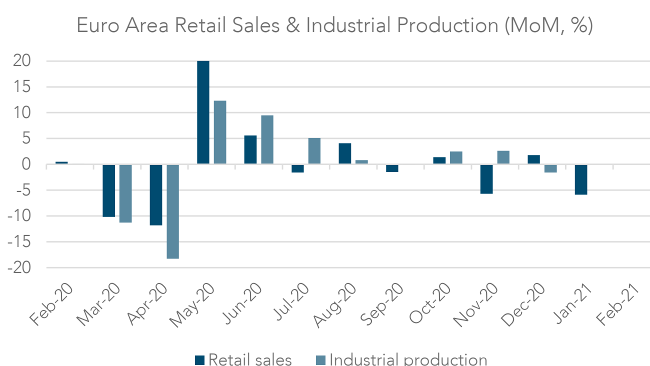
MACRO

Euro Area

The final estimate for Q4 GDP growth rate in the Euro Area was of -0.7% quarter-on-quarter, resulting in the economy shrinking by 5.1% year-on-year in Q4 and 6.6% in 2020 as a whole. In 2021, current forecasts estimate Q1 and Q2 quarter-on-quarter GDP growth rates of –0.9% and 2.2%.

Containment measures in certain countries have been relaxed, such as Italy and Spain, while certain economies, such as Germany, have extended their lockdowns further. Because of the extended period of containment measures, consumption is still expected to contract in Q1, as markets expect retail sales over the period to contract further. In fact, January's retail sales contracted severely by 5.9% compared to December's increase of 1.8%, declining well below the expected 1.1% contraction. However, this decline is still less severe than the sharp reduction seen in Q2 last year.

Manufacturers adapted well to the lockdown periods as evidenced by the seven consecutive months of industrial production growth, prior to December's decline of 1.6%. However, there is some evidence of supply chain problems, these being visible around the supply of semi-conductors, affecting the auto production industry negatively, together with trade disruption, including trade with the UK given the Brexit-induced halt in net exports.

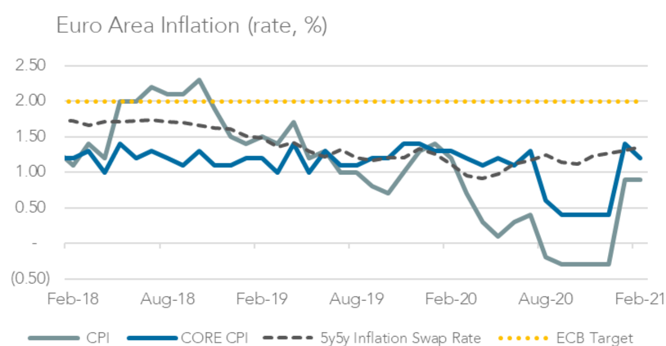


Source: Bloomberg

Looking at survey data, the final Composite PMI for February was 48.8, higher than the 47.8 recorded in the previous month and market expectations of 48.1. This mainly indicated a consecutive four-month contraction of the private sector, as restrictions continued to disrupt business activity across the region. This is primarily reflected by weak Services PMI which, although improving slightly to 45.7 from 45.5 in February remains in contractionary territory. On the other hand, February's Manufacturing PMI movement from 54.8 to 57.9 reflected the largest

expansion in output and new orders since October's peak.

January saw a sizeable uptick in inflation with final HICP inflation rate rising from –0.3% to +0.9% year-on-year, while the core inflation rate shot up from +0.2% to +1.4%. February's flash HICP inflation remained unchanged from January's +0.9%, in line with market expectations, while the flash core inflation rate declined to +1.1% from +1.4% as expected. January's jump in inflation was attributed to one-off factors including the cancelation of winter clothing sales and the reversal of a German VAT tax break which was conceded during the period of pandemic.



Source: Bloomberg

It is anticipated that January's inflation jump is likely to be followed by further increases during 2021, moving above the target 2%, firstly due to the base-effects which will boost the year-on-year comparison figures and secondly, the likelihood of an initial outsized rebound in demand combined with supply shortages. We expect the inflation overshoot to be transitory in nature and to peak in the second half of the year. Beyond that, inflation is expected to settle back towards the 1% area. The main driver behind the subsequent weakness is that the biggest driver of underlying price pressures is still aggregate demand, which is expected to remain poor given the slack in the Euro Area economy.

The revised jobs data for Q4 showed employment increasing by 0.3% quarter-on-quarter, compared to the market consensus of 0.1% and the previous Q3 figure of 1.0%. This means that, despite the lockdowns, over half a million jobs were created during the final quarter of 2020. Having said that, the overall job count is still more than 3 million less than during the final quarter of 2019.

The hit to the labour market during 2020 was not as bad as expected when considering the extent of the economic contraction. This shows that the more targeted measures in the autumn months combined with the government's extended job protection schemes were successful in cushioning the blow to the labour market.

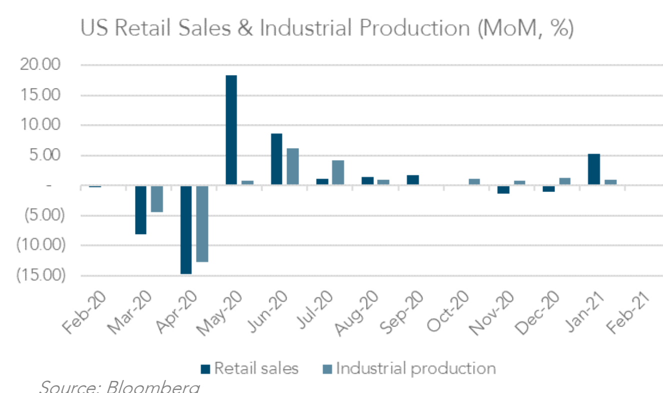
January's unemployment level remains unchanged from December's 8.1%. Unemployment is still expected to gradually rise in 1H2021 as most of those who left the labour force return once measures are eased out, firms re-open and government protection schemes are reduced. The absolute level of employment and labour force participation rate remains well below pre-pandemic levels indicating the slack that has opened in the Euro Area economy as a result of the pandemic.

The rise in real bond yields and widening of sovereign spreads may lead to the assessment that financing conditions have tightened. This, combined with the fact that downside risks have intensified with the slowdown in activity data, pointed to growing expectations of reinforcement in the ECB's dovish communication. While increasing the total size of the PEPP envelope will be ineffective, given that current stock of holdings is well below the total target size of purchases, the focus has shifted to the ECB's pace of purchases in the months' ahead.

United States

The second estimate for Q4 GDP growth was of an annualised increase of 4.1%. Still, the economy slowed from the record expansion of Q3 of 33.4%, as the rise in virus cases and restrictions on activity moderated consumer spending. Full 2020 GDP contraction was more modest at 3.5%.

The outlook for 2021 continues to improve given the pace of vaccination roll-outs, which reached 22.7% at end-February, and the approval of the $1.9 trillion stimulus plan which is expected to provide an additional boost to spending. The forecast for the annualised quarter-on-quarter GDP growth rate for Q1 and Q2 are 3.2% and 5.6% respectively, leading out to a full year forecast for 2021 of 4.9%.



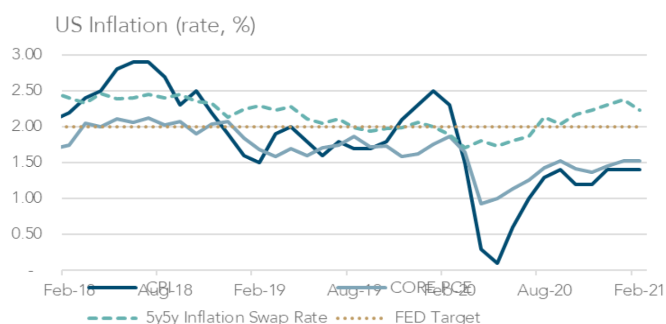
Source: Bloomberg

Unlike Europe, retail sales in the US jumped by 5.3% in January as stimulus cheques introduced in December helped boost consumer spending while virus restrictions began to be eased in some states. The increase in producer prices of 1.3% in January compared to December's +0.3% reflects a broad increase in price pressures, pointing to strong gains in services prices in the near term. This points to the possibility of a sharp GDP growth in 2021.

Industrial production increased by 0.9% in January mainly driven by an increase in manufacturing output of 1.0%. The data shows that industrial production is still lagging behind the recovery in consumption which underpins the expectation that industrial will continue to grow at a sustainable pace.

The final Composite PMI for the US rose to 59.5 during February, signalling the sharpest pace of expansion in private sector activity. In fact, the final Services PMI increased to 59.8 over the prior month's 58.3, as new order inflows expanded at the steepest pace since April 2018. However, despite further pressure on capacity, service providers registered only a fractional rise in employment.

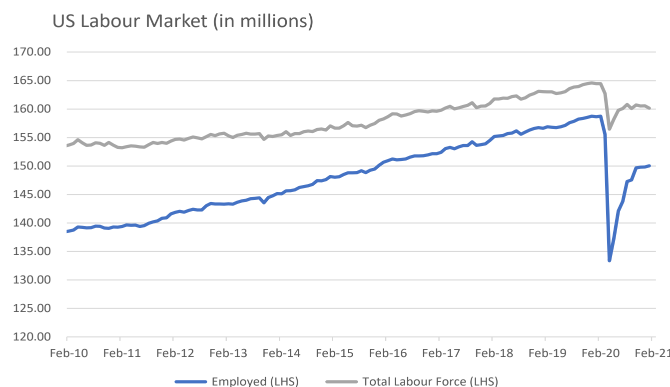
February's Markit Manufacturing PMI was at 58.6, a decline from the prior month's 59.2, however fairly in line with expectations of 58.5. This points to a sustained upturn in the US manufacturing sector. Although the rate of overall growth eased, it is the second fastest growth since April, supported by sharp increases in output and new orders. The positive data is corroborated by the jump in the ISM Manufacturing PMI to 60.8 in February from 58.7. This points to the strongest expansion in factory activity since February 2018, with the jump in the price paid component suggesting that strength is feeding through the greater upward pressure on prices. Unprecedented supply chain disruption remained apparent, with supplier shortages and transportation delays leading a substantial rise in input costs, these partially being passed on to clients through increased charges.



Source: Bloomberg

Despite the improving activity data, core inflation fell to 1.4% in January from 1.6% in December, illustrating that price pressures have not yet gained traction. This is expected to reverse, however, given that base effects are expected to lead both core and headline inflation above 2% this year. Core prices remained subdued in many sectors, with inflationary pressures only appearing to pick up in clothing prices and medical care services. The 0.3% rise in headline prices left CPI inflation unchanged at 1.4% in January.

Given that the virus-induced economic weakness is starting to be reversed as cases are falling sharply and states are easing restrictions, inflation should pick up. Further, as the big declines in prices last year drop out of the annual change, inflation is expected to pick up sharply in Q2. There is concern surrounding the $15 per hour minimum wage implementation. Economists believe that if firms had to raise wages to the new minimum wage level, they would have to raise prices to generate the additional income rather than reducing their labour force. This would result in added upside risk on inflation.



Source: Bloomberg

The gradual lifting of restrictions suggests that employment should begin to pick up in the months ahead, especially in those sectors where the labour market was hard hit. Jobless claims remain elevated, however they are no longer trending higher. In fact, the 4-week moving average, which removes the week-to-week volatility, declined to 807.75 thousand in the week ended 20 February from the prior week's 828.25 thousand.

Even as job growth has stagnated, the unemployment rate has continued to decline, but there is probably more spare capacity in the labour market than the headline unemployment rate suggests, as over 4 million people have dropped out of the labour force since the pandemic began. The number of people employed has remained at c. 9.5 million below pre-pandemic levels.

The Fed continues to sustain financing conditions with its QE purchases of $120 billion each month, and this support will not be withdrawn any time soon. Chair Jerome Powell stated that "*the economy is a long way from [Fed] employment and inflation goals, and it is likely to take some time for substantial further progress to be achieved*". This is a clear indication that, even with more fiscal stimulus this year, the Fed will not slow the pace of its asset purchases until next year.

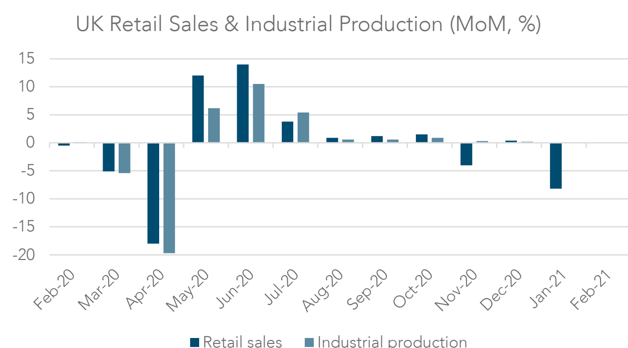
Furthermore, in his Semi-annual Monetary Policy Report to Congress, Powell said that the Fed remains committed to using its full range of tools to support the economy and to help ensure that the recovery from the difficult period will be as robust as possible. Powell further added that the inflation rate is on track to moderately exceed 2% for some time, with the Fed's new commit-

ment being to the full employment side of its mandate, regardless what happens to inflation. Therefore, we believe that the Fed will start tightening monetary policy once both inflation and employment reach high levels.

United Kingdom

Overall annual GDP in 2020 declined by 9.9%. However, according to preliminary estimates, GDP grew by 1.0% quarter-on-quarter during 4Q2020. The increase in Q4 is evidence that the economy has built up some immunity to lockdowns, and even though the third lockdown would affect GDP recorded in January, a technical double-dip recession has been avoided for the time being with expectations pointing towards a sharp rebound in 2H2021.

The economy continued to be heavily supported by government spending, which rose by 6.4% quarter-on-quarter in Q4, while household spending contracted by 0.2% quarter-on-quarter and business investment rose by 1.3% quarter-on-quarter. Labour productivity, measured by output per hour, sank 4.5% quarter-on-quarter during Q4, compared to the prior period's jump of 5.6% quarter-on-quarter.



Source: Bloomberg

Retail sales declined by 8.2% in January, the biggest decline since April 2020, coming in worse than the expected decline of 2.5%. This decline occurred as tighter nationwide restrictions were implemented, significantly affecting sales. Even though retailers have to endure a few months on depressed sales, households are in a good position to ramp up spending once the economy and shops re-open, given the high amounts of household savings. Industrial production edged up 0.2% in December from the previous increase of 0.3%, and lower than market expectations of 0.5%. This left production levels at 3.6% below pre-pandemic levels.

February's Composite PMI increased to 49.6 from 41.2, signalling broadly stable levels of UK private sector output, with Services PMI for the same period increasing to 49.5 compared to 39.5, the softest rate of decline as the country remains under lockdown. February's Manufacturing PMI increased to 55.1 as output rose at the weakest pace over the past nine-months. New orders expanded as domestic demand improved and new export business inched higher given improved demand from several markets. It must be noted however that the pandemic, Brexit and shipping difficulties constrained export order growth. Markets remain positive with expectations of manufacturing expansion and that Brexit uncertainties continue to decline.

The annual inflation rate edged up to 0.7% in January, where clothing retailers were prompted to discount more heavily than normal, while core consumer prices remained unchanged at 1.4%. The unwinding of one-off factors during 2020, such as the temporary hospitality VAT cut and the 9% rise in Ofgem's utility price cap, together with an expected sharp return in spending is expected to cause inflation to jump above 2.0% towards the end of 1H2021. However, it is expected that a correction in oil prices, the effects of the stronger pound and the lagged effects of spare capacity will drag inflation back below 2.0% during 2022.

The unemployment rate for December rose to 5.1% from November's 5.0%. The marginal deterioration came as unemployment was still contained by the government's furlough schemes which are supporting c.4 million jobs (c. one in five employees). Average earnings growth accelerated more quickly than expected to 4.7% in December, the highest since 2008, driven in part by a fall in the number and proportion of lower-paid employee jobs, and by increased bonuses, which had been postponed earlier in the year. The job losses were concentrated in the low-paid sectors, such as accommodation and food services and retail, and within these sectors, the job losses seem to have been concentrated amongst lower earners. Full-time employment has only fallen by c. 30 thousand since January compared to a drop of c. 560 thousand for part-time employment. The ONS believes that these compositional changes in the workforce boosted headline 3-month year-on-year average earnings by about 2.8 ppts in December. The number of persons claiming for unemployment benefits declined by 20 thousand to a 2.6 million in January. This represents a monthly decrease of 0.8%, however remaining at 109.4% above March levels. January's monthly decline in the claimant count measure suggests that the labour market fared a little better in January.

The Chancellor's budget speech on 3rd March focused on maintaining a high degree of fiscal support which saw extensions of existing policies. The budget introduced an additional fiscal boost of 2.6% of GDP which is expected to continue to sustain the job market and economic conditions further supporting expectations of a strong and fast recovery once the economy is expected to lift containment measures and activity picks up towards the end of 2Q2021.

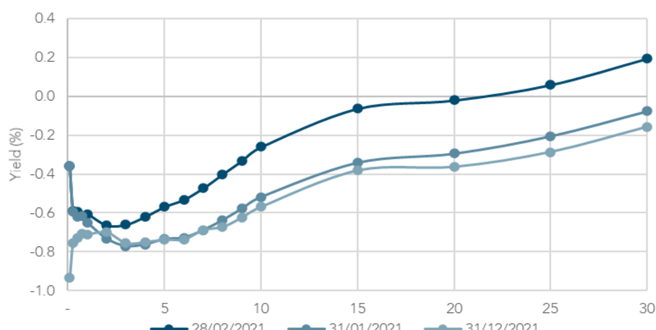
RATES

Euro Rates

Sovereign spreads experienced some widening during the recent sell-off in benchmark bond yields, this being attributed to higher rate volatility, lower ECB purchase flows (during the sell-off) and diminishing support in the central bank's communication. On a year-to-date basis, the ratio of ECB purchases to net supply was far outsized in Germany versus the other countries thus suggesting that official flows have contributed to this widening. At the same time, the slow rate of progress across Euro Area economies in combatting the virus raises fears of a longer period of low economic activity which will weigh on growth forecasts and reduces the expected speed of the recovery. This in turn puts pressure on national budgets and increases concerns around the eventual normalisation in higher public debt levels. We expected such developments to trigger a response by the ECB at the policy meeting in March.

The upwards movement in long-end German sovereign yields gained momentum in February, though to a lesser extent than US or UK yields. Similarly, the increase was boosted by a rebound in real rates as some expectations of an eventual policy tightening started creeping in, as opposed to stronger growth.

German Sovereign Curve



Source: Bloomberg

As noted previously, the more muted move in Euro Area rates is primarily explained by relatively smaller increases in inflation expectations, and a reversal in the uptick 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 relatively low, and the ECB is expected to keep rates unchanged or lower for longer, thus putting pressure on real yields.

The move in real rates was quickly reversed following some pushback by ECB officials suggesting that they are closely eyeing the rise in yields and that a rise in real rates may be too abrupt at this stage of the recovery. Given that the rise in yields is a fairly recent development, markets will continue to watch very closely any communication related to this.

The messaging given by the ECB at the January meeting essentially indicated that their priority at this stage is to maintain, and not enhance, financing conditions. This indicated a greater tolerance for higher yield levels by the ECB, unless driven by a deterioration in underlying fundamentals. Therefore, we expected the March meeting to be an important one in terms of signalling the ECB's tolerance for such a move higher in yields to the market given that higher real yields and wider sovereign spreads can be interpreted as undesired tightening in financing conditions which can trigger a response from the ECB. In fact, the Christine Lagarde communicated the intentions to step up the pace of purchases considerably in order to counteract the rise in yields.

Economic slack in the Euro Area is underestimated, particularly in peripheral countries, and therefore increases the scope for actual inflation to be realised at lower levels than originally expected.

Again, the gap in vaccine roll-outs between Europe versus US and UK increase scope for a more pronounced economic divergence which will continue to support further widening in cross-border yield spreads. We expect economic data to remain in focus and to continue to create "noise" or mixed signals given the scope for wide deviations from estimates. This in turn is expected to keep volatility high in Euro rates.

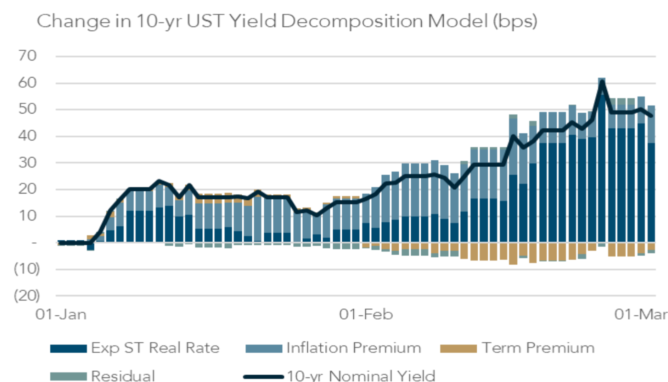
Positive data and higher growth prospects are better suited to sustain a move higher in Euro rates, as opposed to expectations of policy tightening. However, economic conditions will unlikely sustain higher levels of inflation, or growth, over the medium term which weakens the scope for yields to settle at higher levels.

Given the substantial move higher in yields, the scope for further negative curve returns has lessened at this stage and the risk of disappointing data or a weaker economic performance can lead to yields moving lower. However, volatility in rates is expected to remain relatively high and the sensitivity to the US market can continue to pull Euro Area yields higher during episodes of sell-offs in Treasuries. Our preference is to remain cautious in adding duration given the volatility we are experiencing in benchmark yields, however following the move higher in yields, we are looking at adding curve risk more favourably.

US Rates

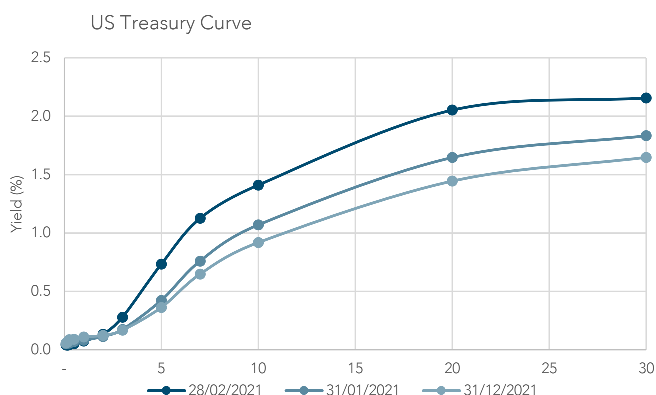
The move higher in long-end yields, which steepened the US treasury curve further in February, has been driven by a revival in the real rate, up to 44 bps since January, while inflation premium moderated by c. 6 bps, down to 10 bps since January.

The shift in the components driving the continued rise in rates was in line with our earlier observation that a move higher in nominal yields needs to be driven by higher real yields, as opposed to higher breakeven rates, and that real yields were looking rich.



Source: Bloomberg, Curmi & Partners Ltd.

In our previous update, we observed that, while the strong base effects on inflation data is a "given" and should be priced in, expectations on policy normalisation in view of the new reaction function of the Fed have heightened the implications of an overshoot in inflation, even if it is temporary. Whilst such risks remain prevalent, the extent of the steepening or sell-off from an inflation overshoot has lessened, given that markets are now pricing in an earlier policy normalisation. Steepening has first come from widening in 5s30s (in January) and then from 3s10s (in February).



Source: Bloomberg

Markets are pricing in earlier monetary policy tightening and a steeper trajectory of rate hikes. Whilst part of this is warranted given the reflationary expectations, the concurrent sell-off in equities suggests increasing market concerns of pre-emptive policy tightening. At the same time, market expectations on policy normalisation may be deemed to be too hawkish when considering inflation expectations beyond this year. Therefore, market pricing remains highly sensitive to Fed communication which downplays the strength of the rebound in inflation in the near-term.

There is scope for the sell-off to moderate given markets seem to be getting far ahead with pricing in monetary policy tightening while multiple reasons remain for the Fed to maintain a dovish stance for longer. Secondly, there is a limit to how close a lift-off in rates can be priced in and how sharp the trajectory in rate hikes can be, given the indications provided by the Fed that they will first terminate QE programmes before normalising rates. Moreover, the shift in their policy approach is more reflective of a very gradual normalisation path.

Given the higher inflation expectations and quicker rate hikes are priced-in the yield curve, at this stage of the bond sell-off, we will likely see more balance in the market forces, which drove bond yields higher. An accelerated rebound in real rates will lead to weaker risky assets which will result in downward pressure on yields. However, markets will continue to test the Fed's intentions vis-à-vis its lift-off policy when the economic recovery gains traction. Expectations still point to very strong data in Q2 which could sustain higher front-end pricing, unless we see convincing pushback from the Fed.

With a high probability of additional fiscal stimulus, the scope for an accelerated economic performance in the US, which outstrips other advanced economies, is expected to continue to sustain the widening differentials in cross-border yield curves.

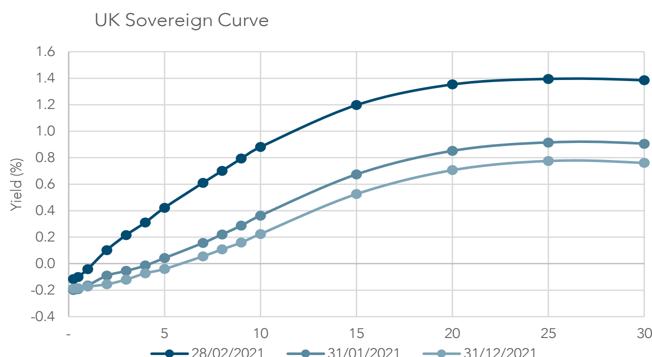
Even though we expect the bond sell-off to calm down due to the factors mentioned above, we still see scope for yields to trade higher in the US over the medium term. At the current levels of 1.5%, the 10-year is at the levels which we expected to reach later this year. However supportive growth and inflation forecasts continue to raise the forecasted end-point for yields:

1. Deployment of the latest stimulus package will neutralise any uncertainty left which will support yields;
2. Expectations of strong growth and inflation data from Q2 onwards supported by increased activity and base effects will strengthen front-end pricing of Fed policy expectations; and
3. Risks of inflation overshoot still has scope to boost yields as mentioned above.

UK Rates

The drivers behind the 50bps surge in UK 10-year gilt yields are more balanced showing wider inflation premia and higher expectations of short-term real rates. This is consistent with the strong re-pricing in the short-end of the curve, indicating a higher propensity attributed by the market to an earlier lift-off in policy rates by the BOE. The move is strongly backed by the progress achieved in the vaccination roll-outs which is boosting expectations of economic propensity despite pains in the short-term.

Given the re-pricing in the OIS curve, the market-implied probability of a rate cut has been neutralised. This is re-



Source: Bloomberg

flective of the upbeat tone at the last policy meeting on the UK's economic outlook and noted the preparatory work needed to analyse the most suitable approach to tighten monetary policy.

We previously noted that QE purchases have been the tool of choice for the BOE to stir financing conditions. In the minutes of the last policy meeting in February, the bank indicated that in a phase of policy tightening, it should reassess whether it is appropriate to retain the stock of assets purchased up until the policy rate reaches a level from which it could be cut materially (looking at 1.5%), before unwinding QE holdings. This change in language suggests that tightening would come first from QE reversal. As a result of the above developments, the move upwards in yields has been flatter across the curve compared to US and Euro Area.

The current pace of QE purchases was expected to absorb net gilt supply as indicated by the DMO. However, in early-March, the DMO announced that it will issue ore bonds than expected (£296 billion vs £250 billion) following the recent budget announcement. There is a marginally higher chance that the BOE scales up its QE target purchases to manage supply pressures, but if the pace or target of purchases is not ramped up significantly, yields are expected to continue to rise.

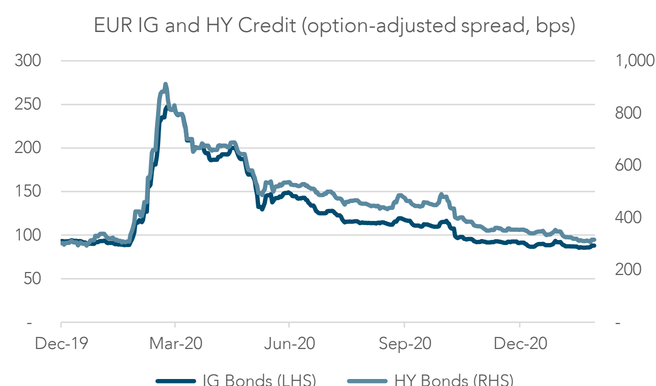
We expect consolidation in UK rates given the sizeable move seen since the start of the year. However, given the expected issuance, the strong expectations around the pace of the recovery and price levels and with little sensitivity shown by both the Chancellor and BOE Chairman on rising borrowing costs to finance their budget plans, the scope for yields to trail higher over the medium-term remains. Therefore, our preference is to reduce the duration risk to UK curves for the time being.

CREDIT

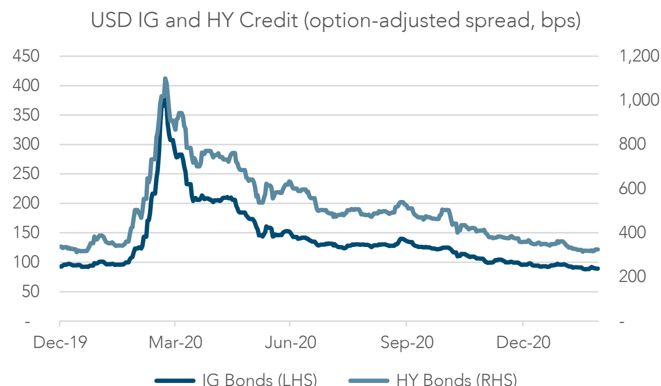
Despite the optics of posting tighter spreads vs Bunds during February, Investment grade ("IG") corporate credit traded notable weaker in absolute terms. Bund yields moved 25bp wider during the month, delivering a hit to IG of roughly 0.77% on a total returns basis, comprised of 0.32% in active positive excess returns, largely offset by a 1.09% negative impact driven by benchmark sovereign yield widening. This theme was consistent across all sectors within the IG universe, with transports, insurance and REITs the biggest gainers, while finance companies were the biggest losers.

Despite our expectation of the ECB buying an average of c.€10 billion per month during 2021, as we noted in January, at this stage, returns within the IG corporate space will depend largely on Bund moves, continued stimulus and vaccine success. Unlike 2020, there is currently minimal spread within IG to cushion against Bund movements, and hedging rates will remain critical for IG performance.

High yield ("HY") corporate credit provided the most mainstream shelter against the global rates surge within fixed income, having posted positive total returns of 0.63%, which was hard to find anywhere in bonds last month. Excess returns were even better at 1.20%, as HY extended its winning streak to five months. The 25 bps Bund widening was countered by 29 bps of HY spread tightening, as well as ample carry. Almost all sectors gained, led by transport and the consumer space, while communications and energy lagged. CCCs led the charge, while BBs lagged as high-beta prevailed. The



Source: Bloomberg



Source: Bloomberg

index added €5.6 billion of market cap, driven by supply and performance.

Corporate bond spreads tightened against sovereigns during the month as market focus shifted to the rise in inflation and its effects on bond yields and values. During the month, investor risk appetite as measured through CDS levels, implied that bond investors perceived a lower level of risk in corporate bond markets. Better risk sentiment and tighter spreads is attributable to continued government support through their respective programmes together with the positive expectations surrounding the vaccine roll-out, despite a sluggish start. The weakness seen in sovereign yields was driven by the release of economic data which showed that inflation was either in line or above consensus estimates. Simultaneously, investors had begun pricing in some expectations of an eventual policy tightening to take place sooner.

Whilst absolute levels of inflation continue to remain low, unprecedented fiscal stimulus and the continued accommodative monetary policy through historically low interest rates and bond buying programmes have been key drivers for the increase in inflation expectations. As governments continue to support the real economy through their respective programmes given the substantial decrease in economic activity, and as economies are expected to return to some sort of normality once heard immunity is achieved, inflation is expected to pick-up as a result of consumer's pent-up demand and increased spending. The expected rise in inflation should lead to higher corporate profitability and more resilient investor risk sentiment as cash flows improve and leverage declines, though the absolute level of spreads, particularly within the IG space, has left little room to absorb moves in benchmark rates.

Central bank monetary policy remained unchanged during the month. However, central bankers did provide reassurance to markets through commentary intended to temper fears of tapering or rate increases. Fed Chair Powell reaffirmed the Fed's ultra-dovish monetary policy stance during the month, as he reiterated the Fed's preference to wait for the US to reach full employment and for inflation to rise above 2% before raising rates.

February was also marked by the publication and release of corporate earnings for the full year and 4Q2020 for most of the IG universe. Generally speaking, despite the adverse conditions as a result of government forced lockdowns and restrictions to curb the spread of the virus, corporate earnings were deemed to be overall positive. Forward looking guidance provided by corporate managers showed that businesses expect an improvement in economic and business conditions during the coming quarters as the vaccine roll-out is expected to restore a certain level of economic activity while government programmes are expected to continue to support businesses.

Primary market issuance in February was muted when compared to the prior year. The flurry of debt issued throughout 2020, when economic uncertainty was still relatively high, is not expected to be repeated in the current year as economic activity picks up and as uncertainty diminishes. Corporations continue to hold high cash buffers compared to historical averages. However, while primary issuance was generally subdued, the UK and US HY markets did see a heightened level of issuance in February compared to the previous year. The increase in primary market issuance in the UK can be explained by a handful of issuers that came to the market with significantly large bond issues, while the resurgence of debt issuance in the US HY market was a result of issuers taking advantage of the record low yields on offer.

While the immediate outlook remains marred by renewed virus outbreaks, we maintain the view that the economic recovery will gather pace later this year. Amidst the gloom, there are encouraging signs with respect to vaccine supply which strengthen the view that the roll-out should gather momentum. There should comfortably be enough doses to meet the EU goal of vaccinating 70% of adults by the end of September. We therefore expect vaccine roll-outs to accelerate, which should allow restrictions to be removed and economic activity to get back on track during the second half of the year in most developed markets. Inflation will pick up around the world in the months ahead, though this will be driven predominantly by temporary factors rather than a persistent demand-driven increase. With GDP still below potential in most economies, central banks are likely to keep policy very loose for longer. This may lead to a sustained bout of higher inflation in some regions, though this is unlikely to materialise in the short term.

Although the incoming economic data is likely to remain poor until around mid-2021, we expect that riskier assets will continue to comfortably outperform safe haven assets over the medium-to-long term. We also anticipate that this will be accompanied by a further rotation within credit markets toward pro-cyclical industries as well as continued weakness in the dollar. The key risk to this view would be further unexpected delays in the vaccine distribution and that policy makers withdraw support prematurely, undermining the economic recovery and the prospects for risky assets.

The principal risk to HY is that credit losses continue to climb due to short term fundamental or structural issues.

The resurgence in infections that has taken hold over recent months is a reminder that we can not take the benign default environment as a given. The positive narrative around a vaccine toward 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 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 the most defaults. The trailing 12-month global speculative-grade default rate was 6.6% at the end of December and will climb to 7.3% in March before falling to 4.7% at end 2021 under baseline Moody's forecasts.

With that said, despite the recent increases in benchmark yields, borrowing costs globally have largely receded to pre-crisis levels, with confidence in an economic recovery sparking double-digit gains in the riskiest debt. Healthier balance sheets are causing investors to focus more on rising stars as more companies aim to re-establish IG credentials and re-admission to bigger indices. As investors put aside fears over default risk and instead focus on rising inflation that comes with rebounding growth, we can expect a structural shift out of longer dated quality issuers into shorter dated, higher risk assets. During February we have seen a larger proportion of upgrades back into IG, outpacing downgrades, whilst a recent report by JP Morgan highlights the expectation of roughly $284 billion of rising stars over the next 2 years, albeit with only $31 billion for this year.

Long-term bond yields have risen rapidly this year, prompting pushback from ECB officials in recent days. The initial response from policymakers had been to downplay concerns over rising bond yields, suggesting they can manage the risk to the Euro Area economy with verbal interventions, including a pledge to accelerate bond-buying, if needed, though they did not see the need for drastic action such as expanding the overall size of the €1.85 trillion emergency asset purchase program for the time being. Nevertheless, in the near term, we expect the Governing Council to step up the weekly pace of PEPP purchases to maintain favourable financing conditions and protect the post-COVID recovery but, ultimately and over the longer term, the trajectory of yields in the Euro Area will likely be related to government debt sustainability in Southern Europe. Indeed, in its latest monetary policy decision, published on Thursday 11th March, the ECB has said it will accelerate the pace of its bond buying over the next three months in response to the Eurozone's rising borrowing costs and faltering economic recovery amidst the recent rise in coronavirus cases.

The ECB's total QE buying rose in February, though the share of corporate credit dropped. Total QE rose to €81 billion from the prior €71 billion per month across both PEPP and APP. Despite the rise, the ECB bought €5 billion in net corporate credit, leading to a 6% corporate credit share in net QE purchases, dropping from 8.4% in January. The bulk of the increase went to government bonds in February, led by PEPP. The €5 billion of net corporate credit buying translated to €6 billion gross, including €1 billion of CSPP redemptions. We expect €8-9 billion of monthly net corporate credit buying in 2021, maintaining an 8% share within total QE. January was in line, but February disappointed. We expect a better March amid more ECB portfolio redemptions and the messaging during the latest ECB policy decision on Thursday. The primary share in February fell to 20% from 47%, as new eligible corporate supply dropped to €13 billion. Despite that, the ECB ended up buying just 9% of all eligible new issues, via CSPP and PEPP, below January's level but in line with February 2020. The ECB was involved in two-thirds of new issues during the month.

With declining virus cases in the US allowing states to begin easing restrictions on activity, we expect the accelerating vaccine roll-out and continued fiscal support to help drive GDP growth. Despite some minor obstacles, President Joe Biden has successfully passed the stimulus bill in the United States in early March. A combination of a strong economic rebound, continued loose fiscal policy and the Fed's new, more flexible framework implies that the risks to inflation remain skewed to the upside. But we do not expect the Fed to begin tapering its asset purchases until next year and believe that rate hikes remain unlikely.

Within Europe, we still anticipate a strong recovery later this year, despite the immediate outlook appearing poor. Given that GDP is likely to contract slightly in Q1 and the current slow pace of vaccine roll-outs compared to other economies, the easing of lockdowns will allow GDP to begin increasing sharply around the middle of the year. Meanwhile, inflation will likely temporarily rise to c. 2% by end 2021, only to drop back in 2022 as temporary effects causing the spike fade away. Against this backdrop, policymakers will persist with substantial fiscal and monetary policy support and, accordingly, we expect a further gradual reduction in the spread between risk and safe haven assets over the coming months.

EQUITY

The rise in the 10-year treasury yield of c. 50 bps in February to 1.4% was a cause of concern for investors in the last week of February. Rates have been on a steady rise for quite some time, bottoming at around 0.5% in July as global economic expectations started to improve. However, higher inflation expectations was the driver of the increase in rates until January. Breakeven rates rose 60 bps, from 1.6% in August to 2.1%. During this period, real rates rose by just 10 bps to –0.4%. This has changed in February, with breakeven rates largely unchanged while real rates rose 33 bps.

On a total return basis, global equities returned 3.0% in Euro terms over the month of February, after a –0.2% loss in January. The positive news flow around the vaccine, as well as falling COVID-19 case growth was greeted by equity investors. Although divergence in the vaccine roll-outs still exists, there are signs that the situation is slowly starting to stabilise.

In total, 1.9% of the global population has received the first dose of the vaccine. As for COVID-19 case growth, total cases reached 114.1 million at end February, representing a daily increase of 303 thousand cases. The 7-day moving average now stands at c. 386 thousand daily cases, down 27.9% from the end of January.

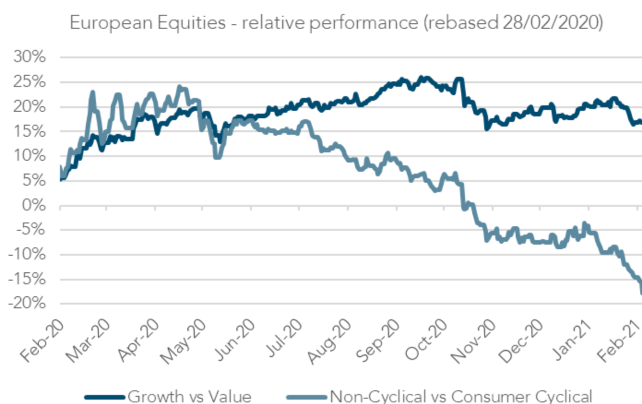
In the last week of February, global equities lost 2.4% as investors fretted about the negative impact this could have on the equity market valuation. Since the Pfizer announcement in November, the yield on the UST10 jumped 48 bps to 1.4% at the end of February. While rising inflation expectations has been the main driver of the rise in UST10 since the Pfizer announcement (+42 bps), over the last month the real yield has jumped 33 bps. A rise in real yields is more of a concern than a rise in inflation expectations.

Historically, investors have been more comfortable during periods of rising inflation expectations than rising real yields. This is because equities offer investors protection against inflation, as both earnings and dividends should rise during periods of inflation. Inflation is more common during periods of economic growth, another positive for equities.

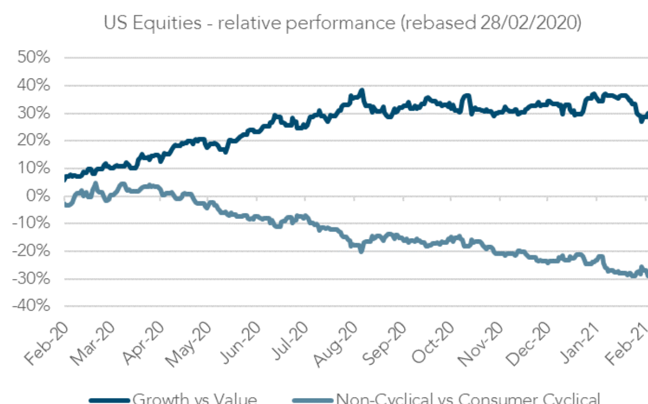
Looking at data since 2016, global equities have delivered an average weekly return of +1.3% against a backdrop of rising breakeven rates and falling real rates. Additionally, returns have been positive 76.6% of the time. Returns were similar during periods of rising inflation expectations and real yields, with a similar positive hit rate (+66.0%) with slightly lower average return (+0.7%). On the other hand, when inflation expectations fell, equities retreated (-0.5% on average when real yields rose and –1.0% when real yields fell).

On the other hand, rising real rates are harder to digest, as this has implications for the risk free rate, and consequentially for valuations. Bearing in mind the current lofty valuations, we think this concern merits some attention. We remain positive on the asset class for 2021, as we think the rise in the risk free rate will be offset by a drop in the equity risk premium. We are happy with our positioning to less expensive sectors that are set to benefit from the expected growth.

We believe investors should not be concerned about higher yields at these levels. Looked at in isolation, the concern on rising yields is valid when considering that global equities are trading on a FY22 PE of 16.3x, representing a premium of 23.4% over the 10-year median forward PE and 17.5% over the 5-year median. The high valuation levels are supported by the low yield environment and therefore, it would be reasonable to assume that higher yields should equate to lower valuations. Looking at the performance of the S&P500, the average weekly return since 2018 for US equities stands at 0.2% per week on average, but returns have averaged –1.0% per week when nominal rates rose by more than two standard deviations and –3.9% per week when real rates rose by a similar magnitude.



Source: Bloomberg



Source: Bloomberg

We expect equities to perform well against a backdrop of strong global synchronised economic growth, coupled with loose fiscal and monetary policy. There are currently no signs that growth will lead to a more hawkish stance from major central banks, with our view supported by the amount of slack in the labour market.

A rise in yields does not necessarily lead to lower valuations. Theoretically, a rise in the risk free rate would lead to higher cost of capital, and consequentially lower equity valuation. However, we believe this ignores the fall in equity risk premium. With the risks from the pandemic slowly abating, with the Brexit agreement settled and US/China trade war seemingly a thing of the past, we would expect the equity risk premium to fall. This should set-off any impact from a rising risk free rate, assuming no steep rise in rates.

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	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 remain positive on the asset class in the near term. 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 2H2021 could weigh on the European equities and the value rotation. 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. A correction remains a possibility but there are currently no signs pointing to a bear market.

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

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