Investment Strategy Update

April 2021

CURMI & PARTNERS

Curmi & Partners Research

- Economic growth expectations remain supported by the continued success in the vaccine programmes achieved across advanced economies.
- The rate of new cases has generally remained, with most countries to scaling down containment measures, allowing activity to pick up.
- US economic progress is becoming more visible in hard economic data showing the impact of the last round of stimulus and the lifting of Covid restrictions.
- Data is showing that the US will rebound stronger and faster compared to other advanced economies.
- Inflation rates across economic regions are trailing higher given the strong base effects, the surge in energy prices and the return in economic activity.
- Business surveys continue to indicate expansion with the more-severely hit service sectors finally showing a more convincing rebound in conditions and in expected business activity.
- Employment reports continue to show incremental improvements in the US labour market, while Europe and UK are expected to continue to see a gradual deterioration in unemployment rates as governments reduce wage subsidies.
- Financial markets have generally maintained a positive sentiment in recent weeks, reflective of the improving economic conditions with equity markets extending the value-led rally.
- Market participants are becoming more confident about the economic recovery and has generally favoured sectors that are expected to perform more strongly during the recovery.
- The sell-off in bond markets has subsided in March, bringing about a period of consolidation as markets seemed to have priced in a lot of optimism in terms of inflation expectations and front-end pricing vis-a-vis central bank policy normalization.
- Whilst we remain cautious with adding further duration risk in our bond allocations for the time being, we expect an eventual reassessment in benchmark bond yields once the temporary factors boosting inflation and economic output fade and more clarity is given on how central banks will normalise monetary policy.
- In the meantime, we believe that our overweight in high yield bonds and the higher cyclical sensitivity in our equity positioning will continue to benefit from the sequentially positive economic data releases during the economic recovery.

The first quarter of the year was marked by rising bond yields and an equity market rally led by a rotation from growth to value stocks. The improving economic growth prospects and the gradually receding uncertainty surrounding the timing and strength of the economic recovery, led market participants to price in higher inflation expectations, stronger earnings growth projections, tighter risk premia and in some regions, namely US and UK, earlier normalisation in monetary policy.

The expansionary fiscal impulse has underpinned the expectations of a stronger return in demand and spending. In the case of the US, where fiscal spending has been more abundant and primarily focused on direct payments to households and higher unemployment benefits, the early signs of a strong cyclical upturn is materialising in actual hard economic data releases as containment measures are gradually being lifted with the progress made in virus immunization programmes. As a result, consensus forecasts are looking at a 5.8% real GDP growth rate in the US in 2021.

Fiscal support in Europe and the UK has been more visible in the limited fallout in unemployment rates as a result of the job retention schemes, whereas activity data has seen more modest increases compared to the US. In any case, the positive GDP growth forecasts are drawing on the sharp expected return in activity from Q2 onwards, probably later for the Euro Area, despite the weak economic activity in the first quarter. Consensus estimates are forecasting GDP growth in 2021 at 4.2% for the Euro Area and 5.0% for the UK.

Forward-looking business survey indices corroborate these expectations across advanced economies with the service sectors now also indicating an improvement in expected business activity.

The encouraging economic trajectory has generally led to positive market sentiment which benefitted risky assets, namely equity markets, commodities and high yield credit, at the expense of safer assets including sovereign debt and high quality corporate credit. The longevity of the current reflationary pressures remains a key debate for investors given the higher inflation premia now priced into financial assets and the growing expectations that central banks will at some point change course and reverse policy to cool down inflation.

Our assessment is that we will continue to see economic data coming in sequentially positive in reflection of the generally ameliorating conditions across advanced economies. The return in activity combined with base effects is expected to distort economic data releases with a bias towards upward surprises. Therefore, we remain cautious of euphoric market sentiment to short-term optimism and prefer to anchor our assessment on the medium-term expectations on economic productivity and employment. With this view, we observe that the market is pricing in too high inflation rates beyond 2021 and too early central bank action compared to what can reasonably be achieved in the labour market recovery. In spite of this, we do not expect to see a market reassessment over the next few months given that economic data is expected to continue to support the current narrative.

As a result, we remain cautious in rate-sensitive bond markets in the near term as we expect to see more episodes of weak curve returns. Moreover, we see further upside potential in the value-rotation trade in stocks, despite the strong run we had since November, as we expect the rebound in cyclical stocks to remain supported by the improving economic growth dynamics.

As one-off effects on economic statistics fall out and the temporary supportive factors start to fade, we expect the rate of positive data releases to slow down leading to a shift in focus towards longer-term determinants for the growth and inflation outlook, primarily the state of labour markets and level of employment, developments in core prices, normalised aggregate demand, public and infrastructure investment.

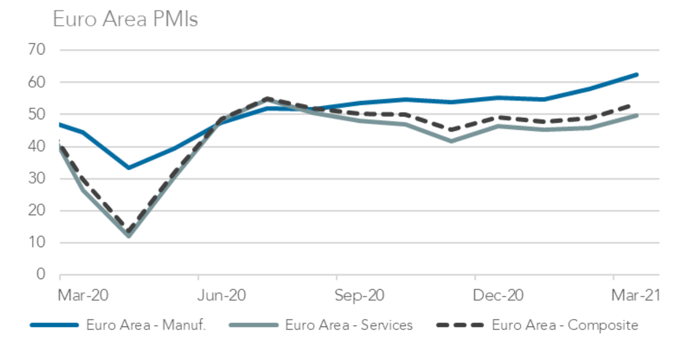
MACRO

Euro Area

Ongoing containment measures during Q1 are pointing towards a further contraction in GDP for the quarter than previously expected. It is being anticipated that restrictions will stay in place for longer than desired in major Euro Area countries, especially given the rise of virus cases and the sluggish vaccine rollout when compared to other economies, hinting to a possible recovery in Q3.

The ECB has revised its GDP forecast figures in its March meeting, with 2021 GDP growth being forecast at 4.0%, compared to the 3.9% forecast in December, while 2022 GDP growth is forecast at 4.1%, down from the previous forecast of 4.2%.

Industrial production in the Euro Area for January rose by 0.8% month-on-month from the prior month's decline of 0.1%, beating market expectations of an increase of 0.2%. Industrial exporters are expecting to benefit from a strong growth in foreign demand in the near term.



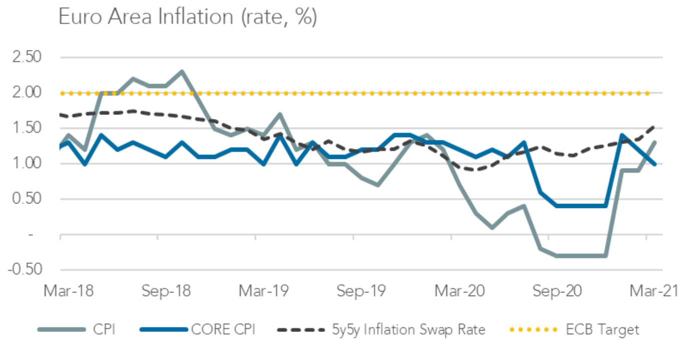
Source: Bloomberg

The final Composite PMI rose to an 8-month high in March, reaching 53.2, compared to market expectations of 52.5 and the prior month's 48.8, even though the level of activity remained low. This can be explained by an improvement in operating conditions, where output and new orders increased at record rates, helped by a fast increase in export orders. The services sector PMI signalled a marginal rate of contraction coming in at 49.6 in March, up from 45.70 in February, with incoming new business and foreign sales declining further, while employment growth was slightly positive.

Inflation in the Euro Area retained the upward trend in March, with expectations that it will rise above 2.0% in the second half of the year. However, this will be largely due to temporary factors and pandemic-related distortions that would fall out of the year-on-year comparison during 2022. As a result, we expect inflation in the Euro Area to decline back to around 1.0% levels again when these transitory factors fade.

The increase in HICP inflation from the actual year-on-year figure of 0.9% in February to the flash estimate of 1.3% in March was in line with market consensus. This increase was almost entirely driven by a pick-up in energy inflation, moving from -1.7% to +4.3%. Current movements in oil prices indicate the possibility that energy inflation will continue to rise in the near term.

On the other hand, core inflation fell from the actual 1.1% year-on-year print in February to the flash estimate of 0.9% in March. The decline came below market consensus which expected the rate to remain in line with February's figure. Economists view this decline as being the effect of January's postponed or cancelled winter sales coming to an end.



Source: Bloomberg

There is growing evidence of price pressures building in the manufacturing sector, with the eventuality that inventory shortages could push up prices of goods. Economists believe that clothing and holiday prices should rebound once economies re-open which, combined with the base effects related to the reversal of Germany's temporary VAT cut, will also boost core inflation in the second half of the year.

The unemployment rate was unchanged at 8.3% in February, above market expectations of 8.1%, despite virus measures being tightened. This further highlights the extent to which government policies have protected jobs during the pandemic and lockdowns, with firms still relying on such subsidies, albeit nowhere near as heavy as they did last spring. In any case, the gradual increase in the unemployment rate is underestimating the slack in the labour market given the substantial government intervention in the form of job retention schemes. Because of this, the lower level of persons employed only partially captures the fallout in the labour market compared to pre-pandemic levels.

Economists believe that due to the continued support through the extension of such schemes, the risk of a sharp surge in unemployment in 2021 remains low. However, it is expected that unemployment will creep back up over the next quarter to c. 9.0%, as firms' hiring intentions remain subdued and government support is expected to be tapered when the economy gains traction.

Financing conditions in the Euro Area remain highly accommodative as the ECB left key interest rates at record-low levels during its March meeting. It was pointed out that it would conduct emergency bond purchases at a significantly higher pace over the next quarter, aiming to bring government bond yields down, following the surge in yields since the start of the year, and to support economic recovery. These purchases will be made "flexibly according to market conditions and with a view to preventing a tightening of financing conditions".

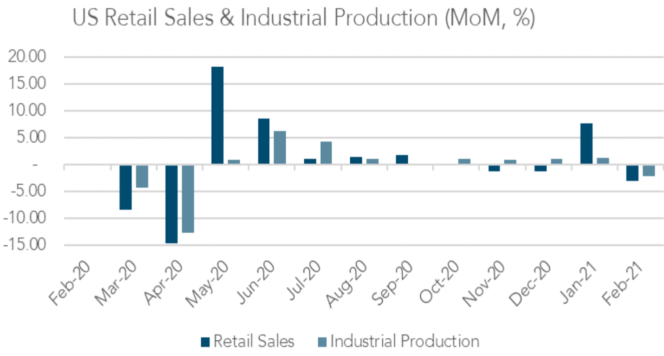
The ECB did not make changes to policy, maintaining its PEPP total envelope of €1.85 trillion to be spent until at least the end of March 2022. Further, the ECB kept its overall inflation outlook broadly unchanged.

The latest TLTRO auction, which was the first since the ECB raised the borrowing limit in December, took the longer-term refinancing operations over €2 trillion.

United States

The outlook for the US economy for 2021 continues to improve given the positive progress achieved on the vaccine front and the next round of fiscal impulse and stimulus cheques which are expected to continue to support growth in internal demand. In fact, at its March meeting, the Fed revised its economic growth projections for 2021 up to 6.5%, from December's forecast of 4.2%.

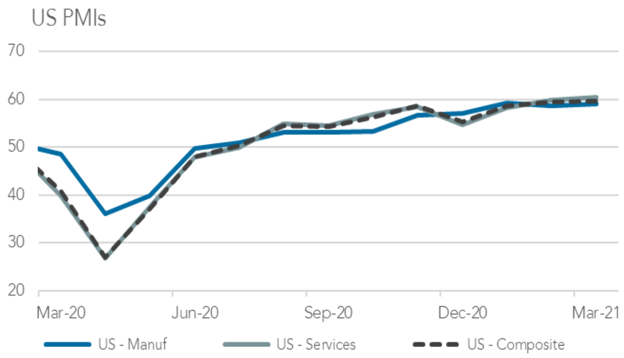
Retail sales in February declined by 3.0% month-on-month compared to the prior month's expansion of 7.6% and disappointing market expectations of a decline of just 0.5%. However the decline reflects the fading of the boost from the $900 billion fiscal stimulus in late 2020 and disruption caused by the severe winter weather, in spite of the easing of restrictions around the states.



Source: Bloomberg

With the next round of larger stimulus cheques which are expected to hit March data, economists expecting a renewed surge in spending. Real consumption growth expectations are of c. 10.0% annualised in Q1, and as the vaccine rollout pace allows for a widespread reopening of the economy over the coming months, Q2 is expected to have an even stronger rate of growth in consumption.

The drop in industrial production in February of 2.2% month-on-month, compared to January's increase of 1.1% and market expectations of +0.3%, was largely a result of the severe storms that hit the country in the second half of the month. This will also most likely be reversed in March as the weather returns to seasonal norms. There were also signs of global supply shortages playing a role, which could prove to be a longer-lasting drag on production, causing concerns that output would not close the gap with goods demand which are set to be boosted by the latest round of stimulus cheques. However, this lag may create scope for second round effects that may give increased sustenance to the rebound in economic activity. As inventory levels remain lean due to the sharp return in spending, industrial production has further space to catch up and utilisation capacity to gradually increase as we continue to progress through the period of economic recovery.

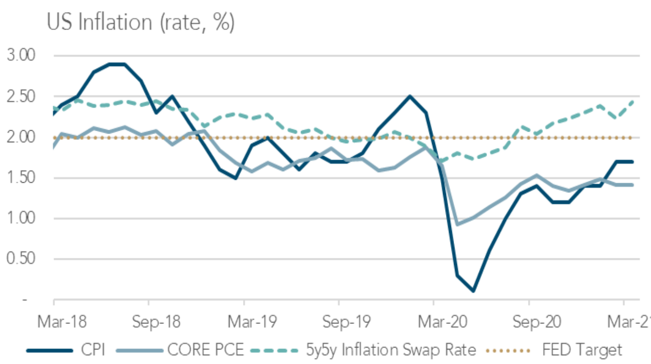


Source: Bloomberg

The final Composite PMI stood at 59.7 in March, marginally higher to the prior month's 59.5 and beating expectations of 59.1. The business survey signalling the fastest upturn in services output growth and new orders growth since mid-2014, although it must be noted that production was reportedly held back by supply shortages.

New business output expanded the most in six years, reflecting strengthening client demand amid the easing of restrictions in some states as infection rates decline, with firms showing more confidence in the vaccine rollout programme, fresh stimulus and a resulting boost to new sales.

The rise in CPI inflation to 1.7% in February from the prior month's 1.4% was largely due to higher energy prices. The print came in line with expectations while Core inflation remained unchanged at 1.3% compared to the prior month's and market expectations of 1.4%.



Source: Bloomberg

The continued surge in crude oil prices points to further gains in March which are set to go well beyond the base effects linked to the plunge in prices last spring.

It is expected that base effects will push core inflation above 2.0% by April, while numerous factors point to a more sustained rebound in underlying price pressures over the coming months given the imminent fiscal stimulus set to increase demand at a time when many sectors are facing severe supply constraints. As a result, it is expected that Core PCE inflation, the preferred inflation measure of the Fed, will exceed the 2% target in 2021. However, as the fiscal impulse and short-term imbalances fade, we expect Core PCE inflation to moderate and decline back towards the 2% area in 2022.

Looking at the US labour market, the unemployment rate fell to 6.0% in March from 6.2% in February. The improvement in the headline figure came in line with market expectations, this being the lowest rate since the onset of the pandemic. The labour force participation rate edged up to a 3-month high of 61.5% from the prior month's 61.4%. Moreover, the March jobs report shows that c. 916 thousand jobs were added to the economy, the most in 7 months and well above the market consensus of 647 thousand with the largest job gains occurring in the leisure and hospitality sector, the public and private education sector and construction sector. While the improvement in labour market data is certainly a step in the right direction, the US economy still remains with about 8.4 million jobs short of the pre-pandemic level.

We expect the rate of improvement in the labour market recovery to slow down as the current forces that are boosting economic momentum start to fade.

The Fed made it clear that it still has no plans to tighten monetary policy for the time being up until it is confident that the economy is on a resilient path in restoring full employment. The median estimates of the Fed's "dot plot" indicates that rates will remain unchanged until the end of 2023. This primarily reflects that evaluation of committee members that the strong expected economic growth this year will only a transitory impact on inflation.

The Fed made minimal adjustments to the policy statement, alongside leaving the policy rate on hold at 0.00-0.25% and the pace of asset purchases unchanged at $120 billion per month. The current pace of purchases is to remain unchanged until substantial further progress toward maximum employment and price stability goals are realised.

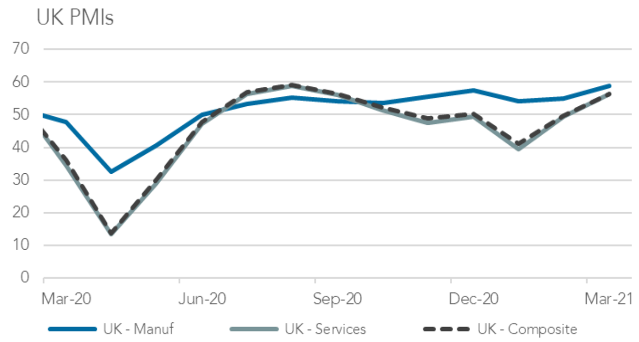
Chairman Jerome Powell argued it was too soon to discuss tapering asset purchases, underlining the commitment to wait for "substantial further progress" towards the Fed's goals. The Fed signalled no intention of adjusting the programme to counter recent increases in longer-term Treasury yields.

United Kingdom

The drop of 2.9% month-on-month in GDP in January was not as bad as the consensus expected contraction of 4.9%, with 16.3% month-on-month drop in education output contributing 0.9ppts to the decline as schools remained closed.

January's GDP is being seen as the lowest point for the economy, as the vaccine rollouts are progressing rapidly, with c. 47% of the entire population being vaccinated as at 11th April, and that the worst of the impact from Brexit, particularly in international trade, has passed. It is further believed that by 2022, the economic output will be reaching pre-pandemic levels, as long as another surge in virus cases is avoided.

The modest increase of 2.1% month-on-month in retail sales for February, which came in line with expectations, proved that the third lockdown was tough for retailers as sales remained suppressed, leaving sales at 3.5% below pre-pandemic levels. The largest contributor keeping retail sales suppressed was clothing and footwear sales (-9.7% from prior level), which is expected to bounce back once non-essential retailers open in mid-April.



Source: Bloomberg

The final Composite PMI stood at 56.4 in March, fairly in line with the market consensus of 56.6 and above the prior month's figure of 49.6. The survey is signalling the strongest rate of output growth in six months. This was supported by an increase in total new work due to stronger client demand (both domestic and from overseas markets) and forward bookings ahead of easing lockdown measures.

The annual inflation rate eased to 0.4% in February, compared to the prior month's 0.7% and the market consensus of 0.8%. The main reason for the downward movement mainly came from a fall in prices for clothing and footwear and second-hand cars. These drags on inflation will probably fade once people return to the shops when non-essential retailers open in April. The core inflation rate slowed in February to 0.9% from the 1.4% market consensus and prior month figure.

The BOE expects inflation to rise towards the 2.0% target at end of the year, mainly due to oil prices, regulated household energy prices and other one-off effects. However, in view of the transitory nature of the increase in price pressures, expectations point to a drop to below 2.0% during 2022. Economists believe that while the pandemic will lead to more inflation eventually, there is little evidence that sustainable inflationary pressures are building just yet.

The drop in the unemployment rate from 5.1% in December to 5.0% in January, which was below the market consensus of 5.2%, reiterates the extent to which the government's job furlough scheme has protected jobs during the pandemic (the scheme supported c. 4 million jobs). Economists expect the rate to rise even further, peaking at 6.0% by early 2022, a bulk of this being driven by those who left the labour force and are returning once the economy reopens, rather than from people losing their jobs.

In the meantime, the MPC did not follow in the ECB's footsteps by stepping up the pace of its quantitative easing ("QE") purchases. Instead, it echoed the message of the Fed by emphasising that rate hikes are still a long way away. This suggests that rates will not rise next year as the markets expect.

Alongside the unanimous vote to leave the Bank Rate at +0.1% and the stock of QE at £895 billion, the MPC maintained its commitment to complete the £150 billion of extra QE launch in November by "around the end of 2021". This is consistent with the pace of QE being slowed at some point from the current £4.4 billion a week. Policymakers signalled that the central bank stood ready to increase the pace to ensure the effective transmission of monetary policy.

The MPC further stated that it does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the inflation target.

The extension to many support measures in the Budget and the staggered withdrawal of policy support means that the aid given to the economy will not be suddenly taken away. The expiry of the various support measures seems to be scheduled for when the economy and the hardest hit sectors are much healthier and more ready to cope without these lifelines as the economy follows the route out of the lockdown.

RATES

Euro Rates

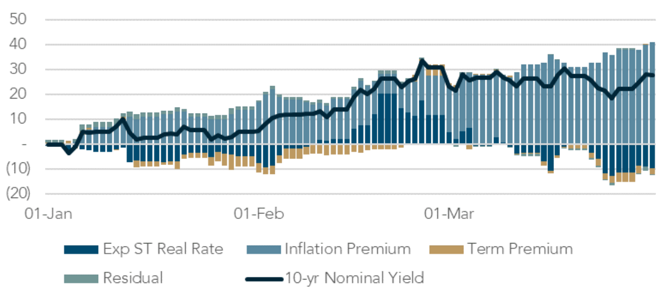
Peripheral sovereign spreads were the main beneficiaries in March following the ECB's announcement that it will increase the pace of PEPP purchases. Whilst the risk of a re-widening in sovereign spreads is unlikely at this stage, we do not see substantial scope for further spread tightening given:

- the growing economic divergencies across the Euro area exacerbated by the slow vaccine progress;
- the limited joint fiscal support with the more-problematic nations having lower capacity to increase fiscal spending at national level; and
- concerns that the higher debt burdens in the more-severely impacted countries will necessitate an extended period of time to regularise.

March saw an interesting development in the German sovereign curve, namely a pivoting movement at the 10-year point and a steeper curve. The decomposition model of the movement in the 10-year point shows the pricing of short-term rate expectations following the latest ECB meeting has declined while inflation premia continued to widen.

In our previous update, we noted that the scope for further negative curve returns has lessened and the risk of disappointing data or a weaker economic performance can lead to yields moving lower. March has in fact seen the 10-year bund yield trading sideways, and dipping back down to -0.38%.

Change in 10-yr Bund Yield Decomposition Model



Source: Curmi & Partners, Bloomberg,

Long-end Euro rates came marginally down in March, further widening cross-regional spreads, primarily driven by the ECB's communication, weaker economic data and low progress on the vaccine front resulting in increased uncertainty on the strength of the economic recovery.

We feel that the decline in front-end pricing is well placed in view of the various challenges in the Euro Area to see a concerted economic expansion that is broad enough to lead to a sustained increase in price pressures. The lack of fiscal action and longer expected timeline for the economic recovery reduces the prospects of a strong return in economic employment and productivity, consequently resulting in weak pass-through effects.

The basis to scale-up duration in March so far remains intact. Since the scope for positive curve returns is limited, the increased duration risk is only justified if adequate compensation is provided from spread returns.

We remain cautious with adding further curve risk at this stage given the movement lower in yields from the February highs, the "noise" from unstable or erratic economic data releases, and the scope of substantial upward repricing in the event of positive surprises in economic data (resulting in outsized movements higher in yields).

The risk for an upward movement in yields is particularly high if the downside risks to the economic outlook continue to fade. This can be the result of possibly a meaningful pick up in the speed of the vaccine rollout programmes across Europe and/or improved fiscal spending (at national or pan-European level).

Moreover, in the near term, the scope for increased accommodative action by the ECB is unlikely. The next round of staff projections will probably see an upward revision in the growth outlook. The consensus amongst council members to increase PEPP further is, for now, both unlikely and useless. The ECB's action has been an important driver in sovereign bond markets in March and this underlying support is likely to weaken as economic conditions ameliorate.

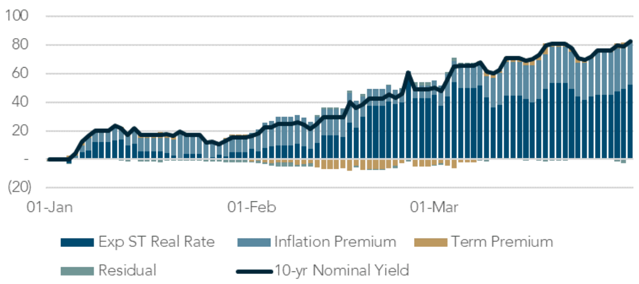
The resulting higher inflation premium being priced-in, following the reassessment in expected short-term rates, could be the factor that provides scope for positive curve returns over the medium term. We believe that this may present opportunities to add curve risk as the one-off and temporary factors driving economic data gradually fade, and the trajectory for economic recovery and inflation progression becomes clearer.

US Rates

Growing optimism on Q2 data in view of the progress achieved in the rate of inoculations, the low rate of new cases, as well as the continued fiscal support, has continued to support higher inflation premia being priced in the US curve.

Concerns of an overheating US economy have started to emerge in view of the reluctance of the Fed to act pre-emptively to curb a rise in inflation above its 2.0% target and to stick to easy monetary policy and allow inflation to run above target to compensate for periods of low inflation – the "average inflations targeting" approach now adopted by the Fed. As a consequence, our decomposition model shows that the movement in the 10-year yield has been driven by higher inflation premia and higher average short-term rates, reflective of a faster normalisation process in Fed policy implied by market pricing.

Change in 10-yr Treasury Yield Decomposition Model



Source: Bloomberg

The Fed continues to express concerns on the fragility of the positive streak of data coming out of the US which will unlikely result in a lasting effect on inflation. As noted in our Macro outlook we share this view, as we expect inflationary pressures are expected to be transitory and to moderate over the medium-term to be more reflective of a below-potential level of employment.

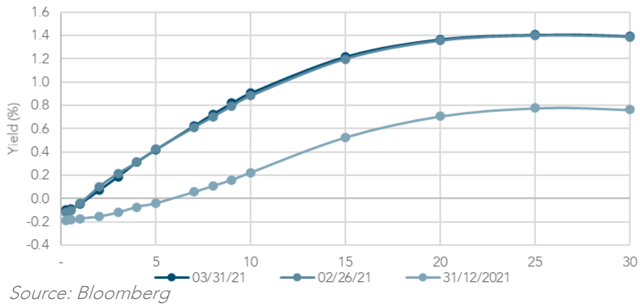
As noted in the last update, we continue to reiterate that there is scope for the sell-off to moderate given that the market seems to be getting far ahead with pricing in monetary policy tightening while multiple reasons remain for the Fed to maintain a dovish stance for longer. These include protecting easy financing conditions, low employment, high debt burdens and financial market disruption. 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.

This has been confirmed in the relatively more muted moves higher in US yields over the month of March. However, if upcoming economic data continues to be supportive we will likely see upward pressure on yields as the overheating argument gathers strength.

In March, the belly of the curve traded higher as markets continued to price in earlier hikes by the Fed with implied pricing showing that the first rate hike was brough forward to early 2023.

We continue to believe that market expectations on policy normalisation may be deemed to be too hawkish when considering inflation expectations beyond this year. Market-implied inflation measures appear to be too optimistic when compared to economist forecasts and the Fed's own projections underscoring the elevated front-end pricing. As noted previously, sequentially improving data is expected to continue to feed this narrative with positive sentiment, possibly continuing to drive the steepening of the US curve. At the same time, a disappointment on the data front can lead to a temporary reassessment in the interim, bringing about a correction in yields, however this is less likely to happen.

UK Sovereign Curve



Source: Bloomberg

We expect movement in the Treasury curve to be highly sensitive to upcoming economic data, now that more clarity has been provided by the Fed via-à-vis its own response to the recent rise in yields. This will either confirm the currently strong growth and inflation outlook or bring the optimistic market pricing into question.

On this basis, the risk remains for long-end yields to move higher given that leading economic indicators continue to point to further economic expansion. The possibility of an overshoot in inflation remains likely given the factors supporting price pressures which, even though may still be temporary, may exacerbate front-end pricing and boost inflation premia further.

While we maintain that market expectations on inflation and Fed pricing is excessive, we will unlikely see any reassessment in the short-term given the strong economic impulse. Once the first round effects of the stimulus boost fade and base effects on economic data start to normalise, the scope for a market realignment increases which can bring about opportunities from front-end repricing.

UK Rates

March saw hardly any movement in the UK gilt curve. Positive progress on the vaccine front continues to support the growth outlook for the UK economy despite current conditions remaining severely challenging.

The BOE displayed little sensitivity to the movement higher in UK gilt yields since the start of the year but at the same time remains committed to maintaining an easy monetary policy for the time being.

Talk of the potential introduction of negative rates has fallen by the wayside given the improving inflation expectations with only a marginal lower adjustment in front-end pricing following the reaffirmation of the BOE's forward guidance on policy rates.

Despite the improving economic outlook, unemployment continues to inch higher. The BOE judged that there is a "material degree of spare capacity at present". The BOE seems to indicate that it would similarly be premature to act on the back of boosted economic data and to be patient for evidence that shows that economic employment, and therefore the underpinning conditions for stronger levels of inflation, is closer/at potential levels before tightening policy.

Given the currently high issuance calendar, following the recent budget announcements, the BOE is expected to retain the current pace of QE purchases which will limit any upward movements in gilt yields. The pace of purchases is expected to be reduced in summer when issuance is expected to decline.

If the current challenges are overcome and the expectations of stronger economic performance in Q2 and beyond is materialised, we expect the debate on whether the BOE should reassess and/or remove stimulus to gain popularity.

The consolidation in UK rates given the sizeable move seen since the start of the year, which we have anticipated in our previous update, has so far materialised throughout March in the limited movement seen in gilts.

Market pricing indicates that the first rate hike will occur by Q4 2022. This, in our view, is too optimistic and explained by higher market expectations on the inflation outlook as a result of the somewhat euphoric optimism on the trajectory of the economic recovery.

It is more likely that the first BOE rate hike will come later in 2023 mainly since (1) we expect the inflation surge in the near term to be temporarily overdone and to moderate as one-off factors fade, (2) the fallout in employment will take longer to recuperate and wage growth to gain traction, and (3) the BOE will first tackle the phasing out of QE purchases first, before making adjustments to policy rates.

The risk of excess economic capacity for an extended period raises doubts on the likelihood of high inflation over the medium term. Therefore, the relatively high inflation premia in UK rates limits the extent of an upward movement in yields on the back of improving inflation data (in the absence of an inflation overshoot).

Whilst the recent consolidation in UK rates is well placed, given that markets are now awaiting the realisation of the optimistic economic environment in actual economic data, the risk of an outsized move upwards in yields on the back of positive economic releases is high given the current market conditioning. In view of the already high front-end pricing, we expect such an outcome to lead to an upward movement in long-end yields resulting in a steepening of the curve.

CREDIT

The rise in yields on safe haven government bonds has taken a breather in Europe over the last four weeks, as dovish central bank policy, reconfirmed during the March ECB monetary policy meeting, along with the sluggish economic recovery due to high infection figures, has effectively pulled the brakes on the sell-off in European benchmark bonds, allowing Euro Investment Grade ("IG") credit to deliver its first positive months of 2021, amid flat spreads and a stable bund.

Overall, Euro IG delivered gains 0.21% for the month, as the March new issue supply also remained moderate, helping to insulate spreads. Recent strong performance in High Yield ("HY") credit has continued for a sixth straight month as, similar to IG, spreads have remained fairly flat and remain a shelter against the threat of further increases in benchmark rates. Euro HY managed positive returns of 0.73% in March, with carry predominantly driving gains. While heightened COVID infection case numbers in many European nations and a slower than-desired vaccine rollout are ongoing challenges, corporate earnings have been resilient, and default rates remain very low.

Although the sell-off in UK gilts has largely halted in line with European counterparts, holders of gilts are suffering their worst quarter in at least two decades, as the swift rollout of the vaccine has given investors more confidence in the route to economic recovery.

UK IG credit has undeniably suffered during this period, posting negative returns of 4.65% during the quarter, of which only negative 0.14% attributable to March in light of the stabilisation in gilts. Similar to European counterparts, the spreads offered within HY provided some cushion for investors against volatility in benchmark rates and has continued to trade well over the period.

The US HY market returned 0.15% in March, bringing the YTD return to 0.85%. The move continues the pattern of HY outperforming IG credit, due largely to the responsiveness of HY spreads to growing expectations of stronger economic growth, whilst rising Treasury yields weigh on IG bonds. For reference, Treasury yields closed March roughly 33bp wider, leading to a 1.72% decline in total returns for US IG during the month.

For 1Q2021, corporate defaults totalled 13 globally, compared with 30 during 1Q2020, as government and central bank actions have played a critical role in averting an otherwise more dire default cycle. Moody's analytics expect the trailing 12-month HY default rate to fall to 3.2% by the end of the year. On 22 March, Fitch Ratings adjusted its bond and loan default forecast for full year 2021 to 2.0% and 3.5% respectively, from a year end 2020 default rate of 3.3% and 3.7%. Fitch expects 2022 default rates to reach 3.0% for bonds and 4.0% for loans. The decline in near term default rates reflects buoyant capital market conditions and the expectation that social distancing restrictions will be eased for good in 2H2021 as vaccination programmes take effect. Simultaneously, Moody's forecast a sharp increase in rising stars among rated companies this year compared with last year, with projections showing a rising star rate for Ba1 companies jumping to 11.9% for the 12 months ending in July, up from 3.4% a year earlier.

As discussed, after a disappointingly slow start, vaccinations in the EU look set to gather pace during Q2, as supply from existing vaccine suppliers improves and new vaccines come online. The expectation remains that in early Q3, European economies can begin emerging from winter lockdowns in a more sustained manner and economic growth at this point should accelerate briskly. Full normalisation will take time given a gradual removal of restrictions, lingering caution and some scarring effects from the crisis, though Euro Area activity is expected to reach pre-crisis levels in the first half of 2022.

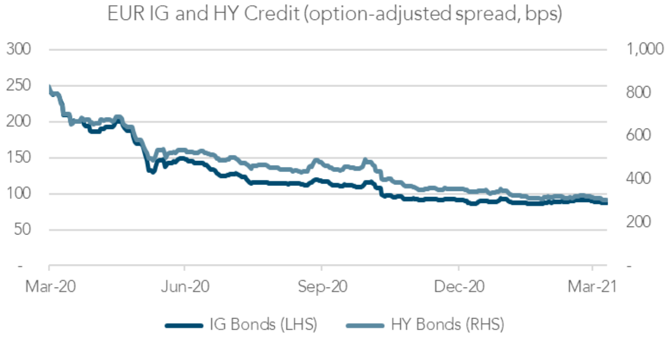
Inflation is expected to remain volatile over the next year, driven largely by distortions from tax changes and CPI basket weight changes. However, looking beyond these distortions, we continue to see inflationary pressures remaining muted given ample slack in the economy. We expect credit investors to look through inflation for the time being, focusing more on the view that the ECB looks set to remain supportive, keeping rates unchanged and continuing to add to its asset purchase program through the end of 2022. Fiscal policy also looks set to remain stimulative, helped in part by EU Recovery Fund disbursement from mid-year 2021, though orders of magnitude will be less than in the US.

The key upside risk is a greater release of pent-up demand as economies reopen, whilst the key downside risk to Euro credit concerns the speed and efficacy of vaccination programmes and a greater degree of scarring in labour markets and companies heavily affected by the crisis. Fiscal policy may also be an area of uncertainty regarding outlook, though at this stage, this is an event for late 2022 or beyond, as European fiscal policies look set to remain in their current form for the foreseeable future.

The vaccine rollout in the UK is off to a quick start, and the government is on track to remove most restrictions by early summer. We expect activity to rebound fairly quickly from the second quarter, gradually catching up with activity in the rest of Europe, having fallen more sharply in 2020. Fiscal policy, meanwhile, is likely to mechanically turn contractionary toward the latter half of 2021 and onward, as COVID-related emergency measures gradually roll off. As highlighted earlier, we expect UK economic activity to return to pre-pandemic levels sometime in the first half of 2022, similar to our expectations for the rest of Europe.

UK inflation looks set to increase over the cyclical horizon, though also similar to Europe, it will be a volatile path, with changes to both CPI basket weights, tax policy and other one-off effects adding some temporary noise. Distortions aside, underlying inflationary pressures are likely to run below the BOE's 2.0% target during 2022, still hindered by high levels of economic slack. Against this backdrop, the BOE looks set to gradually taper its asset purchases from summer 2021 onward and finish its net purchases by year-end, creating some uncertainty on the pathway spreads may take as the market re-adjusts to a lower level of central bank activity. The key upside risk in the UK remains a sharper-than expected rebound in consumption, driven by a faster normalization of household savings, whilst downside risks, similar to Europe, relate to more severe pandemic-related scarring, particularly in the labour market.

The ongoing improvement in the outlook for US GDP in 2021 continues to bode well for corporate credit spreads, as massive fiscal stimulus combined with an improved public health situation are set to create a surge in economic activity. COVID-19 vaccinations are



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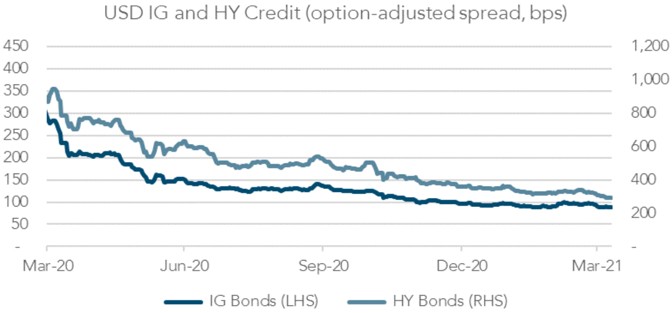


Source: Bloomberg

now well underway, consistent with the expectation that the majority of the population will be vaccinated by the end of the second quarter. The additional COVID-19-focused fiscal stimulus that passed in December and March amounts to nearly $3 trillion and is estimated to contribute 2.5–3.0 p.p. to 2021 growth. Growth is expected to decelerate meaningfully in 2022, though to remain above trend, as the sharp decline in the fiscal stimulus is offset by continued reopening and recovery.

It is likely the Fed will slowly begin to reduce the level of monetary policy accommodation by tapering asset purchases in late 2021 or early 2022. However, we continue to expect a prolonged period before the Fed raises rates. Fed officials have clearly indicated they need to see a complete and inclusive recovery in the labour market and inflation sustainably at 2.0% before raising interest rates. According to the Fed's own March 2021 forecasts, the Fed won't reach these goals until at least 2023. The key downside risk remains the potential for new virus variants that could significantly derail the recovery.

EQUITY

March marked another month of positive performance for the equity market. The underperformance of emerging markets so far in 2021 has come as a surprise when compared to their developed market counterparts. We believe that this underperformance is due to political factors and the lacklustre vaccine rollout as virus cases continue to grow at exponential rates. Notwithstanding, we remain positive on emerging markets for the current year. In developed markets, value stocks have outperformed growth so far in 2021, but a key question is whether this value trade has more legs or if a lot of the good news is already priced-in.

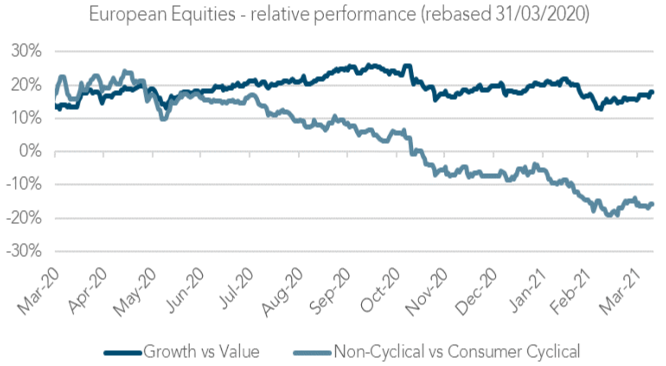
The rally in risky assets continues to gather pace. Global equities delivered a total return of +6.3% in Euro terms during March 2021 as investors become more confident on the economic recovery that is taking place. While the rollout has diverged amongst countries, it is starting to look more likely that economies will be able to open up to some extent as we get closer to the end of the first half of 2021.

A year ago global equities were in free fall as the virus spread started to accelerate outside of China. The total return for global equities during 1Q2021 of +9.3% in Euro terms is a far cry from the -19.1% generated during the same period last year. It helps to highlight not only the swift and sound response from central banks, but also the speed at which pharmaceutical companies have operated to develop multiple effective vaccines.

Financial conditions remain very easy compared to history and there is currently no sign that central banks will change their monetary policy considerably. Additionally, the global uncertainty index has been falling steadily over the past year as the impact from COVID-19 and political risks (namely US/China and Brexit) fade. This should eventually lead to a lower equity risk premium, counteracting any rise in the risk-free rate.

We have looked at data since 1990 and we noted that as inflation expectations rise, the equity risk premium tends to decline. We think this is logical, bearing in mind that most of the time higher inflation expectations are a consequence of strong economic growth. Equities tend to do well during periods of higher inflation expectations, in part as earnings should rise during such periods. Additionally, flows into equities tend to be higher during such periods, as both dividends and earnings should rise during periods of higher inflation, while bonds generally offer limited protection to inflation. Our view remains that inflation will overshoot the 2.0% target over the summer, which should have particular consequences for equities. This underpins our preference for value stocks over the coming months.

The rotation that started in November 2020 has continued to gather pace so far this year. Global value



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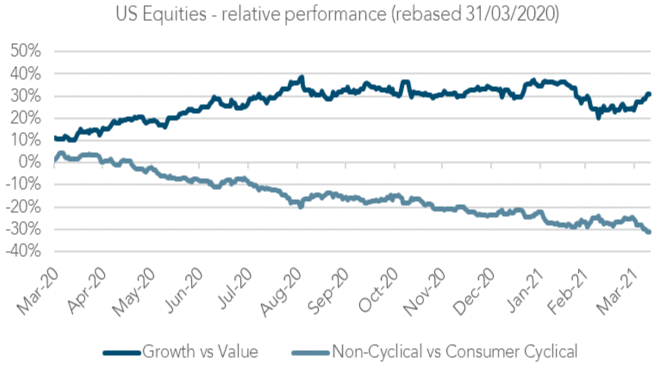

Source: Bloomberg

(+14.2%) has delivered a total return that is three times higher that delivered by global growth (+4.3%) during 1Q2021. Despite this outperformance YTD, global growth (+214.9%) is still the clear winner over global value (+91.3%) when looking at the total return of both strategies since 2007. Looking at valuations, global growth stocks are trading on a forward PE premium of 81.0%, down from 98.6% at the start of the year. This is well above the 10-year median premium of 26.8%. Despite our positive near term outlook for value stocks, we do not expect the current premium to coverage the median.

The shift in equity leadership since the announcement by Pfizer in November has boosted last year's laggards over the past months. The improving economic expectations coupled with the $1.9 trillion fiscal stimulus package announced in the US have further boosted this trade. Rising bond yields and inflation expectations have contributed to the outperformance of value stocks relative to growth stocks on a year to date basis.

The outperformance has been strong after a decade of underperformance for value stocks. The long term trends remain largely unchanged, in that we expect long term economic growth to remain muted with long term inflation below target. However, the coming months should continue to be favourable for value stocks given the outlook for rising inflation and accelerating economic growth.

Conditions still appear favourable for value stocks in the near term. We look at four indicators to get more clarity around what upside remains for value stocks, these being outlined below. Whilst it is difficult to quantify we believe the value rally has still got legs.

1. *Value vs. Growth and Cyclicals vs. Defensives* – Value and cyclical stocks generally do well during periods of economic expansion. Cyclical sectors have rebounded strongly since April 2020, now outperforming defensives when calculating performance since 2006. On the other hand, even though value stocks have outperformed their growth counterparts, they are still languishing behind. Whilst we do not expect the gap to close completely, value stocks have tracked cyclical stocks more closely during periods of strong economic growth.

2. *Value vs. Growth and the 10-year bund yield* – Rising bond yields have generally been associated with periods of growth outperformance. Generally, bond yields rise during periods of economic expansion due to rising inflation expectations. Value sectors like banks, energy and basic resources all benefit from such a backdrop. Goldman Sachs expects the 10-year bund to reach 0% in 2021 (from the current c. -0.3%) which should bode well for the value trade.

3. *Value vs. Growth and the Global Economic Uncertainty Index* – High periods of uncertainty over the past decade have been a source of support for growth stocks. Investors opted for stocks that are less sensitive to economic growth. Events like Brexit, US/China trade talks and COVID-19 have increased uncertainty level but on the other hand, investors had to digest higher policy uncertainty in the form of higher government debt levels, low interest rates and weaker long term economic growth outlook. We have seen some of these risks fading in the past weeks which is not yet reflected in the value vs. growth outperformance.

4. *Value vs. Growth and EU PMI* – Pro-cyclical equities have rebounded since November and are now pricing in a lot of the recovery in activity. Despite this, value has lagged compared to other strategies.

Bearing in mind the expected acceleration in activity, the inflation outlook for the remainder of the year and the impact on yields, we expect value stocks to outperform in the coming months. Therefore, our bullish outlook for banks, basic resources and energy remains intact. We also expect names that have not yet recovered from the pandemic to outperform as the path to normality becomes clearer.

We believe that upside remains, especially in Europe, where there are currently doubts on the region's economic recovery prospects. In our view, such concerns are overdone. Despite our positive outlook, investors should be ware that risks remain:

1. Equities rallied strongly since November, which leaves the market susceptible to a correction;
2. A new virus variant where the efficacy of the current vaccine is low could derail the global economic recovery; and
3. Global economic recovery is weaker than currently expected.

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, the launch of the EU Recovery Fund in January and the 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. We are less constructive on IG credit in both USD and GBP. 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 selected basis. The scope to remain selective in carrying high yield positions remains while the scope to opportunistically identify unjustifiably discounted bodies 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 decompressions 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 emerging market 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, keeping our current allocations across sectors unchanged. We are overweight value sectors like banks and basic resources but slightly underweight energy. The outperformance of value stocks continued during March, this being a major catalyst for the portfolio performance so far during 2021. Bearing in mind the expected acceleration in activity, the inflation outlook for the remainder of the year and the impact on yields, we expect value stocks to continue to outperform in the near term. Therefore, our bullish outlook for banks, basic resources and energy remains intact. Furthermore, we expect names that have not yet recovered from the pandemic to outperform as the path to normality becomes clearer. Additionally, we are overweight the more cyclical construction and materials sector. We are relatively less positive on cyclicals, however we feel that our stock allocation should do well for different reasons, including the COVID-19 recovery story. We believe that upside remains, especially in Europe, where there are doubts on the region's economic recover prospects. In our view, such concerns are overdone, however, despite our positive outlook, investors should remain aware of the risks that are present.

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

DISCLAIMER