Investment Strategy Update

May 2021

CURMI & PARTNERS

Curmi & Partners Research

- The US economy is recovering at a fast pace with the level of output expected to surpass pre-pandemic levels this year given the stimulus boost and the relaxation of measures
- UK economic activity has picked up given the removal of measures, with retail sales data confirming the strong rebound in spending and is expected to remain high with the reopening of non-essential stores.
- Euro Area GDP is expected to improve in Q2 as the vaccination pace will allow governments to lift restrictions. Despite the technical recession, more recent data is synonymous with the vaccine rollout and increase in economic activity.
- The recovery in labour markets remains unclear given the mixed data releases and the extended government support programmes mostly prevalent in the Euro Area and the UK.
- The huge miss in job gains in April is raising concerns of a slowdown in the US labour market recovery and the possibility of restoring pre-pandemic levels of employment.
- Inflation rates are rising sharply across economic regions, most notably in the US, given the demand-supply imbalances as economies reopen and the strong base effects.
- Central banks maintain their position and continue to support favourable financing conditions, despite the rise in inflation, citing concerns on the fragility of the economic recovery.
- Euro long-end rates rose in April as markets are repricing the growth outlook resulting in a steeper curve. US and UK rates trade sideways as economic data releases validate the high expectations priced in USD and GBP yield curves.
- Credit spreads remain well-behaved in the context of easy financing conditions and positive business prospects, with limited risk of sharp rises in real rates.
- Equity markets trailed higher given signs of a more broad-based recovery and the positive results released during the first quarter earnings season.
- As the economic growth momentum continues to pick up, we prefer to scale down our duration risk namely in euro-denominated sovereign and investment-grade corporate bonds.
- We remain confident on continued outperformance in high yield credit versus investment grade, however, we maintain a high level of scrutiny in our selection given that insolvency risks cannot be discounted.
- We see further upside in the equity market rally through a value rotation for the near term, while we also continue to see attractive rewards to careful stock-picking of names that are expected to benefit strongly from the economic reopening.

Signs of a more broad-based recovery in economic conditions are emerging now that consumer-facing service sectors are seeing increased activity as advanced economies are gradually scaling back restrictive measures. Moreover, following the relatively subdued growth expectations for Europe in earlier months because of the slow pace of inoculations, we have seen substantial progress in recent weeks across the major member states which is buoying prospects on the economic outlook as the momentum of the recovery is expected to "catch up" with other advanced economic regions.

The commodity bull market, supply shortages and high transportations costs continue to increase cost-push price pressures. Moreover, the sharp surge in consumer demand, particularly in the US and the UK, is resulting in a short-term imbalance which, in combination with pronounced base effects, is driving a surge in inflation rates. This has so far been more visible in the US, with the latest headline inflation rate recording a year-on-year increase in prices of 4.2% overshooting expectations of 3.6%. We will likely see a similar effect playing out in the UK and Euro Area data releases. Having said that, we still argue that the policy-growth mix in these regions is less conducive towards achieving the very strong reflationary pressures which we are seeing in the US.

The debate on the persistency of high inflation is intensifying given these expectations and the significant implications that such dynamics may have on monetary policy going forward. We still maintain that the long-standing dynamics, which have depressed inflation rates at stabilized levels of employment over the last decade, are expected to prevail once the short-term effects of reopening gradually fade and the demand-supply interaction normalizes. As a result, whilst we see inflation trailing higher in the near term, we expect inflation rates to gradually retrench going into next year.

The medium-term outlook for US inflation is, however, less certain as the potential for US inflation rates to be sustained at high levels is becoming less unlikely. The strength of the recovery in the labour market is unclear given the mixed data prints. However, some argue that the Fed is overestimating the extent of economic slack in the US economy, and that we could see wage inflation picking up at higher levels of unemployment relative to the pre-pandemic experience.

The positive sentiment in financials markets was synonymous with the improving underlying economic conditions and receding health risks. The earnings season for the first quarter results was also encouraging, not only in terms of the generally better results compared to estimates, but also in terms of reducing uncertainty on the impact of weak winter months on corporate profitability as well as providing greater clarity on the earnings outlook as many enterprises reinstated profit guidance.

Given this backdrop, we continued to see poor performance in safe haven assets with sovereign and investment grade corporate bond markets giving the weakest performance, whilst riskier assets continue to see price gains.

We expect further steepening in the Euro benchmark yield curve as we see a high probability that the bond market will reprice the growth outlook and increase inflation premia further from here on. On this basis, we prefer to reduce curve risk to Euro rates for the time being to safeguard our bond allocations from adverse movements in yields.

Whilst we remain positive on sub-investment grade credit, we acknowledge that the scope for strong price gains is very limited going forward given the substantial tightening in credit spreads. At the same time, because of the benign credit environment and improving growth outlook, we similarly attributed low risk of rewidening in credit spreads for the time being.

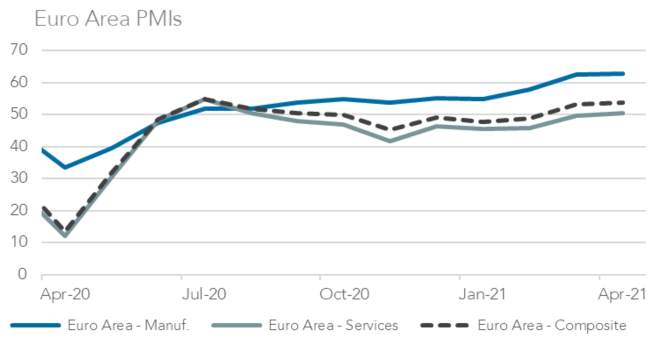
We also see further upside in the equity market rally as long as data releases continue to sequentially improve on the back of the reopening of economies and rebound in activity. We continue to favour maintaining a pronounced tilt towards value stocks, given that we expect the value rotation to continue in the near term. At the same time, we continue to remain highly selective and see scope to continue identifying stocks at attractive valuations which are expected to benefit strongly from the economic reopening.

MACRO

Euro Area

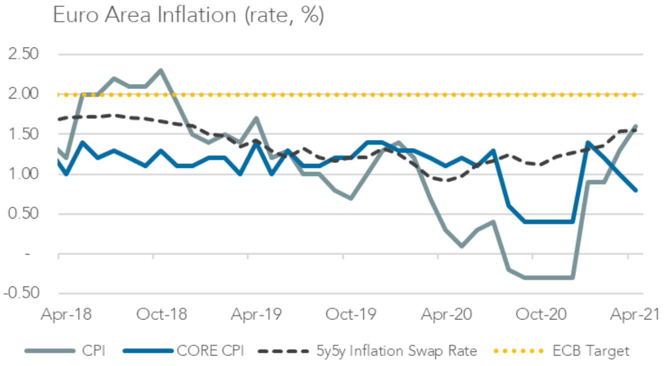
The Euro Area flash estimate for Q1 GDP showed that the economy contracted 0.6%, leaving the economy at 5.5% below its pre-crisis peak. This double-dip recession came about as countries remained in lockdowns which continued to disrupt the services industry. However, GDP is expected to improve in Q2 as the vaccination programme allows governments to lift restrictions, opening the economy once again.

Retail sales for March grew by 2.7% over February levels, beating market expectations of 1.5%. Retail sales are expected to continue to improve in the coming months, given the planned lifting of restrictions, with household consumption said to start recovering in Q2. On the other hand industrial production did not see the same rebound just yet, increasing minimally by 0.1% over February levels, coming in lower than the expected 0.7% movement month-on-month. This was a result of supply shortages which continued to hold back the pace of the recovery.



Source: Bloomberg

The final Composite PMI stood at 53.8 in April, above the prior 53.2 and just above expectations of 53.7. the data point was supported by a record expansion in the manufacturing sector and a rebound in service sector activity. New order growth across the region was the strongest for over 2.5 years. However, despite the strong expansion in manufacturing, production problems worsened with delivery times lengthening at a record pace and backlogs of work rising, forcing firms to run down their stocks of finished goods for the eleventh straight month.



Source: Bloomberg

The April flash inflation rate stood at 1.6%, in line with market expectations and above March's 1.3%. The increase in April was entirely driven by a pick-up in energy inflation. By contrast, core inflation edged down from 0.9% to 0.8%, its lowest rate this year. Given the movements in oil prices, energy inflation is likely to rise a little further in May and remain high over the rest of the year, with expectations that core inflation will increase too.

This upward trend in headline inflation is supporting expectations of inflation rising above 2.0% in the near terms. However, this increase past the ECB target is expected to be temporary, given the short-term demand and supply imbalances with expectations that the rate of increase in price levels will fall back below the target in 2022.

There is growing evidence of price pressures building in the manufacturing sector as certain inputs are in short supply, and metal prices and freight rates are rising. The retail sector is also expected to see a sharp rise in prices particularly given the expectations that holiday prices are expected to rebound once the tourism sector reopens.

Looking at the labour market, the unemployment rate marginally improved in March coming in at 8.1% from the prior 8.2%, contrary to expectations that unemployment had actually increased to 8.3%. The improvement was mainly explained by the decline in the number of unemployed people of 209 thousand from the previous month to 13.2 million. Overall, economists expect that the unemployment rate will rise slightly as government support programmes is tapered and people that left the labour force during 2020 eventually return. Over the medium-to-long term, however, we expect employment to recover in line with the rebound in economic activity.

There are positive signs on firms' hiring intentions pointing towards a year-on-year growth in employment, however the current economic slack is still substantially wider in the Euro Area compared to pre-pandemic levels. This is due to more unemployed people as well as those persons available to start work but are not actively looking for a job due to greater difficulty in job hunting due to restrictions.

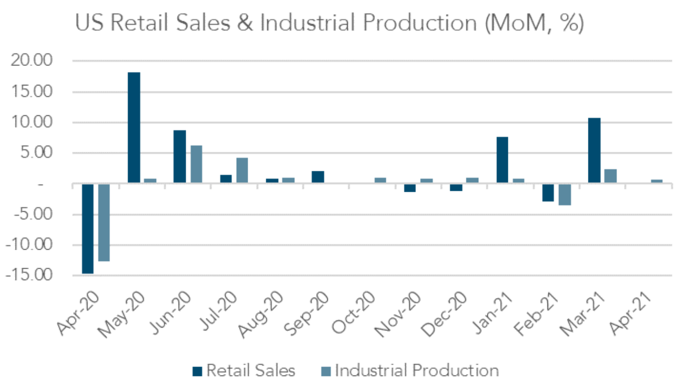
As the first signs of improving economic conditions are emerging in the Euro Area, financing conditions remain overall accommodative to support the flow of credit in the economy, During its April meeting, the ECB left monetary policy unchanged as officials took a wait-and-see approach after March's decision to conduct emergency bond purchases at a significantly higher pace over Q2. The ECB reiterated that the PEPP envelope might not need to be used in full if favourable financing conditions can be maintained but could be recalibrated if required to help counter the negative pandemic shock on inflation.

President Lagarde said at the press conference that although inflation has picked up over recent months due to temporary factors, underlying price pressures remain subdued in the context of significant economic slack and weak demand.

Next Generation EU has the potential to provide a significant stimulus to the economy, making €800 billion available over the next 6 years, which is equivalent to over 5.0% of EU GDP. The impact on GDP might be smaller than most economists expected, while the impact on long-run potential output is uncertain. Whether or not the fund leads to higher supply capacity depends on how well it is invested, and the extent and nature of reforms that are implemented.

United States

Driven by the two rounds of stimulus cheques sent out in the first three months of the year, Q1 growth accelerated to 6.4% quarter-on-quarter annualised. This was driven by a massive 10.7% surge in consumption which left the level of GDP less than 1.0% off its pre-pandemic peak. The level of output is expected to reach this peak in Q2, with the likelihood that any remaining output gaps would be eliminated before the end of this year. Economists expect that Q2 GDP growth will be c. 8.0% quarter-on-quarter annualised, driven by continued strength in consumption, and, eventually, inventory rebuilding and a recovery in exports too.



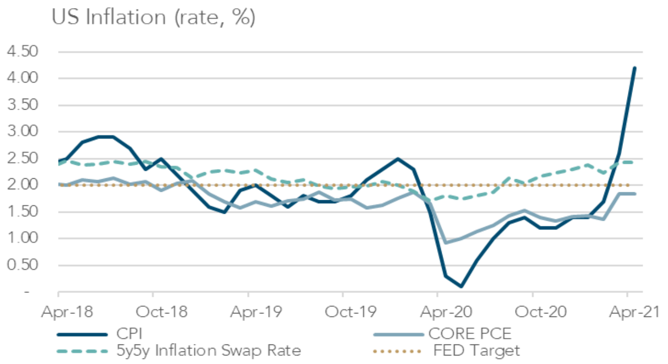
Source: Bloomberg

Looking at business survey data, the final Composite PMI stood at 63.5 in April compared to the prior 59.7 and market expectations of 62.2. The overall expansion was supported by faster growth in both manufacturing and service sector activity. New business growth and new export sales were the steepest on record. Raw material shortages also aided the increase, with firms seeking to pass on supplier price hikes through market upticks in output charges.

Retail sales stalled in the month of April showing no month-on-moth increase following the sharp surge seen in March. The print for April also included a further upward revision for the March month-on-month increase in retails sales from 9.8% to 10.7%. The increase has been mainly attributed to the first round of stimulus cheques sent to most households, together with the businesses reopening amid restriction easing and the moderation of the cold weather disruptions in the Winder months.

With the vaccination rollout proceeding at a faster pace and household finances in strong shape, it is being expected that stronger spending on services will continue to drive rapid economic growth in 2Q2021.

Industrial production increased 0.7% month-on-month in April, missing market expectations of 1.0%. Manufacturing output rose 0.4% due to the return to operation of plants that were damaged by the sever weather in February and which had remained offline in March. However, factory output was hit by a drop in motor vehicle assemblies that principally resulted from shortages of semiconductors.



Source: Bloomberg

The substantial surge in April CPI of 0.8% month-on-month (exp: 0.2%) was concentrated in sectors that are reopening and/or facing intense supply shortages. These effects are expected to eventually normalise, however, in the interim we continue to see greater scope for inflation to overshoot estimates. Moreover the collapse in prices this time last year means that the big monthly gains in both headline and core CPI translated into even bigger jumps in annual terms. Altogether, these effects resulted in headline inflation rising to 4.2% from 2.6%, and core CPI inflation increasing to 3.0% from 1.6%.

Transitory upward pressures on prices linked to the reopening of the economy and supply disruptions means inflation will remain elevated over the rest of 2021. However, it is being argued that there are signs of a more sustained turnaround in inflation. With output likely to be above potential next year and wage pressures already unusually elevated for the state of the labour market, economists expect core inflation will average close to 2.5% in 2022 and 2023.

The unemployment rate rose to 6.1% in April 2021, from the prior month's 6.0% and defying market expectations of 5.8%. This came about as more workers began looking for work and re-entered the labour market which saw the participation rate increasing from 61.5% to 61.7%.

The number of Americans filing new claims for unemployment benefits continued to decline reaching 473 thousand in the week ending May 8th, the lowest level since March 2020. This decline came about as the labour market recovery gained some momentum in the spring months, as the pace of vaccinations accelerated allowing the economy to gradually reopen and as the $1.9trn relief package boosted demand.

The US economy added 266 thousand jobs in April following a downwardly revised 770 thousand rise in March and well below market expectations of 978 thousand, as employers face worker shortage. This is reflective of the loosening of restrictions driving job gains in the worst-affected sectors, with leisure and hospitality employment rising by 331 thousand, while local government education payrolls increasing by 31 thousand. However, these gains were smaller than expectations, and they were partly offset by declines in sectors that had seen outsized payroll gains throughout the worst stages of the pandemic.

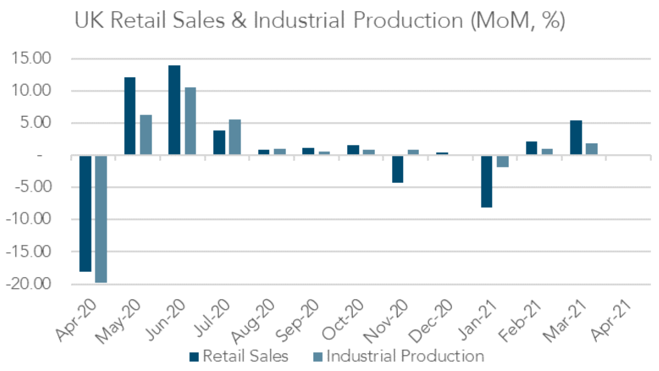
Despite evidence of rebounding economic activity and a surge inflation, the Fed has reiterated its commitment to maintain a highly accommodative stance given the weak progress achieved in labour markets. The Fed left its federal funds rate unchanged at 0-0.25% and said it will continue to purchase bonds at a rate of $120 billion a month. The Fed acknowledged that inflation has risen but argues that this "largely" reflects transitory factors.

Policymakers noted that indicators of economic activity and employment have strengthened amid progress on vaccinations and strong policy support but stressed the pandemic continues to weigh on the economy, and risks to the outlook remain. The Fed offered no hints that it was considering slowing the pace of its asset purchases. Chairman Powell argued that "it is going to take some time" before "substantial further progress" has been made toward meeting the Fed's goals.

United Kingdom

Economic output in February grew by 0.4% on a month-on-month basis, following the prior month's contraction of 2.2%, falling short of market expectations of a 0.6% growth. This minimal change was expected for the month of February as the economy remained in lockdown and only started relaxing measures later in the first quarter. Economists believe that vaccinations and the reopening of the economy will to trigger a rapid rebound in activity over the next months.

The BOE has in fact raised its 2021 annual GDP forecast to 7.25% from its previous estimate of 5.0%, recognizing the easing of restrictions on economic activity and the country's fast vaccination rollout. However, 2022 forecast expansion was revised lower to 5.75% compared to February's announced forecast of 7.25%.



Source: Bloomberg

In the meantime, retail sales grew 5.4% month-on-month in March, reflecting the impact of the easing of restrictions on consumer spending. This showed that the economy made some progress even before non-essential retailers reopened in April. It is expected that April sales levels will rise further, especially in clothing sales.

Similarly, industrial production for the month of March grew 1.8% month-on-month, surpassing the market expectation 1.0%.. The pandemic has had a generally negative impact on production output, with production remaining 1.8% below February 2020 levels.

Despite reports of semi-conductor shortages constraining supply in other economies, the 4.4% month-on-month increase in net car registration data for March suggests that seasonally adjusted car production grew by 2.0% month-on-month. However, it must be noted that the global shortage of semi-conductors has forced some UK car manufacturers to temporarily close in April.

More recent, business survey data corroborates the improving business conditions. The final Composite PMI for April stood at 60.7, compared to the prior month's 56.4 and the market expected 60.0. Service providers experienced the quickest increase in activity since October 2013, driven by sharp increases in business and consumer spending upon the reopening of customer-facing businesses. Despite efforts to rebuild business capacity, backlogs of work were accumulated to the greatest extent for nearly six years, which suggests that pent-up client demand will continue to boost activity in the months ahead. Furthermore, manufacturing experienced the steepest upturn in output since August 2020. However, at the same time, the sector remained disrupted by supply-chain delays and input shortages, which contributed to increased purchasing costs and record selling price inflation.

The annual inflation rate for March edged up to 0.7% from the prior 0.4%, coming in below the market expected 0.8%. Economists believe that this rebound is the start of the climb to above 2.0% by end 2021. The rise in CPI inflation in March is the confirms that energy price effects are no longer subdued, with the rise in fuel price inflation from -3.5% to +3.5% adding 0.2ppts to CPI inflation. Economists believe that since fuel prices fell by 7.8% m/m in April 2020 and will rise by c. 1.0% m/m in April 2021, CPI inflation for April will rise by 0.3ppts from this contributor solely.

Some of the downward influence on core inflation from the pandemic has also started to fade as core prices rose by 1.1% in March compared to the prior month's rise of 0.9%, in line with market expectations. The unemployment rate fell for the second consecutive month to 4.9% in February 2021 compared to the prior 5.0% and the market consensus of 5.1%, this occurring during a period where the country was under tight COVID restrictions. The labour market remains supported by the government's furlough scheme, which was extended until end of September.

Economists still anticipate a surge in the unemployment rate, peaking at 6.0% by early 2022 as people who left the labour force return to the market and become classified as unemployed, rather than due to people losing their jobs. The number of employees on company payrolls fell by 56 thousand between February and March, pushing the total number of jobs lost since the pandemic outbreak to 813 thousand.

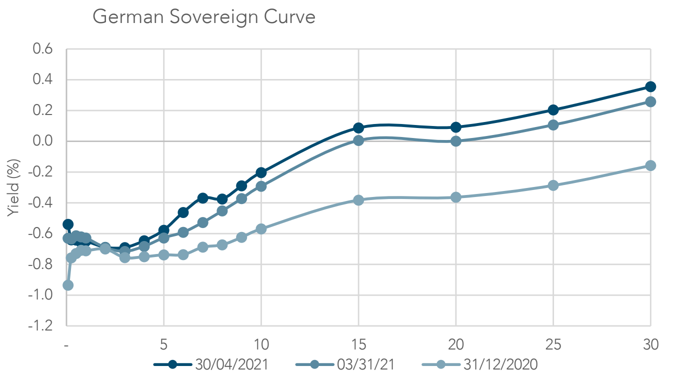
On the monetary side, the BOE kept policy unchanged during its May meeting and announced a slowdown in the pace of purchases of government bonds to £3.4bln per week from £4.4bln between May and August, signalling it is on course to end emergency support by the end of the year. The MPC's decision to slow the pace of its asset purchases is not a signal about the strength of the economy but that it represents an "operational" adjustment to the flow of purchases as the target stock amount of purchases remains unchanged.

The BOE also highlighted that it does no intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2.0% inflation target sustainably. The MPC suggested that conditions for tighter policy may be in place in late 2022.

RATES

Euro Rates

Improving economic conditions and the gradual reopening of economies led to the pricing of higher inflation premia to levels that are more in line with the change in inflation premia in other advanced economies seen since the start of the year. Euro rates underperformed in April as 10-yr Bund yield rose by 9 bps in April when US yields declined, and UK yields remained stable, showing a degree of "catching-up" with the curve movements seen in regions which achieved higher inoculation rates and were able to lift restrictive measures earlier to allow economic activity to pick up.



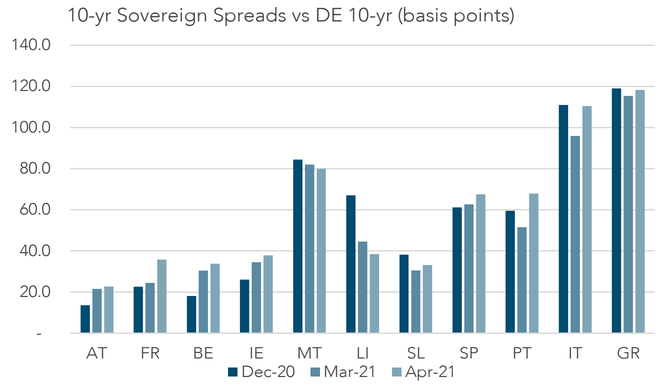
Source: Bloomberg

As growth prospects are improving given the higher rates of inoculations, we expect the ECB to become less sensitive to gradual moves higher in sovereign yields driven by growth expectations..

On the other hand, we still maintain that the lack of concerted fiscal action and longer expected timeline for the economic recovery reduces the prospects of a strong return in economic employment and productivity, which will consequently result in weak pass-through effects. On this basis, we do not expect reflationary dynamics to be as pronounced in the Euro Area.

Sovereign spreads widened as the benchmark curve shifted higher, whilst market support from ECB action is waning given the lower probability of further policy measures being announced any time soon as the growth outlook is buoyed by the gradual reopening of economies – ECB's June staff projections are expected to show upward revisions in growth and inflation.

Updated issuance plans suggest that funding requirements by sovereigns will be higher that previously expected. GS estimates Euro Area deficit to be 7.8% of



Source: Bloomberg

GDP in 2021, compared to 7.6% in 2020. Italy expected deficit is 11% of GDP, increasing debt stock by 3-4% which explains the underperformance in BTPs. Revised net-supply expectations, assuming a fixed-PEPP envelope is expected to continue to favour Bunds whilst Italy is expected to go into positive net supply.

Improving outlook should bring a gradual reduction in policy support and whilst this is generally positive for spreads given reduced uncertainty, it supports short duration positions and increases risk of sovereign spread widening (more likely at the long-end) as the handover from policy to growth will mean reduction in ECB support which will lead to decompression of risk premia at the long-end. (Peripherals are more sensitive to stock effects under ECB purchases).

With upcoming data releases expected to continue to show positive economic progress, which in turn further reduces the scope of any further action by the central bank, we see core yields in Europe to continue to trail higher in the short-term.

The increase in the pace of purchases communicated at the March policy meeting has countered the widening of spreads in the imminent term, however, it has had a limited effect on benchmark yields and spreads over recent weeks. Research suggests that level of yields and spread developments have been much more dependent on the stock of ECB purchases as opposed to the flow.

We remain cautious with adding further curve risk at this stage given that (a) market reactions will remain sensitive to "noise" in economic data releases which are expected to surprise to the upside (as economies reopen), (b) no further action is expected by the ECB for the time being to put pressure on yields (c) the scope of substantial upward reprising in the event of sustained positive surprises in economic data still remains that could potentially lead to outsized movements higher in yields.

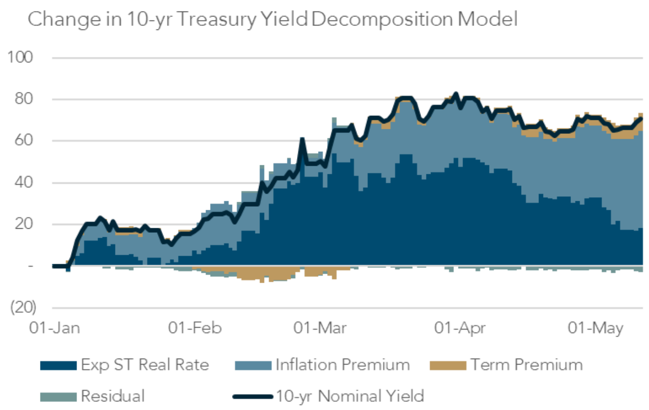
Risks in the short-term are skewed towards a gradual move higher in euro rates. However, we do not consider the improving outlook to be strong enough to warrant a change in stance by the ECB given that the long-standing dynamics which have weighed on inflation for the last decade will likely prevail over the medium to long term, as short-term forces subside.

On this basis, we believe that front-end pricing will remain firmly anchored. As a result, we expect continued improvement in economic momentum and inflation to support steeper euro benchmark curves to a limited extent for the time being.

US Rates

Despite the economic data releases surprising to the upside in April, we saw the upward movement in Treasury yields retracing 11bps during the month. The move was triggered by the release of the minutes of the FOMC March meeting and the numerous speeches and comments made by FED officials downplaying the significance of the positive streak of economic data. Lael Brainard commented that while the US economic outlook has brightened considerably, "*it's more likely that the entrenched dynamics that we've seen for well over a decade will take over*".

The narrative was reiterated at the April monetary policy meeting anchoring the Fed's decision to remain highly accommodative and to label the recent rise in inflation as "transitory" whilst citing concerns on economic slack in view of the low level of employment in the US.



Source: Bloomberg

Because of this, we have seen a pull back in US Treasury yields, not due to softening inflation expectations, but due to moderated Fed-pricing. This is seen in the move lower in the expected future short term real yields which more than offset the increase in inflation premium. The latter is being driven by both actual price indices surprising to the upside as well as upward revisions in inflation forecasts.

The evolution of data surprises seems to have increased in the first releases of April data, these surprises relating to retail sales, jobs and price data. However, such data surprises need to be taken within the context of much wider dispersions in market forecasts which in turn reflects the wide range of views and assumptions around the timing and pace of economic acceleration. Due to this, we note that the dovish tone of the Fed is well placed in so far as moderating overly optimistic expectations on the economic growth outlook and counter concerns on economic overheating.

The main argument for the transitory nature of the inflation surge lies on the assessment that the economic slack is deep enough to the extent that the duration of the recovery in employment will be longer than the temporary factors supporting higher prices. However, this also assumes that the natural rate of unemployment at which the economy achieves full potential is the pre-pandemic level of employment. This argument is now being challenged by the possibility that the effects of the pandemic could lead to lower natural rates of employment. Under this scenario, the Fed would be underestimating the risk of inflation through higher pass-through effects.

As the dovish arguments seem to be losing traction in view of the strong economic momentum being realised in actual economic data, the Fed could be cornering itself in either ignoring/underestimating the strength of the recovery which can lead to a prolonged overshoot in inflation, or be required to reassess its stance which could lead to market disruption and a reinforcement in front-end pricing.

Both scenarios would lead to higher long-end yields over the medium term, with the former being driven by a widening in inflation premia and a steepening in the nominal curve. The latter would be driven by higher real rates on the back of accelerated Fed-pricing which would likely see a simultaneous flattening in the belly to the long-end of the curve.

We expect the US 10-year yield to continue to trade within the defined range (1.50% - 1.80%) with a bias to break out higher on the back of the following potential catalysts:

- A series/accumulation of positive data (upward) surprises – we emphasis the word "series/accumulation" because when considering the wide dispersion of forecasts, we will require multiple data points to validate a broad view that the economy is growing while individual data surprises are less informative.

- A faster rate of job gains – as the level of employment increases, the risk of economic slack weighing on prices over the medium-to-long term diminishes.
- A reassessment by the Fed about the persistency of inflationary pressures and risk of overheating.

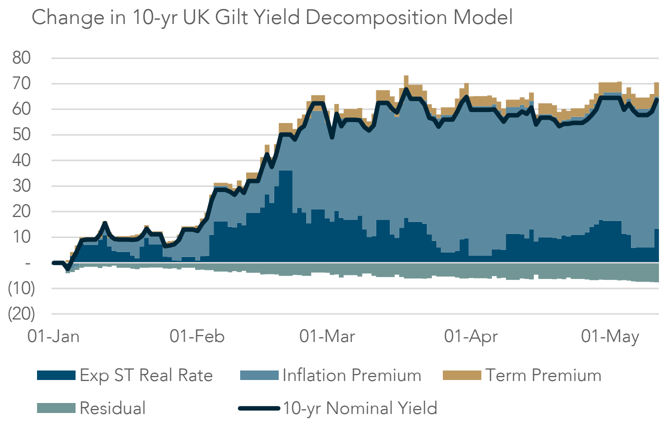
The risks to this outlook is the fact that the state of the economy remains fragile given that health risks have not fully subsided and that the recovery across the global economy is uneven. Therefore the scope for externalities to hinder the pace of economic recovery and, consequently limit any sharp movements higher in yields, remains.

Once the first round effects of stimulus boost fade and base-effects on data normalise, we will have more clarity on the persisting effects on the economy, while concentration in forecasts and more "normal" market sensitivity to data releases is expected.

UK Rates

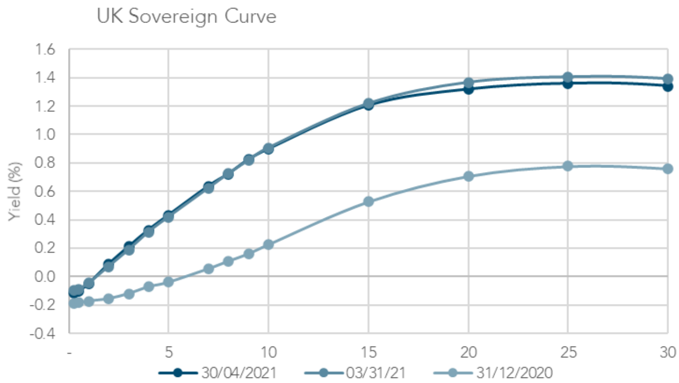
High inflation premia with limited pricing of any policy rate changes by the BOE continue to explain the elevated level of yields at the long-end of the curve compared to the start of the year. This time, such premia have been partially validated by the uptick in inflation data in the UK which is expected to continue to pick up sequentially in upcoming data releases as base-effects support higher year-on-year rates and the reopening of the UK economy is showing signs of a sharp surge in spending which should be supportive for price levels.

Despite the fact that economic data released in April confirmed some positive improvements in economic activity and inflation in the UK, we have seen very limited movement in the Gilt curve during the month. The muted reaction to the positive data releases is reflective of the optimistic market pricing earlier on in the year which are now being validated by the realisation of improving economic conditions.



Source: Bloomberg

We expect any significant moves upwards in the curve to be triggered by consistently positive data releases which would neutralize any residual risks or uncertainty on the economic recovery or alternatively from a sustained overshoot in inflation rates to the extent that would require preemptive action by the BOE – which would therefore see higher yields supported by elevated pricing of policy rates.



Source: Bloomberg

Bank of England displayed little sensitivity to the movement higher in UK gilt yields since the start of the year and has continued to express its commitment to maintaining an easy monetary policy for the time being despite upgrading its outlook for the UK economy and scaling down the expected fallout in employment as government gradually reduces wage subsidies.

The technical taper in the pace of purchases had limited effect on UK rates since the main relevant factor is the overall target size of purchases (which was kept unchanged) with the BOE labelling the slowdown in purchases as an operational adjustment. Given that the size of monetary injection is unchanged, the adjustment carries very little monetary policy significance.

Having said that, the outlook for long-end Gilt yields remains asymmetric with risks tilted to the upside as cyclically supportive data will continue to dominate the narrative, further emphasizing the growing evidence of underestimation by the BOE on the timing of the next rate hike (BOE expects no rate changes until 2024) or the timing of the balance sheet run-off.

However, downside risks to the economic recovery and uncertainty on the outlook of the UK economy emanating from the evolution of the pandemic as well as political risk (following the SNP win) should not be discounted.

CREDIT

April was characterised by a tightening in US corporate credit spreads within both the investment grade ("IG") and high yield ("HY") segments of the market, with the riskier segment of the HY corporate bond market seeing the largest movements during the month given the sustained positive risk sentiment.

The UK corporate bond market also experienced a decline in yields due to an improvement in economic sentiment as spreads tightened given the relaxation of restrictions which allowed businesses to re-open and the Government's success in its attempt to vaccinate a majority of the population during the month. The easing of restrictions that occurred on the 12th of April with the re-opening of non-essential shops, pubs and client-facing services contributed to improved sentiment in the corporate bond market with further easing of restrictions to occur in May and June expected to continue to benefit UK businesses going forward.

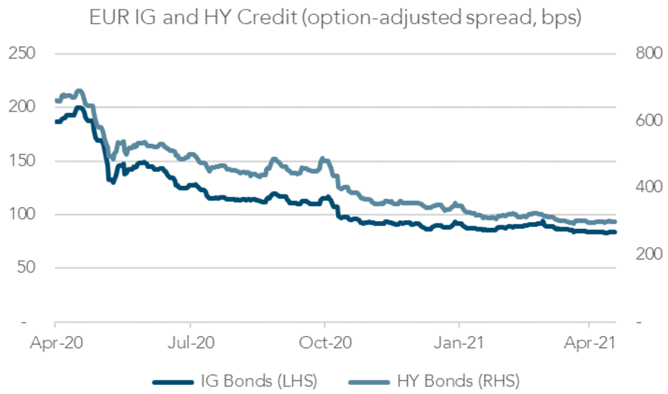
European corporate credit spreads also tightened during the month, in line with the UK and US. Although the vaccination campaign within the Euro Area lags behind its UK and US peers, significant progress has been made in recent weeks, which helped fuel the move tighter in spreads. The decline in yields was nevertheless predominantly due to the continued government fiscal stimulus within the bloc and the ECB's elevated level of purchases through its bond buying programmes.

Overall, global upgrades continue to outpace downgrades in early May, albeit at a slower pace than experienced toward the back end of April. Much of this activity reflects more stability and growing confidence around the trajectory of the recovery, though uncertainty around the evolution of the coronavirus pandemic and its economic effects remain.

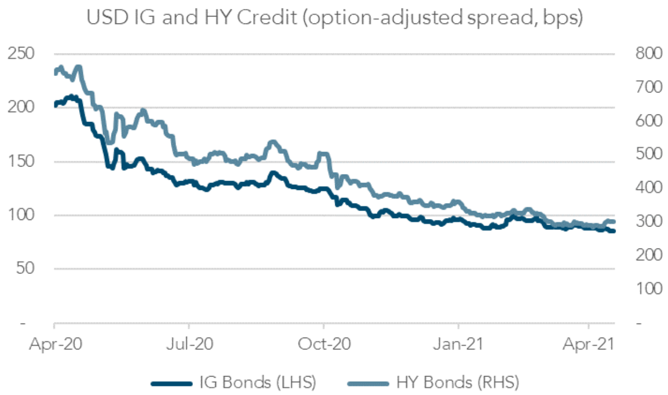
S&P data registers the year-to-date global corporate default tally at 39 following the addition of Codere's technical default at the end of April. With this addition, the default tally in Europe has reached 10, exceeding the 8 that had occurred year-to-date through April 2020. By the end of 2020, the regional tally had reached an all-time high of 42. Similarly, at this point in 2020 and 2019, there were 67 and 45 global defaults, of which only 8 and 5 were from Europe respectively. The majority of global defaults within the 2021 YTD tally have constituted distressed exchanges, with only a handful representing missed interest and principal payments.

As highlighted in our previous update, Fitch Ratings had recently adjusted its European bond and loan default forecast for 2021 to 2.0% and 3.5% respectively. Subsequently during April, Fitch Ratings also further reduced its 2021 U.S. high yield default rate forecast to 2.0% from 3.5%. The agency cited enhanced liquidity and low near-term maturities due to favourable capital market access and government stimulus as the key rationale for lowering default expectations. The improvement in operating conditions, as vaccination distribution continues to ramp up, also provides additional comfort in the revision. The revised 2021 default forecast represents the lowest rate since 2017. The rate could finish the year in a 1%-2% range as the current strong economic backdrop should support operating fundamentals for most sectors.

Despite a somewhat disappointing macro backdrop earlier in the year, the Euro corporate bond market has continued to display remarkable resilience. We feel that optimism around the re-opening of the economy will continue to gain momentum, keeping risk premia anchored around current levels. Additionally, the ECB's boost to the pace of its asset purchase programs should continue to fuel the strong search-for-yield motive, and limit the potential for increased dispersion in corporate credit. Of course, the risk of a disappointment on the economic growth front is not insignificant, though the supportive stance of monetary policy should limit any material negative moves if this were to come to fruition.



Source: Bloomberg



Source: Bloomberg

First quarter 2021 corporate earnings for HY firms have so far mostly met or exceeded analyst expectations or consensus estimates, driven in part by a combination of commodity strength, a resilient consumer, corporate cost discipline and continued tailwinds related to the vaccine-led re-opening.

We generally remain optimistic about the prospects for Euro HY during Q2 given the prospects for low default rates and ongoing central bank support and the preference remains to be overweight HY vs IG despite rising fears of rich valuations within the space, with BB/B paper within the cyclical space being the clear favourite. Spreads offered on CCC paper are testing investor confidence, with current levels effectively back to very compressed pre-covid levels. Whilst we do not expect spread widening against the current supportive market backdrop, there may be less opportunity to generate material risk-adjusted excess returns within the space.

We continue to remain optimistic around the economic recovery in the UK as the region successfully emerges from one of the world's longest lockdowns, along with a clearer post-Brexit picture and a vaccination campaign that is well ahead of its counterparts in mainland Europe. Despite this position of relative strength surrounding the BOE's GDP growth forecasts, the bid for UK risk remains quite weak in global credit markets, and the valuation gap between UK and non-UK issuers across all currencies remains high.

Given the relative strength of the UK from an economic and vaccine standpoint, we feel confident that spreads on UK risk assets are in a position to outperform their non-UK counterparts going forward. With that said however, the likely biggest downside risk to UK risk assets remains a failure of the UK government to navigate and execute on the various post-Brexit issues that still need to be addressed, especially vis-à-vis Northern Ireland. Simultaneously, as the BOE begins to taper its pandemic QE program, private markets will need to absorb c.£30bn of net gilt supply in the second half of 2021 based on the DMO guidance, laying the groundwork for higher gilt yields which will invariably weigh on absolute returns in corporate credit.

Given this backdrop, we would prefer maintaining a shorter duration stance for any UK risk, as the yield curve appears more likely to steepen in the coming months as momentum in the economy accelerates and longer-dated maturities surrender their relative richness.

We maintain a positive view on US credit thanks to excellent liquidity, strong earnings, and a resilient reopening trajectory. Nevertheless, we reiterate a preference to limit portfolio sensitivity to rising rates and to volatile sectors, and prefer to minimise exposure where valuations appear expensive.

USD HY continues to offer better opportunities than IG amid an improving default rate situation, though maintaining a strong focus on security selection is critical. The recent rally in USD corporate credit has pushed IG and HY spreads to their 8th and 4th percentile ranks, respectively. However, while the realized volatility of USD HY bond excess returns has collapsed to near all-time lows, the same measure remains close to its median level in IG. By comparison, it appears at this stage that the reward being offered on USD IG credit for the given level of risk is sub-optimal, and one would expect that HY will continue delivering a superior risk-adjusted returns given lower realised levels of volatility.

Although the US economy is set to accelerate at a sustained pace, the expectation remains for the Fed to refrain from pulling back on its ultra-accommodative monetary support. As discussed, hiring in the US was a huge let down in April, leading us to believe that discussions of tapering or withdrawing support are off the table for the time being.

EQUITY

The rally continued in April as global equities gained +4.7% (in US dollar terms), the strongest performance so far in 2021. Global equities have already generated double digit (+10.0%) returns on a YTD basis as the economic recovery becomes more obvious and risks continue to fade. The US has taken the lead in terms of economic performance, benefiting from an earlier relaxing of curtailment measures as opposed to other developed economies. At the other end of the spectrum, emerging economies had to contend with a flare up in cases.

The US economy has benefited from reopening earlier than most other developed countries, whilst consumption has been boosted by the various stimulus packages announced since the start of the year. We expect other countries to follow in the coming months, with the UK being closest in terms of easing of lockdown measures where we shortly expect to see a strong pick-up in data. Europe remains someway off in terms of reopening but economic data has been fairly resilient and this bodes well for the region.

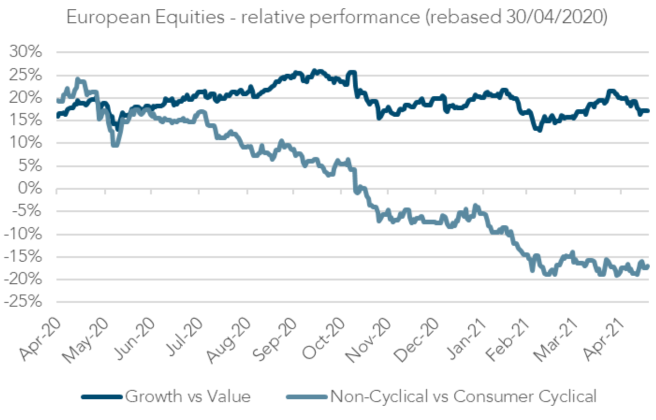
The economic acceleration in the US provides us with confidence that other regions will also recover, supporting equities in the near term. We remain positive on European equities in general, due to their exposure to global trade and the tilt towards value. We might have already seen the peak in the US economy, but for Europe, there remains room for further acceleration in activity. Looking away from domestic economies, it looks like emerging markets face a tougher challenge in the near term as COVID-19 cases have soared in recent months. The journey towards normalisation will not be liner and unfortunately, from a humanitarian point of view, some countries will fall behind. From an economic perspective, the most important economies seem to be well on the road to recovery, which should bodes well for equities.

We have discussed our preference for value stocks in a period of global synchronized economic growth on various occasions. We believe there is still room for outperformance in the coming months. However, we are now starting to look beyond that, to try and identify sectors that could outperform the market. Since the global financial crisis, we have seen growth stocks rallying strongly as investors invested in companies that could still deliver growth in a low economic growth environment. We expect growth stocks to resume their rally once bond yields moderate later on this year. However, we also note that the current push to zero emissions presents investors with a unique opportunity, and we expect environmentally friendly stocks to be the leader in the next rally. Another point to make is that the Tech rally has mainly benefited the US (Nasdaq), but a "green" rally could put Europe in the spotlight. The ambitious emissions targets set out by the EU means that the region has taken the lead, and other countries or companies from outside the EU will have to follow Europe's lead.

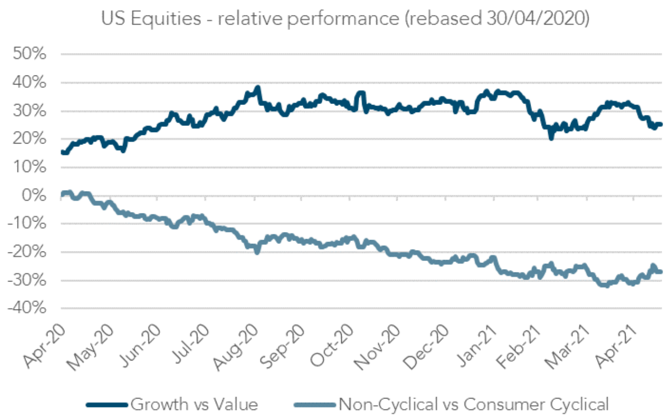
The outperformance delivered by growth stocks during April does not change our short term view. Global growth stocks significantly outperformed their value counterparts during April, with a total return of +3.9% for the former against +0.8% for the latter. This narrows the YTD outperformance for value stocks to 6.7%. The underperformance was mainly explained by the pullback in yields during the month. Investors are more comfortable during periods of rising inflation expectations than rising real yields. Therefore, the 9bp pullback in real yields provided investors with more incentive to get back into growth stocks, supported by the strong 1Q2021 result beats (vs expectations) reported by these companies.

The backdrop remains unchanged despite the pullback in yields. The expectation is still for strong synchronized global economic growth to materialise, while conditions remain supportive on the policy front, as rates are expected to stay low for an extended period while fiscal policy remains loose. To summarize, we view the current economic growth expectations, coupled with zero rates, loose fiscal policy, steepening yield curve and rising commodity prices as supportive for risky assets, especially stocks that have a high exposure to the economic beta. None of this has changed since the end of March. Below we will revisit the main themes discussing in last month's report.

1) *Value vs. Growth and Cyclicals vs. Defensives* – The performance for both value and cyclical stocks is mainly driven by economic expectations, which explains the outperformance of cyclical stocks relative to defensives in April, but not the underperformance for value stocks relative to growth. We think that a lot of the positivity is now being priced in cyclicals while upside remains for value stocks. The underperformance since the end of the bear market in March last year is unwarranted when considering the current favourable backdrop, especially the potential for rising yields and inflation.
2) *Value vs. Growth and the 10 year bund yield* – Last month we noted that rising bond yields have generally been associated with periods of value outperformance. Over the past month the German 10-year yield rose slightly (7bp), and while we acknowledge that the move was very small, it continues to confirm the current trajectory for yields. We see this as supportive for value stocks in the near term, as curtailment measures in the region are eased and the economy is re-opened.



Source: Bloomberg



Source: Bloomberg

3) *Value vs. Growth and the Global Economic Uncertainty Index* – One of the main driver of the growth outperformance since the global financial crisis has been the higher uncertainty around economic growth. When looking at the Global Economic Uncertainty Index we can conclude that uncertainty has not been consistently at these levels since at least 2018 (data is still not available for April but we expect the uncertainty index to be lower). The growth/value outperformance has tracked the uncertainty index closely since 2016, but a gap has opened over the past months. We think that this gap is more likely to close due to value outperformance than a significant rise in uncertainty.

4) *Value vs. Growth and Global PMI* – The global manufacturing PMI rose to 55.8 in April, the best reading since April 2010, up from 55.0 in March.

Economists expect the global economy to peak in 2Q2021 as curtailment measures are eased and the benefit from favourable comps start to fade. We expect inflation and yields to follow suit, and this will provide support for value stocks. Although it is difficult to establish a precise timeline, a lot will depend on what happens with yields once the economy reaches the peak. If yields continue to rise (following the peak) then value stocks should continue to outperform.

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Sovereign Bonds	Negative	U/W	Upside potential in sovereign bonds has been substantially diminished given the limited scope for further ECB action and growing list of reasons for sovereign spreads to decompress. On this basis, the outlook for periphery credits is less supported at current levels with spreads expected to continue to widen. We maintain an underweight stance in sovereigns given the weak outlook for curve and spread returns. We see a risk of inflation premia decompressing in the near term, and on that basis, we remain tactically underweight.
Investment Grade Corporate Bonds	Neutral to Negative	N	We believe that high grade returns will depend on German Bund movements, stimulus and vaccine success. ECB has stepped up purchases in March, which have been supportive for spreads. However, unlike 2020, there is currently no cushion against Bund movements within IG corporate credit, and protecting against adverse curve risks 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 the general positive 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 continue seek yield opportunities.
High Yield Corporate Bonds	Positive	O/W	High yield markets have rallied considerably from the mid-March 2020 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 has lessened. We continue to seek opportunities on a name-by-name basis. We continue to view any minor spread decompression between high yield and investment grade as an opportunity to add exposure in the space.
Developed Market Equities	Positive	O/W	Our performance has benefitted from our preference for value stocks against the current backdrop. We expect this narrative to continue, at least until the global economy reaches its peak. Beyond the value trade, we continue to eye the climate targets that major economies are aspiring to reach. We view this as a potential wining trade post recovery. Europe has taken the lead in the climate change fight, and we believe this could provide the region with a competitive advantage over other nations, similar to how US equities have benefited since the global financial crisis. This is expected to provide investors with an attractive investment opportunity for the coming years. April was another good month for risky assets, in particular for our selection of stocks. The outperformance during the month was attributable to stock selection and allocation, slightly offset by FX. Apart from this, we are currently slightly overweight the asset class. No changes were made to our sector tilt during April. We believe that the changes made in the previous months should drive outperformance in the coming months.
Emerging Market Equities	Positive	O/W	Emerging markets lacklustre performance was extended into April as a number of key emerging economies continue to grapple with the virus spread. This has led to significant variation in country performance with LATAM underperforming. We remain comfortable with our EM country exposures going into the second quarter with overweight allocations in Mexico and Brazil and a smaller overweight position in China. On the other hand, we remain underweight South Korea, Taiwan and India.

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

DISCLAIMER