Investment Strategy Update

July 2021

CURMI & PARTNERS

Curmi & Partners Research

- Survey-based indices and high-frequency data indicate continued expansion in economic output across advanced economies.
- Inflation rates have surged substantially in the US and the UK where the reopening effects have played out more strongly compared to the Euro Area.
- US labour market data is been mixed, in contrast to the pronounced upward trajectory in other macroeconomic variables highlighting the extent of the employment gap following the sharp loss in jobs last year.
- As unemployment in the UK and the Euro Area have remained optically lower given the wage support schemes, the expected fallout as the support is withdrawn has lessened given the pick-up in activity.
- Central banks have continued to fight concerns over the rise in inflation and maintained a dovish tone, despite the broad acceptance that we are at the cusp of a coordinated rate hike cycle across G10 economies.
- Firmer front-end pricing in the US treasury curve followed the hawkish dot-plot of June where FOMC members projected two rate hikes in 2023.
- The flattening of the US yield curve as short-end yields moved higher and long-end yields moved lower spilled over to other currency regions leading to a rally in long-end sovereign government bonds.
- This came as the pronounced market positioning for a reflationary trade started to unwind leading to increased market volatility with episodes of weakness in equity markets, emerging markets and commodities.
- We continue to maintain a fairly shorter duration position despite the rally in bonds and a high cash balance given our view that the risk for yields to move higher remains.
- Whilst we are not positive on curve risk, we favour higher spread duration positions in EUR given the high hurdle for a meaningful monetary policy change.
- We maintain higher exposures to lower-rated corporate credit, despite the strong performance, as a key source for income returns with limited curve risk within fixed income markets.
- We continued to reduce exposure to US equities given our preference towards European value stocks. Whilst we have generally scaled down our equity allocations, we are repositioning into selected picks at discounted prices with strong upside potential.
- We maintain a positive outlook in emerging market equities, given the expected lag in the economic recovery, whilst looking at the LATAM region's strong potential for outperformance.

In recent weeks, movements in global financial markets have uncovered important underlying dynamics which we expect will become more prominent in the current stage of the economic recovery and the evolving path of the virus.

Economic data across advanced regions continue to point towards a sustained expansion as countries continue to unwind containment measures although the different speeds of reopening has so far greatly favoured the US and the UK economies.

As the growth outlook remains firmly buoyant, increased downside risks have resurfaced with the emergence of the Delta virus variant and the possibility that new variants can deal another blow to the global economy. Countries with the highest vaccination rates have resisted the reimposition of restrictions as cases are rapidly increasing. This has been manifestly the case in the UK which saw the sharpest rise in new cases due to the Delta variant leading the government to postpone further lifting of measures by four weeks.

The efficacy of the newly-minted vaccines is being put to the test and the UK experience has so far been a lab experiment for this. What we have seen is a delinking in new virus cases and the rate of hospitalizations and deaths which have so far seen limited traction. This is generally perceived as a positive indication that the return in economic activity may not necessarily reverse sharply with another wave of infections.

Survey-based indices and high-frequency data continue to point towards a sustained expansion in economic output. Inflation has been particularly notable in outscaling projections as rising commodity prices, supply-chain disruptions and the rapid growth in spending saw prices rise sharply month-over-month with some citing concerns of potential economic overheating.

Despite the rosier picture, labour market data has generally been disappointing or contrasting the positive trajectory in other macroeconomic variables, highlighting the wide employment gap that was brought about by the pandemic that will require far more economic progress to be closed. The economic slack has been the cornerstone in the central banks' argument to maintain a highly accommodative stance and ignore the likely transitory and above-target inflation rates.

With these developments in economic conditions, markets have been reassessing the growth and inflation outlook which has underpinned the strong risk-on rally since the start of the year that has benefitted stocks and high yield credit while safe-haven assets, namely high quality corporate credit and sovereign bonds, took the brunt.

Moreover, the recent narrative has circled around the economic weakness in China, the Delta variant and risk of new variants leading to renewed health risks, the peaking growth in the US and the withdrawal symptoms of fading fiscal support going into next year. The underlying components of price data and employment data have been supporting the view of a low-growth low-inflation environment when the recovery plateaus. The reassessment of the inflation and growth outlook has led to a large unwind in reflation trades since mid-June.

Growth stocks have outperformed value stocks, emerging market equities have underperformed developed market equities, gold and other commodities have retraced and long-end bond yields moved dramatically lower, particularly in the US and the UK. In other words, market positioning has been particularly vulnerable to any hawkish signals from central banks, slowing growth momentum and renewed virus risks. Whilst we still retain that this is a bull market for equities, we have sought to retrench our equity risks following the strong results since the start of the year, to protect against such periods of market weakness. Whilst we still favour a tilt towards European value stocks, we have sought to scale-down positions which have re-rated higher during the market rally. We added exposure to reopening and thematic plays through stocks which are trading at discounted levels which can simultaneously provide a cushion against market-wide sell-offs.

The scope to continue enhancing carry returns through enhanced positioning in lower-rated bonds has diminished given the tightening spreads at the higher-end of the credit risk spectrum. Nevertheless we remain constructive on sub-investment grade corporate credit through carefully selected positions given the ultra low default rates, supportive rating environment and benign financing conditions.

Returns in investment grade corporate and sovereign bonds are expected to remain highly explained by curve movements given the limited scope for further spread returns. We generally continue to favour holding longer duration positions in Euro given the high hurdles for any contemplated adjustments to monetary policy.

At the same time, we continue to hold relatively higher cash balances given the apparent fatigue in the reflation trade and the risks of a move higher in rates. This allows us to maintain flexibility to reintroduce exposures at the opportune time.

MACRO

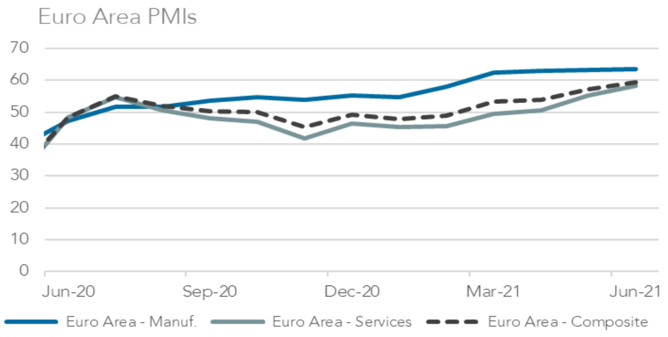
Euro Area

At the June monetary policy meeting the ECB updated its GDP projections for 2021 and 2022 upgrading them to 4.6% and 4.7% from 4.0% and 4.1% respectively. The projections are being supported by stronger global and domestic demand, as well as by the continued expansionary support from both monetary and fiscal policy. Given the reopening dynamics, economists are expecting household consumption to be the key driver of GDP growth over the next year.

The latest data release for Industrial production rose by 0.8% month-on-month in April, beating the market expected and the prior month's reading of 0.4%, suggesting that the sector is continuing to recover, given the lagged effect to the recovery in retail sales. However, supply disruptions are expected to continue to drag on for longer, constraining the manufacturing sector recovery. Having said that, the strong momentum in underlying demand should sustain the gradual recovery in production.

In fact, retail sales for the month of May rose by 4.6% month-on-month, compared to the prior contraction of 3.9%, coming in higher than the expected 4.4% increase. Retail sales rose above their pre-pandemic level as restrictions continued to be lifted and spending in the services sector is recovering at a rapid pace.

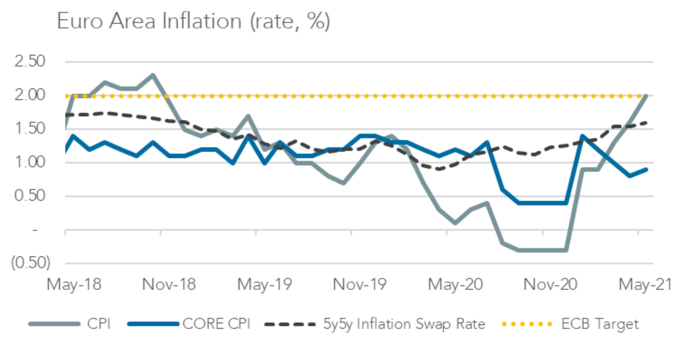
The final Composite PMI stood at 59.5 in June, compared to the prior 57.1 and beating expectations of 59.2. The strong survey release shows improved growth momentum during the month of June and indicating that price pressures are now spilling over into the services sector. The services sector experienced the steepest pace of expansion since 2007 due to the easing of the pandemic measures in many Euro Area countries. How-



Source: Bloomberg

ever, the continued increase in backlogs of work and supply-side constraints have limited production during the month.

Looking at inflation, the flash headline HICP figure for June came in at 1.9% down from the 2.0% print in May and in line with market expectations. When looking at the largest Euro Area economies, it is clear that the dip in headline inflation came from Germany, with its CPI declining from 2.4% to 2.1%. This is explained by declining services inflation which is mainly reflective of changes in the timing of holidays.



Source: Bloomberg

The flash core inflation rate also dipped to 0.9% in June from 1.0% in May, in line with market expectations. The dip came as non-energy industrial goods inflation rose by 1.2% while services inflation dropped to 0.7%.

Economists believe that inflation will likely rise again in the coming months, led by higher inflation in Germany. Consensus forecasts for Euro Area inflation in 2021 have been revised upwards from 1.7% to 1.9%, only to come back down to 1.4% next year and beyond.

These estimates are broadly in line with the June ECB staff macroeconomic projections which foresees annual inflation at 1.9% this year and 1.5% next year. The inflation outlook has been revised upwards from the March projections of 1.5% for 2021 and 1.2% in 2022. The estimate for 2023 was left unchanged at 1.4% during June highlighting the notion that the inflation surge is transitory.

Economists suspect that inflation could overshoot to above 2.5% in the second half of 2021, with non-energy goods and services inflation likely to edge up further. It is most likely that inflation will drop back fairly sharply next year as some base effects go into reverse.

Labour market conditions seem to be improving with the unemployment rate edging down to 7.9% in May, marking the lowest level since May 2020. This level was slightly below market expectations of 8.0% and the prior month's 8.1%. The release shows signs of recovery in the labour market amid the gradual easing of coronavirus-induced restrictions, with the reopening of many service sector firms boosting hiring activity.

The continued reopening of the services sector since May should mean that employment picked up again in June. Economists believe that the extent to which this can reduce the unemployment rate further will depend both on how many people return to the labour force over the coming months and also how much firms draw on their furloughed workers to meet higher demand.

Therefore, the risk of a delayed surge in the unemployment rate has diminished yet once again, with this being dependent on the number of persons who may lose their jobs as government support for firms is tapered.

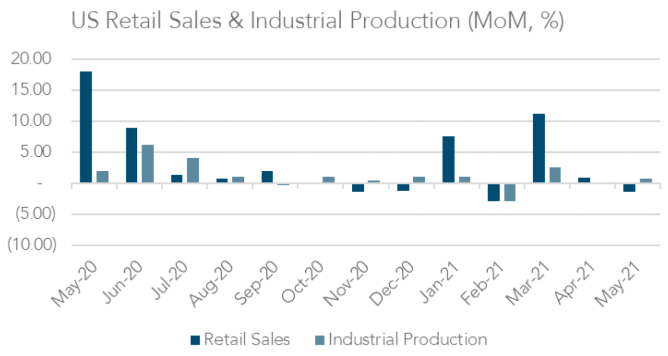
Financing conditions in the Euro Area remain easy, thus supporting the recovery of the region. The ECB left monetary policy unchanged during its June meeting, saying it expects net purchases under the pandemic emergency purchase programme ("PEPP") over the coming quarter to continue to be conducted at the current "significantly higher pace" compared to the first months of the year.

President Lagarde said it is "too early and premature" to discuss an exit strategy from the PEPP. Economists expect the ECB to slow down PEPP purchases later this year in the last quarter, following the September meeting, but it could eventually make an offsetting increase to other asset purchases once the PEPP envelope of EUR 1.85trillion is spent. Given long-standing dynamics which have limited the build in price pressures in the Euro Area we expected that the ECB will leave the deposit rate unchanged for longer than market consensus.

United States

At the June Federal Open Market Committee ("FOMC") meeting, the Fed updated their economic projections, with the 2021 median now showing GDP growth at 7.0%, up from 6.5%. The upgrade reflects the broader consensus of stronger growth in the US during the first phase of the economic recovery.

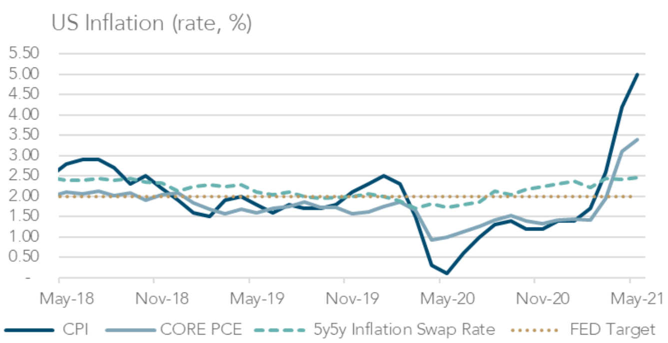
Having said that, retail sales shrank 1.3% month-on-month in May, reversing April's growth of 0.9% and coming in much worse than the market expected growth of 0.8%. The decline seems worse than the data suggests since April's figure was revised up from 0.0%. The release came as Americans shifted spending to services as the economy reopens with travel picking up and the fiscal boost are fading. The drop included a 3.7% month-on-month fall in motor vehicle sales, which if excluded, is equivalent to a drop in core sales of 0.8%.



Source: Bloomberg

Industrial production increased 0.8% month-on-month in May, following the prior month's 0.1% expansion, beating market expectations of a 0.6% month-on-month increase. This was driven by a 0.9% gain in manufacturing output, suggesting that some of the shortages holding back production in recent months could have eased. However, the level of manufacturing output is still slightly below its pre-pandemic peak and continues to lag the earlier resurgence in goods demand.

The final Composite PMI stood at 63.7 for the month of June, below the prior 68.7, coming in slightly shy of the market expectations of 63.9. Despite this pullback in PMI data, both services and production sectors saw an improvement following the further relaxation of restrictions given rising customer demand. However, supply-chain disruptions continue to hinder output from expanding further.



Source: Bloomberg

Annual inflation increased to 5.0% in May from 4.2% in April, surpassing market expectations of 4.7%. Core consumer prices increased 3.8% in the same period, compared to the prior 3.0% and the expected 3.4%. Core PCE rose to 3.9% from 3.6% in April, in line with expectations.

The increase for the month was driven by reopening effects particularly in sectors most directly affected by the pandemic, with prices for these sectors expected to continue to rise rapidly. These very sharp inflections in price levels as a result of the pandemic have produced a sharp surge in inflation which is expected to ease as base effects fade and some of the upward pressure on prices in the pandemic-hit sectors subsides. In any case, economists are expecting core inflation to remain above the Fed's target of 2.0% for the near term.

The Fed continued to stick to its view that the surge in inflation largely reflects "transitory factors", but officials revised their projections for policy rates up significantly for 2021 and the median projection now shows two 25bps interest rate hikes in 2023. Notably, the expectations for long-run inflation was unchanged at 2.0% from March forecasts, highlighting their evaluation that high prices are transient. As transitory supply effects abate, inflation is expected to drop back toward the Fed's longer-run goal.

Officials now think that core PCE inflation will be at 3.0% in 2021, compared with a median forecast of 2.2% back in March. Nevertheless, the median projection for 2022 increased only trivially to 2.1% from 2.0%, suggesting that members are still comfortable that core inflation will quickly drop back to near the 2.0% target.

The labour market has continued to show signs of recovery, supported by the reopening of the economy, amid the rapid pace of vaccinations and the ongoing government support. However, employers have been complaining about the struggle to fill open positions. The unemployment rate edged up to 5.9% in June, compared to the prior month's 5.8%, coming in worse than the expected 5.7% as the number of persons employed leaves a gap of c. 7.5 million from pre-pandemic levels. The labour force participation rate remained unchanged during the month of June at 61.6% showing that there is still reluctance for inactive individuals to look for work — this is a key risk for the employment gap.

Non-farm payrolls for the month of June increased by 850,000 jobs, beating market expectations of 700,000 and the prior figure of 583,000. This was driven by those sectors most sensitive to the continued return to normalcy, including leisure and hospitality (+343,000), public and private education (+270,000) and retail (+67,000). The strong payroll gains could be a sign that some of the factors holding back labour supply have started to ease, particularly the enhanced unemployment benefits which are expiring earlier in several states, ahead of the original September expiration date. Average hourly earnings grew by a modest 0.3% month-on-month, compared to the prior and expected 0.4%, suggesting that shortages could be easing, with year-on-year estimates remaining unchanged at 3.6%.

The mixed jobs report for June showed progress in hiring, indicating that the labour shortage has started to ease as conditions normalise with a concurrent moderation in wage growth. However, the higher unemployment rate and low participation rate highlight the economic slack and that there is a long road to achieve full employment levels.

Within this context of surging inflation and slow recovery in labour market conditions, the Fed judged to keep the target range for its federal funds rate unchanged at 0-0.25% in June 2021, but brought forward its projections for the first rate hike from 2024 to 2023, projecting two rate hikes of 25bps. Chair Powell argued that the economy is still not close to achieving the substantial further progress toward its dual mandate goals that would trigger a tapering of its monthly asset purchases. Economists do not expect that tapering will begin until next year. Financing conditions eased further with the move lower in long-end yields, despite the higher front-end pricing of an earlier policy hike.

The Fed announced it will extend for a final time its paycheque protection programme ("PPP") liquidity facility by an additional month to 30 July 2021. The extension is being made as an operational accommodation to allow additional processing time for banks and other financial institutions to pledge to the facility any PPP loans approved by the Small Business Administration through the 30 June expiration of the PPP programme.

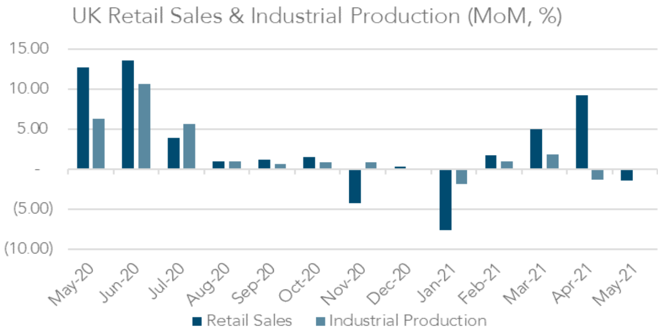
United Kingdom

The latest monthly GDP data release in the UK showed that the economy expanded by 27.6% year-on-year in April, the highest on record and in line with market expectations. This was due to the low base year as well as the supportive conditions as restriction continued to ease around the country. For context, this followed a 1.4% year-on-year growth in the month of March.

The jump in GDP in April was another sign that consumers are eager to spend as the economy reopens. On a month-on-month basis, GDP grew by 2.3% marking the fastest growth since July 2020 following 2.1% gains in March. The recovery was almost entirely driven by those sectors which were reopening. This expansion left GDP at just 3.7% below pre-pandemic levels. Economists believe that the economy will get back to February 2020 levels by the autumn months, if not sooner.

The BOE revised its GDP growth expectations upwards for the second quarter of 2021 to 5.5% from 4.25%. The July consensus forecasts for full-year 2021 GDP growth have similarly been revised upwards from 6.2% to 6.7%.

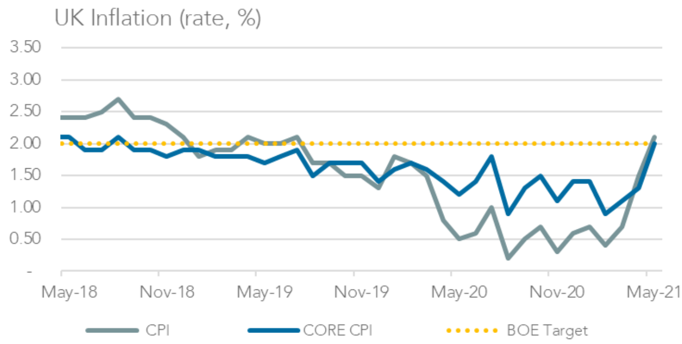
Industrial production shrank 1.3% month-on-month in April, following a month of growth of 1.8% and compared to market expectations of a 1.2% expansion. The main reason for this drop was a decreased of 15.0% for mining and quarrying due to planned temporary closures for maintenance of oil field production sites.



Source: Bloomberg

Retail sales declined by 1.4% month-on-month in May compared to a month earlier which saw an increase of 9.2% month-on-month and coming worse than the market expected growth of 1.6%. This came about as a result of the reopening of indoor hospitality in mid-May, altering spending patterns and prompting households to spend more time socialising.

The final Composite PMI for June stood at 62.2 dipping from the prior 62.9 but beating market expectations of 61.7. This pointed towards a strong expansion in both services and manufacturing sector activity amid looser pandemic restrictions, improving global market conditions and growing customer demand. Supply-chain and distribution difficulties continue to disrupt production schedules, leading to longer vendor lead times.



Source: Bloomberg

The rise in CPI inflation from 1.5% in April to 2.1% in May came above market expectations of 1.8%. This was the highest rate since July 2019, surpassing the BOE target inflation rate of 2.0%. The surge reflects the ongoing economic recovery and reopening efforts, as well as the low base year. The headline rate came in 0.3% higher than forecasted by the BOE in their May report. Core inflation also experienced a significant surge during the month of May, moving from 1.3% to 2.0%, beating market expectations of 1.5%. Economists think that CPI inflation will peak at 2.9% later this year, compared to the last months forecasts of 2.6%, and that the expected further surge in costs earlier in the price pipeline will keep inflation above 2.0% for a while longer than originally anticipated.

The unemployment rate fell to 4.7% in the three months ending April, in line with market expectations, edging down from the prior month's 4.8%. Economists expect that the rate will rise to 5.5% by year end. The labour market continued to show signs of recovery, supported by the easing of many restrictions, the rapid pace of vaccinations, and the government's furlough scheme.

The level of employment rose by 113,000 to 32.5 million. This though was still more than 500,000 lower in April than pre-crisis levels. Average weekly earning (inc. bonuses) surged 5.6% year-on-year to £571 in the three months ending April given the compositional effects of a fall in the proportion of lower paid employee jobs.

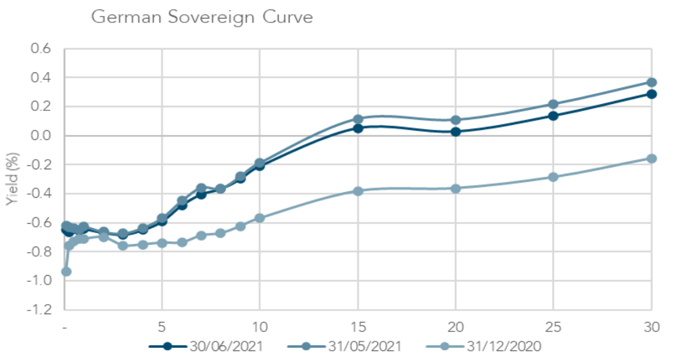
The BOE unanimously kept its interest rate unchanged at 0.1%, and by a majority vote of 8-1, left its bond buying programme unchanged. The BOE reiterated that it does no intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2.0% target sustainably. The MPC indicated during its June meeting that, even if inflation will rise above 3.0% over the next six months, it will not be putting that much weight on it highlighting the transient nature of the surge. This dovish communication has continued to contribute to easy financing conditions in GBP.

RATES

Euro Rates

The modest compression in sovereign spreads was sustained in June accompanying the move lower in long-end benchmark bond yields with the periphery being the top performers in this recent rebound in spreads. Despite some expectations that the ECB would lower the pace of purchases given the positive economic developments, improved outlook and the low summer volume and supply, it reiterated that it will continue with its current "substantially higher" pace of purchases for the time being. This is the main explanatory factor behind the recent compression in spreads.

Even though supply fluctuations only have a marginal effect on relative performance in Euro Area government bonds, the main factors are quantitative easing ("QE") stock considerations and the pace of purchases. We still anticipate a moderation in the pace of purchases during the summer lull which will probably surface post-event.

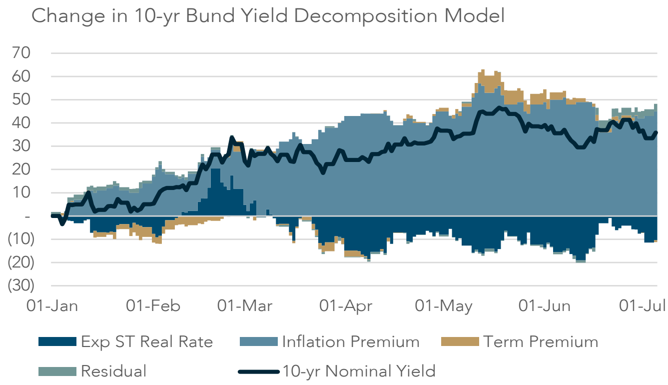


Source: Bloomberg

Long-end EUR yields have generally moved lower in sympathy with US treasury yields during the month of June however, the moves were less pronounced given the upward bias in long-end yields coming from:

1. The lagging European recovery resulting in a more gradual climb in yields since the start of the year;
2. PMI data in Europe is continuing to improve given the later reopening of most European countries;
3. The surge in inflation and inflation premia is still underway; and
4. Expectations that central bank purchases could have been tapered going into the summer months, removing some downward pressure on yields.

There has been no visible change in front-end pricing as, the baseline view that the ECB will take much longer to adjust forward guidance, has continued to firmly anchor the short-end of the curve. The net effect was a bull flattening movement led by a decline in inflation breakeven rates. The dip in Euro Area inflation in May is taken as evidence that price pressures are harder to build. The reasons for this include an uneven recovery (leading to uneven price developments across countries), fiscal expansionary support which has been far lower in scale compared to other advanced economies, labour market developments and latent effects on employment levels given work-retention schemes.



Source: Curmi and Partners; Data: Bloomberg

The Delta variant is in focus now given the rise in cases across the Euro Area, presenting downside risks to the near-term growth outlook which, as we have seen before, is expected to impact mainly the southern states which are more dependent on seasonal tourism. The UK reopening experience is the most relevant to watch in this sense as a precursor to what we should reasonably expect in Europe. The delinking of hospitalisation and death rates from case growth rates points in favour of growing confidence in the efficacy of vaccines reducing the likelihood of the reimposition of stricter containment measures.

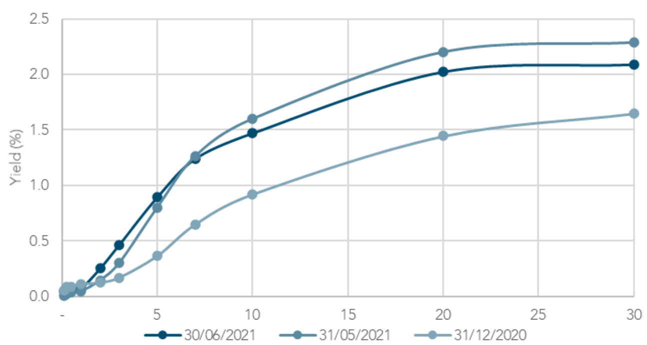
At this stage, we are looking at opposing forces of growing economic momentum as countries are reopening for the summer months and the growing downside risks for new virus variants which could derail the recovery. Whilst the economic outlook is generally supportive, the case is growing for waning price pressures mainly due to labour markets not seen to be as tight as other economic regions, peaking oil prices, reopening effects on prices expected to be muted given the uneven lifting of restrictions and the fluidity in travel restrictions across the Euro Area.

On this basis, the risks for a move higher in sovereign yields is losing strength in the near term. Technical factors favour downward pressure on yields. Upside risk around economic data releases could be subsiding raising doubt not only on the optimistic outlook but also reduces the likelihood of policy adjustments by the ECB.

US Rates

The events of June have tested market positioning and gave further definition to the inflation debate in the US and pricing of inflation premia. At the same time, labour market data was disappointing for April and May, while the stronger print for June alleviated concerns on labour-force shortages which concurrently highlight the extent of the economic slack in the US. This has tamed expectations of continued increase in wage growth. The latter has been a cornerstone in the inflation argument due to the growing notion that high inflation can be sustained at lower levels of employment in a post-COVID environment.

US Treasury Curve

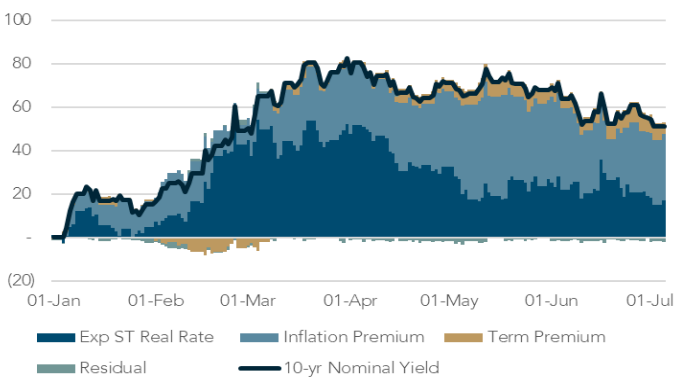


Source: Bloomberg

Given this backdrop, the rally in the US Treasury market is well placed despite the uncharacteristic reaction to a hawkish FOMC meeting coming primarily from a re-rating of the long-term inflation outlook following the strong widening in inflation risk premia which explained the rise in nominal yields since the start of the year.

The initial reaction to the hawkish outcome of the FOMC meeting on 16th June was a kneejerk reaction in US Treasuries with the 10-year yield rising from 1.49% to 1.59%. However, as the market digested the communication, the 10-year yield declined sharply to a low of 1.35%. At the same time, we saw the 2-year to 5-year yields moving higher resulting in an overall flattening of the curve. The move in the 2-year to 5-year area of the curve is mainly attributed to front-end pricing with futures implying a 25bps rate hike by September 2022.

Change in 10-yr Treasury Yield Decomposition Model



Source: Curmi and Partners; Data: Bloomberg

Behind this move was the widening differential in 10-year and 5-year breakeven rates, with the 10-year breakeven rate moving lower more rapidly following the FOMC meeting in reaction to the Fed's guidance of two rate hikes in 2023 bringing forward its guidance of the lift-off in rates from 2024.

The US Treasury market has been rallying since end-March when the US 10-year yield reached a pandemic high of 1.77%. As can be seen from the decomposition model, at first the move was explained by a decline in the expected short-term real rates component up to mid-May, suggesting that the market has overestimated the rate of policy normalisation by the Fed with the central bank reiterating over and over again the requirements for substantial further progress in economic data before considering tightening policy.

During the month of June, the continued decline in the 10-year yield from 1.59% to 1.47% is almost entirely explained by the decline in 10-year breakeven rates from 2.45% to 2.34%. The movement in the expected short-term real rates components was self-correcting given "not-here not-there" messaging of the Fed (hawkish dot-plot, dovish narrative).

Labour market data is expected to continue to come in stronger following the June report. This will be interpreted as a faster recovery of the 7.5 million job gap, which is the main reason why the Fed has so far held back from full committing to the hawkish tilt at the last FOMC meeting.

On this basis, we expect the Fed to accelerate policy tightening guidance in future meetings, possibly after summer and initiate discussions on tapering. We therefore expect the short-end and belly to remain offered for the time-being on upside risks in jobs growth and increased front-end policy pricing (the next step for the Fed is to discuss tapering).

In the first few days of July, we saw the rally being extended further with the 10-year yield dipping to below 1.30%. The move is mainly driven by a decline in real rates, on the first instance, but we will likely see an adjustment in the inflation expectations with a repricing lower of breakeven rates. The move (at least the sheer magnitude of it) seems to be largely technical and squaring of short positions.

However, we have also seen the rising virus cases globally as well as the OPEC+ impasse (with increased risk of a correction in oil prices) being attributed as potential forces behind the rally over these last few weeks. Moreover, the mixed jobs report is seen to be falling short of the reassuring conditions required to see a sustained recovery in the labour market. This is sustaining the "Goldilocks" outlook and reinforces the notion that Fed intervention has to remain for longer. Therefore, the move lower is mainly real-rates-driven. This is particularly evident when looking at 30-year real yields which have practically unwound the 2021 sell-off.

Near-term bias is for long-end yields to remain under pressure and for the curve to flatten due to:

1. Seasonality as the Summer months tend to see lower yields.
2. Increased market volatility.
3. Limited changes in central bank communication expected before September.
4. Lingering risks of oil price war or agreement on higher production hikes following the July impasse.
5. Noisy data and lack of directional catalysts decreasing scope of outright shorts.

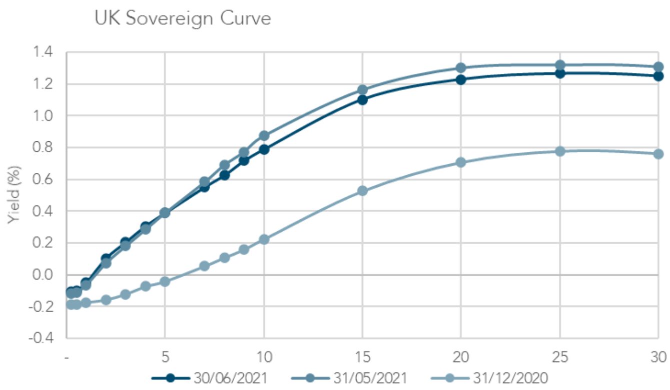
Over the medium term, we still think that higher long-end yields are better supported by a rebound in real rates. The key risks to this outlook include: (a) new variants and increased number of cases following the reopening warranting a more cautious approach by policymakers; (b) tight labour market conditions fail to normalise thus restricting job growth, wage growth risks resurfaces; and (c) extended reluctance by Fed to commit to a hawkish tone due to market disruption risks, undesired effects on financing conditions, as well as indirect pressure to maintain policy rates low due to rise in public private debt burden.

UK Rates

UK 10-year Gilt yields declined by 8bps in June in a move which saw a pivoting movement in the UK curve (similar to that of the US Treasury curve). The move is primarily explained by a decline in inflation premia as the 10-year breakeven rate lost 10bps.

This mirrors the general sense that the economies that have reopened earlier are seeing the rate of growth peaking in the second quarter while price pressure may start losing strength as economic conditions continue to normalise, short-term imbalances fade and we can possibly be seeing weakness in the commodity rally (mainly oil prices).

Optically, firmer front-end pricing is not seen to be driven by an anticipation of an earlier move by the BOE, but it seems to be more about roll-down i.e. moving closer to the first rate hike purely by the passage of time.



Source: Bloomberg

In fact, the main hawk amongst MPC members is the outgoing chief economist Andy Haldane who has been very vocal about the inflationary risks in the UK, advocating earlier action by the central bank. Governor Bailey's dovish tone seems to have prevailed (particularly given the backdrop of increasing downside risks to the outlook) with key macroeconomic variables being the labour market and wage growth developments, and forward inflation expectations. Swap markets have hardly changed implied pricing of a mid-2022 lift-off in rates.

The BOE judged that the current easy monetary policy remains appropriate despite the upward revision in their near-term projections in May and the strong data prints since then.

Given our assessment that inflation will prove to be temporary and that market expectations of an inflation overshoot in the near term are too high, we expect the BOE to act later than the current market-implied pricing. With that said, we will unlikely see a reassessment in front-end pricing for the time being given that reopening effects should still provide upward bias in data prints. Also, at this stage, markets will remain highly sensitive to this and could continue overestimating the read-through of current data. Moreover the spill-over effects from Fed hawkishness can continue to see correlated support in yields in the short-end of the GBP curve.

Therefore, we continue to see short-term upside risk for 5-year rates as front-end pricing could shift outwards. Upward pressure on long-end yields should ease off as 5y5y inflation expectations are expected to continue to correct lower.

CREDIT

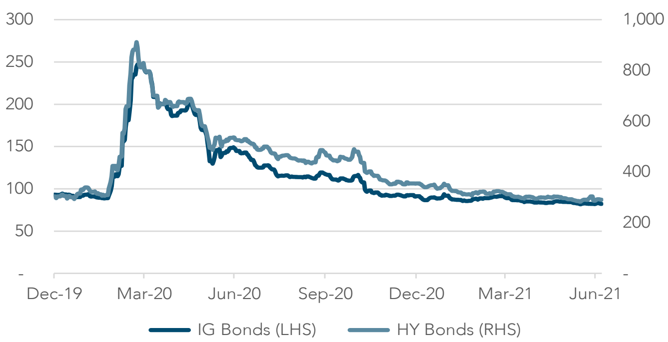
Euro Credit

Eurozone corporate bond spreads tightened during the month of June as sovereign yields also declined during the same period. The ECB's accommodative stance, the continued vaccine rollout and the reopening of European economies improved the prospects of European corporate bond issuers despite the rise in cases in the bloc as a result of the virus variant.

The European high yield ("HY") market has extended its rally for a ninth successive month and continues to look set for a positive second half of the year despite reasonably strong net supply and volatile benchmark rates over the first half of the year.

While the stable bund yields have generally helped fixed income during June, the combination of a further compression in HY spreads and better carry available in the asset class has helped to deliver sustained positive returns for the month. The strong pace of rating actions and absolute lack of defaults further aided sentiment and performance for the asset class.

EUR IG and HY Credit (option-adjusted spread, bps)



Source: Bloomberg

The progressive move wider in bunds seen for most of this year has hit high grade returns almost every month, causing investment grade ("IG") credit to deliver a negative return for IG for the first half, despite spread returns being positive over the period. The moderate IG supply and relatively stable bund during June has helped to deliver one of the best performing months of 2021 for IG. The expectation remains that the bund yields will continue to determine total returns for the rest of the year for IG credit.

The relatively smaller July net supply, typical for this time of the year, is likely to support spreads and excess returns over the short term, whilst the upgrade/ downgrade momentum from rating agencies should also improve sentiment.

The overall HY index saw strong growth in June, with the net entry of twelve bonds and c. +€10 billion of par paper, driven primarily by new issues. Unlike the IG market, July has not been a particularly quiet month for HY in recent years, adding four bonds worth €1.8 billion on average over the past decade. The expectation is for July's net HY supply to be in-line with or more than this average given the momentum in HY new issues thus far in 2021 — that is a step down from June, though above historical average issuance.

We expect new supply to be well digested, as defaults remain low and investors seek HY due to the vaccine-led economic recovery and as a shelter from rising bund yields. By comparison, IG issuance is likely to remain muted over the summer months and also below that seen in June. With credit spreads continuing to compress further into new territory, the paradigm of ratings step-downs for carry is no longer as straightforward as it once was and we continue to prefer adding names carrying more idiosyncratic risk for outperformance.

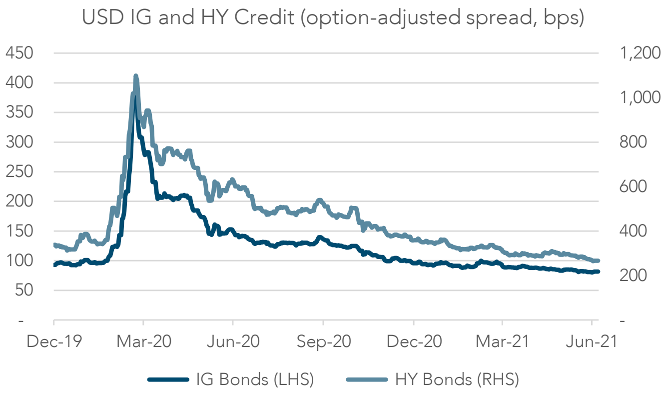
IG credit breakeven levels still stand close to the record-low levels reached toward the end of 2020, which led to the negative total returns this year due to the move in bunds. As bund yields have begun to climb again since end-April and the messaging around increased QE buying has had mixed results in maintaining low yields, IG credit remains relatively vulnerable. HY breakeven, on the other hand, continues to offer a reasonable cushion at current levels, and should remain attractive over the medium term.

In terms of curve positioning within Euro IG, whilst we remain concerned around the potential for rising bund yields to impact the longer end of the curve, we note that the +10-year bucket within the index currently trades at its widest option-adjusted spread ("OAS") on record relative to the 5-7 year bucket, implying that whilst the belly of the IG curve has mostly recovered from the 2020 rout, the long end continues to lag on a relative basis.

US Credit

US corporate credit spreads tightened during the month of June despite the decline in US Treasury yields as yields within both the IG and HY segments of the US corporate bond market declined by a larger degree. The contraction of corporate credit spreads occurred despite the Fed indicating that it would be raising rates earlier than expected, in 2023 rather than 2024, and begin tapering asset purchases within the Secondary Market Corporate Credit Facility by the end of the year following its mid-month FOMC meeting.

Despite the continuation of the Fed's dovish monetary policy stance, the contraction of US corporate bond spreads can be better explained by fiscal policy and positive economic data as the American economy continued to reopen. US corporate bond spreads are close to record lows across both IG and HY which, when combined with still subdued Treasury yields, implying little room for total returns to withstand any renewed volatility in rates.



Source: Bloomberg

Over the second half of the year, potentially wider spreads driven by inflationary fears and further discussions around tapering, are expected to result in muted spread returns, whilst higher risk-free rates translate into potential curve losses for both asset classes. As a result, we continue to prefer exposure to Euro credit relative to USD, largely due to the technical picture being notably stronger in Europe than in the US as the ECB remains highly active in purchasing corporate debt.

IG spreads have held in a narrow range for June, trading between 80-85 bps, with the quarterly range being between 80-92 bps over the whole of Q2. Economic growth and ample liquidity have supported valuations, even amidst aggressive moves tighter by Treasury yields. We believe the likelihood for significant spread tightening is minimal at this stage, implying that US IG will have difficulty repeating, or even holding on, to its recent strong performance, and is likely to underperform over the coming months.

Similarly, the second half of the year is expected to be more challenging than the first half for US HY, as risk-free rates and spreads may both contribute to negative total returns. Through the end of June, the asset class has returned 3.62% on a year-to-date basis, aided by cycle lows in spreads and a partial reversal of the Q1 adverse move in Treasury yields.

It appears likely that the index may lose ground on both fronts over the coming months, as an incrementally less accommodative Fed pressures risk-free rates, and as economic momentum slows. Absent any added stimulus, investors are seeing spreads in US HY potentially drifting back toward the 350 bps area.

The emergent tightening bias to global monetary policy and easing of fiscal stimulus measures raises the prospect for wider spreads across US HY corporates. At 268 bps as of the end of June, OAS was at 14-year lows and consistent with resistance levels from 2005-06. The only other notable test remaining is the 233 bps record low experienced in 2007, which may be difficult to realise given comparatively lower nominal yields.

UK Credit

UK corporate credit spreads also tightened in June, however, IG rated debt tightened by a larger degree than non-IG debt. HY spreads were mostly influenced by the UK Government's decision to delay the full opening of the economy by four weeks because of the recent rise in coronavirus cases.

The BOE's meeting in June did not leave a marked effect on corporate credit spreads as the central bank expects inflation to increase temporarily above 3%, before subsiding, while GDP is also expected to experience a temporary rise given the economic effects of the gradual restriction easing. The pandemic hit the UK economy harder than most in 2020, but the successful rollout of vaccines has opened the door to much of the lost ground being made up quickly over the coming months as restrictions imposed to curb the spread of the virus are lifted.

Against a backdrop of an economic recovery that is gathering pace, inflationary pressures that are more likely to be transient, and unemployment remaining broadly stable in the coming months, with the number of individuals on the furlough scheme set to keep falling, we view spreads on offer in the UK bond market, both for IG and HY, as attractive.

Our concerns with the UK bond market stem from the uncertainty around the BOE's review of its tightening policy, and the effects this may have on benchmark rates. The market consensus at this stage has been for the BOE to raise rates during 2022 and for the size of its QE balance sheets to be reduced over time after the market has digested rate increases.

Given the outlook on inflation and the messaging from the BOE, the likelihood is that policy tightening will take place later than initially expected, with rates being raised between late 2022 or early 2023, and for the BOE to stop or greatly reduce QE reinvestment shortly after.

Given wide spreads in the UK corporate bond market relative to the EU and US, and the risk of higher benchmark rates (albeit potentially later than initially anticipated) as a result of the combination of tighter policy and QE unwind, we would prefer corporate bond participation at the short-to-medium end of the UK curve for spread pick up with minimal underlying rate risk.

EQUITY

Global equities rallied +16.9% (in € terms) during the first six months of 2021. The successful vaccine rollout in developed economies, as well as improving macroeconomic data published, resulted in a risk-on rally for most of the period. June marked another month of positive performance for global equities, with a total return of +4.8%, as US equities rallied strongly. This was the best monthly performance registered by global equities since March.

Our expectation at the start of the year was that the conditions were right for European equities to finally outperform their US counterparts. This did not materialise in the first six months of 2021, with US equities (S&P 500) delivering a total return of +18.9% (in € terms) compared to +15.8% for European equities (STOXX 600).

In fact, looking at monthly performance over the past six months, European equities only managed to outperform US equities in May, when inflation concerns weighed on the latter's performance. The sluggish start to the vaccine rollout weighed on European equities earlier in the year, while COVID-19 concerns have resurfaced in June.

The expectation for strong global economic growth, rising commodity prices and fiscal/monetary accommodation created the perfect environment for value stocks to outperform growth stocks. So far, global value stocks have delivered a total return of +18.8% (in € terms) compared to +14.8% (in € terms) for growth stocks.

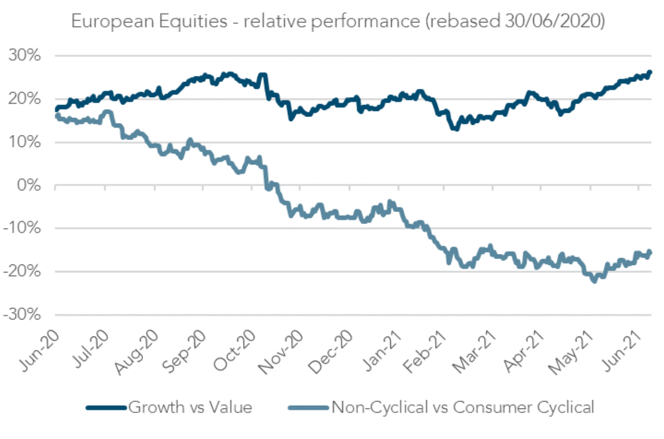
This outperformance pales in comparison with FY20, when global growth stocks delivered a total return of +23.3%, while global value stocks' total return came in at –8.4%. During June, global growth stocks (+7.8%) significantly outperformed global value (+1.8%). This outperformance is mainly related to the FOMC press release in June, more specifically the shift up in the median dot in 2023 to two hikes.

Financial conditions remain very easy, and interest rates should remain low for much longer, while global economic conditions have improved considerably over the past months. There are increasing signs (PMIs) that US economic growth has peaked, with the UK and EU economies expected to peak in the second or third quarter (assuming no additional lockdown measures).

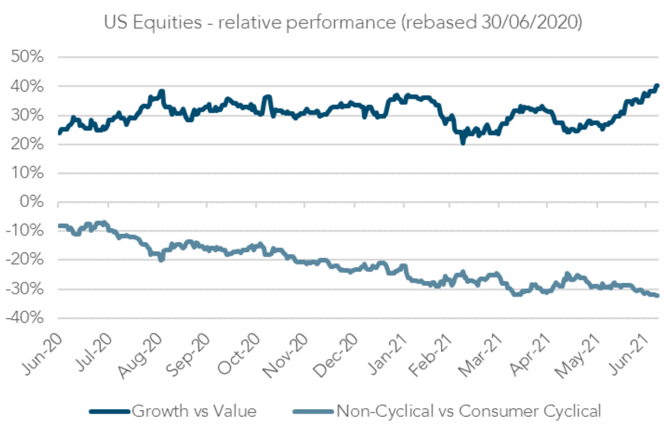
The lag between the US and the rest could suggest that upside remains for equities in other geographic regions like the EU and UK.. We remain positive on European stocks going into the second half of 2021.

Emerging market equities delivered a total return of +10.8%, well below the returns seen in developed markets. This is quite unusual in periods of strong global economic growth, but we think this is related to (1) continued tension between the US and China; (2) difficulties in controlling the virus spread; and (3) disappointment in the vaccine rollout.

As previously discussed, global value stocks underper-



Source: Bloomberg



Source: Bloomberg

formed growth during June on the back of heightened inflation and COVID-19 concerns. Under normal circumstances, higher inflation expectations would boost value stocks (value stocks were the second best performing asset class during the 70's), but the liquidity injected by central banks over the past decade and the fiscal measures announced over the past year pose additional risks to the equity market.

The negative impact on the global economy should central banks fall behind the inflation curve (keeping in mind where we are in terms of fiscal and monetary policy) cannot be downplayed, but this remains an unlikely scenario.

Despite the FOMC leaving the 2023 inflation forecast unchanged (2.1%), the market implied probability (derived from caps and floors) of US inflation overshooting has been hovering around record highs. This implies that the market is currently pricing-in a scenario where inflation overshoots (over 5 years), forcing central banks to adjust (potentially aggressively) policy to bring inflation under control. This could explain the performance of value stocks, keeping in mind the economic performance during a period of central banks trying to get inflation under control.

We continue to believe that this is unlikely given current information. The June payroll numbers brought about some respite, with wage inflation reported in-line with expectations. We believe that economic data released later in the third or last quarter of 2021 will provide more insight on the inflation outlook for the US economy (and the potential impact on growth).

The Delta virus is highly transmissible leading to a surge in cases in the UK and Spain amongst others. A study by the ONS has found that the positive rate in England among individuals aged 16-24 was 17 times higher than among the 70+ in late June. This reflects a much lower full vaccination rate among the young and more social interactions. This implies that the risk of new restrictions being implemented due to a surge in new cases is low. However, a surge in cases can still weigh on economic growth through travel bans, low consumer confidence and labour shortage.

Despite the current situation being ideal for Europe and value stocks, EU stocks (+15.8%) have so far underperformed their US counterparts (+18.9%), while EU value stocks (+15.0%) have underperformed growth (+16.4%).

We think this is unwarranted, in view of the economic growth expectations for 2021 and the outperformance of US equities and growth over the past decade. We expect this to reverse in the second half of 2021 as economic growth in the EU peaks and confidence in the vaccine increases. Our view is underpinned by improvements seen in the traditional value sectors in Europe, as banks are well capitalised and the impact for increased regulation should now be behind us, while in the energy and mining sectors, companies have delivered on their cost reduction measures.

As a region, Europe is much more geared to global economic growth, partly explained by the sector allocation of the index. Finally, we believe that the successful vaccine rollout in the EU will lead to easing of measures, which should lead to higher bond yields (a positive for value stocks).

As conditions normalise after the COVID-19 shock, we expect a return to the "Goldilocks" environment which has prevailed since the global financial crisis as structural problems remain. This implies that companies that can deliver consistently high growth will be rewarded by investors. However, we think that a differentiating factor over the next decade will be the push by governments to achieve the ambitious self-imposed climate targets.

The growth outperformance before the pandemic was mainly in capital light companies, but this will have to change in the future if governments are serious about the climate goals. The infrastructure spending (by governments) and capital expenditure (by corporations) required to electrify operations is substantial.

Companies that have an edge, that is climate champions in different sectors like electric vehicles, clean energy generation, and so on, will see a substantial increase in demand, leading to growth in revenues and profits. With investors becoming more conscious on the urgent need for climate change to be addressed, we expect climate champions to outperform over the next decade.

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Developed Market Sovereign Bonds	Negative	U/W	Exposure to sovereign credit has diminished, with the vast majority of benchmark issues still trading into negative yielding territory. The outlook for periphery credits remains supported, but as noted in previous updates, reflationary pressures and the gradual withdrawal of central bank support is likely to continue weighing on the asset class over the medium term. We maintain an underweight stance in sovereigns given the predominantly negative yield on offer for the asset class in absolute terms and would be cautious on adding further curve risk given the scope for economic data releases to surprise to the upside.
Investment Grade Corporate Bonds	Neutral	N	We believe that high grade returns will depend largely on movements in benchmark rates, further stimulus and vaccine success. The ECB has pledged to step up purchases for the time being, which has been supportive for spreads, however, unlike 2020, there is currently very minimal cushion against bund movements within IG corporate credit, and the ability to hedge benchmark rates has become a critical factor within IG performance. We are less constructive on IG credit in both USD and GBP given timing differences on the potential withdrawal of central bank support. The default and rating environment for global credit has improved significantly since the start of the year as economic conditions have continued to stabilize, minimizing the risk of fallen angels on both sides of the Atlantic. 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 any minor spread decompressions between high yield and investment grade as an opportunity to pick up additional exposure in the space.
Developed Markets Equities	Positive	N	Our view at the start of the year was that Europe and value stocks will outperform US and growth stocks over the coming months, buoyed by strong global economic growth, rising commodity prices and loose monetary and fiscal policy. However, this has not materialised, mainly due to investor concerns surrounding the strong performance of the asset class (these being wary of potential reversals), the disappointing start to the vaccine rollout at the start of the year, and the rise in COVID-19 registered cases over the summer months. However, we expect European and value stocks to be preferred by investors as we approach peak growth in the region. We are well positioned for this, with an exposure to both the value trade and re-opening beneficiaries in the region. During June and early July, we reduced out exposure to the US dollar on the back of the FOMC release. There is scope for US dollar strength in view of the earlier lift-off implied by the FOMC median dots. This underpins our view that other regions will outperform the US during the second half of the year.
Emerging Market Equities	Positive	O/W	We believe that country selection will be a key driver of returns during 2021. We remain comfortable with our emerging market country exposures going into the second quarter of 2021. Our position on LATAM remains unchanged and we think that the region's performance will recover in the second half of the year as global economic conditions improve and vaccine rollout accelerates. As for our overweight position for the asset class, we remain confident that emerging market equities will recover during a period of global synchronised economic growth and a commodity bull market.

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

DISCLAIMER