Investment Strategy Update

August 2021

Curmi & Partners Research

- Economic data releases continue to point towards a sustained recovery in advanced economies.
- Labour market data has provided encouraging signs on the recovery from the fallout in the level of employment and the progress in reeling back the economic slack.
- Survey-based indices point towards further expansion but have softened from previous highs in the US and the UK indicating that we are probably past the peak growth rates in economies that have reopened earlier.
- Conversely, Euro Area economic data has generally lagged the recovery and is now expected to outpace other advanced regions as vaccination rates continue to improve while output in other regions moderates.
- The resurgence in new cases fuelled by the Delta variant is bringing about renewed concerns on economic activity given the possible reimposition of containment measures restricting mobility.
- The increased downside risks to the growth outlook has brought about the downgrading of growth and inflation expectations by market participants.
- The UK, where curtailment measures were eased despite the rise in cases, shows encouraging signs that highly-vaccinated nations can weather another wave of infections without reintroducing severe restrictions.
- High quality bonds have rallied sharply in recent weeks with the decline in benchmark bond yields due to safe haven flows, while the high yield bond market returned more modest gains given some widening in spreads.
- Equity markets have continued to rally following the strong earnings releases for Q2 supporting future earnings expectations, however, the value rotation trade remained under pressure with growth stocks broadly outperforming.
- Despite the slower expected growth rates in the near term, we remain optimistic on the economic recovery over the medium-term.
- We see scope for a corrective re-steepening in benchmark yield curves given that the recent rally seems to be overdone, but we continue to focus on spread returns with longer-dated Euro bond positions.
- We maintain an overweight allocation in high yield bonds and we remain highly selective in identifying suitable and attractive names.
- We remain optimistic on DM equities but we retain a neutral allocation to the asset class given the high degree of market vulnerability to the changing narrative around COVID and central bank communication.
- We expect European stocks to outperform as we continue to prefer maintaining a tilt towards value stocks.
- We continue to hold a higher allocation to EM equities given the lagging performance of the stock market making current valuations look relatively cheap given the elevated future earnings growth rates and the delayed economic recovery.

While economic data releases over recent weeks have generally continued to point towards further progress in the economic recovery, the resurgence in cases across major economic regions fuelled by the Delta variant of COVID-19 is weighing on sentiment bringing about concerns of a slowdown in the pace of the recovery.

The big reopening gains are likely behind us as we are moving past the peak of economic growth momentum in the regions that have reopened earlier. This is becoming more evident in the US, China and the UK where leading indicators, namely sentiment data and survey-based indices are suggesting less generous gains in output in the near term.

The rise in new virus cases has brought about renewed downside risks to the future growth. So far we have seen limited reaction by governments and health authorities to restrict activity given the resurgence of cases. Having said that, the risk is that, if cases continue to rise, we may reach a critical level which would prompt authorities to reimpose restrictions due to concerns on hospital capacity and death counts.

The downgrading of growth expectations, given the recent surge in cases, is deemed to be the main fundamental factor explaining the flow to safe haven assets and the accelerated decline in bond yields since June. Consequently, we saw strong returns in the investment grade sovereign and corporate bond markets, particularly at longer maturities given the decline in benchmark bond yields, while short-end rates remain buoyed by the expectations of an impending hike in policy rates. This has resulted in the general flattening of benchmark yield curves. More modest gains have been generated in the high-yield market as credit spreads have marginally widened in lower-rated securities.

On the other hand, equity markets in developed economies have continued to rally drawing on the strong earnings results in Q2 which led to upgrades in future earnings. Having said that, July was the second month where growth stocks have outperformed value stocks as the value reflation trade came under pressure. The increased downside risks to the growth outlook has weighed on those sectors that are most sensitive to economic expansion, while the decline in discount rates generally support valuations of growth stocks with back-end-heavy earnings and cashflow profiles.

As COVID numbers and risks of new, possibly vaccine-resistant, variants continue to drive market sentiment, we are encouraged by the UK experience so far where the disconnect between the sharp rise in new cases and the manageable increase in hospitalisation rates and relatively low crude mortality rates proves the real world efficacy of the vaccine. The UK experience, where curtailment measures have been eased despite the rise in cases, so far goes to show that nations that have achieved high levels of vaccination rates are able to weather another wave of infections with far less consequences on public health and therefore less scope to reimpose restrictions on mobility and social interactions.

While we expect slower growth in the near-term, we remain optimistic on the medium-term trajectory of the economic recovery as vaccination rates continue to climb, improving labour market data shows progress in recovering economic slack, long-term fiscal plans should increase productivity while accommodative monetary policy continues to provide relief in the flow of credit and cheap financing to boost investment.

On this basis, we deem the decline in benchmark bond yields to be overdone as the impact and longevity of the renewed downside risks are deemed to be overestimated by the market. Therefore, we expect a corrective steepening movement in benchmark curves in the next few months. We continue to favour longer duration positions in the Euro bond market where the risk of a persistent and substantial rise in rates is limited given the weak inflation dynamics in the area, as we continue to focus on enhancing spread returns. Conversely, short-dated US Dollar and Sterling bonds are starting to look attractive given that the firm front-end pricing suggests adequate discount for the risk of a potential earlier rate hike by the respective central banks.

We continue to observe that the strong returns in the HY market achieved earlier this year will unlikely be repeated at this stage given the very tight spread levels. Boosting returns by stepping down in credit quality is now a less obvious investment strategy. At the same time, the default environment remains fairly stable and credit rating action is on a favourable path. Therefore, we continue to see scope in boosting carry returns through careful selection in the high yield space.

Across equity markets we continue to favour European stocks with a tilt towards value in our mix of positions. The continued climb in the vaccination rates across the Euro Area have now exceeded the rate of inoculations in the US and will possibly soon exceed that of the UK as well. The delayed reopening is reflective in the lagged effect on survey-based indices, consumer spending and production, while other advanced economies are showing signs of peaking economic growth. On this basis, we expect the European stock market to outperform in the near term where value stocks trading at deeper or relatively cheaper valuations should benefit the most.

Despite the very weak performance and increased volatility in Emerging equity markets, we remain optimistic on the asset class given the delayed economic recovery and the elevated expected earnings growth rates which make current valuation levels seem attractive. Within this space, we continue to favour a higher exposure to Latin America.

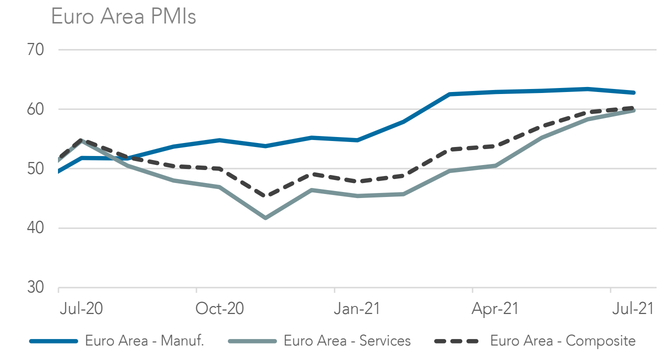
MACRO

Euro Area

The bloc's recovery gained momentum on the back of continued re-opening efforts, helped by the rapid pace of vaccinations and ongoing government support. During the second quarter of 2021, the flash GDP growth amounted to 2.0% quarter-on-quarter. Looking forward, economists are expecting a strong GDP growth release for the third quarter of the year, perhaps at a little over 2.0% quarter-on-quarter gain, which would bring the economy close to, but still below, its pre-pandemic level.

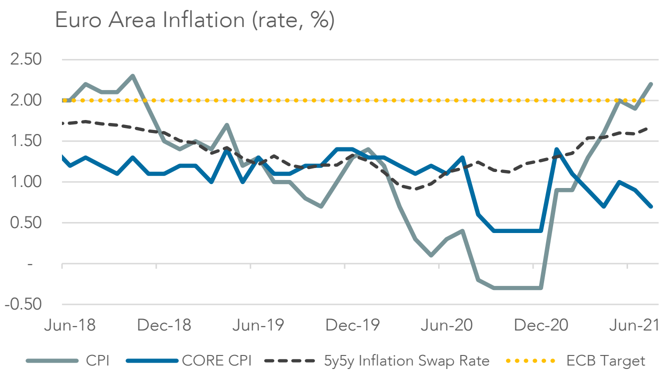
Industrial production was impacted by the global semiconductor shortage which hit auto production during the month of May. In fact, industrial production fell 1.0% month-on-month during May, following the prior month's growth of 0.6%, coming in worse than market consensus expected decline of 0.2%. Supply disruptions look set to drag on for a while yet, constraining the sector's recovery. Excluding vehicles production during the month, industrial production fell only slightly in May.

During the month of June, retail sales grew by 1.5% month-on-month, following the prior month's revised growth of 4.1%, coming in slightly lower than the expected 1.7% growth. This was mainly a result of an advance in sales of non-food products and fuel trade.



Source: Bloomberg

The final Composite PMI for July stood at 60.2, fairly in line with the expected 60.6 and improving on the previous figure of 59.5. This was a result of a steep expansion in both the services sector and the manufacturing sector as COVID-19 restrictions continued to be eased. New business increased at the fastest pace in 14 years, while output rose at the softest pace since February. However, operating capacities were tested in July, as evidenced by the record increase in backlogs of work. Manufacturers continued to face substantial supply-side challenges, with input lead times lengthening to one of the greatest degrees recorded.



Source: Bloomberg

The flash annual inflation rate for the month of July was of 2.2%, compared to the prior 1.9%, coming in above the 2.0% being forecasted by markets. The increase for July was primarily driven by a pick-up in energy inflation and food inflation.

On the other hand, core inflation dipped to 0.7% compared to the prior month's 0.9% and the expected 0.8%. The main reason for this dip was two opposing directions in the elements of core inflation: an increase in services inflation and a decrease in non-energy industrial goods. The decline is also partly due to base effects from last year's delay in summer sales.

Since inflation resumed its upward trend, economists are expecting a further rise in the remainder of the year to c. 3.0% for the headline rate. However, this will be largely due to temporary factors and supply shortages, which are expected to fade in 2022, bringing inflation back to below 2.0%.

Economists expect energy inflation to edge up a bit more, before dropping early next year. Economists further suspect that core inflation will also rise. This is because of several factors including the persistent supply shortages, rising prices in services as the economy reopens and base effects of the German VAT cut last year.

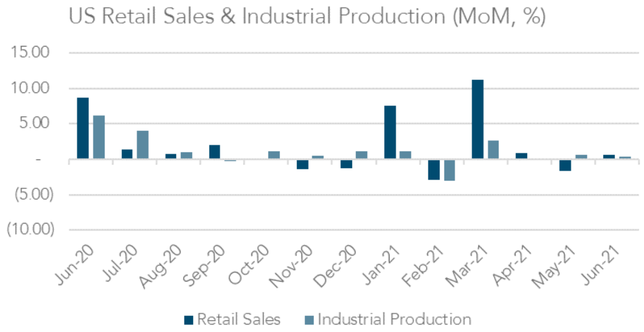
Looking at the labour market, Euro Area unemployment for the month of June edged down to 7.7% from the prior 8.0%, beating expectations of 7.9% largely explained by the gradual easing of restrictions. This data supports economists' views that the jobless rate is unlikely to rise even as governments scale back their job support schemes as underlying activity continues to pick up.

The ECB revised its forward guidance on interest rates during its July meeting, saying that it expects interest rates to remain at their present or lower levels until it sees inflation reaching the 2.0% symmetric target. This wording was revised from the "below but close to 2.0%" original target. The central bank also indicated that a rate change will occur well ahead of the end of its projection horizon and durably for the rest of the projection horizon as it judges the realised progress in underlying inflation and whether this has sufficiently advanced to be consistent with inflation stabilising at 2.0% over the medium term. In all, this amounts to a strong commitment not to raise interest rates prematurely. The central bank retained its pace of asset purchases at €20 billion per month, reiterating that the PEPP envelope can be recalibrated if required, while confirming it will be reinvesting maturing PEPP bonds at least through the end-2023. Economists believe that the ECB will continue large-scale purchases for at least the next two years.

United States

The US economy advanced at an annualised rate of 6.5% quarter-on-quarter in the second quarter of 2021, well below market expectations of 8.5% given the bigger drag from inventories than anticipated and a surprise fall in government spending linked to the end of the PPP programme. Economists are assuming that the third quarter will grow by 4.0% annualised as the inventories drag will only partly be reversed but increasing risks of a further slowdown in the fourth quarter.

Retail sales for the month of June rose 0.6% month-on-month compared to the revised previous figure for May of a 1.7% decline. The data print exceed the expected 0.4% decline. This occurred as demand for goods remained strong despite the recent shift towards spending to services. Sales rose in multiple sectors such as electronics and appliance stores, gas stations, restaurants and bars and clothing stores. Sales of motor vehicles, however, dropped as the global semiconductor supply squeeze hit production.

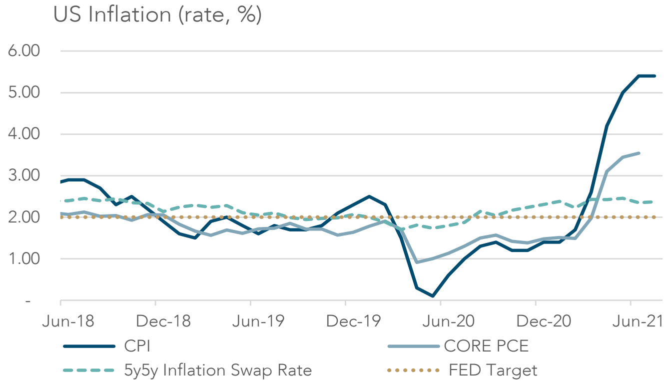


Source: Bloomberg

Industrial production rose 0.4% month-on-month during June coming below the market forecast of 0.6% and the prior monthly increase of 0.7%. The modest increase was mainly due to a weather-related spike in utilities demand and a recovery in mining output, together with the drag on manufacturing output. Manufacturing output edged down by 0.1% as an ongoing shortage of semiconductors contributed to a decrease of 6.6% in the production of motor vehicles and parts. As shortages are set to persist for a while longer, economists expect output to rebound only gradually over the remainder of the year.

The final Composite PMI for July stood at 59.9 fairly in line with the expected 59.7 level coming in below June's 63.7. This was due to the slowest expansion in the services sector since February, however a fresh record high for the manufacturing sector. New business growth experienced a softer rise, while domestic and foreign client demand remand strong. Supplier shortages and delays continued to exert upward pressure on input costs and hampered firms' ability to process incoming new work. As a result, cost burdens rose at a record-breaking rate and the accumulation of backlogs accelerated. Efforts to ease pressure on capacity were however hampered by reports of a shortage of suitable employees. Nonetheless, output expectations remained upbeat amid hopes of further boosts to client demand over the coming year.

The annual inflation rate for the month of July was unchanged at 5.4% compared to the prior month coming in slightly higher than expectations of 5.3%. The elevated inflation levels illustrate that supply bottlenecks stemming from the pandemic are still putting upward pressure on prices in some sectors. The key concern is that inflationary pressures are now building in cyclically-sensitive sectors which could prove to be longer lasting.



Source: Bloomberg

Core CPI inflation increased 4.5% in June over the 3.8% in the prior month and the expected 4.0%. The small handful of categories most directly affected by the pandemic were again the key drivers of the increase.

While the upward pressure on prices from goods shortages and reopening should eventually fade, economists expect a sustained acceleration in wage growth allowing core inflation to drop back only gradually over the coming quarters. Economists expect that core CPI inflation will be 2.8% next year, much higher than Fed officials appear to be anticipating.

The unemployment rate declined to 5.4% in July from June's 5.9% (the lowest level since March 2020). The print came in well below market expectations of 5.7%. However, the labour force participation rate was little changed at 61.7% in July and has remained within a narrow range of 61.4% to 61.7% since June 2020.

The US economy added 943,000 jobs in July, well above the market expected 870,000 and the prior increase of 938,000, as the rapid pace of vaccinations allowed the country to continue its re-opening efforts and prompted businesses to hire more workers to respond to growing demand. Notable job gains occurred in leisure and hospitality, in local government education, and in professional and business services. The recovery in the jobs numbers is expected to continue in the coming months.

Many companies are still struggling to hire employees as enhanced unemployment benefits, ongoing childcare responsibilities and health concerns may discourage some workers from looking for a job. Having said that, both new claims and continuing jobless claims declined in the last two weeks of July. The total number of claimants is likely to decline further in the coming weeks due to the early phase-out of federal enhanced unemployment benefits across many states ahead of the official

September expiration data, and as schools reopen and demand over the summer picks up.

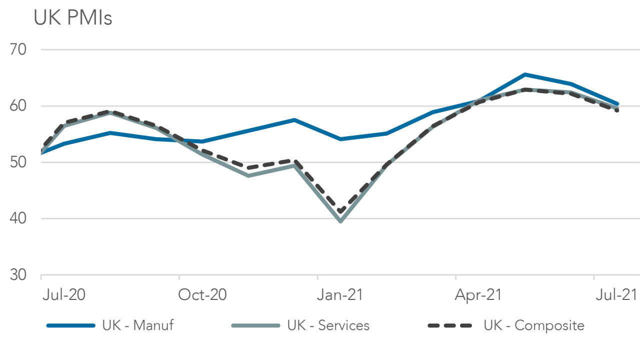
On the monetary front, the Fed left the target range for its federal funds rate unchanged at 0-0.25% and bond-buying at the current $120 billion monthly pace during the July meeting. Further, the Fed offered some hints that asset purchases could start being reduced soon in spite of the threat to growth from the delta variant. Officials have highlighted that the US economy has made progress toward employment and inflation goals, and that it will continue to assess progress in coming meetings. Economists are expecting an announcement in August or September, with the tapering of purchases probably not beginning until the start of 2022.

United Kingdom

In May, the UK economy expanded 0.8% month-on-month compared to the prior expansion of 2.0% and the expected 1.5% month-on-month growth. The effects of the 'pingdemic' may have weighed on economic activity in July, with economists expecting the second quarter GDP growth to be weaker than previously anticipated. That said, solid gains in GDP are being expected in the coming months making up for June and July's weakness given the broader reopening of businesses. The BOE is projecting GDP to grow by 7.25% in 2021, unchanged from its May forecast, and by 6.0% in 2022 showing an upward revision to the May forecast of 5.75%.

Industrial production for the month of May rose to 0.8% month-on-month, following the prior month's revised 1.0% contraction, coming in below market expectations of 1.5%. Growth was mainly driven by electricity, gas steam and air conditioning, mining and quarrying. Industrial output was 2.6% below February 2020 levels.

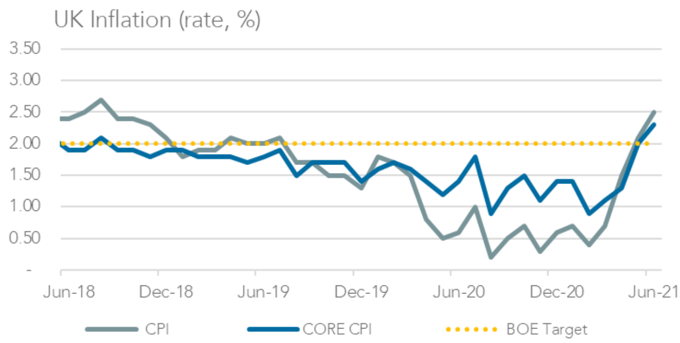
Retail sales for June rose 0.5% month-on-month, following the prior revised decline of 1.3% in May, showing a slightly faster acceleration than the market expected 0.4% gain. The bulk of the gain was due to a 4.2% month-on-month rise in food sales, which was partly due to extra spending during the Euro 2020 football tournament.



Source: Bloomberg

The final Composite PMI stood at 59.2 for July coming in slightly softer than the June's 62.2 but better than the expected 57.7. This was due to the slowest expansion in the services sector since the end of the lockdowns, mostly due to staffing shortages, supply chain issues and the end of the full stamp duty holiday for residential property sales. Nonetheless, the manufacturing services saw the strongest expansion. New business growth eased to a four-month low but remained close to recent record peaks, even as new export orders increased. This is supported by the re-opening of the economy and stronger demand seen from domestic and overseas markets. Backlogs of work increased for the fifth successive month. Logistic delays caused by stretched international supply chains meanwhile led to a further market lengthening of supplier lead times. Raw material shortages, supply disruption caused by the pandemic and Brexit, as well as capacity issues across the distribution network also contributed to delivery delays.

As for prices, the annual inflation rate increased to 2.5% in June accelerating from the prior month's 2.1% at a higher rate than the expected 2.2%. This was the highest level in almost three years, leaving the rate above the 2.0% target. The bigger-than-expected rise suggests that cost pressures are feeding into consumer prices sooner than economists anticipated. Transport made the biggest upward impact, while low base effects from last year continues to elevate year-on-year inflation data prints. The BOE predicts inflation will exceed 3.0% in the short-term although price pressures should provide to be transitory over the medium term.



Source: Bloomberg

Core inflation increased 2.3% in June compared to the previous figure of 2.0% and the expected 2.0%. The rises in clothing inflation, restaurant inflation and hotels inflation show that the reopening of these sectors after the lockdowns are boosting prices. The faster rise in second-hand car prices is a result of a surge in demand as the semi-conductor shortage has reduced the supply of new vehicles.

In the meantime, the UK unemployment rate edged up to 4.8% in the three months to May, compared to the prior level and market consensus estimates of 4.7%. In the latest employment data report for the 3-month period ended May, there was an increase in the employment rate to 74.8% compared to the prior 3-month period's 74.7%. This stood at 1.8pps lower than before the pandemic.

The number of employees on company payrolls surged by 356,000 to 28.86 million during the month of June, marking the largest increase since the start of the pandemic. The number of persons claiming unemployment benefits declined by 114,800 in June, following May's decline of 92,600, this being the fourth and biggest drop as the economy is picking up momentum and labour market conditions continue to improve. The latest employment figures pointed towards a continued turnaround in the labour market, despite the impending end to the furlough scheme at the end of September.

Average weekly earning (inc. bonuses) surged 7.3% year-on-year to £574 in the three months ending May. Annual growth in average employee pay has reported been affected by (1) temporary factors that have inflated the increase in the headline growth rate, (2) compositional effects where there has been a fall in the number and proportion of lower-paid employee jobs, and (3) base effects where the latest months are now compared with the start of the pandemic when salaries were first affected and pushed lower.

The improving economic data in the UK has not yet pushed the BOE to change monetary policy during its August meeting, with policymakers reiterating that they do not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2.0% inflation target sustainably. Still, officials signalled that some modest tightening of monetary policy over the next two years is likely to be necessary if the economy continues to improve. They highlighted that this expected trajectory in monetary policy is likely to be necessary for the bank to be consistent with meeting the inflation target sustainably in the medium term.

The MPC maintained its commitment to complete the £150 billion of extra QE by "around the end of 2021". The BOE is also the first central bank to give clear guidance on the tapering of asset purchases as it said it would start reducing its stock of bonds when its policy rate reached 0.5% (previously 1.5%) by not reinvesting proceeds and it would start considering actively selling the stock of purchased assets when the rate reached at least 1.0% (previously 1.25%).

Economists now expect the MPC to raise rates from 0.10% to 0.25% by August 2023 and to announce a further 25bps hike by February 2024, before shrinking its balance sheet by ceasing to reinvest in maturing assets in 2H2024.

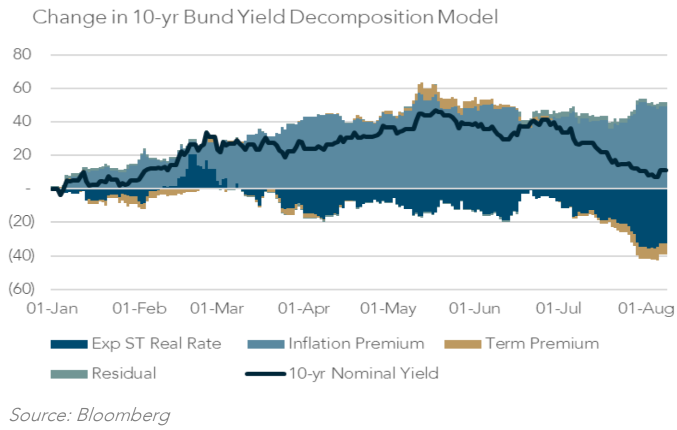
RATES

Euro Rates

The decline in the 10-year Bund yield from the peak reached in May has accelerated during July given the broader downgrade of growth expectations, and the moves seen across G10 rates, effectively reversing the entire move higher since the start of the year. After reaching a peak of –0.13%, the German 10-yr sovereign yield declined by 25bps during July from –0.21% at the start of the month to –0.46%.

The rise of the Delta variant and growing cases across advanced economies led to a general risk-off market sentiment which saw renewed interest for safe-haven assets in recent weeks. Moreover, the initial remarks made by the ECB following the strategic review may be viewed as making the bank more "structurally dovish" in view of the longer distance for the bank to achieve its inflation goal. This has in turn strengthened market expectations that accommodative monetary policy through low interest rates and quantitative easing which, together, reinforced the downward pressure on EUR rates.

When contextualising the main factors that seem to have triggered the move lower, we believe that the sheer extent of the move has been mainly due to technical factors: the covering of short positions, the low trading volumes in the summer months and the squaring of reflation trades entered into since the start of the year. On this basis, we find that the move lower in EUR rates is overdone. Inflationary expectations remain markedly higher and, while the central bank has not guided towards policy normalization, the reasons to maintain the current level of monetary stimulus (particularly the current pace of QE purchases) have been weakening.



Source: Bloomberg

Downside risks to the growth outlook driven by virus concerns and slowing economic momentum (globally) seem to be the main reasons explaining the move lower in yields. However, the expected slowdown in economic momentum and easing inflationary pressures is probably expected to be the least pronounced in the Euro Area.

Therefore we are of the view that the move lower in EUR rates is overdone as the downside risks to the growth outlook (the main factor supporting bond prices) are overestimated. Evidence so far has shown that nations with higher vaccine take-up can weather a surge in cases without having impactful consequences on economic activity. Having said that, the Euro Area on-the-whole is seen to have been scaling down restrictive measures far more slowly compared to the US and UK which could be one of the factors limiting the speed of the economic rebound. This turn is seen to be playing due to two effects: (a) the approach adopted in most countries individually have been generally more cautious; and (b) the uneven or incongruent approach across member states has limited the return in economic activity.

Inflation expectations remain fairly elevated compared to the start of the year while the decline in real rates have explained the move lower in long-end nominal yields. However, strengthened forward guidance by the ECB following the recent strategy review raises the bar for a lift-off in rates irrespective of inflation developments in the Euro Area. It is important to note that the ECB continues to tie policy action to forecasts and not realised data like the Fed which in itself could be deemed to be a relatively more hawkish approach.

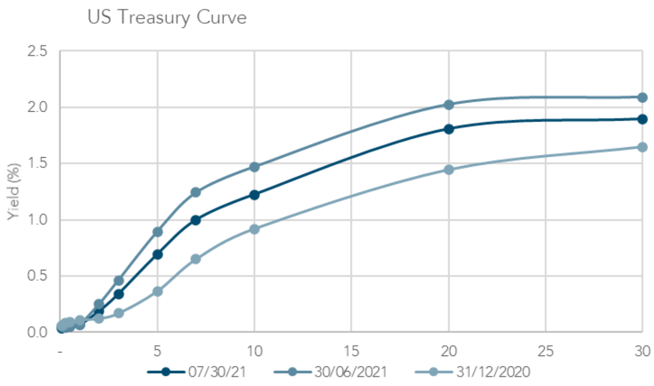
The dovish communication takes away the risk of upward pressure in short-end or belly of the curve (unlike the US and UK curves) even as macro-economic data improves. Moreover, there are also growing expectations of additional quantitative easing bond purchases, once the Pandemic Emerging Purchase Programme is exhaustedand terminated, probably through increased APP purchases.

Given the pronounced market pricing of continued support by the ECB and the higher uncertainty on the growth outlook due to the Delta variant, we deem the risks to be tilted towards a move higher in EUR rates and a re-steepening of the curve during the second half. The potential catalysts for such a reversal include:

- The continuation of strong economic data releases showing sustained expansion;
- The reopening experience despite the surge in Delta variant and positive vaccine effects should encourage limited containment measures by health authorities;
- With improving economic conditions warranting reduced central bank support, markets could be on balance disappointed by central bank communication on QE going forward; and
- Fiscal impulse in Europe has been less front-loaded compared to other regions increasing the possibility of sustained long-term fiscal support as the Next-Generation EU programme is deployed.

US Rates

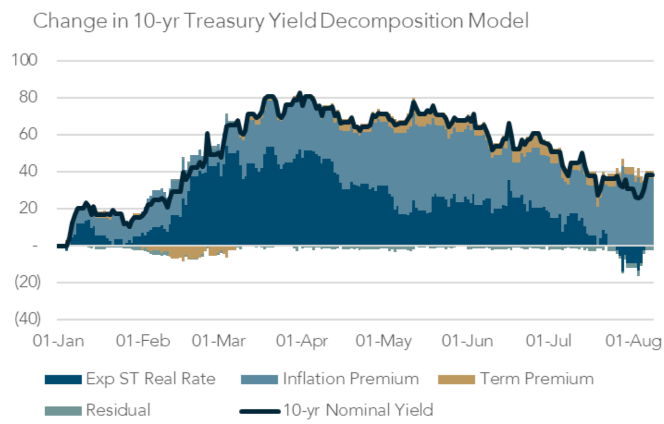
In contrast with the widely held expectations that yields would move higher as economies recover with the lifting of measures, we have seen a substantial decline in rates across G10 regions, particularly in US treasury yieds which seems to be mainly attributed to the downgrade of growth expectations. Whilst these are legitimate concerns, the rally in the US treasury markets seems to be overdone when considering the sheer magnitude of the decline in long-end yields.



Source: Bloomberg

The flattening of the US Treasury curve may signal the growing anticipation of the economy returning to the stagnating conditions seen over the last decade and the need for low neutral rates throughout. However, the move lower in long-end rates is this time explained by a decline in real rates and assumed lower neutral rates over the long term as opposed to a decline in inflation premia.

Given the much stronger economic fundamentals of this recovery, one would expect natural rates to be higher, not lower. Therefore, the flattening of the curve is more likely reflecting the market pricing of the central bank's inability to raise rates to previous long-run levels either because the slack in employment will persist or because the inflation cannot be maintained at around target levels in a sustainable manner. This in turn shows that, despite the elevated inflation expectations, there is a high-



Source: Bloomberg

er inflation tolerance from the central bank than the current communication suggests. In other words, the pullback in yields and the flattening of the curve is most likely reflecting higher market pricing of a stagflation-type of environment especially now that markets are becoming less concerned of an inflation overshoot.

The path for higher rates is now expected to take longer. However, as the Delta variant risks prove to be manageable and incoming economic data remains strong, these should reduce downside risks to the growth outlook which have been recently supporting bond pricing. Moreover, as a number of smaller central banks start to normalise policy, it should give market participants higher visibility or confidence of an eventual policy normalisation in other G10 economies.

We expect rates in the US to move higher in the second half and beyond, even though reaching the higher levels expected earlier this year will take longer given the reassessment of the curve and change in the market's perception of neutral rates which now requires more evidence to stimulate a rise in real rates. Goldman Sachs's updated projections of the 10-year US Treasury yield by year-end is at 1.6% from the previous 1.9%.

In the near term, the moderation of the economic momentum in the US as well as the normalization in elevated inflation prints will keep the pricing of a lift-off in rates in check, possibly contributing to closing the gap between market pricing and Fed guidance. Therefore, we expect a near-term steepening as a corrective move to the recent flattening which we believe is over done. Over the medium-term, we expect a move higher in rates to be driven by front-end (primarily the roll-down of rate hike expectations), accompanied by a bear flattening in the belly and long-end of the curve.

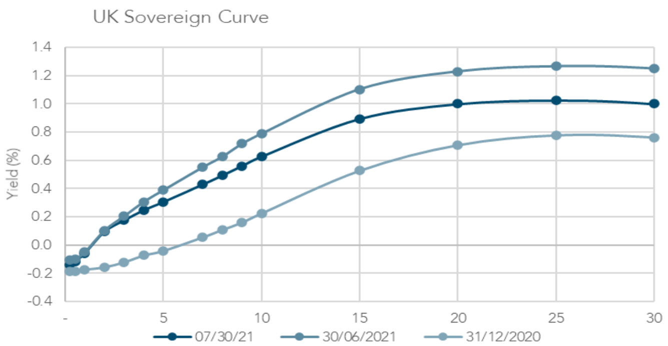
Economists anticipate a deceleration in growth in the US later this year and next year. Similarly, forecasts show an easing of inflation pressures with core PCE expected to bottom out at 1.8% in 2022. This downward trajectory is expected to limit any sharp moves higher in yields, however, the continued improvement of the economic position as it re-emerges from the pandemic (particularly as employment picks up) reinforces the scope for central bank policy normalization. This should limit any further declines in long-end yields whilst keeping short-end rates buoyant.

The potential catalysts for a rebound in rates during the second half include the upcoming Fed meetings, particularly the September meeting which will now include 2024 projections as markets will focus on how these square off against current implied pricing, and accumulating positive data releases on the jobs front showing a firm recovery in employment. Both catalysts should support a real-yield-led sell-off.

The recent yield curve bull-flattening has been atypical in view of an impending rate hiking cycle. The hawkish tilt in the June meeting explains the upward pressure in the short-end of the curve but is certainly not a compelling argument for falling forward real yields.

UK Rates

The decline in long-end UK Gilt yields is broadly attributable to the same forces noted earlier as move across G10 yield curves have generally displayed high correlation. However, it is worth observing that the move lower in long-end yields was marginally less pronounced in UK rates compared to other regions and the degree of curve flattening was in fact stronger. The divergent movement is explained by the prescriptive approach of the BOE involving greater transparency on its approach in normalising monetary policy.



Source: Bloomberg

Moreover, the economic recovery and, so far, the positive vaccine effects which enabled the country to reopen despite the surge in the Delta variant, has continued to support the growth outlook for the UK and the path expected to be taken by the BOE based on its projections. Additionally, economic data remains supportive, with PMI data showing a high pace of expansion, labour market data showing progress and inflation continuing to come in higher. Therefore, the relatively smaller decline in long-end yields is explained by the expected withdrawal of central bank intervention in the Gilt market as the BOE terminates QE purchases and eventually reduced reinvestments of QE holdings.

On the other hand, short-end rates remain buoyed by the firm front-end pricing given the rate hike expectations in the UK. In fact, we have hardly seen any movement in short-end rates during July both in the sovereign curve and the OIS curve.

Market pricing implied a 15bp hike by May 2022 and another hike by end-2022 which continues to seem too aggressive compared to economist forecasts looking at 2H2023 for a lift-off in rates and the BOE's own guidance for a 2024 rate hike. Having said that, the strong front-end pricing seems to be a reasonable premium for the risk of upside inflation and labour market surprises which could very well lead to an earlier shift in policy.

As the UK's reopening experiment continues to succeed, the risks remain for yields to move higher across the curve — at the long-end as a corrective move following the recent rally in bonds and, at the short-end, given the continued roll-down in rate hike expectations. With that said, the belly of the curve (5 to 7-year area) looks particularly vulnerable on a relative basis given the possibility of front-end pricing shifting outwards even though a re-assessment in front-end pricing may not be imminent.

Moreover, the BOE sequencing of the balance sheet run-off with policy rate adjustments should lead to a more parallel movement across the curve (as opposed to the flattening movement seen in the US due to a hawkish Fed), primarily since (a) the policy rate path is proving to be an important pricing factor for the rest of the curve, and (b) the elevated net guilt supply increases bias towards higher Gilt yields even before active sales of QE holdings kick in.

CREDIT

Euro Credit

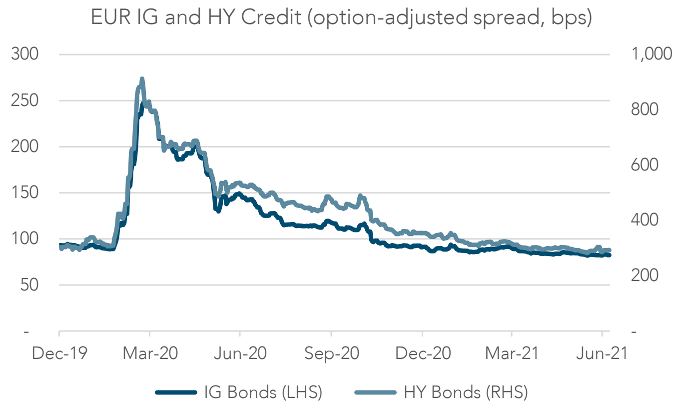
Corporate credit spreads within the Eurozone followed a similar pattern during the month of July as seen in both the US and the UK. The Delta variant and the rapid rise in cases during the month remained top of mind for investors with a flight to safety as the German Bund rallied.

Economic indicators published during the month for the bloc's largest economy, Germany, either beat or were in line with forecasts. However, the main talking point, besides the impact that the rise in cases had on corporate credit spreads was the ECB's announcement that it will be adopting a new inflationary target of 2% which is symmetric and medium-term in nature which grants the central bank more flexibility to move in either direction in the short-term. Moreover, following the Governing Council meeting on 22 July, rates and asset purchases were left unchanged.

European high yield ("HY") has extended its rally for a tenth successive month, though has lost out to investment grade ("IG") credit in July following the significant move tighter in Bunds over the period. HY total returns were +0.47% as wider corporate option-adjusted spreads have led to marginally negative spread returns over the period. By comparison, tight breakeven rates have caused the move in Bunds to lead to a +1.14% return for EUR IG credit, marking a record month for the asset class for 2021.

IG returns will likely continue to depend on Bund moves and vaccine success, despite the ECB buying a gross amount of c.€8.5bn a month on average in 2021. An accelerating vaccine rollout and the reopening in Europe should help spreads over the summer, as we expect August net supply to be modest, potentially similar to July given the strong momentum in new issues in 2021, though well below June, with any new supply likely to be well digested by the market and further supportive of spreads. Within IG, we see the long end of the curve offering historically stronger value relative to the front end as this segment appears to have lagged the rally.

Despite the lacklustre returns for HY in July, the consistent EUR HY rally over the last three quarters stands out in a period of volatile global rate pressure and we continue to believe this space has room to improve over the second half of the year, supported by the wave of upgrades, low defaults, and improving fundamentals. At its last meeting toward the end of July, the ECB changed slightly its forward guidance to present a more dovish stance. As a result, any tapering announcements previously expected during Q4 have begun to look increasingly unlikely. As such, a strong technical backdrop from an active ECB offering substantial support via CSPP and PEPP, and some short-term sheltering from benchmark rates following a strong month for the asset class, should continue to be supportive for corporate credit over the coming months, with the latter driver likely better supporting HY over IG counterparts.



Source: Bloomberg

US Credit

US corporate credit spreads widened during the month of July, most notably within the HY segment of the market. The sell-off during the month occurred as demand for safe haven assets increased with the yield on the US Treasury declining to 1.22%. The spread widening was predominantly driven by concerns over the rise in cases due to the more transmissible Delta variant despite generally positive economic data released during the month and a more hawkish tone adopted by the Fed on possible tapering and an earlier-than-expected rise in the Federal Funds Rate.

Concerns around the rise in cases, which according to data published by the Centres for Disease Control and Prevention rose to 77.6k at the end of July compared to 13.9k at the beginning of the month on a seven-day moving-average, did not result in a corresponding increase in deaths. In fact, the number of deaths on a seven-day moving-average have only shown a marginal increase, while 58.1% of the total US population has received at least one dose of the vaccine as at end of July compared to 55.0% at the beginning of the month.

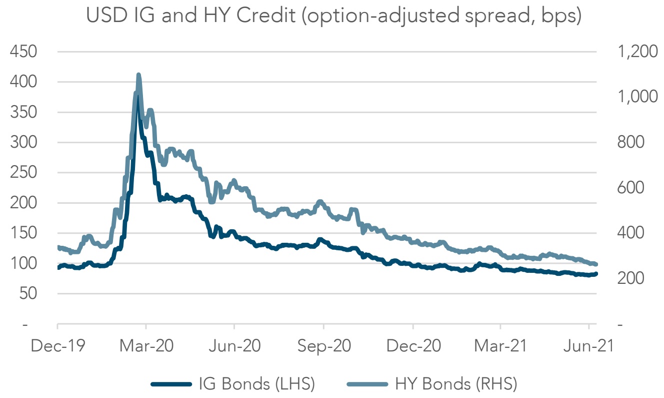
The rise in corporate bond yields also occurred as the US economy showed signs of deceleration towards the latter part of the month following the publication of employment and GDP data, while the Fed, which kept rates and asset purchases unchanged during its July meeting, has hinted at the possibility of tapering its asset purchases before increasing rates, although further progress is required before such action is taken.

Continued Treasury yield declines have pushed the Bloomberg Barclays US Corporate Bond Index marginally above break-even entering August. Simultaneously, high-yield returns have spent a couple of weeks moving sideways to marginally better, with spread drift being balanced by a continued bid for US Treasuries.

We are incrementally more comfortable with spreads following the modest push wider, though the view remains that a prospective reduction in Fed bond buying could prove problematic for US corporate credit, given compressed yields and the related duration and convexity profiles for IG and HY. Economists continue to expect an announcement around August/September, with tapering commencing some time in early 2022.

Whilst we continue to prefer EUR exposure over USD given stronger central bank signalling, we note that the belly of the USD IG curve appears to offer historically more resilient value to both the short and longer ends of the curve.

Longer-dated spreads within the IG space may also potentially offer some resilience in the coming months as ratios versus shorter-dated dollar corporates are, to a lesser extent, also at historically wide levels. Looking to HY, in relative terms and despite option-adjusted spreads for CCC corporates widening past 500bp for the first time since early June, the tranche has continued to richen relative to both better-rated BB and B tranches, with investors perceiving fewer default risks and looking to maximize yield as justifiable reasons to pour into CCC paper. By comparison, the B versus BB relationship is more neutral, with BBs looking modestly rich. Preference within the HY space would be for shorter term paper, again in a bid to minimize any impact from potential tapering headlines.



Source: Bloomberg

UK Credit

Despite the re-opening of the economy on 19 July, as the majority of restrictions were lifted within England, corporate credit spreads widened against UK sovereign paper during the month. Investors flocked to the safety of Government bonds as the spread of the Delta variant dampened economic growth expectations.

While the number of deaths increased marginally with 88.5% of the UK population having received at least one dose as at end of July, the number of daily cases has increased rapidly. In fact, the number of cases on a seven-day moving-average reached a peak of 47.9k in mid-July. However, while economic data published for prior months generally came in lower than expectations, the BOE adopted a more hawkish tone.

Toward the end of July, the IMF sharply revised higher its growth outlook for the UK economy for 2021 to 7.0%, after having given a more downbeat assessment in April when the country was only just beginning to relax COVID-19 restrictions. Britain has now fully vaccinated more than 70% of adults and there appears to be a slow down in the recent surge of the Delta variant which had delayed the lifting of most remaining social-distancing rules in England until 19 July. The expected strength of the UK economic rebound gives us comfort around UK credit spreads, though the key risk remains around potential policy missteps, that is an earlier than expected tightening in monetary policy by the BOE or a premature move to fiscal tightening before the recovery is fully entrenched.

At the latest MPC meeting, the BOE signalled that it is getting closer to tightening monetary policy and provided a roadmap for how it plans to tighten policy. What remains unclear is particularly *when* the bank would first be raising interest rates, though the focus remains on developments in the labour market and inflation as a yardstick for BOE action.

Given wider spreads in the UK corporate bond market relative to EUR and USD, and the risk of higher benchmark rates as a result of the combination of potentially 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.

Default Rates

European corporate credit trends continue to improve, with upgrades consistently outpacing downgrades in 2021. The core drivers remain very much in place: economic recovery, vaccination progress, easing pandemic restrictions, plentiful liquidity, and a strong market appetite for risk.

Cost inflation and supply chain pressures remain acute in many sectors but are not yet hurting broader profit margins or translating into an inflation surge that would alter the interest rate and stimulus calculus of central banks. There are however growing risks, particularly in relation to ongoing market risk appetite and low risk premiums. The cumulative picture of rating changes since the onset of the pandemic tells a more appropriately nuanced story: vaccine success and timely intervention from policymakers has turned the tide, but credit quality remains depleted and vulnerable to setbacks.

Forward-looking indicators of the ratings outlook continue to improve sharply. The European non-financial corporate net negative bias, an indicator of potential ratings actions, stood at 18% at the end of June, down from a peak of 37% a year ago. Of S&P's ratings, 70% carry a stable outlook versus 57% a year ago.

The picture in the UK is slightly worse, with a current net negative bias of 25% versus 45% a year ago, reflecting a higher relative exposure to sectors still under duress from the pandemic.

Recovering revenue and cash flow are fundamental factors underpinning the improving outlook. Within the rated European non-financial corporate space, S&P expects just two industries (oil & gas and transportation infrastructure) will have average revenue below pre-pandemic levels by end-2022. By then, projections are for one-third of sectors to deliver revenues more than 10% higher than pre-pandemic levels and, in some cases, revenue could be substantially higher, with improvements potentially having further to run considering pent-up demand across European households, having accumulated excess savings of €300bn last year, equivalent to 2.7pp of GDP.

The pace of recovery continues to vary across and within industries. The direction of travel is still positive for most sectors however, with even pandemic-affected sectors having seen substantial improvements in their ratings outlook over the last year.

EQUITY

Equities have enjoyed a strong start to 2021 as economic growth accelerated. Global equities rallied +19.0% from the start of the year to the end of July, as the economic activity recovered from the impact of the lockdown and other curtailment measures imposed by governments over the past 14 months. The recovery has been strong but geographically dispersed due to various factors including case growth, which generally led to additional curtailment measures and vaccine deployment. This theme was the main market mover during the first quarter of 2021.

Inflation overshoots led to some market jitters as the economic recovery started to gain some traction. In the US, core PCE exceeded 3% (in April 2021) for the first time since 1992, leading to a spike in equity volatility. Investors were concerned that the Fed could be forced to act early, which could weigh on economic growth, should the inflation overshoot persist for longer. We argued at the time that such overshoot is transitory, mainly driven by the re-opening, as the economy recovered from the deepest recessions since WW2. At first, the inflation overshoot favoured value stocks as investors initially looked for an inflation hedge (global value outperformed growth in May, but has lagged behind in June and July). Yet, the reflation trade came under pressure as economic growth in certain countries started to moderate.

The services industry has been heavily hit by the pandemic. Restaurants, hotels and travel had to close down to help minimize the spread of the virus. Manufacturing was less effected, and the recovery was much faster, with a peak in March. Services lagged behind, with curtailment measures eased gradually by the government. The Services PMI seems to have peaked in May. Meanwhile, it took just one year for real personal consumption to recover to pre-pandemic levels, another possible indicator of peak growth. This growth moderation has weighed on investor sentiment during June and July.

The notion that we are past peak growth for the global economy has weighed on value stocks. The expectation at the start of the year was that value stocks would finally outperform their growth counterparts, supported by strong synchronized economic growth, loose fiscal and monetary policy and a rally in the commodity market. This has been the case for most of the year so far, but the trend has shifted sharply since June with value underperforming growth in both months (by 6.0% in June and 2.3% in July). This underperformance of value is being primarily driven by concerns over the moderation in growth in the two largest economies: the US and China.

In China, the swift unwind of pandemic policy support as the economy recovered has weighed on activity, with all four PMI's declining in June. This led to a surprise cut in the RRR rate by 50bp, which exacerbated investor fears around China growth. The release of the Caixin manufacturing PMI (50.3 in July, down from 51.3 in June and below consensus of 51.0) was also disappointing.

Notwithstanding, fears of a sharp deceleration seem to be overblown according to Goldman Sachs, with solid credit growth, still-robust trade and sequential improvement in industrial activity and retail sales. The Caixin Services PMI rose to 54.9 in July from 50.3 in June (consensus at 50.5). We think investors need to feel comfortable around growth in US and China for value to come back in favour, and positive economic surprise could be a near-term catalyst.

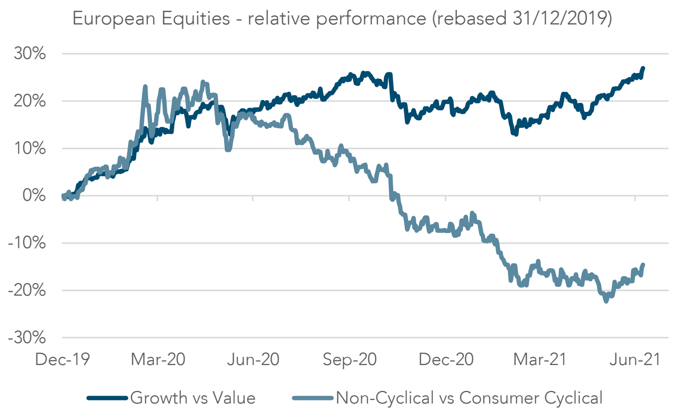
The delta variant spread has only added to the doubts on the global growth trajectory. Concerns over the delta variant spread have created a challenging backdrop for value stocks as it could have a negative impact on global economic growth. Cases rose sharply in the UK and in other countries around Europe. We note that there has been a clear disconnect between case growth, hospitalisations and deaths when comparing the current data with data reported earlier in the year, before the vaccine deployment reached certain levels. We are seeing a significant differences in countries with a high vaccination rate (UK, US and Europe) and those with low levels (EMs) or those countries that employ a zero case policy (Australia, NZ and China).

Conditions remain supportive for value stocks but we do not expect a broad based outperformance. Value stocks rallied strongly since the Pfizer vaccine announcement in November 2020, as investors started to price-in the impact of the recovery on economic growth. During this phase, the traditional cyclical sectors outperformed, with the rally being broad-based. On a YTD basis, Banks and Energy, both traditional value sectors that have struggling since the global financial crisis, have been the clear outperformers. Despite this, as conditions start to normalise, stock selection (as opposed to sector exposure) will be the main driver of alpha in 2H21.

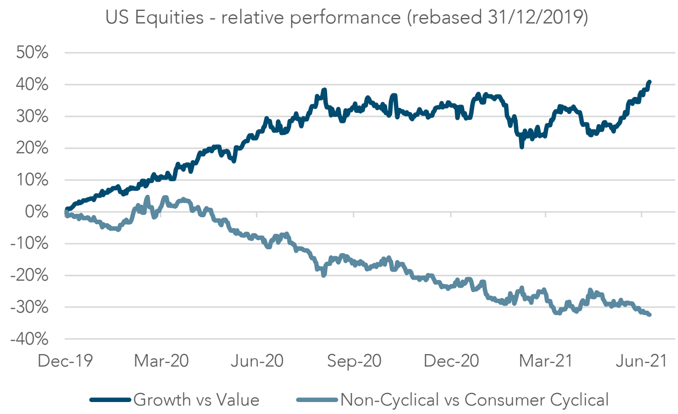
COVID-19 remains a key risk factor but we are encouraged by recent events. The spike in COVID-19 cases has weighed on investor sentiment in recent weeks. However, the initial signs are net positive. We look at the UK as a live lab, as a major economy that has vaccinated a large portion of its adult population, whilst also easing curtailment measures despite rising cases. The key point has been the clear disconnect between case growth and hospitalisations during the delta spread episode. This, in our view, should provide some comfort that the vaccine works in so far as limiting the number of people that have to be admitted to hospital and consequentially, deaths. Therefore we see this development as positive for economic growth prospects.

At the other end of the spectrum, the current vaccines might not be effective against a new variant that could be discovered in the future. This highlights the importance of the getting people vaccinated as quickly as possible, as unvaccinated people have been described as "variant factories" by an infectious disease expert (Dr. William Shaffner, a professor in the Division of Infectious Diseases at Vanderbilt University Medical Centre). There has been a lot of resistance to mandatory vaccination, but employers are now ramping up pressure on unvaccinated workers, including Google, Facebook and Walt Disney Co, as well as the federal government and the state governments of California and New York.

As a number of economies have are probably past peak growth rates, our positive view on Europe remains supported. The current consensus view is that we are past



Source: Bloomberg



Source: Bloomberg

peak growth for the global economy as growth in the US and China has moderated. Despite this, Europe's recovery has lagged other countries due to the delay in the vaccine deployment earlier in the year. Since then, the vaccine rollout has picked up momentum with the region now ahead of the US in terms of percentage of the population that have received at least one dose of the vaccine. The economic surprise index has turned positive and we think that Europe will outperform once investors get comfortable around US/China growth and the Delta variant.

The 2Q21 earnings in Europe have surprised by an average of 9.3% to the upside. Goldman Sachs say that this continues the trend of above average earnings beats which started last year. Earnings surprises have been led by cyclical and value companies, with an average net income surprise of 12.3% (cyclicals) and 12.1% (value). More than half of the companies that have reported so far have beaten consensus by at least 5%. The strong results season has led to an acceleration of revisions, with consensus FY21 EPS for the SXXP revised +3% upwards since the start of the month.

Having said that, European value stocks have underperformed growth so far this year by 4.5%. This is very unusual during periods of synchronized economic growth. Moreover, the moves in Euro inflation break even rates and Euro bond yields have generally outpaced the relative performance of cyclical versus defensives and growth versus value stocks than what one would typically expect in periods of widening inflation premia and higher long-end yields. This implies that upside remains for carefully selected stocks in Europe, especially if inflation continues to overshoot in the current months, which in turn could lead to higher yields.

On balance, our view remains unchanged despite recent market developments. We maintain our positive stance on Europe and value names, at least until we see signs of peak growth in Europe. Valuations remain attractive at these levels and conditions supportive for such tilts in our portfolio according to our assessment.

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Developed Market Sovereign Bonds	Negative	U/W	Sovereign bonds have performed well in recent weeks following downgrades to growth expectations and renewed market fears driven by the spread of the Delta variant. Despite recent movements, we see the broad expectation for higher benchmark rates over the long term, as the recovery and vaccine rollout continues, as unchanged. As such, we advocate an underweight position to benchmark developed market sovereign credit, particularly in light of the broadly negative yield on offer for the asset class in absolute terms, and would be cautious on adding curve risk. The outlook for periphery credits in Europe remains supported by Central Bank policy, but as noted in previous updates, reflationary pressures and the gradual withdrawal of support is likely to weigh on the asset class over the medium term. We maintain an underweight stance in sovereigns given the predominantly negative yields on offer for the asset class in absolute terms and would remain cautious on adding further curve risk.
Investment Grade Corporate Bonds	Neutral to Negative	N	We believe that high grade returns will depend largely on movements in benchmark rates, further stimulus and vaccine success. The ECB has continued its narrative of accommodative monetary policy which provides comfort. However, historically low IG corporate credit spreads continue to offer minimal cushion against bund movements, 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 the expectations of earlier withdrawal of central bank support compared to European counterparts. 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.
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 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 in 2021, buoyed by strong global economic growth, rising commodity prices and loose monetary and fiscal policy. After an encouraging start to the year, European equities and value strategies lost some ground (to US stocks and growth strategies), primarily due to concerns over global growth. These concerns were mainly the result of : (1) rising COVID-19 case growth; (2) US economy reaching peak growth; and (3) Some signs of slowdown in China. Notwithstanding, we expect European and value stocks to outperform over the coming months as we approach peak economic 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 July, we reduced our exposure to the US dollar and US equities on the back of the FOMC release. There is scope for USD 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 the remaining months of 2021. We remain comfortable with our emerging market country exposure going into the third quarter of 2021. Our stance on LATAM remains unchanged and we think that the region's performance will recover over the coming months as concerns over global economic growth fade away. As for our overweight position for the asset class, we remain confident that emerging market equities will recover, driven global synchronised economic growth and a commodity bull market.

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

DISCLAIMER