Investment Strategy Update
September 2021

Curmi & Partners Research

- Normalisation in spending habits and capacity constraints with the recent surge in virus cases are weighing on the pace of recovery in advanced regions.
- Despite the moderation in growth rates in the near term, projections continue to point to a sustained trajectory in the economic recovery.
- Rate of increase in jobs has slowed down given the Delta-led slowdown raising concerns of persistent slack in the economy. However, increase in vacancies and managers' hiring intentions point towards a continued gradual recovery in employment levels.
- Inflation rates are seen to be peaking following the upswing in temporary factors but are expected to correct sharply lower in 2022.
- Lingering virus uncertainties are raising concerns of stagflationary economic conditions if slack persists.
- While central bank communication shows commitment to maintain easy financing conditions, the focus has shifted to the timing and merits of tapering in asset purchase programmes.
- A tapering move by the Fed is deemed to be more economically meaningful given the open-ended nature of its $120bln monthly purchases, while the reduction in pace of purchases by the BOE and the ECB are in line with the scheduled termination of their emergency programmes.
- The baseline expectation is that increased vaccination rates, continued policy support and stabilizing credit quality will lead to a decline in default rates.
- We expect the shift in the central banks' narrative to encourage a real-rate re-steepening of benchmark bond curves which is why we prefer limiting duration in fixed income allocations.
- We remain positive on high yield credit given the improving trajectory in operational performance and debt levels, however, we retain a highly selective approach given the current tighter spread levels.
- The recent underperformance in value stocks in the rallying equity markets seems inconsistent with the positive growth trajectory and improved outlook for earnings.
- We retain a high beta profile in developed market equity allocations with the inclusion of value names while limiting the overall exposure to the asset class.
- We expect the economic rebound in lagging emerging economies to gather pace once the availability of vaccines improves. This combined with the prospect of above-average earnings growth rates supports our preference for emerging market equities with a tilt towards LATAM.

Hard data and survey based indices are indicating a moderation in the pace of growth in economic output in regions which have been able to scale back containment measures earlier on following the winter lockdowns. Looking at the US, UK and China, PMI data, retail sales and industrial production data releases saw a decline over the summer months. Whilst some normalisation in spending patterns and moderation in aggregate demand have contributed to the deceleration in economic expansion, the surge in COVID-19 cases and related restrictions have continued to disrupt supply chains and kept capacity utilization levels at low levels primarily affecting manufacturing sectors.

On the other hand, vaccination rates in Europe have continued to climb higher, boding well for a safer reopening which should better sustain the positive momentum in the economic recovery. For this reason, we expect the rate of growth in the Euro Area to peak with a delay compared to the US and the UK economies.

The recovery in labour markets have generally resonated the improvement in economic conditions. Following the extensions in government job retention schemes in the UK and the Euro Area, the expected fallout in the number of unemployed persons today is expected to be far less when these support measures are withdrawn, in view of the economic progress.

The US, on the other hand, has been reporting solid monthly job gains as the sharp drop in the number of people employed with the onset of the pandemic continues to recover. With that said, August was the first month, since the lifting of restrictions, to see a mediocre increase in jobs. This was attributable to resurging virus cases limiting hiring in hospitality and leisure. However, more states are gradually stopping the enhanced unemployment benefits which should provide higher motivation for individuals to actively look for jobs which will in turn improve the labour force participation rate.

As COVID risks continue to shape investor confidence, recent research reports covering data from the UK and Israel brought into question the concept of herd immunity given the waning efficacy in certain types of vaccines. While the disconnect in the case growth rates and the hospitalization rates is encouraging, the subject matter is being shifted to the deployment of boosters as the next necessary step to curb contagion and limit hospitalisations.

While the slowing growth momentum has weighed on near-term projections, the growth outlook remains strongly supported over the medium term. Because of the broad anticipation of an inflationary economic growth phase, central banks are expected to start lowering the degree of monetary stimulus firstly by gradually reducing their asset purchases programmes. This process of "tapering" takes various shapes and meanings across the different currency blocs but generally marks the start of a normalising monetary policy cycle across advanced economies.

The slowing growth momentum, renewed virus concerns with the spread of the Delta variant and central bank tapering expectations have translated into cautious market behaviour in the summer months - bond yields have declined following the peaks of May, the US Dollar strengthened, commodity prices have weakened and the rallying stock markets have been led by quality names and the continued outperformance of growth stocks versus value stocks.

The reversal in yields has provided investors with some respite in the prevailing reflationary conditions. Having said that, we prefer limiting duration in our bond exposure given our view that a re-steepening in yield curves led by long-end selling pressure has become more likely. The central banks' gradual reduction in asset purchases and the delinking of the rate lift-off decisions is expected to provide the right conditions for real rate term structures to translate into steeper curves.

In the meantime, we maintain a highly selective approach with managing credit risks given that the spread pick-up for a step-down in quality is becoming increasingly less compelling. However, given the ameliorating rating trends and benign credit and financing conditions, we continue to hold higher exposures to high yield credit given the higher carry and lower sensitivity to movements in benchmark bond yields.

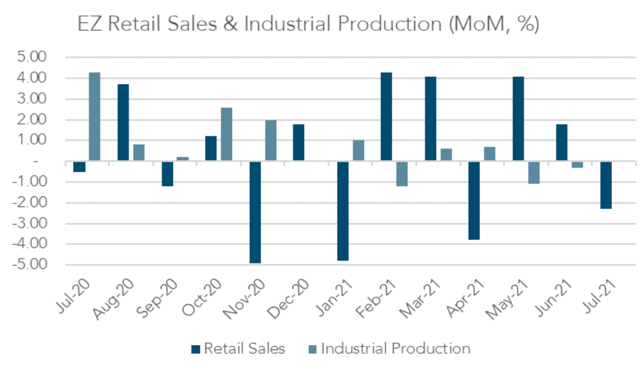
On the equity side, we view the recent underperformance in European value stocks to be unwarranted. Given our evaluation that underlying conditions are still describing the early growth phase of the economic cycle, we remain confident that value stocks will see support from the improved earnings outlook especially since valuations are looking more attractive with the recent depression in forward-based metrics.

MACRO

Euro Area

Economic activity and demand rebounded following the reopening of the economy. Coupled with the rapid pace of COVID-19 vaccinations and ongoing government support, the second estimate for the second quarter of 2021 showed a higher growth of 2.0% quarter-on-quarter (first estimate: 1.5% quarter-on-quarter), in line with the market consensus, following two consecutive periods of contraction. Economists are expecting another strong number for the third quarter, at perhaps just over 2.0% quarter-on-quarter, which would bring the economy close to, but below, its pre-pandemic level.

Industrial production for the month of June fell by 0.3% month-on-month compared to the prior month's decline of 1.1% in line with the market expected decline of 0.2%. This decline was largely due to the ongoing supply-chain difficulties which particularly affected Germany's auto sector. These are only expected to normalise slowly given the lingering virus risks and therefore, economists do not expect industrial production to contribute significantly to economic growth in the coming months, even though demand is still high.



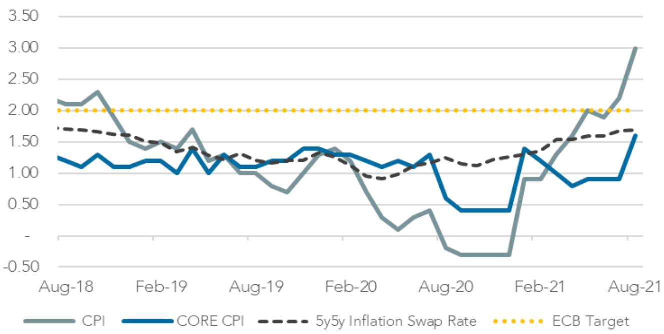
Source: Bloomberg

The contraction in June will likely have more than reversed in July with the consensus forecast at +0.6% month-on-month, primarily driven by small upticks in the largest countries, as well as increases in economies like the Netherlands, Belgium and Ireland.

Retail sales for the month of July fell by 2.3% month-on-month, compared to the prior month's growth of 1.8% and the expected drop of 0.4%. This showed that the recovery in retail sales halted in July, however the view remains that consumption will grow strongly in the third quarter as the blip in retail sales reflects consumers shifting their spending from goods to services. The July data saw a contraction in all categories of retail sales, with sales of food and drink falling for the fourth consecutive month, showing that consumers are reverting from their lockdown spending habits to more "normal" spending patterns.

The August final Composite PMI stood at 59.0, coming in marginally lower than the July figure of 60.2 and the expected 59.5. In any case, the strong reading suggests that the broader economic recovery continued to trend upward, albeit at a slightly slower pace than in the prior month for both the services and the manufacturing sectors. New business and new orders continued to increase in August, however backlogs of work increased as manufacturing production growth eased amid signs of strong capacity constraints which continued to push firm costs upwards.

Euro Area Inflation (rate, %)



Source: Bloomberg

The final annual inflation rate for August was confirmed at the flash 3.0%, this being well above the prior month's 2.2%, the market consensus of 2.7% and the ECB's target 2.0%. Still, several policymakers have continued to dismiss inflationary pressures as temporary, while others voiced concerns about a quicker-than-expected increase in consumer prices as domestic demand recovers, mainly reflecting a low base year due to the coronavirus crisis and the global supply squeeze.

Similarly, the final annual core inflation rate for August climbed to 1.6% (in line with the flash rate) from the prior month's 0.7% and the market expected 1.5%, this remaining below the ECB's target. The increase here was largely due to goods which in turn was partly driven by base effects related to last year's VAT cut in Germany and the unusual timing of summer clothing sales.

Economists now believe that rising costs are likely to push inflation up even further in the coming months, possibly resulting in inflation not falling quite as quickly next year as they originally assumed. However, they still suspect that by the end of 2022, inflation will be a long way below the ECB's target as pandemic-related shortages and logistical disruptions have eased and consumer-facing services prices have all reached pre-crisis norms, with producers being able to increase their output.

Looking at the labour market, the unemployment rate edged down in July to 7.6%, in line with expectations, showing continued improvement on the prior month's 7.8%. This is the lowest reading since May 2020, and was broad based throughout the region, with no country seeing an increase in unemployment. Economists see the fall in unemployment in July as being primarily due to a decline in the overall labour force rather than an increase in employment, highlighting that the labour market recovery still has a long way to go. Going forward hiring activity is expected to remain strong as the economy recovers, resulting in the jobless rate continuing to fall. Furthermore, given the improving labour market underlying condition, the tapering of furlough schemes is not expected contribute to a fallout in the unemployment rate.

The July meeting, where the ECB was set to revise its interest rate guidance to match its new monetary policy strategy, confirmed that a minority of the Governing Council members objected to the dovish shift in the Bank's interest rate guidance.

Policymakers agreed that revising the forward guidance on rates aimed to provide a credible commitment to bringing inflation up to the new target, as well as provide safeguards against a premature tightening of monetary policy in the current environment, but did not necessarily imply "lower for longer" interest rates. However, the German and Belgian central bank chiefs opposed the new wording that stipulated rates will not rise until the ECB sees inflation reaching 2.0% "well ahead" of the end of its projection horizon, saying it could be seen as subject to greater uncertainty than shorter-term forecasts and could be perceived as deviating from the medium-term orientation of the monetary policy strategy.

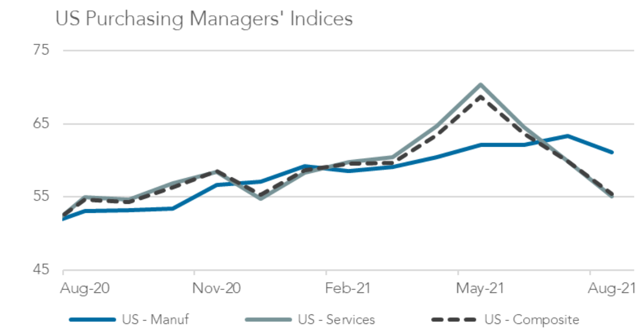
At the September ECB Governing Council, the macroeconomic projections for the Euro Area have been revised upwards reflecting the recent solid activity indicators boding well for Q3 performance. The ECB communicated a moderation in the pace of purchases but continues to emphasis the importance of easy financing conditions whilst maintaining policy rates unchanged. We continue to expect the ECB's policy stance to remain a lot more accommodative than either the Bank of England's ("BOE") or the Federal Reserve's ("Fed"), as the BOE and the Fed are expected to taper their asset purchases to zero by the end of this year and 3Q2022, respectively.

United States

The annualised second estimate for GDP growth during the second quarter showed the economy advancing by 6.6%, marginally higher than the initial estimate of 6.5% but below the expected 6.7%. Going forward, the rapid spread of the Delta variant, supply-chain disruptions, the shortage of workers and a cooling housing market are seen to be weighing on the economy's growth momentum. Because of this quarter-on-quarter growth rates are expected to moderate going forward.

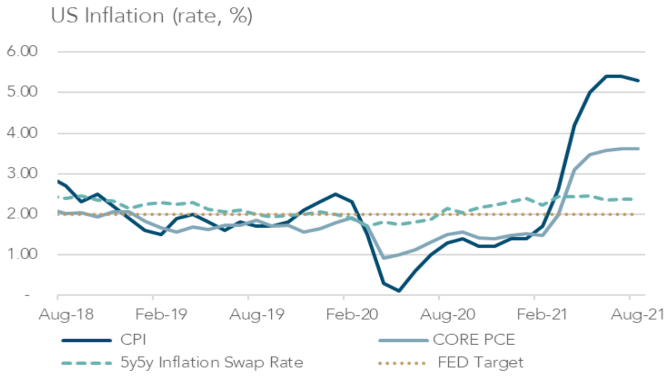
Retail sales fell 1.1% month-on-month during the month of July falling more than the expected 0.3% drop, following the prior month's 0.7% increase. This was led by a decline in auto purchases, the surge in prices and the resurgence in COVID-19 cases which hit consumer demand. This print also reflects the recent shift of spending from goods to services following the reopening of the economy. Economists believe that the spread of the Delta variant has dealt another blow to consumer confidence in early August, suggesting that retail spending will remain under pressure.

Industrial production increased by 0.9% month-on-month during the month of July, above the market consensus of 0.5% and the prior month's 0.2%. This increase was driven by a 1.4% rebound in manufacturing that was partly due to a 11.2% surge in motor vehicle production which according to economists appears to be a seasonal distortion as the semiconductor shortage meant that fewer than usual auto plants entered their annual shutdowns for retooling. Economists further believe that the boost seen in July will likely be partially reversed in August, and that a continued strong recovery in manufacturing output will be unlikely until the supply problems in the autos sector are resolved.



Source: Bloomberg

The August final Composite PMI stood at 55.4, in line with market expectations, however below the prior 59.9 as a result of the weaker expansions in both the manufacturing and services sectors. The expansion was supported by strong upturns in business activity, production and new orders. Nonetheless, output growth was reportedly hampered by capacity constraints and material shortages, with backlogs of work rising markedly and at the fastest pace since October 2009.



Source: Bloomberg

The annual inflation rate for August eased to 5.3% from the prior 5.4%, in line with market expectations. On the other hand, the annual core inflation rate fell to 4.0% in August from the prior 4.3% and below the expected 4.2%. These movements act as a sign that the recent surge in inflation from the economic reopening has run its course and is indeed transitory. Furthermore, the delta spread continued to disrupt auto manufacturers who announced new factory closures due to new delta-related global supply chains shortages which are likely to get worse. However, economists believe that although the spread of the delta variant is weighing on recovery, with possible declines over the coming months as reopening inflation pressure fades, there are still plenty of signs of a building cyclical inflationary pressure.

The unemployment rate reached the lowest rate in August since the pandemic struck at 5.2% inching down from the prior 5.4%. This came about as the labour market continued to gain jobs following the reopened of businesses in the US and despite reports of labour supply shortages and concerns over the lingering threat of the virus resurgence. The jobless rate remained c. 3.5% above the pre-pandemic level, but is expected to decline further in the coming months, helped by strong economic activity and demand for labour.

The economy added 235,000 jobs in August, the lowest in seven months and well below the market expectation of 665,000. The mediocre release suggests that the Delta variant is weighing on the progress in the labour market recovery and on the broader economy. Leisure and hospitality employment remained unchanged month-on-month after 300,000 job gains in July, while retail jobs disappointed as they fell by 29,000. We do not consider the extent of the slowdown in jobs growth to derail the talks on tapering of asset purchases by the Fed. However, if weak job numbers persists, the scope to taper asset purchases could be pushed to early next year.

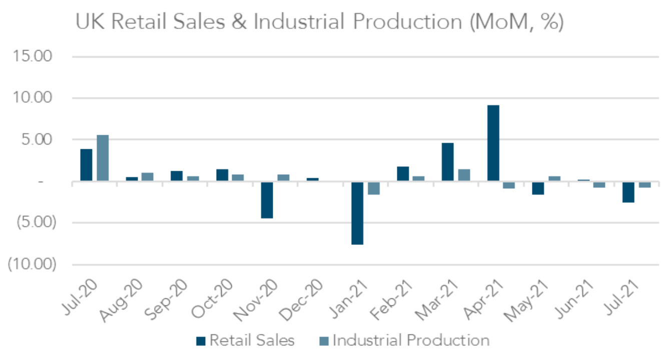
Without the return of more low-wage leisure and hospitality workers in August, average hourly earnings increased by 0.6% month-on-month, compared to the prior 0.4% and the expected 0.3%. Despite the month-on-month changes in the underlying composition, the wage growth figure still shows that the rising demand for labour associated with the recovery has put upward pressure on wages.

During the Jackson Hole symposium, Fed Chair Powell signalled that tapering would begin before the end of the year, although a reduction in asset purchases will not carry a direct increase in interest rates. The Fed is expected to continue to hold the target range for the federal funds rate at its current level until the economy reaches conditions consistent with maximum employment, and inflation has reached 2.0% and is on track to remain above 2.0% for some time.

We expect the Fed to wait until the November meeting to announce a reduction in the monthly pace of its Treasury securities purchases and mortgage-backed securities purchases, with the tapering itself beginning in December. Although, it is expected that tapering will be a key talking point in this month's policy meeting.

United Kingdom

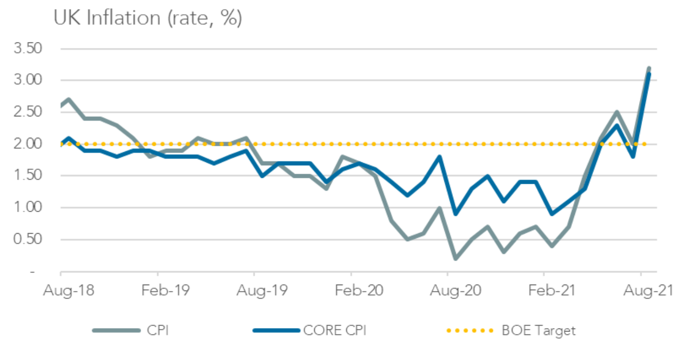
The preliminary estimate for the second quarter GDP growth stood at 4.8% quarter-on-quarter, in line with market expectations, showing a fast acceleration from the first quarter contraction of 1.6% . This came about as activity and demand rebounded following the easing of restrictions. June was an unexpectedly strong month (1.0% growth month-on-month; May: 0.6%) despite the surge in virus cases, suggesting that the recovery maintained its momentum at the end of the second quarter. Economists expect GDP to return to its February 2020 peak in October, but the risk is that the virus and the "pingdemic" caused GDP to take longer to reach this level.



Source: Bloomberg

Industrial production in June fell 0.7% month-on-month, compared to the expected growth of 0.3% and the prior month's growth of 0.6%. The fall in production was led by mining and quarrying and electricity and gas, leaving industrial output at 3.2% below its February 2020 level. Retail sales for July also fell by 2.5% month-on-month, disappointing the expectations of growth of 0.4%. The slowdown is attributed to the rising COVID-19 cases, UEFA Euro 2020 Championship and bad weather which forced people to stay at home.

The August final Composite PMI stood at 54.8, coming in lower than the prior month's 59.2 and the expected 55.3. The release points towards a slower pace of recovery in the economy marking the worst month for business activity growth this year. Furthermore, the manufacturing sector saw the slowest pace of expansion since March, although it remained strong overall, amid reports of shortages of inputs and delivery delays.



Source: Bloomberg

The annual inflation in August jumped to 3.2%, well above the prior 2.0% and the market expected 2.9%. This was mainly a result of the low base effect from the prior year, because, in part, of discounted restaurant and café prices in August 2020 resulting from the government's Eat Out to Help Out scheme and, to a lesser extent, reductions in VAT across the sector. Similarly, core inflation increased to 3.1% in August compared to the prior dip to 1.8% and the expected 2.9%. Economists are expecting CPI to continue to rise sharply in the next few months, potentially peaking as high as c. 4.5% by the end of the year. In any case, similar to other regions, the sharp rise in inflation is expected to cool and drop back below the 2.0% target by end 2022. Moreover, economists do not believe the BOE will respond next year by tightening monetary policy, provided the spike in inflation does not feed through into higher inflation expectations or persistently faster pay growth.

The unemployment rate fell to 4.7% during the three-months ending June, below the market consensus which expected unemployment to remain at the prior level of 4.8%. This suggests that the labour market is continuing to recover following the relaxation of many restrictions. Still the rate remains 0.8% higher than pre-pandemic levels and does not capture the decline in furlough schemes which began to unwind in July. However, given the improving economic conditions the rate of unemployment is not expected to rise drastically once the furlough schemes are entirely wound down.

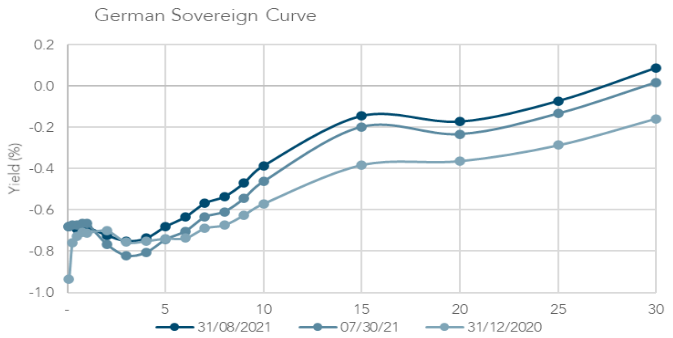
Job vacancies hit a record high in June while redundancies decreased to pre-pandemic levels. The surge in job vacancies highlights the worsening staff shortages in many industries. The year-on-year average earnings for the three months ending June (including bonuses) stood at 8.8% from the prior 7.4%, coming in close to expectations of 8.6%. This marks the highest level since 2001. The rapid increase in ages is being 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 proportion of lower paid jobs, and (3) base effects where the latest months are now compared with the start of the pandemic when earnings were first affected and pushed lower.

Looking at financing conditions and monetary policy, the BOE retains a wait-and-see stance by leaving its monetary policy tools unchanged during its August meeting. Policy makers reiterated 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 target sustainably.

RATES

Euro Rates

The German sovereign curve repriced higher given the elevated inflation print in August. Europe has been displaying delayed reopening effects given that inoculation rates took longer to pick up and governments have scaled back containment measures later compared to the UK and the US. Having said that, the pace of vaccinations has risen markedly in recent weeks, boding well for the current momentum in economic expansion and the region's resilience to the spread of COVID variants. Survey based indices may show that sequential growth may have also peaked in Europe, but in any case, the direction should remain positive.



Source: Bloomberg

As a result of the pace of vaccinations, together with the effective scale-down in the pace of purchases in August (which is typical for the low liquidity summer months), ECB officials have become more vocal on the debate of lowering the pace of purchases in the Euro Area.

The presumably high vaccine efficacy in Europe against the delta variant and the lower attached downside risks to the economy, combined with higher risk for upside surprises in inflation, have resulted in general market expectations circling around the September meeting for the ECB to communicate a slowdown in the pace of purchases during the fourth quarter. The pace of purchases was €80bln in Q1 and €100bln from April onwards. We have anticipated a step down back towards the €80bn mark as the base case expectation for the September monetary policy meeting.

The September meeting included the updated staff macro-economic projections which should show upgrades given economic data in July and August. PMI data has remained strong, inflation ticked up in August, COVID risks somewhat contained given high vaccine rollout; and financing conditions have improved since the ECB switch to a "significantly higher" PEPP pace.

Markets continue to anticipate a post-PEPP expansion in APP which the ECB will probably provide further clarity on towards the end of the year.

The constructive economic outlook in the Euro Area, the expected steady (but low) contribution from the pan-Euro Area fiscal programme and the expected change in the ECB's focus towards reducing accommodation signals the scope for a move higher in long-end yields.

The broad expectations have supported very low expected short-term real rates for the time being, with the OIS curve showing practically no change in the overnight effective rates expected over the medium-term. Having said that, given the lower for longer interest rate path priced in the Euro curves which could see sensitivity to upside surprises in inflation, a repricing higher in Euro curves on the back of higher inflation premia or a decompression in term premia cannot be excluded.

With the slowdown in purchases largely priced in, any uptick in yields will be contained given that the ECB will likely maintain a highly dovish tone, and the scale back of purchases will be very gradual.

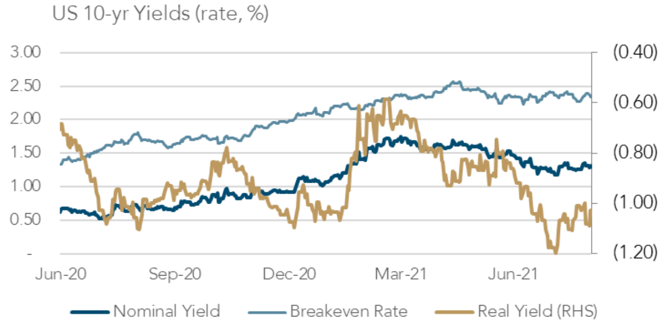
The move higher in the German curve on the back of the improved backdrop led to some compression in sovereign spreads. Moreover, credit term structures in the Euro area sovereign space has already started to show signs of flattening (namely France, Spain and Italy).

As we have noted in previous updates, stock effects have been the main determinant for sovereign spread movements. To this end, given our base case expectations of a quantitative easing ("QE") slowdown in September, the EGB space is expected to remain somewhat supported given the favourable supply/demand outlook of the rest of the year. Net issuance post-QE purchases is expected to remain negative.

Given the sensitivity of sovereign spreads to the QE composition and purchases and the limited support expected from benchmark curve movements, we anticipate continued discrimination in spread movements going into year end across the Euro Area sovereign space. This will mainly be affected by the relative funding position of nations.

US Rates

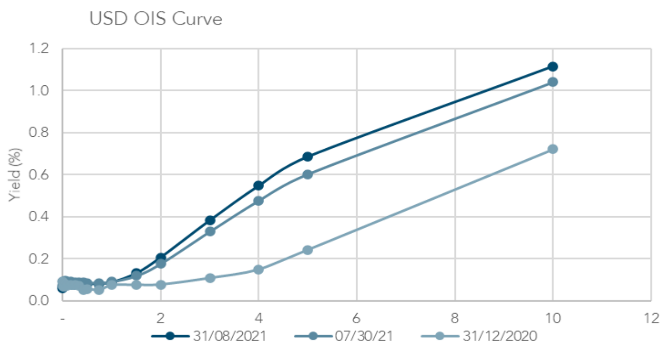
August has been a relatively muted month in terms of movements in the US 10-year when considering the swings seen since the start of the year. We have seen the 10-year US Treasury yield rising by 8bps to 1.31% during August bringing about some steepening of the curve.



Source: Bloomberg

10-year inflation breakeven rates actually moved lower during the month on the back of the soft price prints as the US economic growth momentum and sharp return in consumer spending seems to have peaked. As a result, the move higher in the nominal rate has been mainly driven by real rates, largely reflecting stronger expectations built in the US Treasury curve that the Fed is closer to decide on tapering asset purchases, thus relieving the downward buying pressure on long-end yields.

The steepening 2s10s by 6bps seems to be well placed given Powell's speech at the Jackson Hole symposium which seems to be a step towards decoupling the tapering of asset purchases from policy rate increases.



Source: Bloomberg

The short-end remains firmly anchored in the OIS curve indicating unchanged market pricing of an eventual rate increase despite the growing expectations of tapering in asset purchases.

Given that now we seem to be over the inflation "hump" and the focus has clearly shifted on the Fed's communication on the tightening approach, we are seeing a bias for yields to trail higher. Markets are eyeing November as the potential policy meeting when tapering is made official. However, we note that the September meeting will be an important one since we will understand the Fed's reaction to recent weaker job figures and the inclusion of 2024 projections in the dot plot which will provide valuable insight on the member's inflation outlook and the appropriate policy response.

We note considerable differences in today's tapering guidance and the surrounding conditions compared to the taper tantrum of 2013. The message has been clearly telegraphed by the Fed (with the exception of the timing). Inflation dynamics are completely different, the job market is still recovering, the extent of monetary support (monthly purchases) is much larger, the Fed' strategic review makes the bank strategically more dovish than before and there is growing market acceptance that the Fed is risking to be behind the curve given the pronounced price pressures.

On this basis, we expect any move higher in US yields on the back of a tapering announcement to result in a further steepening of the curve given (a) Powell's effort to decouple asset purchases from policy rate decisions and (b) given the expected moderation in inflation data, the sell-off is expected to be real-rates driven with the belly of the curve looking to be most vulnerable to such a move.

In our previous update we said that "we expect near term steepening as a corrective move to the recent flattening which we believe is over done – downside risk factors to the growth outlook seem to be overestimated and the extent of the move lower was exacerbated by technical factors". This has pretty much materialized. However, we also said that "over the medium term, we expect a move higher in rates to be driven by the front-end (primarily the roll-down of rate hikes) accompanied by a bear flattening in the belly and long-end of the curve." This is now proving to be less the case given that the Fed seems to have shifted focus to steepening the curve first.

We do not expect the weak jobs print for the month of August to completely derail the Fed's tapering discussion. We feel that it has become essential for the Fed to scale back purchases now from the very high $120bln a month in purchases when considering that the current improved economic conditions do not seem to warrant such level of accommodation.

We do note however, that the rising COVID cases in the US (as well as hospitalization rates given the relatively low rate of vaccinations), could present a higher hurdle for the Fed to communicate a decisive and sizeable action. Combined with the fact that we are past the initial reopening boost and inflation data is expected to moderate, so far it seems to be a safer course of action for the Fed to step back purchases only very gradually.

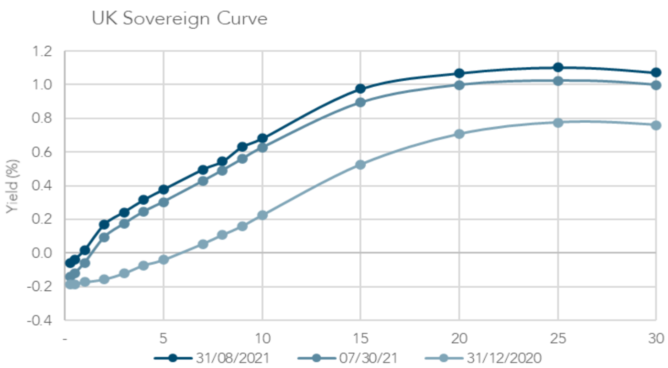
Because of these conditions we expect any sell-off in US treasuries to remain fairly contained. Moreover, the balance of risks and the direction towards tapering, as well as the current pronounced (possibly overestimated) front-end pricing, increases the scope to consider short-dated USD paper.

UK Rates

The parallel move upwards in the UK Gilt curve is consistent with our previous observation that "the BOE sequencing of balance sheet run-off with policy rate adjustments should lead to a more parallel movement across the curve". This is consistent with the fact that front-end pricing remained elevated while the decline in QE purchases has been very well telegraphed.

Current market pricing implies a 10bp hike by February 2022 and a further 15bp hike in May 2022. Further rate hike expectations beyond 2022 are comparatively lower (implied rate for December 2024 is just above 0.50%). This may reflect market expectations of an initial policy adjustment given the progress in the economic recovery but lack of conviction on a stronger tightening cycle; or it could be related to the halting of reinvestments of maturing QE holdings when the policy rate reached 0.50%, thus requiring an element of caution in avoiding a fast deceleration/unwinding of the easy monetary policy.

Ignoring the temporal blip in the July inflation print the move higher in nominal rates has been mainly explained by higher inflation premia given the broad expectations that inflation will move markedly higher in the UK.



Source: Bloomberg

Front-end pricing so far remains elevated compared with the expected BOE path, with economists forecasting a 2H2024 lift-off in rates. Much will depend on the labour market recovery given that furlough schemes are being wound down and the pass-through effects. If current inflation results in stronger inflation expectations or faster pay growth, we could see a quicker reaction by the BOE.

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. PMI data showed a respectable pace of expansion despite dipping in August, while labour market data showed progress with a limited expected fallout when furlough schemes are terminated.

The belly of the curve (5-7-year area) remains particularly vulnerable on a relative basis given the possibility of front-end pricing shifting outwards even though a reassessment in front-end pricing may not be imminent.

Conditions continue to support scope to remain net short duration in UK, possibly repositioning exposure at the short-end of the curve.

CREDIT

Euro Credit

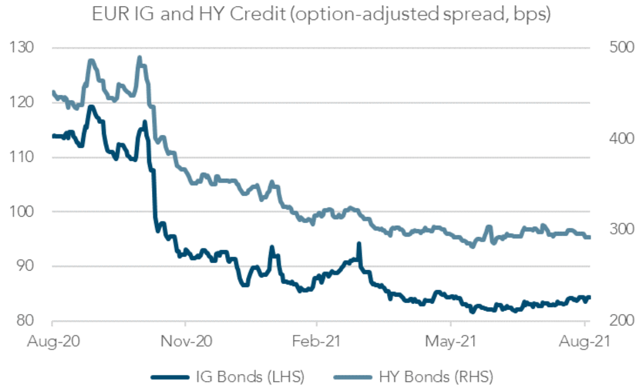
During the month of August, spreads within the European corporate bond market were generally tighter against the Bund, with the high yield ("HY") segment of the market tightening by a larger degree when compared to the investment grade ("IG") segment of the corporate bond market as inflation and a pickup in economic activity drove demand for speculative grade corporate bonds.

With that said, Euro IG corporate credit gave up 41bp of the strong performance achieved in July, as volatility in benchmark bund yields was (and remains) the key driver of returns for the asset class. An 8bp bund widening in August, with spreads remaining relatively flat overall, ensured a total return loss for the month. Returns for this asset class look set to remain on a knife edge, with rates continuing to drive IG total returns and credit spreads looking to hold steady until the end of the year.

Euro HY has continued to deliver solid results for fixed income investors, having beaten IG by a wide margin during August following the move wider in bunds, stretching its winning streak to 11 months. This consistent Euro HY performance over almost a year stands out in a volatile fixed income market suffering from global rates pressure, though we remain confident that the asset class will continue to perform for the remainder of the year. Good momentum in positive rating actions, spread buffers, and low default rates should continue to aid sentiment for the asset class as the economy continues to rebound. With that said, the paradigm of ratings step-downs for carry is no longer as straightforward, more so within the IG space.

August saw a supply shutdown, in line with historical trends, though as in previous years, we expect a surge of issuance in September as European investors return to the market. Net additions historically average €17.0bn and €5.2bn of par paper during the month over the last decade for IG and HY respectively, and the expectation is for this September's net supply to be in line with that average or slightly better given that credit is trading at record tights. New supply should nevertheless be well digested given the positive sentiment Euro HY currently enjoys.

Whilst we think that the runway is long for the ECB to implement any meaningful withdrawal of support, we do think that there is more scope today to reduce duration on the IG exposure given both tighter spreads and the potential impact to long term rates that a more hawkish tone may bring. Within the HY space we remain comfortable with our currently short duration profile.



Source: Bloomberg

US Credit

Similar to European corporate bond spreads, during the month of August, US corporate bond spreads also tightened as the rebound in economic activity drove demand for corporate bonds despite a rise in the US Treasury yield during the month driven by expectations of Fed tapering, which is set to occur sooner than expected.

However, while economic data points released during the month played their part in the spread tightening, the main driver during the period was the expectations around the Federal Reserve's tapering of its asset purchase programmes and the July FOMC minutes that were released in August. The FOMC minutes showed that Federal Reserve officials are adopting a more hawkish approach as the majority of officials believe that the central bank could start tapering later this year.

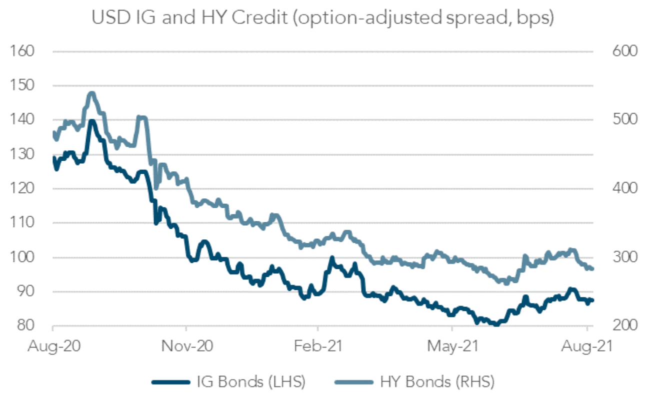
US IG credit was impacted last month by a widening in benchmark rates, with the index losing 30bp in August and taking the asset class into negative total returns on a year-to-date basis. By comparison, spread tightening within the US high yield space was sufficient to offset the volatility in benchmark rates, having delivered a solid 51bp of performance during the month.

US HY spreads closed August at +288bp, roughly 6bp tighter than levels seen at the close of July, after having peaked earlier in the month at +314bp. Spreads had been drifting wider during the month on declining investor confidence and bearish positioning into the Jackson Hole symposium later in the month which, ultimately, proved to be less controversial than initially expected, reversing much of the widening seen.

We continue to believe that IG returns will continue to depend largely on movements in treasuries, and remain cautious on the asset class given the hawkish tone struck by the Fed in recent weeks and despite the lack of specific clarity on the timing of Fed tapering.

The 2013 taper tantrum saw 10-year nominal yields rise 95bp between the then-Fed chair's speech and the peak in yields some months later. Given that the market has been expecting a taper at some point in the near future, such dramatic moves are unlikely, however that is neither to say that the market is fully pricing a taper, and some impact – even if just due to technical factors – will likely materialise once more clarity is obtained.

As such, given the likelihood of the Fed withdrawing support for bond markets over the near term, we see scope for US IG and HY to underperform driven both by spread and benchmark widening and would prefer maintaining higher exposure to Euros in relative terms.



Source: Bloomberg

UK Credit

The spread tightening within the UK corporate bond market was mainly driven by the Bank of England's hawkish stance and messaging over monetary policy, despite a rise in Gilts, as the reopening of the economy continued together with the country's vaccination drive.

The view around UK credit spreads remains largely unchanged as we remain confident around the economic recovery for the UK market - despite lower than expected services PMI data in August - as the vaccine rollout persists and hospitalizations remain low.

Spreads within UK HY and IG corporate bond markets continue to trade wide relative to Euro and USD paper which given the economic backdrop, remains attractive, though we would caution against extending duration.

Default Rates

After downgrades outpaced upgrades by nearly eight-to-one in 2020, speculative-grade upgrades have exceeded downgrades year to date by almost two-to-one. Despite the recent improvement, the large number of downgrades last year still casts a shadow. Since the start of 2020, speculative-grade downgrades still outnumber upgrades (353 to 106).

That said, the negative bias on speculative-grade issuers in June (24.9%) fell to almost half the value from last June (48.2%). Vaccine progress, the easing of pandemic restrictions on economic activity, ample liquidity, and the strong market appetite for yield are all contributing to improved credit metrics.

The overall speculative-grade net rating actions improved significantly during Q2, to only negative 1.8% in the 12 months ended June 2021, from negative 17.5% through March, though the overall reading may mask significant variability across sectors.

Among all, the leisure and media sector remains the weakest, at negative 16% net rating actions. Others, such as consumer services - the largest sector in Europe - are now seeing a slight advantage in net upgrades (3%). Net bias improved for most speculative-grade sectors as well; however, this is where leisure lags the most, with a net ratings bias of negative 46%, compared with an overall speculative-grade net bias of negative 16%.

The relative rating distributions across sectors vary as well. The media and entertainment sector, which made up 13.4% of speculative-grade corporate credits at the end of June, has the largest concentration of 'CCC/C' ratings at 30.4%, followed by the oil and gas and transportation sectors at 29.2% and 26.3%, respectively. This leads us to believe that some sectors will contribute more defaults than others. It will likely take longer for these sectors' financial positions to recover, and they could increase the default tally.

S&Ps default statistics and forecasts include both selective default and default ratings as instances of default. S&P Global Ratings views distressed exchanges as selective defaults. Selective defaults also tend to result in much lower levels of economic loss (higher recoveries). In the first seven months of 2021, 77% of European defaults were distressed exchanges, while there have been no bankruptcies or insolvencies so far.

The pace of defaults so far in 2021 has been more modest compared with 2020. Through July, there have been 13 defaults in Europe, three of which occurred in the second quarter. If this were to continue for another three quarters, it would produce only an annualized 1.1% default rate. While markets still appear to support new debt, it is important to consider that 74% of all distressed exchanges are ultimately followed by additional default events.

EQUITY

Over the summer months, equity markets continued in their positive trend, moving close to record highs. This however masks investor anxiety, as evidenced by the outperformance of quality names and the performance for growth strategies throughout the period. This outperformance in growth came at a time when value names reported the largest positive earnings beats, during 2Q2021 earnings season, and their full year earnings estimates were revised higher.

The change in sector and style positioning throughout the summer is a clear signal that investor sentiment has turned more cautious, with the three most dominant worries for investors being: (1) the Delta spread and vaccine efficacy, (2) China economic weakness, and (3) tapering concerns.

The moves observed within other asset classes during the first three weeks of August were generally consistent with periods of growth concerns: (1) a strong US dollar, (2) falling bond yields and (3) weaker commodities. Yields have been on a downtrend since mid-May, which coincides with the period of underperformance for value strategies relative to growth.

Notwithstanding, the reflation trade bounced back during the last week of August as markets appeared more comfortable with the changing dynamics within the global economy, while the Fed communication during the Jackson Hole Symposium was a source of relief for investors.

COVID-19 remains a key risk to the outlook but our opinion remains that nationwide lockdowns in Europe and the US will not be required. The next few weeks will be a key test for the "learn to live with the virus" approach. The re-opening of schools, more people returning to the office and colder weather will provide a key test for the EU, US and other countries that are learning to live with the virus. It will be interesting to see whether case growth will again accelerate, and if the current relationship between case growth and hospitalisations (the latter is rising at a much slower rate than the former) will hold. There is seemingly little appetite for western countries to re-introduce lockdowns, and further live data around the vaccine efficacy could provide a lift to medium term economic expectations.

Decelerating economic growth in China is worrying, especially against a backdrop of rising COVID-19 cases, but we think this weakness will be short lived. The July economic data released in August came in significantly below expectations, especially in consumption and investment and across all sub-categories under industrial production and retail sales. However, the initial take was that activity was negatively impacted by torrential rainfalls and floods in central China, ongoing regulatory measures further restricting real estate and local government borrowing and the spread of the delta variant to multiple provinces triggering the tightest curtailment measures since early 2021 towards the end of July.

It is likely that August will be another weak month (due to COVID-19 restrictions), but the economy should recover after that as the impact from the 50bp reserve requirement ratio cut in July starts to trickle into the economy and one-off factors fade away.

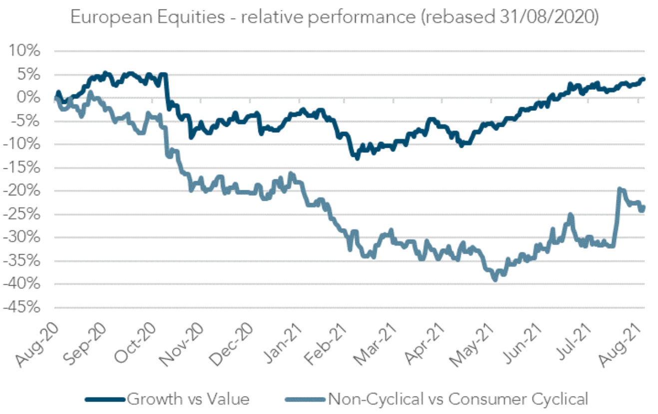
Economic growth in developed economies has likely peaked, as much of the positive impact from the reopening is now behind us. Notwithstanding, a deceleration in the PMI's from unsustainable recovery levels (above 60) to a more sustainable mid 50's level in the coming months would still represent a respectable growth rate. Economists are still expecting growth coming in above trend for developed economies, while financial conditions remain loose, which should support equities over the medium terms.

Despite the equity market rally continuing unabated, there has been a clear change in leadership over the past three months. Global stocks rallied, posting total returns in Euro terms of +4.8% in June, +1.7% in July and +3.0% in August. But despite our positive stance on value stocks, they have underperformed growth in each of the three months, by –6.0% in June, -2.3% in July and –1.7% in August. This has also been reflected in regional performance, with Europe underperforming the US in every month, despite the region hitting peak growth during 2Q21.

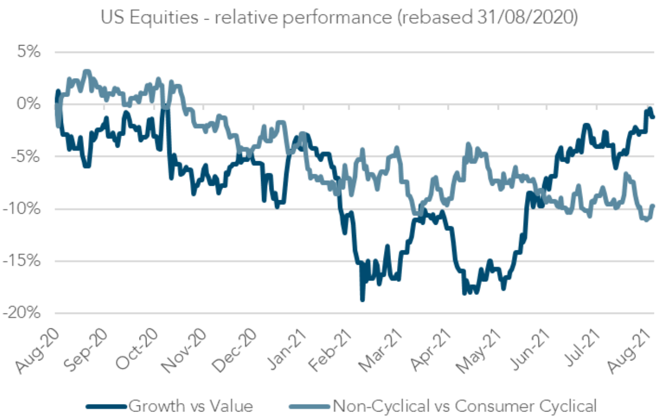
The underperformance during the period has come during a very encouraging 2Q results season. Earnings published over July/August covering 2Q/1H were well ahead of consensus expectations with earnings growth of 72.2% according to Goldman Sachs. This led to a number of positive earnings revisions, with FY21e EPS revised by +8.1% over the past month to 26.8c, while FY22e and FY23e have been revised by +4.3% to 28.8c and +3.0% to 31.0c respectively.

Despite this positivity around earnings growth, which has been absent for many years in Europe, FY21 P/E's have continued to trend downwards. For the first time in years, the positive EPS revisions in Europe have kept pace with the US, and yet Europe's total return for the year is lower. More importantly, according to Goldman Sachs, value names in Europe stand out as the only group of companies that have underperformed their beta implied performance the most. This has happened even though these companies beat market expectations the most during the 1Q21 and 2Q21 earnings season and saw the most positive earnings revisions. As a result, their valuation has collapsed.

A simplistic reason for this weakness can be traced to trading volumes. With many investors on their summer break, and the positive catalyst of the earnings season behind us, the lack of liquidity seems to be impacting prices. August and September have generally been tough months in this respect. Trading volume has on average fallen c. 21.2% in August and 7.5% in September over the past five years. This makes it easier for in-



Source: Bloomberg



Source: Bloomberg

vestors to close winning positions before their vacations.

The market narrative has turned more cautious over the past months. The investor concerns previously mentioned leading to bond yields falling to levels not seen since the start of the year have boosted long duration equities. It seems that this downward trend in yields has paused, with the US 10-year real yield and nominal yield up 16bp and 11bp since the August lows.

The record high cash position in money market funds could provide additional equity flows as clarity over the macro outlook improves. The AUM currently held in money market funds amounts to c. $4.5 trillion on August 25th according to ICI data compared to c. $4.3 trillion at the start of the year. This means that any dips in the equity market could be potential buying opportunities for investors. Barclays say that despite the record inflows in equities this year, bonds and cash positions remain more crowded. Therefore, there is still ample liquidity available to flow into equities.

Our view remains unchanged despite the rising risks in the near term and the increase in investor risk aversion. We think that August and September will be a weak period for developed economies, but we are of the opinion that value stocks will come back in favour as investors become more comfortable with the vaccine efficacy, and the probability of strict curtailment measures falls further. Economic growth remains robust and financial conditions remain relatively easy. The challenge for investors in the coming weeks will be to digest slowing PMI data from the previous unsustainably high levels.

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.
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 positive credit rating trends provide scope to continue to seek opportunities on a selected basis. We remain selective in holding high yield positions remain as we focus on identifying new positions 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) 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 fourth 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 by the global synchronised economic growth and a increased availability of vaccines in emerging regions.

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

DISCLAIMER