Investment Strategy Update

December 2021

CURMI & PARTNERS

Curmi & Partners Research

- Persisting supply chain disruptions will continue to hamper output in both the services and manufacturing sectors, while the rising COVID cases and the new Omicron variant add uncertainty to GDP recovery.
- Rising cases and the new variant are leading to the return of restrictions which will weigh on consumption while consumers are deterred from making in-person purchases.
- Despite the decline in US unemployment rate, the labour market recovery is stuttering possibly due to rising infection rates during the winter months.
- While employment continued to improve despite the termination of government support programmes across the EU and the UK, the recent resurgence in COVID cases and the new variant uncertainty are expected to slow down the recovery.
- Inflation rates soared towards multi-decade highs in the US, the UK and the Euro Area at 6.8%, 5.1% and 4.9% respectively.
- The Federal Reserve announced in December a faster reduction in the pace of asset purchases and guided towards three rate hikes next year given inflation concerns as economic conditions have improved.
- The European Central Bank also gave a mildly hawkish message its December meeting as it announced the reduction in the pace of asset purchases while the Bank of England surprised with a 15bp rate hike.
- Yield curves flattened as long-end rates declined on the back growth concerns and increased uncertainty due to the surge in cases with the 10-year US treasury yield dropping to a recent low of 1.33%.
- Credit spreads across investment grade and high yield markets widened given the prospects of weaker growth and reduced central bank support.
- Equity markets saw increased volatility and sector rotation towards defensives given the headwinds to cyclical stocks.
- We have neutralised our short duration position given that growth concerns will keep downward pressure on long-end rates over the near-term.
- We consider any widening in credit spreads to be potential buying opportunity to add selected positions in both investment grade and high yield bond markets.
- While we maintain a positive medium-term outlook on equities, we have moderated the value-tilt in our portfolios which we expect to reverse when downside risks to the economic recovery recede.
- Although we assess the growth potential for emerging market equities to be underpriced by the market, the increased investor scepticism and weak market sentiment is expected to continue to drive the underperformance versus developed market equities.

Market focus has intensified on the inflation and growth dynamics in the final weeks of the year. Central bankers have acknowledged that inflationary forces are proving to be more long-lasting than previously anticipated with the Fed Chair Jerome Powell dropping the word "transitory" to describe their assessment that inflationary pressures were indeed temporary.

US inflation increased to 6.8% in November, Euro area inflation rose to 4.9% and UK inflation rose to 5.1%. In all cases, the current levels of inflation are near or above multi-decade highs.

The general consensus is that inflation is expected to moderate over the course of the next few years. Firstly because the low base effects will fall out of the year-on-year calculation of price changes. Secondly, following a sharp rally in energy prices, we are seeing stockpiles and production levels increasing which led to the recent stabilisation and pullback in energy prices. Thirdly, the inflationary boost from durable goods prices is expected to translate into a disinflationary drag going forward.

These expectations are however pinned down by the assumption that supply-chain issues will subside as the virus threat abates and the availability and transportation of goods is normalised. Secondly, that the high rates of wage growth will moderate as labour market conditions continue to improve.

On the other hand, the new wave of virus cases, that hit European countries first, and the emergence of the

Omicron variant have added to the uncertainty around the inflation outlook. However, more directly, it is negatively impacting the growth outlook as more countries are reimposing restrictions on travel and activity. Economists have made modest downward revisions to growth forecasts in the main regions for next year.

Despite the renewed threats to the growth outlook, central banks have emphasized their concerns on price developments resulting in increasingly more hawkish messaging by G10 central banks. The December monetary policy meetings of the US Federal Reserve ("Fed"), the European Central Bank ("ECB") and the Bank of England ("BOE") saw the central banks take various actions, to different extents, in a step towards the gradual reduction of monetary accommodation.

The prospects of moderately weaker growth, high inflation for longer and tighter monetary policy resulted in a risk-off tone in markets and higher volatility. In recent weeks, long-end rates fell on the back of safe-haven buying resulting in curves generally flattening despite the hawkish communication by central banks.

Our medium term outlook is that yields will move higher given the expectations that economic conditions will stabilise and that quantitative easing programmes will continue to be scaled back and terminated by major central banks with some expected to hike rates next year. For the time being, we continue to consider flattening movements across yield curves as an opportunity to add exposure to short and medium maturity bonds. On this front, we are keen to hold short-dated USD and GBP paper where curves are flatter and front-end market pricing is already fairly elevated in the context of policy rate hike expectations.

On the back of the Omicron virus headlines, we have temporarily added back duration in our fixed income strategy given the bid for long-end rates. We expect to reverse this positioning and reintroduce a short duration bias when the downside risks to the growth outlook eventually recede.

Despite the weak market sentiment, the environment of negative real yields and high equity risk premia supports our positive medium-term outlook on equities. On this basis, we continue to retain an overweight allocation to the asset class but we have tactically moderated our preference for value stocks versus growth stocks given the headwinds to pro-cyclical assets in the near term. We continue to hold fundamentally improving value stocks which we expect will continue to do well in an expansionary environment. We have also squared our allocation to emerging market equities to limit the sensitivity to market volatility over the near term.

Our preference to remain overexposed to riskier assets is based on our expectation that the economic environment will continue improve and grow above potential and that the withdrawal of central bank support will be very gradual and well-telegraphed in advance to minimise market disruption.

MACRO

Euro Area

The second estimate for the third quarter GDP growth stood at 2.2% quarter-on-quarter compared to the original estimate of 2.0% and the Q2 GDP growth of 2.1%. The Euro Area is expected to grow 5.0% this year according to the most recent forecasts from the ECB, although high energy prices, rising inflation, persistent supply constraints, the increase in virus cases and the new variant continues to threaten the recovery.

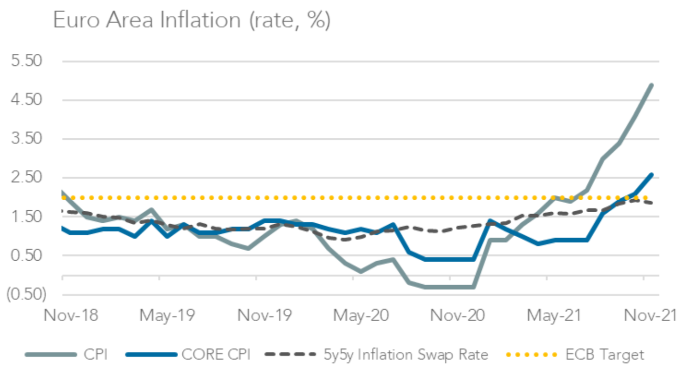
Industrial production for the month of September edged down 0.2% month-on-month following a 1.7% drop during the previous month. The decline was less severe than the market expected drop of 0.5%. This was a result of the continued supply constraints and high commodity prices which weighed on the sector. The underperformance is largely a consequence of the auto sector as semiconductor chip shortages continue. As supply-chain difficulties are likely to persist for some time, the outlook for manufacturing in the coming quarters is weak and will remain a main drag on economic output over the coming months.

October retail sales rose by 0.2% month-on-month, matching market expectations, after declining by 0.4% in the previous month. The increase was partly driven by an increase in online sales, which offset the decline in food, drinks and tobacco sales. This was perhaps a sign that rising virus cases were deterring consumers from making in-person purchases. Customers are likely to become more cautious amid soaring energy prices and concerns over the spread of the new Omicron variant. Rising COVID cases and the return of restrictions are likely to weigh on consumption in the coming months.

The November final Composite PMI stood at 55.4 compared to the prior 54.2 and the market expected 55.8. Growth was primarily a reflection of the services sector performance, which masked the second softest increase in manufacturing production since its recovery began in July 2020 amid severe supply-related constraints. Manufacturing output increased at a faster pace, but the rate of increase remained the second weakest in 17 months.

New orders rose, albeit only marginally. Nonetheless, capacity pressures continued to build, while firms hired additional staff to support the provision of their services. Average input lead times lengthened to a substantial extent once again, while pre-production inventories saw the quickest accumulation since 1997. The PMI data provided evidence that price pressures are continuing to intensify as both the input and output price indices reached record highs.

The November flash annual inflation rate for the Eurozone came in at 4.9%, above the prior 4.1% and the market expected 4.5%, with energy inflation reaching a new record high of 27.4% from the previous month rate of 23.7%. The November flash core inflation rate stood at 2.6%, above the prior 2.0% and the market expected 2.3%.



Source: Bloomberg

The low base for comparison last year is playing a significant role in the rise in inflation. As these base effects fall out of the year-on-year comparison, inflation is expected to tick lower next year. The Omicron variant has increased the level of uncertainty on both the growth and inflation outlook, but so far economists suspect that it will have a fairly small impact on inflation. Furthermore, economists believe headline inflation will remain above target until at least the end of next year.

Lower oil prices will reduce energy inflation, but if the variant exacerbates global demand-supply imbalances, goods inflation could be higher for longer. Most firms are expecting input costs to remain high for a long time. So, while energy effects are expected to bring the headline rate down next year, high input costs look set to keep goods inflation unusually strong for some time.

Looking at the labour market, the unemployment rate for the month of October edged down to 7.3% from the prior 7.4%, in line with market expectations, as the number of people classified as unemployed dropped by 64k. This left the unemployment rate below its February 2020 level of 7.4%.

However, while the labour market conditions continued to improve in October, the recent deterioration of the COVID situation and increased uncertainty due to the Omicron variant will likely lead to a slower recovery over the next couple of months as restrictions are being reimposed. Tighter restrictions might well mean lower demand for labour among services firms and retailers, alleviating labour shortages in these sectors. But this might be partly offset by people dropping out of the labour force once again.

Despite the surge in COVID cases across Europe and the new variant, ECB policymakers have decided to reduce the pace of purchases of their pandemic emergency purchase programme ("PEPP") and confirmed that the programme would terminate in March 2022. Based on our expectations that purchases under PEPP will be conducted at a pace of c. EUR 40 billion per month, we expect that the full EUR 1.85 trillion envelope will not be utilised in full. Secondly, the ECB announced that purchases under the APP programme will be stepped up to EUR 40 billion during the second quarter of next year, up from the current EUR 20 billion, and then reduced to EUR 30 billion in the third quarter and EUR 20 billion in October 2022. The temporary bump in APP purchases when PEPP terminates is intended to smoothen the transition.

The net effect however is perceived to be a mildly hawkish turnaround by the ECB compared to the fairly high expectations on QE. Markets expected additional QE to the tune of EUR 120 and 150 billion in the course of next year. The adjustments just announced in December now point to a EUR 90 billion in additional QE next year with the sequencing of purchases now being less front-loaded than previously expected.

With the notably higher revisions in inflation projections, the ECB moderated its tone with President Lagarde emphasising that net purchases can be stepped up again if and when needed and that rate hikes remain highly unlikely next year. Lagarde mentioned that flexibility in PEPP reinvestments will continue to limit fragmentation risks in the Euro sovereign bond market.

While the decisions of December mark the continued reduction in central bank support, financing conditions are expected to remain well supported given that monetary policy adjustments are clearly telegraphed in advance and the changes are being effected very gradually. Secondly, whilst voicing confidence in the economic recovery, the ECB continues to show a high degree of sensitivity to the high uncertainty around the economic outlook.

United States

The annualised GDP growth rate second estimate for Q3 came in at 2.1% quarter-on-quarter, compared to the revised first estimate of 2.2% and the originally expected 2.7%.

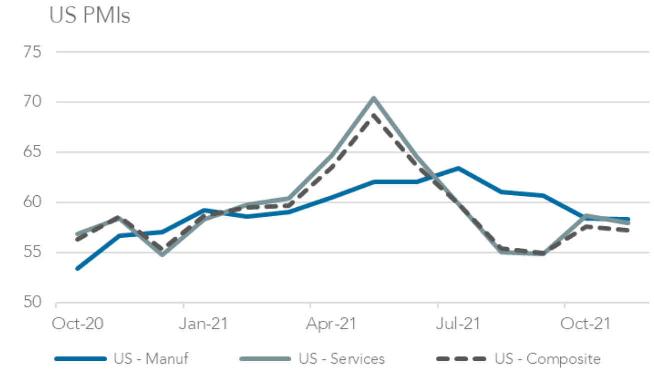
Goldman Sachs cut its outlook for US economic growth to 3.8% in 2022 (previously 4.2%) on a full year basis, citing risks and uncertainty around the emergence of the variant. "*While many questions remain unanswered, we now think a moderate downside scenario where the virus spreads more quickly but immunity against severe disease is only slightly weakened is most likely*". Goldman pointed the spread of the virus could worsen supply shortages should other countries implement tighter restrictions, but increase in vaccination rates among foreign trade partners would prevent severe disruptions.

October retail sales surged 1.7% month-on-month, above the prior 0.8% increase and the market expected 1.4%, as consumers spend more on early holiday shopping and gasoline. By contrast, spending at bars and restaurants was flat, despite the rapid easing of the Delta wave in the South. With case numbers in the rest of the country now on the rise again, the recovery in services spending is likely to remain muted. With the mix of spending moving away from services and back to goods, the pressure on supply chains is only going to get worse in the coming months, putting further upward pressure on prices.

Industrial production for October increased by 1.6% month-on-month compared to the prior decline of 1.3% and the market expected growth of 0.7%. This came in as the unwinding of earlier hurricane-related disruptions and a partial recovery in motor vehicle production boosted manufacturing output. But with global supply problems likely to persist and many factories still not running on full capacity, a rapid pace of growth will unlikely last.

The November final Markit Composite PMI stood at 57.2 compared to the prior 57.6 and the market expected 56.5. Output was led by the Services sectors, as factories were hampered by supply chain disruptions. The upturn in new business was solid amid a strong expansion in services new orders. Meanwhile, foreign client demand signalled a renewed rise. Sharper increases in Manufacturing and Service sector input prices led to the fastest rise in cost inflation on record. Alongside greater fuel and material costs, firms noted a steeper uptick in wage bills. Despite employment rising at the fastest pace since June, firms continued to struggle to work through backlogs of work, which rose at the second-fastest pace on record.

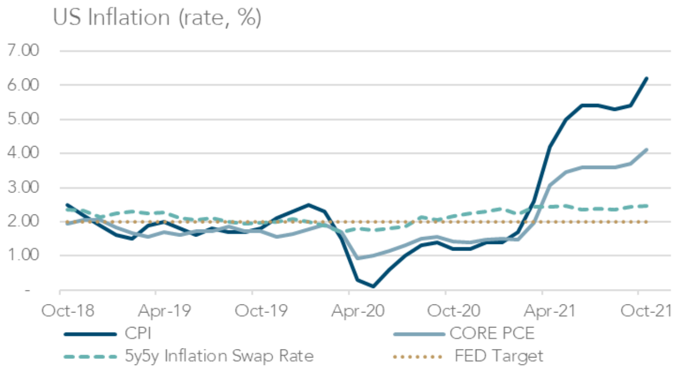
The October annual inflation rate stood at 6.2% compared to the prior 5.4% and the market expected 5.8%, as the upward pressure from supply shortages remains intense and that, even when these effects eventually fade, rising cyclical pressures are likely to keep inflation



Source: Bloomberg

unusually high. Similarly, the October core inflation rate increased to 4.6% from the prior 4% and the market expected 4.3%. The gain in core prices was helped by the unwinding of the earlier drag on travel services demand from the Delta variant, with prices for hotel rooms and car rentals rebounding.

Economists believe that while it remains difficult to predict how far or for how long the various "transitory" factors will boost inflation, there is mounting evidence that inflationary pressures are building throughout the economy, underlining their view that inflation will remain elevated for much longer than Fed officials expect.



Source: Bloomberg

Economists believe there is some debate about whether Omicron will add to inflationary pressure if it affects supply more than demand, but the recent pullback in energy prices suggest that, initially at least, the impact will be strongly disinflationary.

The unemployment rate for November came in at 4.2% compared to the prior 4.6% and the market expected 4.5%, marking the lowest unemployment rate since February 2020 as the number of unemployed persons fell by 542k to 6.9m. The labour force participation rate edged up 61.8% from the prior 61.6% (1.5pps lower than in February 2020).

The US economy added 210k jobs in November, below the prior 546k and the market expected 550k, the lowest increase since the 306k decline in December 2020. This suggests that the labour market recovery was faltering even before the potential impact of the new variant, possibly due to the rising infection rates. The headline miss was largely due to a muted 23k rise in leisure and hospitality payrolls, hinting that the winter wave of virus infections could already be weighing on that sector. With new cases on the rise again even, leisure sector employment growth looks set to remain weak over the winter. Average hourly earnings for all employees on private non-farm payrolls increased by 0.3% month-on-month in November compared to the prior and market expected increase of 0.4%.

During the December Federal Open Market Committee ("FOMC") meeting, the Fed has decided to double the pace of reduction in asset purchases from USD 15 billion a month to USD 30 billion a month and to terminate net asset purchases in March 2022. The move to lower the pace of purchases at a faster rate was accompanied with a more aggressive "dot plot" showing committee member projections that rates will be hiked three times in 2022 and another three times in 2023.

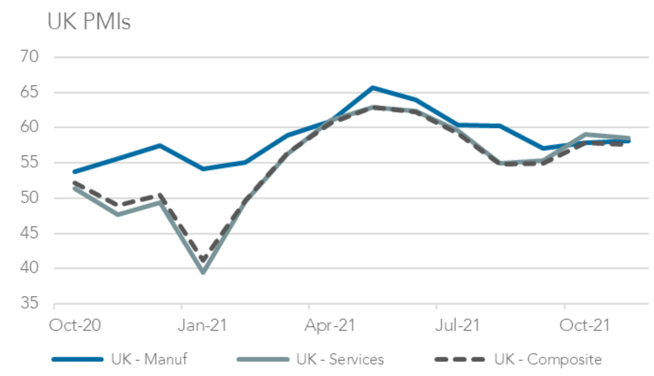
The hawkish outcome of the meeting marks the growing preference by the Fed to normalise monetary policy and curb the high levels of inflation currently being recorded.

United Kingdom

The GDP growth for September was of 0.6% month-on-month, compared to the prior revised 0.2% and the market expected 0.4%. This showed that the economy regained some momentum in September. However, economists believe that continued shortages and the drag on real incomes from higher utility prices will probably result in growth fizzling out soon. The preliminary GDP growth rate for Q3 stood at 1.3% quarter-on-quarter compared to the original expected 1.5%.

September industrial production fell 0.4% month-on-month following the prior month's growth of 1.0% and the market expected growth of 0.2%. This was the result of losses by the electricity and gas sector, oil and gas extraction sector, mining and quarrying sector, water supply, sewerage and waste management sector, and manufacturing sector.

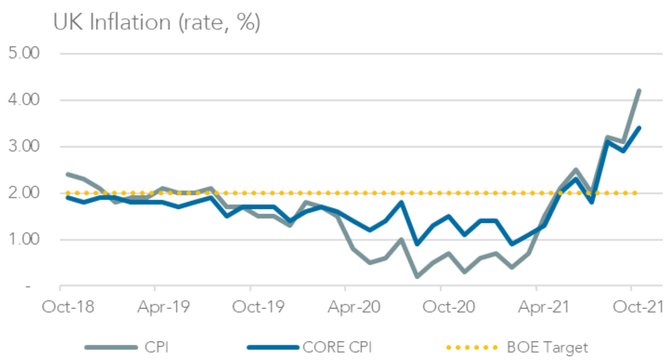
October retail sales grew by 0.8% month-on-month, better than the prior month's 0% and the market expected 0.5% growth, marking the first rise since April 2021. The data releases shows added evidence that activity held up well in October. Consumers continued to revert to pre-pandemic habits with the main upward contribution coming from non-food store sales. Clothing store's sales volumes in October 2021 were only 0.5% below February 2020 levels, reportedly boosted by consumers bringing forward Christmas shopping. In contrast, sales of auto fuel declined 6.4% as consumption returns to more typical levels following strong growth from September's fuel crisis.



Source: Bloomberg

The November final Composite PMI stood at 57.6 compared to the prior 57.8 and the market expected 57.7, with the services sector growth remaining stronger than the recovery in manufacturing production, as the latter is held back once again by shortages of raw materials and electronics components. New order growth and the pace of job creation remained strong overall despite staff shortages, while inflationary pressures continued to build. New export sales fell amid reports of weaker demand from China, disruption to trade with the EU in part due to Brexit, and the cancellation of some orders due to extended lead times. Capacity also remained stretched at UK manufacturers, with backlogs of work rising to a near record extent.

The annual inflation rate for October stood at 4.2%, above the prior 3.1% and the market expected 3.9%. Similarly, the October core inflation rate stood at 3.4%, above the prior 2.9% and the market expected 3.1%. The bigger-than-expected leap took CPI inflation to a 10-year high and to twice over the BOE's target. The majority of the CPI surge was due to an 11.9% month-on-month gain in utility prices after Ofgem (the energy regulator) raised the standard price cap on 1st October, which lifted utility price inflation from 2.8% to 22.9%. A 3.0% month-on-month rise in fuel prices pushed up fuel inflation from 17.8% to 21.5%. Energy price inflation rose from 0.2% to 7.8% and food inflation rose from 0.9% to 1.3%.



Source: Bloomberg

The rise in UK core inflation in October was partly due to the increase in VAT from 5.0% to 12.5% on 1st October for the hospitality/tourism sector. Indeed, restaurant/ hotels inflation rose from 5.1% to 6.3%. But there were also signs that the combination of strong demand, rising global costs and shortages pushed up inflation elsewhere.

Economists believe that unfavourable base effects may raise CPI inflation to 4.9% in November and the surge in wholesale energy prices may take it to 5.0% by April next year.

The unemployment rate for the three-month period ending September stood at 4.3%, compared to the prior 4.5% and the market expected 4.4%. Still, the rate remained 0.3% higher than pre-pandemic. Employment rose by 247k in the three-month period ending September (prior: 235k; expectations: 185k), with the increase being driven by a record high net flow from unemployment to employment. Total job-to-job moves also increased to a record high of 979k during the same period, largely driven by resignations rather than dismissals. The 3-month year-year average earnings (inc. bonuses) rate eased from 7.2% to 5.8% in the three months ending September (expectations: 5.8%).

The BOE surprised with a 15bp hike in its policy rate in the December meeting as it weighed the high rates of inflation against the growing risks to the economic outlook as cases surged once again in the UK.

Monetary Policy Committee members voted 8-1 in favour of a hike indicating a strong agreement that economic conditions warranted the hike. This came on the back of strong labour market and inflation data while the economic outlook was only marginally downgraded in the face of the Omicron threat.

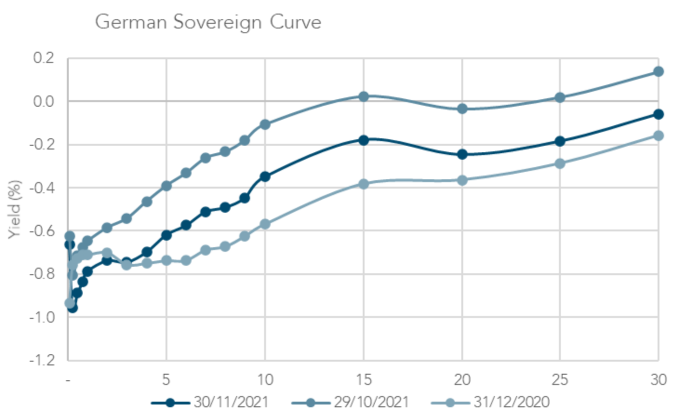
As we look at February as the next meeting when the BOE will likely raise rates to 0.50%, we expect that the BOE will stop the reinvestment of redeeming QE holdings. The BOE is also expected to start actively selling QE holdings when the policy rate reaches 1% which could be later in 2022.

The monetary policy path however will remain closely linked to the ongoing economic and inflationary developments and the impact from another surge in cases.

RATES

Euro Rates

The shift lower in the German sovereign yield curve was initially driven by safe haven flows given the rising cases across Europe and the increased hospitalisation rates in certain countries leading to the introduction of curtailment measures. The move was exacerbated by the Omicron news towards the end of November.



Source: Bloomberg

The outcome of the December monetary policy meeting of the ECB was more hawkish in view of the recent uptick in Eurozone inflation despite the growth concerns given the surge in cases. The Governing Council confirmed that net purchases will end in March 2022 and that net asset purchases under PEPP will be conducted at a slower pace until then.

As we have anticipated, the ECB is now seen to be underdelivering on QE expectations, which will continue to support wider sovereign spreads. Increased downside risks to the growth outlook and reduced support from QE purchases strengthens these expectations.

Having said that, rate hikes remain unlikely in 2022 given the broad expectations of an equally notable decline in inflation in 2022 and the limited evidence of rising prices affecting wages persistently.

Our medium-term expectation is that, as the range of outcomes due to COVID (and Omicron) uncertainty stabilises and central bank intervention is gradually scaled back, we expect the yield curve to shift back higher with scope for steepening. However, in the near-term we continue to see risk for flatter curves as long-end yields are weighed down by imminent risks to the growth outlook.

The belly of the curve in core yields remains vulnerable given the high optionality around policy rate adjustments which could lead to higher premia to be built in this part of the curve.

Although net asset purchases under PEPP wil lend in March 2022, the ECB has highlighted the benefits of flexibility in asset purchases. This flexibility is expected to be carried onto the reinvestment of PEPP holdings and could possibly also be adopted in their APP (ongoing) purchases.

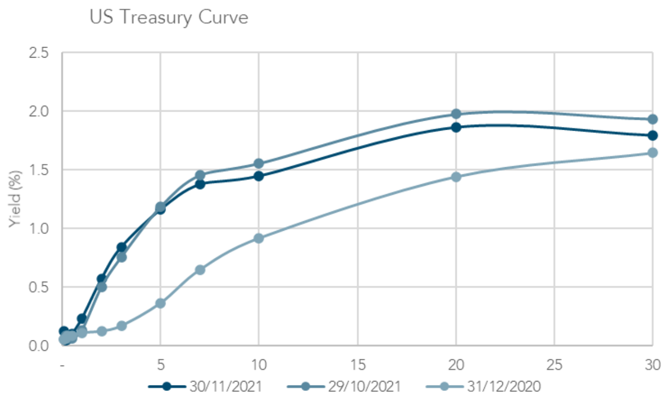
This change in modality is generally supportive for spreads. However, the greater factor that will influence spreads is the size of stimulus and the pace of reduction. The temporary increase in the APP programme in Q2 and Q3 of next year is expected to smoothen the transition when PEPP purchases terminate.

The risk is tilted towards more hawkish communication in upcoming meetings in the absence of any significant deterioration in growth dynamics. This, coupled with increased downside growth risks due to the surge in cases and introduction of measures could see sovereign spreads widen further.

US Rates

November saw the US treasury curve flatten as long-end yields moved lower while front-end yields remained elevated despite rising COVID concerns. The new wave of infections in Europe raises the possibility of a similar development in the US. The very long-end (20s30s) has inverted. Long-end yields moved lower as a result of inflation breakeven rates and long-end real yields moving lower.

Short-end rates have been volatile given the cross-currents of rising COVID concerns and risks to the growth outlook on one hand, and the high levels of inflation and labour market developments on the other. Flattening is therefore driven by the hawkish pivot from the Fed and downside risks from the Omicron variant.



Source: Bloomberg

US treasuries, particularly in the front-end, have underperformed as yields remained fairly elevated compared to the UK and the Eurozone, despite fears of another wave of infections. This seems to be mainly explained by increased confidences of a limited economic impact from another surge in cases compared to other regions given the strong activity and inflation data.

While the marginal contribution towards higher downside risks was expected to keep the bar high for an acceleration of tapering and rate hikes, the Fed decided in December to accelerate the pace of reduction in net asset purchases with committee members now wexpecting three rate hikes in 2022. Markets seem to be expecting the first rate hike in the second quarter with implied pricing now showing higher odds of a hike in March. This will likely gain further traction if labour market data continues to come in strong and inflation remains elevated.

At this stage, a re-pricing higher in intermediary maturity yields is less about a milder virus outbreak in winter and more about the recovery in economic slack and spot levels of inflation.

If front-end yields continue reprice higher, the very steep slope of the real rates curve (inflation swap curve is inverted) may provide a buffer for the belly and long-end yields (decelerating growth next year should offset upside risks from labour market recovery and inflation). Long-end yields are still expected to trail higher through the cycle but volatility in the short-end rates is expected to remain higher given near-term uncertainty on the rate hike trajectory. On the other hand, given the elevated front-end pricing, a surge in cases and a slowdown in the economic recovery could lead to a repricing lower of rate hike expectations if the Fed back-steps towards a softer tone.

The implication for the medium-term outlook on yields depends on the impact of the virus and the pace of recovery in economic slack. Given the Fed's greater emphasis on inflation risks, front-end prices can prove to be less sensitive, keeping the yield curve fairly flat despite uncertainty on the variant's severity.

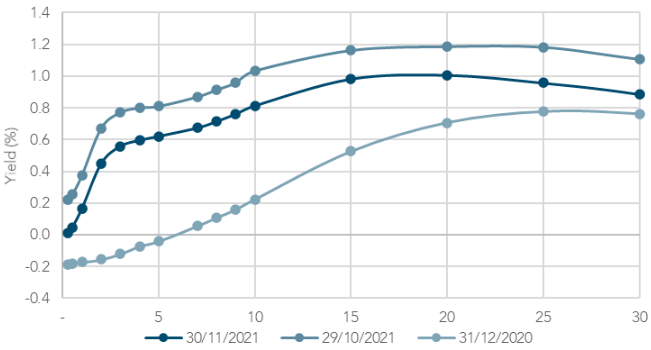
The initial reaction to the Omicron variant was a repricing lower of policy tightening expectations, but more recent Fed comments have lead to the rebuilding of front-end pricing. Weak market sentiment on the back of negative COVID headlines have intensified this price action and could lead to short-term episodes of relief steepening.

Our medium-term expectation is that the yield curve will move higher next year and maintain a flattening bias given: (a) the low possibility attributed to a reassessment of Fed rate hike expectations despite the new variant uncertainties; (b) the absorption of economic slack and high inflation offsetting the concurrent deceleration in growth; and (c) upside risks from an acceleration in taper/rate hike expectations.

UK Rates

Similar to the movement in Euro rates, the UK gilt curve shifted lower given the renewed downside risks due to the surge in cases, as well as the BOE's decision in November to push back on rate hike expectations by surprisingly keeping rates unchanged in November. Having said that, the steep slope in front-end rates saw limited retracement, which is why the move lower across the curve led to a marginal flattening in 2s10s (flattening was more pronounced in the US and for good reason).

UK Sovereign Curve



Source: Bloomberg

Recent economic data releases came in relatively strong (unemployment rate, firm insolvencies and consumer confidence) and with upcoming labour and retail sales data expected to corroborate the positive trajectory, the reasons for a hike shortly have strengthened.

As we have pointed out in previous updates, the risk premium priced in front-end rates in the UK curve seems high particularly in view of the new risks surrounding the increase in COVID cases and the Omicron variant making expectations going into the BoE December meeting much less clearer. In fact, market implied pricing for the December meeting was neutralized with the market pricing for the first rate hike being pushed out to March 2022. The BoE surprised the market with a 15bp hike in December in a move to combat the high inflation in the UK.

The updated issuance guidance at the end of October surprised markets by undershooting expectations by around £25bn. The positive effect from lower net-supply led to some near-term relief with yields pulling lower on the news. Having said that, despite the adjustment lower, the expectation is that issuance will remain high in upcoming years which should put pressure on prices as BOE purchases come to a halt.

Increased near-term risks are leading to a higher possibility of a sizeable reassessment in the policy path of the BOE, particularly since the market pricing of the policy rate trajectory is fairly aggressive. This could be particularly the case in the event of increased growth concerns given a slowdown in activity on the back of the surge in cases over the winter months and the BOE's conditionality on labour market performance. This, combined with the recent cut in supply guidance, will likely remain supportive for UK duration in the near term.

However, the medium-term outlook remains underpinned by (a) the eventual stabilization in COVID trends (and risks), (b) the extended period of high inflation, (c) the normalisation/tightening in monetary policy and (d) the increase in issuance to sustain deficits which tilts the risk towards higher yields across the curve.

CREDIT

Euro Credit

European corporate credit spreads widened against the bund in November as investment grade ("IG") spreads widened by c. 22bps while high yield ("HY") spreads widened by c. 46bps.

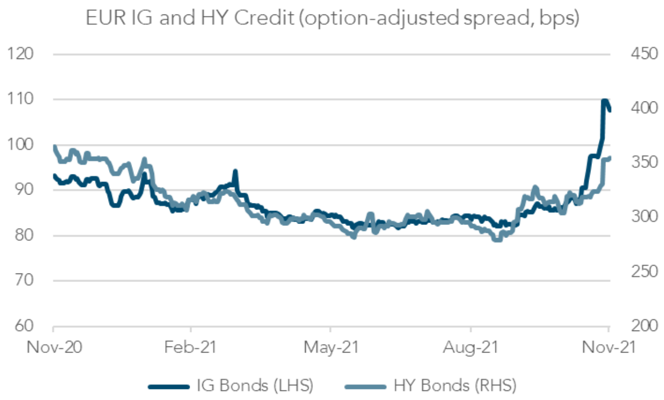
While spreads within both segments of the market widened marginally during the first half of the month, spreads widened further during the second half of the month following reports of a new COVID-19 strain discovered in South Africa. The announcement of the new strain led to a flight to safety as investors flocked to safe haven assets such as the bund and reduced their exposure to corporate credits, particularly HY debt. In fact, the bund declined to c. negative 35bps at the end of November compared to the c. negative 11bps at which it closed at the end of October.

While the market focused on the effects of the Omicron variant, the rise in inflation in the Euro Area together with the ECB's approach towards laxer monetary policy compared to other major central banks were also high on the agenda in November.

November was much worse than what the 0.2% total-return gains for EUR IG credit show, as the asset class effectively lost 1.07% in excess returns. This was driven by a 21bp spread rout which was effectively masked by a 25bp bund tightening, highlighting once again that the tight absolute starting point for IG spreads were insufficient to absorb volatile movements in benchmark rates. IG returns will continue to be at the mercy of bund moves, in addition to the ECB buying less in QE over the medium term. Further lockdowns in Europe will likely again hurt spreads - which are still tight despite November's moves - though as we have seen in November in the case of IG credit, movements in benchmark rates will play a bigger role in overall returns. We expect December net supply to be tiny, as per historical norms.

The weakness in EUR HY, by comparison, is much closer to what we would ordinarily expect from a global risk-off rally, as investors shifted assets out of COVID-exposed higher yielding sectors and into safe havens. The negative November returns were evident across all sectors, though Transportation and Energy fared the worst, after posting a 1.25% and 1.03% total-return losses respectively, as new variant fears took hold.

Looking into next year, given where we are in the recovery cycle and despite recent widening, we think the potential for further material broad-based spread compression appears limited. With limited scope for further compression, our options are to position for carry and fundamentally driven relative performance or, positioning for selective decompression in sectors still under pressure from the pandemic. Given a supportive backdrop in Euro, we think it may be premature to position defensively for materially wider spreads, particularly following the recent moves, and instead remain focused on identifying sectors with some remaining upside potential.



Source: Bloomberg

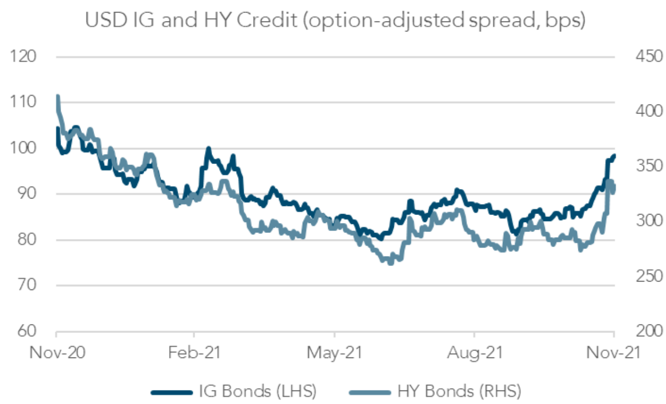
Despite the volatility going into December, across currencies we think the picture will likely be friendlier in the Euro Area than in the US for credit investors. Aggregate demand in the Euro Area is poised to remain strong in 2022, buoyed by a positive growth impulse from the EU Recovery Fund as well as expansionary fiscal policy in Germany. The expectation so far is for a more benign inflation backdrop relatively speaking, which leaves some scope for monetary policy to surprise to the dovish side relative to current market pricing. Nevertheless, we continue to expect PEPP to be concluded in March 2022, though to be followed by a temporary uplift in APP to bridge the remainder of 2022 and ease markets into this transitionary period. This policy gap remains one of the key drivers for our relatively more constructive view on EUR spreads vs. USD counterparts for the time being. Similarly, relative to the USD market, the shorter duration of the EUR IG market as well as its higher spread carry following recent moves is comforting.

Simultaneously, we think the bid for carry will remain strong, as it has been through most of 2021, which leaves us constructive on EUR high carry securities - such as HY bonds - which we expect will outperform IG bonds on a risk-adjusted basis. In effect, the prospect of a slow and gradual normalization of monetary support, coupled with the strong portfolio rebalancing incentives powered by the ECB purchases leaves the case for higher yielding securities quite strong. The risk to this view would be further fears around new variants of the virus derailing the recovery, driving subsequent risk-off rallies that could push HY spreads notably wider.

US Credit

US corporate credit spreads widened against the treasury in November as IG spreads widened by c. 12bps while HY spreads widened by c. 50bps. The US treasury yield trended upwards following the Fed's announcement that it would be scaling back its monthly purchases of $120 billion as the US economy continues to recover amid rising inflation while the central bank decided to keep the federal funds rate unchanged. However, a sell-off ensured during the latter stages of the month, following the announcement of the Omicron variant as the yield on the US treasury declined to the 1.44% level with a sell-off in corporate bonds ensuing and leading to the spread widening seen during the month.

In our last update, we highlighted the likelihood for US spreads, particularly within the HY space, to underperform Euro counterparts. Spreads indeed widened c. 50bp during the risk-off rally (Euro +45bp), pushing US HY 0.97% lower during the month as news of the Omicron variant sent investors seeking safe haven assets.



Source: Bloomberg

Despite the move, credit conditions continue to remain largely favourable, although risks are looming – primarily those around inflation pressures and supply disruptions (including labour shortages) that many borrowers face. The potential for coronavirus variants (such as Omicron) adds another layer of uncertainty about the pandemic and its effects on the economy and credit. With inflation running "stronger and longer", the potential for central bank policy missteps has also increased. As price pressures combine with supply constraints, investors could soon demand higher returns for the risks they are assuming. While pent-up demand has so far outweighed the effects of increasing costs, with many issuers able to pass through prices and maintain profit margins, some sectors have found pass-through to be more difficult. Barring a stabilization or a decrease in input costs, borrowers in a number of corporate sectors may soon suffer profit-margin erosion – of particular concern are brick and mortar retailers unable to stock shelves and operating in competitive environments.

On the supply side, after two exceptionally elevated years for USD IG and HY primary market activity, the expectation is for a return to a more normalized pattern for debt issuance in 2022, given the magnitude of pre-funding, refinancing and liquidity raising already completed.

For the USD IG market, Goldman Sachs forecasts $1.3tn of gross supply in 2022. While this would represent a steep decline vs. 2020 ($2.0tn) and a moderate deceleration compared to 2021 ($1.5tn forecasted), it would still place 2022 in line with the average of the 2014-2019 period. For the USD HY market, Goldman Sachs projects $325bn of gross issuance in 2022, which would represent a reprieve from the back-to-back records set in 2020 ($426bn) and 2021 ($450bn forecasted). That said, the 2022 forecast ranks at the high end of the range of the past several years (excluding 2020 and 2021). Since nearly two-thirds of the gross issuance volumes over the past two years have been earmarked for debt repayment or refinancing, USD HY maturity walls are in a very manageable position while cash balances among HY-rated corporations remain at record high levels.

Nevertheless, given the notable divergence in central bank policy and the wider spreads on offer across both IG and HY, we continue to prefer EUR spreads relative to US. Given the prospect of a lift-off in the second half of the year, we feel that the case has been strengthened for floating rate over fixed rate structures within any US exposure for our portfolios should opportunities arise.

UK Credit

Similar to its European and US counterparts, UK corporate credit spreads followed a similar pattern with spreads widening both in the IG space, by c. 11bps, and the HY segment by c. 42bps.

While the BOE's announcement to hike rates, contrary to market expectations led to an uptick in gilt yields, the move was hampered by the new COVID strain as the yield on the gilt declined to circa 0.81% by month-end. While data points during the month showed signs of recovery within the UK economy, the uncertainty brought on by the Omicron variant led to a sell-off in the corporate market which resulted in the widening of spreads seen during the month between the yield on the gilt and corporate bond yields.

As such, the December meeting resulted in a surprise hike of 15bps, and the trajectory for rate hikes is equally expected to remain fairly steep for 2022. The BOE remains more concerned that high inflation may interact with a tight labour market to drive wages higher, implying that the direction of travel remains toward stimulus withdrawal, when possible. For the ECB by contrast, where the labour market is looser and inflation is supposedly still seen as transient, the focus is on supporting the recovery for the time being which again, underpins our preference for EUR spreads vs both USD and GBP.

With that said, and this has become a recurring theme over the last few months, the wider spreads on offer for GBP corporate credit markets, more so in the speculative grade segment of the market, continue to provide adequate compensation for us to gain comfort around a medium term rate hike cycle of the BOE. We would favour shorter duration exposure (this, despite the potential impact to short term rates following implementation of rate hikes) to minimise the total return impact to holdings from a further widening in either spreads and rates.

Default Rates

With 67 default so far in 2021, the global corporate default tally has declined 67% in the year from pandemic-related peaks of 2020. Through 2021, global quarterly defaults continue to show a downward trajectory, with just seven defaults so far in the fourth quarter, down from 13 in the third quarter. With the continued slowdown in the number of defaults, the 12-month trailing speculative-grade default rate for the US declined to 2.0% in October 2021 from 6.6% in January 2021, while the European default rate fell to 2.5% from 5.1% during the same period.

Expectations remain for speculative-grade defaults to remain low through 2022, with issuer-weighted European and US default rates at c. 2.0-2.5% of HY issuers. On a par weighted basis, expectations are for default rates to be roughly 1.0-1.5% across bond markets, representing a continued benign environment, however looming risks around inflation pressures caused by supply disruptions as well as the recent emergence of the Omicron variant, have added to the uncertainty of the state of the economy and credit quality.

While there are several macro risks prevalent in the market that could reasonably cause some spread widening next year, they are unlikely to lead to a materially larger wave of defaults. Corporate fundamentals have improved significantly this year and are approaching pre-pandemic levels as: (a) cash balances are elevated, helping to keep net leverage under control despite higher total debt balances; and (b) issuers have, for the most part, pushed out near-term maturity walls.

While increased M&A activity or returning cash to shareholders could cause leverage to increase and create some spread volatility, lower interest expenses and tax rates suggest that HY issuers can support 0.75x higher debt loads than in the past. Simultaneously, commodity prices are expected to remain supportive, particularly within the energy sector (which has represented an outsized share of defaults in prior years), and primary markets remain supportive, further limiting the near term need for cash.

Through September 2021, speculative-grade upgrades outpaced downgrades by roughly 2.9x to 1 in the US and 1.7x to 1 in Europe. In early November upgrades began to sharply outpace downgrades, led mainly by banks, consumer products and oil & gas issuers. More recently however, an uptick in downgrades driven by brokerage and food retail sectors has again tightened the gap to just 10. The HY negative bias in both regions fell considerably in the 12 months to the end of October - in Europe to 18.1% from 45% a year earlier, and in the US to 14.4% from 45.1%.

Importantly, the positive bias over the same period had increased to 9.3% in Europe and to 11.4% in the US, resulting in many CCC issuers being upgraded despite higher leverage. The expectation is for a sustained economic recovery to translate into stronger revenue and earnings growth, with many sectors able to pass on higher input costs. However, this is unlikely to lead to a return of the pre-2020 rating distributions in either region given the significant move seen at the onset of the pandemic.

Bank ratings have scope to solidify at current levels. Noting the significant turnaround in the net rating outlook bias to +1% in November 2021 from -31% as of November 2020, most banks credit profiles look set to stay at current levels. By comparison, the global corporate sector showed a net negative outlook bias of about 6% in November 2021, with the gap versus banks mainly due to government support for households and corporates ultimately benefiting banks, as well as banks' diversified loan books, while certain corporate sectors (aviation and hotels) are still hampered by COVID-19.

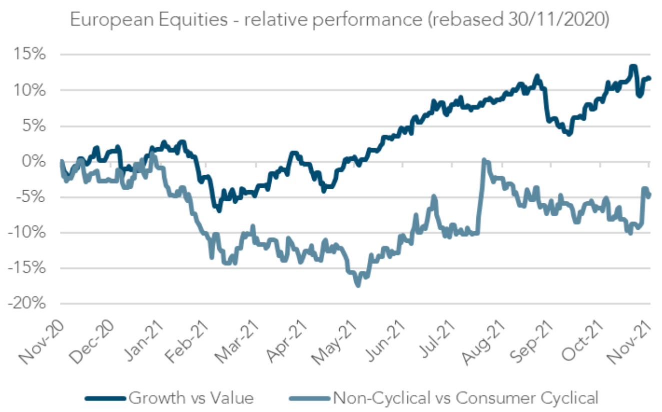
EQUITY

Equity markets were rocked in the final days of November as the World Health Organisation ("WHO") classified Omicron as a variant of concern ("VOC"), sparking rumours about its alleged high transmissibility rate and lower efficacy of currently available vaccines. These rumours stemmed from the fact that the new strain contains c. 50 mutations of which c. 30 relate to the Spike protein. This led to concerns about possible national blanket lockdowns being re-introduced which would have a severe impact on the global economy.

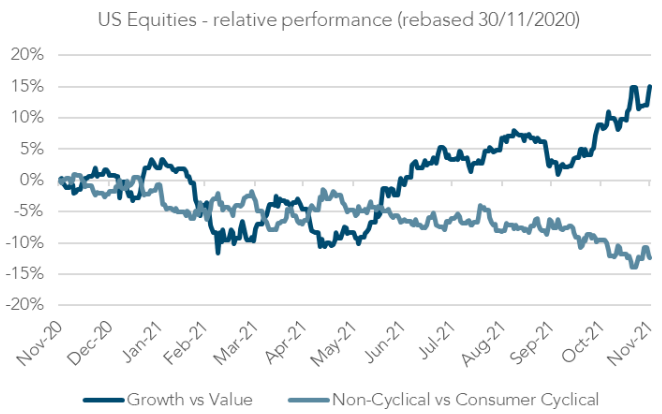
The equity market sell-off was sharp and indiscriminative. Global equities lost –3.0% intraday on 26th November following the WHO announcement that the Omicron variant was classified as a VOC. Despite the implication of possible impact on the global economy from blanket lockdowns, the performance of growth stocks (less sensitive to the macro outlook) outperformed value by only a slight margin (-2.8% vs -3.2%).

We think this implies that the nature of the sell-off was more risk driven rather than a change of positioning within the asset class based on the re-assessment of the global economic outlook. Our view is also underpinned by the impact lockdowns could have on the interest rate trajectory, with central banks unlikely to tighten in that situation. We would see this as net positive for long duration assets (growth stocks) and a continuation of the low growth and low rates environment.

There is a high degree of uncertainty around the characteristics of the Omicron strain. Despite the negative news-flow surrounding the new strain, physicians have



Source: Bloomberg



Source: Bloomberg

suggested that it may take 7 to 14 days to have a clearer view on the transmissibility, the severity of the new virus and efficacy of the currently available vaccines, as patient data is collected. South African physician Angelique Coetzee stated that so far she has not seen any cases that were serious. In Israel, a doctor stated that based on the limited data currently available, it seems that the Omicron will be a relatively mild illness compared to the Delta variant. WHO stated on 1st December that the present vaccines will likely protect against severe cases from the new Omicron variant, but so far they could not say if there is any loss of protection.

Contradictory statements from vaccine manufactures did not help sentiment. Both the University of Oxford, which helped develop the vaccine sold by AstraZeneca, and the head of Biontech, Pfizer's vaccine partner, have predicted that the current vaccine will offer some protection against the Omicron variant, which is in-line with the statement from WHO's chief scientist. However, Moderna's CEO stated in an interview with the Financial Times that new vaccines will be needed, predicting that there is going to be a "material drop" in protection offered by the current vaccines, before saying that we need to wait for the data. These contradictory statements have fuelled volatility in the equity market and we expect this to continue at least until mid-December.

Moderna and Pfizer are now working on new vaccines to target the Omicron variant. Pfizer/Biontech say that an updated version of the vaccine will be produced and shipped within 100 days if the new strain is found to evade existing immunity. Separately, Moderna's CEO stated that it would be risky to shift the company's entire production capacity to an Omicron targeted jab at a time when other variants are still in circulation, and that it would take until the summer to get a billion doses available.

We reiterate our positive view on the asset class going into FY2022 as it is too early to make any informed decisions on Omicron. The equity market is starting to price-in some of the impact of the new strain. However, we think we know too little about its implications to make any changes to our exposures and near-term outlook. The news-flow has been positive on balance so far and we expect a positive reaction should the Omicron virus be mild. Additionally, we ascribe to the view that Omicron could be a positive for equities, assuming it is found to be milder than Delta and becomes the dominant strain (i.e. has a higher transmission rate). In such a situation, the need for curtailment measures could fall, possibly leading to improved FY2022 macro expectations and a faster route to normality. Albeit, the global vaccination rate has stalled and needs to be addressed in order to avoid new strains developing.

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Developed Market Sovereign Bonds	Negative	U/W	Improving economic and labour market conditions, along with persistently higher levels of inflation have led to an overall hawkish tilt in global central bank messaging in recent weeks. We continue to favour an underweight allocation to sovereign credit as the risk of rate rises coupled with the withdrawal of monetary stimulus measures places an upward bias on benchmark rates over the medium term and a material headwind for investors on a total returns basis. Any exposure that is maintained should favour shorter duration positioning in order to limit the potential impact from upward parallel shifts in the benchmark curve. The outlook for periphery credits in Europe also remains uncertain at this stage as PEPP, a significant contributing factor to tighter peripheral spreads, will terminate in March 2022.
Investment Grade Corporate Bonds	Neutral to Negative	O/W	We believe that high grade returns will continue to depend largely on movements in benchmark rates, further stimulus and sporadic covid outbreaks remaining under control. The ECB has continued its narrative of sufficiently accommodative monetary policy, which provides comfort, however the tone has shifted to one that is somewhat more hawkish in terms of the withdrawal of covid-19 QE stimulus measures in early 2022. The broad Euro market IG corporate credit spread, despite some recent widening, continues to offer minimal cushion against benchmark movements, and the ability to hedge benchmark rates has become a critical factor within IG performance. The default and rating environment for global credit has continued to improve 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, which provides an element of comfort around the overall tighter spreads vs historical. We expect that recent spread widening driven by a resurgence of covid-19 cases to be short lived, though prefer to remain neutral given the upward bias to benchmark rates over the medium term.
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 and positive credit rating trends provide scope to continue to seek opportunities on a selected basis. We remain selective in holding high yield positions 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. Wider spreads available in HY continue to provide some additional buffer to movements in benchmark rates, and we prefer holding HY exposure in Euros vs USD where spreads are relatively more attractive and pressure on benchmark rates remains less prominent than alternative currencies.
Developed Markets Equities	Positive	O/W	Our positive view on European stocks has not played out entirely as we expected. Europe has underperformed the US for most of 2021, with May the only month where European stocks outperformed their US counterparts. The underperformance during 1Q21 likely reflects the lacklustre start to the vaccine deployment. This led to concerns that curtailment measures would have to be in place for longer, weighing on the region's economic growth. European equities picked up in 2Q21 as COVID-19 concerns started to fade. However, this soon reversed in 3Q21 and in October. In our opinion the underperformance in 3Q21 was driven by rising concerns around global economic growth. The recent surge in COVID-19 cases has amplified such concerns leading to a decrease in investor risk sentiment. We believe that this will be short-lived, unless the situation deteriorates further and national lockdowns are announced in the big-4 European economies. We have moderated our value tilt given the increased uncertainty on the economic outlook which weighing on cyclicals and value stocks.
Emerging Market Equities	Positive	N	Brazil was the biggest drag on EM performance in view of political and economic challenges. The sell-off in the EM space seems quite surprising relative to the gradual growth recovery (EPS up +5% over the past three months). We have temporarily squared our overweight allocation in EM equities given the sluggish economic recovery in EM ex-North Asia as a result of the slow vaccine deployment and the poor control of spread of the virus.

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

DISCLAIMER