Investment Strategy Update

February 2022

Curmi & Partners Research

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- Survey-based indices and high frequency data dipped in January showing the impact of the temporary period of lockdowns and slow activity.
- Labour data continues to show gradual improvement in the number of persons employed across advanced economies with the Euro Area unemployment rate falling below pre-pandemic levels to 7%.
- The US unemployment rate edged up to 4% in January despite continued increase in jobs, given that the participation rate increased to 62.2%.
- Inflation rates surprised to the upside once again with headline rates in US at 7.5%, UK at 5.5% and Euro Area at 5.1%, leading to increased expectations of imminent monetary policy tightening.
- Market expects the Federal Reserve to hike rates in 2022 and announce the start of the balance sheet reduction towards the end of the first half.
- Similarly, the Bank of England is expected to raise rates to 1.50% with the implication that active sales of QE holdings may start later this year.
- Market expectations point to two rate hikes by the European Central Bank in 2022, implying a termination of QE purchases in Q3.
- The pricing in of a faster rate hiking trajectory by the major central banks led to a sharp movement higher in yield curves driven primarily by real rates rising while inflation breakeven rates remained fairly flat.
- The prospect of lower monetary accommodation and heightened geopolitical tensions led to the widening of sovereign and corporate bond spreads and negative returns across major equity market indices.
- We believe that front-end pricing on the back of rate hike expectations is excessive at this stage and we are probably at the peak of rate hike expectations.
- We note that US curves have scope to move higher by as much as 50bps at longer tenors given the market's underestimation of the terminal policy rate.
- In view of the sharp yield movements already seen so far this year, we expect any further moves higher in yield curves to be more gradual but we expect US and UK rates to underperform.
- With the wider dispersion in spreads, we are looking to continue increasing our exposure to high yield credit on the back of continued improvement in credit fundamentals.
- We are looking to shorten our duration profile further in episodes of market respite by increasing exposure to short-dated corporate bonds and floating rate securities.
- We remain optimistic on equity markets and we are looking to re-establish an overweight allocation with a minor tilt towards European value stocks following the broad-based pullback we have seen across major equity markets since the start of the year.

In recent weeks, markets have been dominated by gyrating headlines covering the Ukraine conflict and the upside surprises in inflation data releases resulting in higher uncertainty on its future trajectory. Moreover, we have seen a relatively weak patch of economic data releases showing a slower momentum in activity as a result of the Winter lockdowns, primarily evidenced in survey-based indices.

The persistently high inflation prints have added to expectations of a faster rate hike trajectory by major central banks. However, current market pricing is implying a fast, yet shallow, rate hiking cycle. Looking at forward swap rates in the US, the market is already pricing in up to seven rate hikes in 2022. However, the terminal rate for overnight funding implied by the market is of about 1.70%. This level seems to be unreasonably low when considering the strengthening economic fundamentals and the very high levels of current inflation. In fact, the Fed as well as consensus estimates are projecting a long run policy rate of 2.5% in view of the current inflation and growth dynamics.

The low implied terminal rate in US curves suggests that yield curves have more room to move higher despite the sharp moves which we have already seen in the first weeks of the year. The disconnect between market pricing and economic forecasts of monetary policy tightening may be explained by three possible causes.

The first potential cause is that the market is reflecting fears that a sharp increase in policy rates may induce an economic slowdown, or possibly a recession, mainly on the assumption that rate increases cannot be delivered fast enough to curb inflation resulting in a dramatic tightening in financing conditions.

The second potential cause is the possibility that equilibrium may be found at a lower terminal rate than what current projections consider to be a fair long-run policy rate. This could materialize if inflation falls to more normal levels faster than expected as economic conditions and supply chains normalise allowing central banks to halt rate hikes.

Lastly, the third potential cause is related to technical market aspects which may explain a supply and demand imbalance at longer maturities. Current funding rates remain at very low and cheap levels allowing for a decent pick up in yields. Moreover, the US treasury market currently still offers an attractive yield premium even on a hedged versus other funding currencies, namely the Euro and the Japanese Yen.

In view of our broad assessment that economic fundamentals are improving, primarily given the continued strength in labour market data, we tend to ascribe to the third potential cause. The implication here is that the realisation of rate hikes is still likely to be a catalyst for an upward re-rate of benchmark yield curves, especially if COVID-related risks continue to recede and geopolitical tensions are resolved in a diplomatic manner.

This baseline expectation is supported by our current assessment that economic growth momentum will remain robust and that activity data will continue to point towards an above-average rate of expansion beyond the first quarter of the year. We expect the global economy to expand by more than 4% in 2022, which is materially above potential on the back of improved medical resources and measures to limit the impact from another surge in virus cases, as well as the high level of savings which should continue to sustain consumption.

We expect growth in the US to be modestly below consensus levels of 3.8% given the net fiscal drag and some negative impulse from tighter financing conditions. On the other hand, the Euro Area should grow at above consensus levels of 4.0% supported by pent-up savings, continued gradual rebound in labour markets and sustained fiscal support with the disbursements of the Recovery Fund.

These conditions should provide a solid underpinning for continued growth in earnings thus allowing for a relatively smooth hand-off from high equity valuations to higher EPS levels with limited, or short-lived, deterioration in price levels. On this basis, we are taking advantage of the recent pullback in equity markets to deploy cash and increase our equity risk across our investment strategies focusing primarily on European value names, although we prefer to maintain a more balanced exposure across stock types at this stage.

The unfavourable interest rate outlook presents a material headwind to fixed income markets given that movements in benchmark yields and credit spreads are expected to limit bond market returns this year. Having said that, credit fundamentals are strong and improving which gives us the comfort to add exposure further down the risk spectrum. We prefer maintaining a short duration bias to limit the sensitivity to interest rate movements and selectively add instruments that offer sequentially better returns in a rising yield environment.

MACROECONOMIC

Euro Area

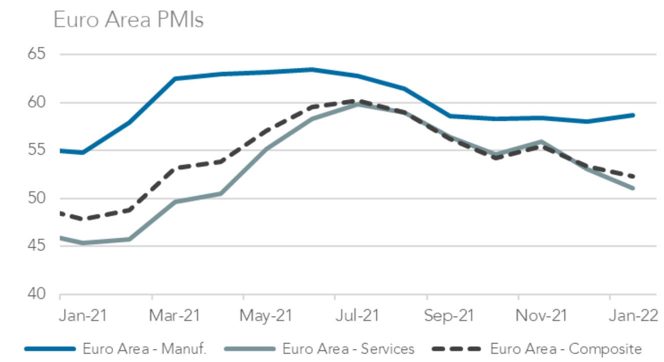
Analysts believe that, against the backdrop of a struggling services sector from tighter restrictions and consumer caution, there is now a great chance that GDP actually contracted in Q4. In fact, the flash estimate for Q4 is now at a meagre 0.3% quarter-on-quarter, the slowest growth in three quarters, mainly due to the Omicron spread and restrictions which hurt the services sector, while labour shortages persisted due to health concerns or quarantine rules. Considering the full 2021 (with flash Q4), GDP advanced 5.2%, slightly above the ECB estimate of 5.1%.

2022 will likely have a weak start as Omicron prompted additional restrictions at the start of the year and made consumers more cautious in social settings. However, with hospitalisations remaining fairly low, any hit to the economy is likely to be small and temporary. Additionally, with many countries now easing restrictions, with some lifting restrictions entirely, we should see the recovery resuming in the coming months.

With regards to the ongoing tension in Ukraine, a Russian military invasion would adversely affect the Euro Area economy by disrupting energy supply, pushing up inflation and reducing household real income. However, analysts believe any economic fallout would probably be fairly small and short-lived and other factors will continue to have much more influence on the economy. The economic fallout from a conflict would depend on the extent and duration of any action.

Industrial production for November grew by 2.3% month-on-month, rebounding from three consecutive months of contraction and easily beating market expectations of a 0.5% growth. Production in all sectors rose with the exception of durable consumer goods. Production of cars continued to increase in November (+4.8% month-on-month), but it is still more than 25% below pre-pandemic levels, highlighting how much supply shortages are still hampering the sectors. What is more, in December, firms outside the auto sector are struggling with supply chain problems too due to shortages of materials. The big picture is now pointing towards a contraction in industrial production for Q4.

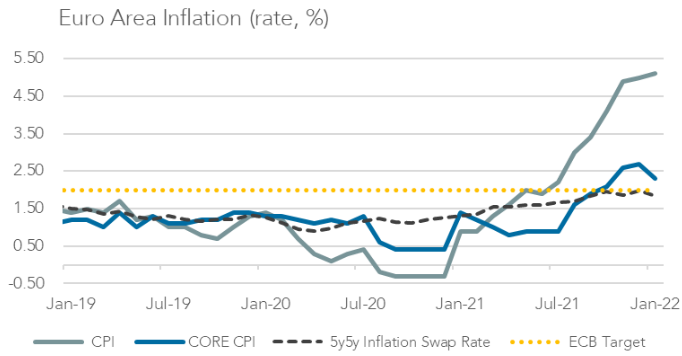
Retail sales sank 3.0% month-on-month in December, the biggest decline in eight months and much worse than market forecast of a 0.5% fall, amid rising Omicron cases and as restrictions were re-implemented. The drop in retail sales volumes in December means that sales growth slowed significantly in Q4 as a whole and possibly in January as restrictions remained in placed till at least mid-month in many countries. While we expect consumer spending to recover over the coming months when restrictions are fully lifted, growth will be constrained by low inventory levels and higher prices.



Source: Bloomberg

The final January Composite PMI stood at 52.3 compared to the prior 53.3 and the flash estimate of 52.4. This signalled a slowdown mainly in services activity due to Omicron constraining activity, while factory activity experienced the strongest growth in five months. New business growth was the weakest in eleven months and operating capacities continued to be stretched across the region, reflecting issues relating to staff availability and supply chain shortages.

Manufacturers seem to be better prepared for the Omicron wave compared to other variant spreads, and prospects are brighter following a further reduction in supply chain delays. With regards to services activity, this will likely pick up as restrictions are eased in the region and consumers return to normal spending patterns.



Source: Bloomberg

The flash annual inflation rate edged higher to 5.1% in January, from the prior 5.0% and the market expected decline to 4.4%, the rise came mainly from Italy due to higher regulated energy prices. Energy continues to record the biggest price increase (28.6% vs prior 25.9%). The inflation rate remains well above the ECB's 2% target amid a power crisis in Europe which sent cost of natural gas, coal and electricity sharply higher while improving demand and pandemic-related supply constrains continue to put upward pressure on prices. On the other hand, the flash core inflation rate eased to 2.3% in January, compared to the prior 2.6% and the expected 1.9%.

Analysts believe that headline inflation will likely fall to c. 2.5% by year-end, though this is assuming that both oil and natural gas prices come down significantly from current levels. This assumption already seems to be questionable given geopolitical tensions in the oil producing states and small OPEC members already not meeting their output hike levels, possibly resulting in tighter levels of oil supply. Analysts are further forecasting core inflation to remain above 2% this year, due to the combination of strong demand, lingering supply chain issues and tight labour market conditions.

The unemployment rate fell to a record low of 7% in December from the prior 7.1% and the market expected 7.1%. Demand for labour continues to improve amid the ongoing economic recovery. The labour force in Q4 almost returned to its 4Q2019 size. Most of the spare capacity that built up during the pandemic now seems to have been absorbed, suggesting that wage growth will start to pick up as the number of persons filing as unemployed is much lower than the growing number of job vacancies which remain unfilled.

The ECB maintained key interest rates at record low levels in the February meeting and pledged to steadily reduce its bond purchases this year, despite a record rise in inflation. The ECB said that activity should rebound strongly as factors restraining production and consumption should ease while labour market conditions continue to improve. Lagarde mentioned that the bank is "much closer to target" on inflation. Still, during the press conference, Lagarde said that inflation risks are on the upside, but pressures should ease this year and that in March the central bank will be in a better position to assess the monetary policy, with the discussion being based on the updated projections.

Also, Lagarde declined to rule out an interest rate hike this year saying the central bank would assess conditions very carefully and there were "no pledges without conditionalities". The ECB confirmed it will discontinue net asset purchases under PEPP at the end of March 2022, and that monthly net purchases under APP will amount to €40 billion in Q2, €30 billion in Q3 and €20 billion from October onwards and for as long as necessary to reinforce the accommodative impact of its policy rates. The ECB also expects net purchases to end shortly before it starts raising the key ECB interest rates.

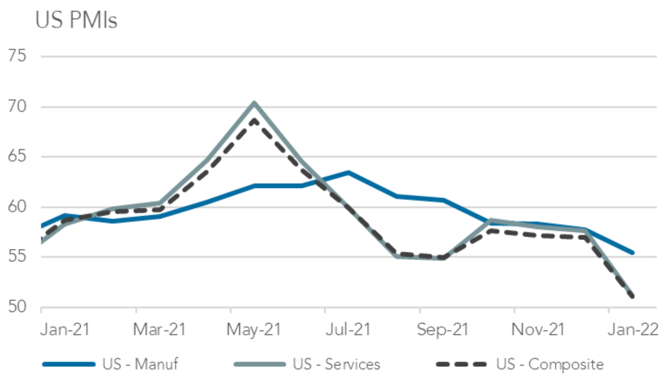
In response to Lagarde's comments during the press conference, investors increased their bets that the central bank will be forced to change course and raise rates more than once this year. Markets are pricing in a rise in the ECB's deposit rate from -0.5% to -0.1% by December. While the ECB left policy unchanged, her comments were widely interpreted as signalling a likely shift to tighten monetary policy earlier this year.

United States

The first estimate of the annualised Q4 GDP growth rate stood at 6.9% quarter-on-quarter compared to the market expected 5.5%. However, the Omicron wave at the end of the year means the economy is starting 2022 on a much weaker footing than expected, with a rebound in January being unlikely.

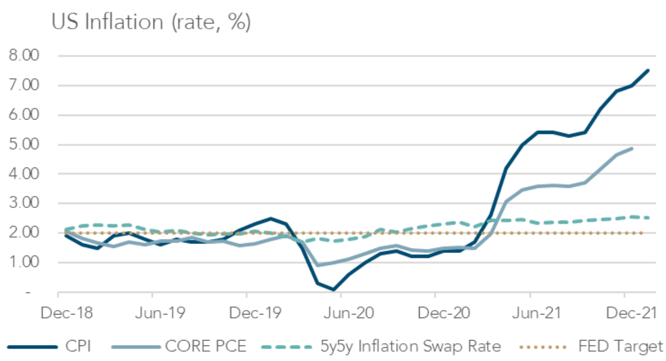
December retail sales sank 1.9% month-on-month compared to the prior +0.2% while the market expected no growth in retail sales. The slowdown came as a result of rising Omicron infections, a surge in inflation and as a large share of holiday shopping was pushed to earlier months on expectations of shipping delays. Most of the decline echoes 2020 trends, when sales in electronics, furniture and non-store sales jumped in October before falling sharply in December, meaning the December decline could be a seasonal problem. With Omicron, it is possible that January figures will show a much sharper drop than originally expected and there could be broader disruption to spending given the number of people self-isolating, but this will be short-lived given case growth have peaked before month-end.

December's industrial production sank 0.1% month-on-month compared to the prior 0.7% growth and the market expected 0.3% increase. The 0.3% month-on-month decline in manufacturing output was broad-based, possibly due to Omicron-related employee absenteeism weighing on output. The 1.3% month-on-month drop in motor vehicle output are less likely to be explained by semiconductor shortages as these continued to ease. In January 2022, there is a possibility of a more severe decline given Omicron absenteeism worsened, but this impact should quickly reverse as infections growth declined from its peak, restrictions were lifted and supply shortages continue easing.



Source: Bloomberg

The January final Composite PMI stood at 51.1, compared to the prior 57 and the flash estimate of 50.8. This pointed to the smallest increase in activity since July 2020. The expansion in new business also softened to the slowest pace since December 2020 as the Omicron wave weighed on demand conditions. A decline in manufacturing export orders dampened growth in new business from abroad. Additionally, firms were able to expand their workforce numbers further which helped to soften the degree of pressure on business capacity.



Source: Bloomberg

The annual inflation rate for January accelerated to 7.5%, the highest since February 1982, compared to the prior 7.0% and the market expected 7.3%. This was a result of soaring energy costs, labour shortages and supply disruptions, coupled with strong demand. Energy remained the biggest contributor to the inflation surge (27.0% versus the prior 29.3%), with gasoline prices surging 40.0% (versus the prior 49.6%). As gasoline futures continue to rally in line with oil prices, energy prices are expected to rise more sharply this month.

January's core inflation rate also surged to 6.0% compared to the prior 5.5% and the market expected 5.9%, the most since August 1982, illustrating that underlying inflationary pressures remain strong. The strength in core prices may have partly reflected temporary staffing shortages due to Omicron, with airfares up by 2.3% month-on-month, and a 1.1% gain in clothing prices reflecting the earlier disruption to Asian factories. There were also some encouraging signs that recent upward pressure from goods shortages is fading, with new vehicle prices remaining unchanged and used car prices rising by 1.5%. The strong rebound in new vehicle production and sales, which in turn should raise supply of used vehicles too, suggests that upward pressure on vehicle prices will soon fade. Core inflation will likely remain well above the Fed target for some time, despite a potentially more favourable base effects and the partial easing of supply shortages.

In January, 467k payrolls were added beating market forecasts of 150k. January figures were a big surprise as Omicron left many Americans out of work due to illness or family care during the month and especially after the ADP report showed private companies cut 301k jobs. The unemployment rate edged up to 4.0% in January, little changed from December's new pandemic low and slightly above market expectations of 3.9%. Over the year, the unemployment rate is down by 2.4pps.

Average hourly earnings increased by 0.7% month-on-month in January, above market expectations of a 0.5% gain and following the 0.5% rise in December. It was the biggest increase in wages in nine months. With labour demand seemingly still strong, a material slowdown in wage growth is unlikely any time soon. The labour force participation rate increased to 62.2% in January compared to 61.9% seen in November and December.

The January labour report indicates that labour market conditions are not as tight as some may have feared. The path to reach full employment is however still underway with conditions continuing to strengthen. The report has continued to fuel expectations of a fast rate hiking trajectory by the Fed.

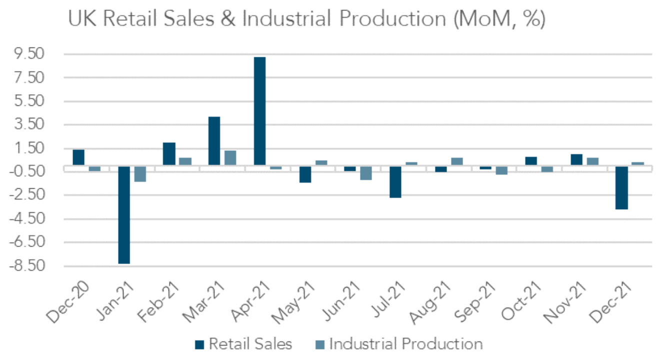
Fed officials did not spring any major surprises at its January meeting, voting unanimously to leave the fed funds rate unchanged at 0.00-0.25% and to finish its asset purchases as scheduled in March. The focus instead was on laying the ground for upcoming rate hikes and the run-down of its balance sheet.

Powell stated that the Fed could move faster and sooner than they did previously to raise the range for the federal funds rate as inflation is well above 2% and the labour market is strong. Additionally, while Powell stated that they could hike rates at every meeting and they are of the mind to raise rates in March, henoted that officials had not made any decisions about the policy path yet.

The reduction of the $8.9tn balance sheet will start after the interest rates hike and the Fed intends to reduce its securities holdings over time. Powell made it clear that a decision is still a "couple more meetings" away, with officials yet to agree on the caps on the amount of assets it will allow to run off its balance sheet each month.

United Kingdom

GDP shrank by 0.2% month-on-month in December, better than the expected decline of 0.6%, suggesting that the Omicron spread later in the year was less severe than initially anticipated. Although the effects of the Omicron wave will probably mean that the economy falls back below its pre-pandemic peak by January, that will probably prove to be a temporary setback. With that said, a sharp rise in taxes and utility prices on 1 April together with longer lasting high inflation is expected to be a drag on the recovery for the rest of this year.

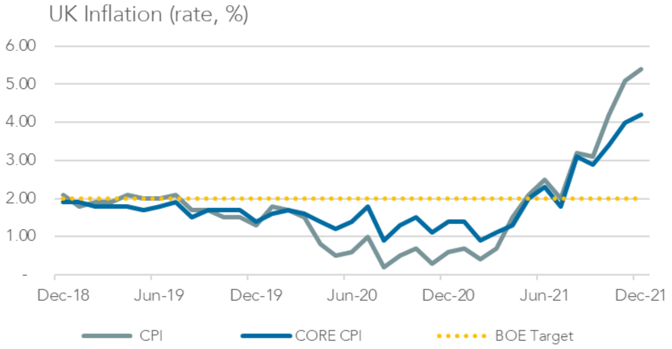


Source: Bloomberg

December retail sales dropped by 3.7% month-on-month compared to the 1.0% growth in the prior month and the market expected drop of 0.6%. This was a result of the rapid spread of Omicron and consumers anticipated most of the Christmas shopping earlier than usual. Retail sales were still 2.6% higher than in February 2020. With encouraging signs that the worst of the Omicron outbreak has passed, and with the 'Plan B' restrictions being lifted, retail sales may recoup some of this fall in January to March. However, it is possible that weak consumer recovery due to the looming cost of living crisis may restrain sales going forward, given that real wages are unlikely keep up with rising prices.

Industrial production for December rose 0.3% month-on -month compared to the market expected 0.1% increase and the prior 0.7% rise. The monthly rise was led by growth in manufacturing of 0.2%, mainly boosted by the manufacturing of basic pharmaceutical products and preparations (12.0%) and of transport equipment (3.1%).

The final January Composite PMI stood at 54.2 compared to the prior 53.6 and the flash estimate of 53.4. This came about as constraints from Omicron began to ease. The manufacturing sector growth outpaced that seen in the services economy, with production rising to the greatest extent since July 2021. There was also a steeper rise in business expenses across the sectors and stronger cost pressures in services contrasted with a modest slowdown in the manufacturing sector.



Source: Bloomberg

The annual inflation rate increased to 5.4% in December from the prior 5.1% and above the market forecasts of 5.2%. It is the highest reading since March 1992 as inflationary pressures persist namely from rising energy prices, supply chain disruptions and a low base effect from last year. Core consumer prices for December rose to 4.2% compared to the prior 4% and the market expected 3.9%.

Inflation is expected to rise even further. The further rise in core producer price inflation, from 8.2% to 8.7% in December, is expected to push core goods CPI inflation higher. And the surge in wholesale gas and electricity prices could result in an increase in utility prices on 1 April in the region of 50%. Analysts believe the result will be a rise in CPI inflation to a little above 7.0% in April. That would be much higher than the peak of 6.0% that the BOE was forecasting when it raised interest rates in December. And although inflation will fall back thereafter, they think it will stay above 4.0% for all of this year and above the 2% target until April 2023.

The labour market appears to have tightened when furlough schemes came to an end just before the start of the Omicron wave. The number of employed persons increased by 60k for the three-months to November, missing market forecasts of +125k, which also marks a slower pace of job gains compared to the addition of 149k in October.

So far, the fallout after the furlough has resulted in a decline in employment of 337k. The data to the three months ending November suggests that the decline is mostly due to people becoming inactive. So far, the end of the furlough schemes has been more about a fall in the supply of labour rather than a big fall in the demand for labour. As a result, the unemployment rate for the three months to November stood at 4.1%, down from the prior 4.2% and beating market expectations of 4.2%.

Data suggests that labour demand remained strong as Omicron struck too. In December, the count of claimants for jobless benefits fell by 43.3k. The combination of strong demand for labour and limited supply pushed up the number of vacancies to a record high of 1.247m in the three months to December. That said, the single-month data show that vacancies fell in both November and December, which could be a very early sign that recruitment difficulties are easing.

Wage growth continued to slow as previous distortions unwound, with 3myy average earnings growth easing from 4.9% to 4.2%. But the monthly gains in wages suggests that job shortages are putting some upward pressure on wages.

In the February meeting of the Bank of England ("BoE"), the monetary policy committee voted to increase the cost of borrowing from 0.25% to 0.5%, the first back-to-back increase since 2004. The minority wanted an even larger increase to 0.75% to get a grip on surging inflationary pressures.

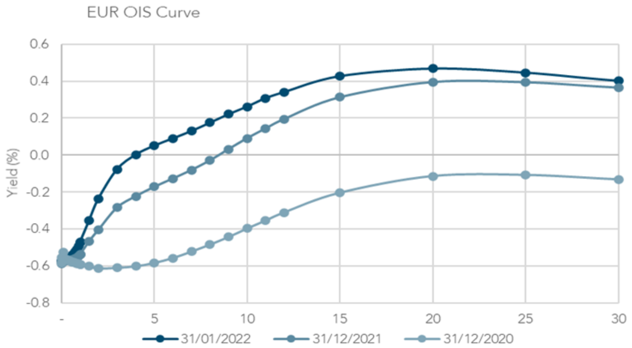
Further hikes alongside the highest rate of inflation for more than 30 years could squeeze disposable household incomes by 2% this year, with a further 0.5% hit in 2023. That would be the biggest annual reduction in spending power since at least 1990 according to BoE officials. This pain would depress spending and reduce the UK growth rate to a crawl of around 1% a year. However, the pain for households would help bring inflation down towards the target 2% within two years, the MPC said. Additionally, Governor Bailey said that there would probably be more "modest" rises in interest rates in the coming months, because the MPC's forecasts showed inflation staying above 2% throughout the next three years if it left interest rates at 0.5%.

In an effort to increase the power of monetary tightening and bear down on inflation, the MPC voted unanimously not to reinvest any of the £875bn of government bonds it had bought under QE programmes when they mature. It will also complete a sale of the £20bn of corporate bonds it holds as part of the £895bn total QE programme by the end of 2023.

RATES

Euro Rates

Euro rates rose following the surprise in inflation data for January as well as the hawkish messaging by President Lagarde at last week's ECB meeting. Front-end pricing now imply two rate hikes in each of 2022 and 2023. Similar to the movement seen in the US, the move was driven by the high expected short-term real rates (higher rate hike trajectory) and uptick in term premia.



Source: Bloomberg

The expectations that data will improve following the soft patch in Q1 and the slowdown in the winter months, together with the likelihood that inflation data continues to accelerate in the first quarter, could see further upward pressure on front-end rates. However, in the meantime, growth remains subdued due to the pandemic wave weighing on activity.

Inflation breakeven ("BE") rates remain fairly stable – 10-year inflation BE is under 2% while surveys point to inflation at around 2%. As previously mentioned, the ECB stated that, compared to December, the risks to the inflation outlook are tilted to the upside particularly in the near term. If price pressures feed through to higher wage growth or the economy reaches full capacity faster, inflation could be even higher.

Goldman Sachs expect QE to be terminated in June 2022 followed by two hikes in September and December and, on this basis, have raised their year-end target for the 10-year bund yield to 0.50% (from the previous forecast of 0.30%). Based on what has been communicated so far by the ECB and the lack of traction in wage growth expectations, Goldman Sachs' view seems to be too aggressive, but a change in guidance in March is warranted. Despite the market pricing of two hikes in 2022 and 2023, given the expectations of strong inflation and growth data in the months to come, it is likely that the market will continue to exert pressure on the front-end as we move towards the March meeting.

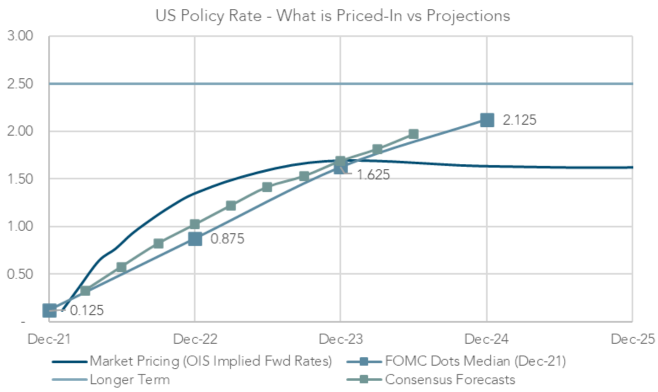
A falling inflation path later in the year will allow the ECB to pushback more effectively against pricing of high rate hike expectations, but the risk in the near term is that yields will continue to trail higher before the decline in the inflation rate.

The widening in sovereign spreads is consistent with the increased front-end pricing. This is because the market brought forward expectations of rate increases in the Euro Area and the condition that asset purchases are terminated before any rate increases has resulted in a weaker outlook for sovereign spreads given the decreases expectations of QE support. However, a change in guidance given that the landscape has shifted, terminating QE in time for two hikes this year seems excessive. In fact, the ECB's survey of Monetary Analysts see another €130bln in QE next year.

The potential stability in sovereign spreads is incompatible with a tightening in ECB policy without a substantial improvement in growth expectations – the debt burden becomes increasingly concerning as interest rates rise. Goldman Sachs estimates the impact from QE ending in June to be 10bps in spread widening in southern countries over core rates. However, strong growth expectations after Q1 should provide a strong underpinning for stable spreads as we move closer to rate hikes.

US Rates

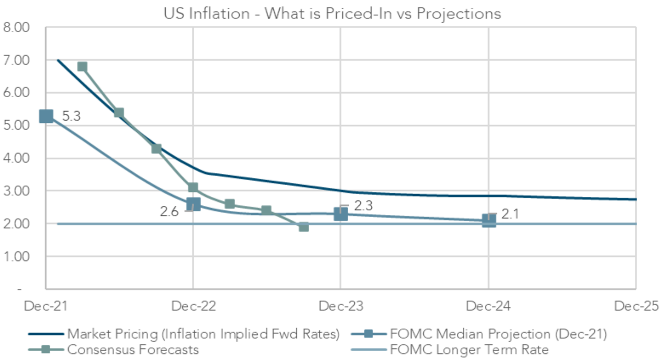
The US OIS curve implies a faster pace of rate hikes in 2022 with pricing pointing to 5 rate hikes by the December meeting compared to consensus forecast median estimates of 3.5 hikes and the Fed's December dot plot showing a median projection of 3 hikes. However, market pricing tapers out to a terminal rate of 1.7%, implying fewer rate hikes next year (less than 2) by December 2023 while median consensus forecasts see just under 3 hikes and Fed projections shows 3 hikes in 2023.



Source: Bloomberg, Curmi & Partners

Current market pricing further out the curve still implies relatively low terminal rates for the rate hiking cycle, with the OIS curve showing the 1.7% area as a terminal rate. This is inconsistent with both FOMC estimates as well as what the economic environment would generally warrant under the current conditions of high inflation and high employment. The 80bps gap in terminal rates equates to a potential sell-off of 50-60bps at intermediate to long tenors (4yrs+) along US curves.

The expected steep decline in inflation rates is reflected in both traded inflation measures as well as consensus forecasts. Inflation swaps for December 2022 are at 3.7% compared to consensus forecasts of 3.1% in 2022 and FOMC December median projections of 2.6%. The inflation swap market implies an inflation risk premium of 60-70bps underpinning the risk for inflation to remain higher than forecasts. Having said that, the uncertainty around the path of inflation warrants a higher risk premium. The market is still pricing inflation to remain above target for the next 4 years and yet prices in terminal rates which are well below the neutral rate.



Source: Bloomberg, Curmi & Partners

The key takeaway from the previous rate hike cycle is that the market under-prices terminal rates at the start of the rate hiking cycle and reprices upwards with the realisation of rate increases. This is probably also due to the fact that swap markets are not cash markets while the funding of bond portfolios becomes increasingly costlier with the rate increases – therefore the realisation of rate hikes remains an important catalyst for the rerating of the curve. In the 2015-2018 rate hike cycle, forward breakeven rates stabilised with rate hikes while the 6-month rates 2-year and 5-year forwards trailed higher implying that the rerating of the curve during the cycle has been realised through high real rates along the curve. Moreover, the curve flattened as spreads closed to zero towards the end of the rate hiking cycle.

Key differences this time round are that: (a) the Fed is not hiking pre-emptively (before inflation goes above target) but inflation is at 7% and projections are still above target despite showing a steep decline with a real possibility that inflation stays at higher levels, and (b) given a higher level of debt there is a lower limit to how high real rates can go before financial conditions tighten too much before weighing on growth. The conundrum is that the Fed is acting late and it cannot act fast enough without tightening financial conditions. Similarly, this time the market is under-pricing the end-point of the rate hiking cycle and the curve has flattened ahead of the rate hikes.

High inflation prints and the January strong jobs report continue to drive yields higher across the curve. The jobs report suggests strong labour demand and upward wage pressures which should continue to underpin higher risk premia in the front-end of the curve.

The reprising at the front-end will continue to rerate the rest of curve. The reluctance to price higher terminal policy rates for this cycle can be explained either by the expectation that this normalisation cycle will be short and that equilibrium can be reached with a modest tightening in monetary policy or (more likely) a supply/demand imbalance at longer maturities. This mismatch is likely explained by the limited supply, or availability, net of central bank purchases relative to demand by investors driven by excess savings, portfolio rebalancing and immunisation flows. This imbalance should clear overtime as policy rates move higher, yield pick-up on an FX-hedged basis is eaten away and the reduction in purchases is seen by central banks. This imbalance should remain relatively persistent for the time being which should limit the risk of material revaluation higher of long-end rates (unless we see an unlikely swift move by global central banks to run down their balances or halt asset purchases much faster than current expectations).

Given the synchronous policy normalisation seen across most G10 central banks, the reprising of the yield curve should be more sustained this time round (compared to the previous hiking cycle) given that global yields are less likely to anchor down treasury yields. Moreover, the risk of the Fed being forced to hike into tighter financing conditions in reaction to an extended overshoot in inflation rates warrant a positive term premium (in contrast with the last hiking cycle).

Although we have highlighted that front-end pricing may be excessive, the continued improvement in the macroeconomic backdrop and the messaging from the central banks continues to point towards higher yields by year-end across the curve.

Regarding the balance sheet run-off, the expected reduction is of c. $2.2-2.7tn according to Goldman Sachs over the next 2-2.5 years. The expected impact from the balance sheet reduction on 10-year yields is expected to be just about 20-30bps according to Goldman Sachs given that: (a) most of the refinancing will be done via bills so the change in net duration supply will be smaller while US treasury supply will be less due to smaller deficits; and (b) the impact on yields may not happen upfront given uncertainty on how successful the Fed can be with QE.

At current levels, the 1-year and 2-year points are fairly priced (compared to floaters) given the premium allowed for faster rate hikes and upside surprises in inflation.

Going forward. the speed in upward movement in yields should moderate given the sharp moves that have occurred in the first few weeks of the year and that current market pricing is already implying a faster pace of rate increases in 2022. Forward inflation swap rates have stabilised in anticipation of peaking spot inflation which weakens the motivation for an extended sell-off in the near term.

The belly of the curve (5-year area) is mostly vulnerable to a repricing. Markets are underestimating the terminal rate of this rate hiking cycle increasing scope for a material move higher in the belly and long end of the curve by c. 50-70bps (keeping everything else unchanged).

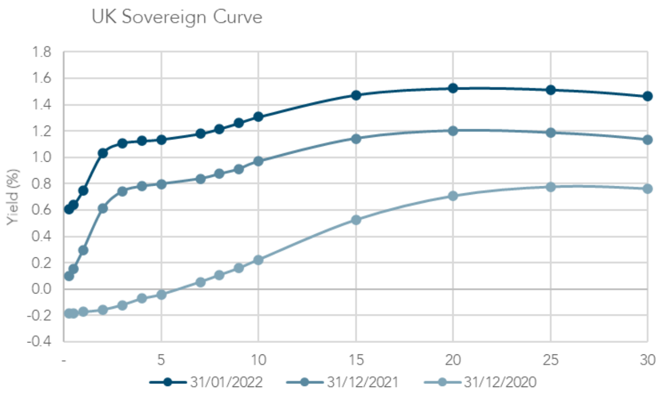
The scope for flattening remains in relation to very short-tenors, particularly in the front-end part of the curve, but movements are expected to be more parallel further out the curve. We expect curves to remain flat at medium and long-tenors, as the realisation of rate hikes is expected to rerate the curve higher.

The move in long-end rates will be primarily real-rates given the base case is that rates are still c. 50bps/60bps too low while breakeven rates are stabilising going into the hiking cycle. However, given the real risk that inflation stays well above current market pricing means that the inflation curve may reprise higher which would simultaneously require more rate hikes to be priced in. In this case, real rates would not be rising fast enough to curb inflation without expecting the Fed to hike into restrictive territory.

UK Rates

The rate increase by the BoE in February has now paved the way for the balance sheet run-off which will start with a £28bln redemption in March.

The hawkish outcome came as the BoE revised its economic projections downwards indicating that growth is expected to slow, unemployment will rise and inflation will decline. Over a 3-year horizon, the bank expects below trend growth, inflation at 1.6% and unemployment to be c. 1% higher. Within the context of a deteriorating growth outlook, the hike shows the MPC commitment to tackle inflation at the cost of hampering activity.



Source: Bloomberg

Given the weaker outcome, the decision by the MPC to forge ahead with rate hikes and the balance sheet run-off shows a higher sensitivity or concern on second-round effects of the current high levels of inflation prints. Given this outcome, further tightening is expected in upcoming meetings.

The curve will likely remain flat (possibly invert) given that the front-end will remain supported by rate hike announcements or expectations thereof, while the bearish outlook on growth can way on long-end yields. However, the slope will be reassessed when the active sales of QE holdings begin, probably in Summer.

Given the backdrop of a more hawkish central bank implying a steeper hiking path and the elevated net supply, we maintain a short duration in UK rates given the risks tilted towards higher rates across the curve.

CREDIT

Euro Credit

During the first month of 2022, European corporate bond spreads widened across the board. Broadly speaking, investment grade ("IG") spreads widened by c. 10bps as high yield ("HY") spreads widened by c. 36bps. Within the IG space, triple B rated debt experienced the widest spread movements of c. 12bps as triple A and single A rated debt widened by c. 8bps, while spreads of double A rated debt widened by c. 4bps. As for the HY segment of the European corporate bond market, single B rated debt experienced the widest spread differential of 59bps as double B rated debt and triple C rated debt widened by 28bps and 42bps respectively.

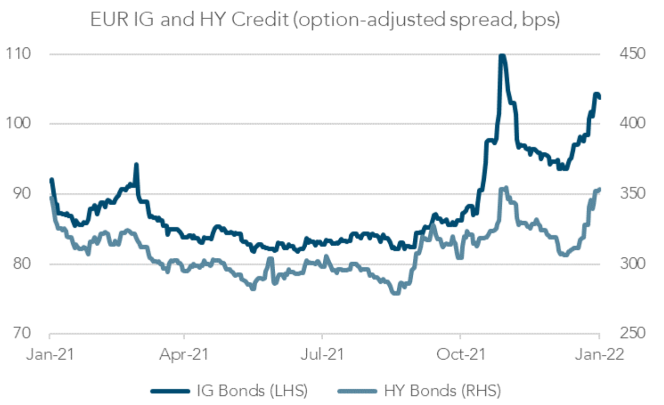
The wider spread movements during the month of January were driven by the sell-off within the corporate bond market, despite the rise in the bund yield to 1bps, as the market anticipated that the ECB will hike rates sooner than previously thought in view of the persistently high levels of inflation in the Eurozone. Lagarde's dovish comments in the February meeting did little to quell investors' concerns as corporate bond spreads widened further following the release of the higher-than-expected January inflation data.

Accommodative policy out of the EU has been one of the key drivers for our positive relative view in the region. The ECB's surprise hawkish tilt has shifted us to a more cautious view on European Credit Spreads, and we anticipate a challenging trading environment for European credit over the coming weeks going into the March ECB meeting. We move to a more cautious view on IG credit given tight valuations and a weaker technical backdrop, and move to a more balanced position on HY.

With the rates market implying more than two 10bps hikes by September, this would imply that the APP and the CSPP could end before that, if market pricing is correctly anticipating the ECB's changed view. Barclays analysts continue to believe that, whereas the APP may be reduced to €30bn in Q2 and €20bn from Q3, a rate hike is not on the table until March 2023, as the ECB will wait for evidence that wage growth supports 2% inflation in the medium term.

The expectation is currently for a gradual build-up of risk premium, as investors further adjust to the reality of a maturing cycle and reduced policy support, and we struggle to see a strong case for a non-linear trajectory. Macro and micro fundamentals should ultimately put a ceiling on how wide spreads can reasonably go in the short term. On the macro side, the economic drag from the Omicron variant will likely continue to fade, which, coupled with strong fundamentals for households, should keep recession fears minimal. On the micro side, whilst it would appear that the peak in credit quality has passed (judging from the stagnating pace of credit upgrades), we think strong liquidity positions and earnings greatly limit the possibility of a tail risk repricing, and the risks of a material rerating remain remote.

For the short term, the focus for credit investors will remain on gauging the ECB's measurement of inflation projections, which sets us up for a volatile five weeks until the next ECB meeting. The stance remains that higher benchmark rates need not necessarily be a headwind to European credit spreads. However, the volatility and uncertainty of underlying rates will be, and we will have plenty of uncertainty until the meeting, with European credit spreads unlikely to be able to tighten materially ahead of that.



Source: Bloomberg

IG credit remains particularly vulnerable owing largely to a continued healthy pace of supply as companies exit earnings season, though also as companies attempt to squeeze in new issues before the music stops (recall Prosus new issues that repriced the issuer curve wider some weeks ago). Vulnerability of IG credit is also driven by absolute spread tightness versus historical and, not least, the potential unwind of CSPP-eligible premiums.

To add to our cautious views, while awaiting more inflation data, we must follow closely the performance of Italian risk in credit. Should the ECB end QE much sooner, the focus could turn to Italian debt dynamics, and in turn Italian credits. As exhibited last week, spreads on Italian paper can unwind rapidly as markets begin to view the ECB as withdrawing support for the sovereign paper.

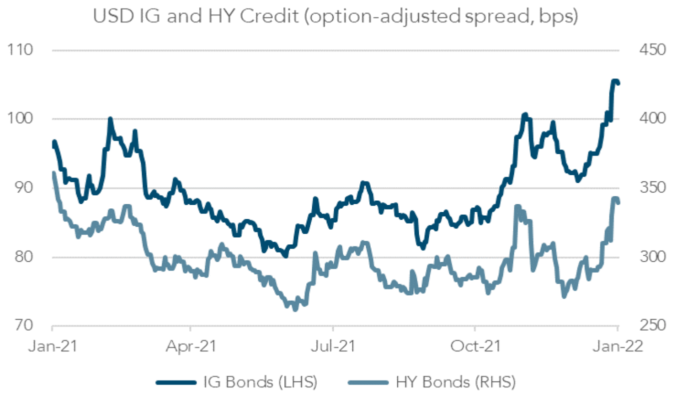
Given the short and medium term bias for benchmark rates to move higher, we prefer maintaining an underweight duration position within European credit, both across IG and HY. Spread volatility is likely to remain a feature of markets until clearer guidance is provided in the March ECB meeting. As a result, given the ability for HY to better withstand spread fluctuations, we continue to prefer an overweight allocation to HY relative to IG.

US Credit

In January, the spread widening within the US corporate bond market was greater when compared to its European and UK peers. In fact, on a broad level, IG spreads widened by c. 14bps and by c. 59bps in the HY market. Within the US IG market, triple A rated debt and triple B rated debt widened by the largest degree in the IG market by 14bps and 15bps respectively, while double A rated and single A rated debt widened by c. 12bps respectively. As for the US HY market, single B rated debt experienced the widest movement in spreads by c. 59bps, with double B and triple CCC rated debt widening by 55bps and 41bps respectively. Similar to what occurred in the Eurozone, wider spreads in the US corporate bond market were primarily driven by expectations of the Fed's imminent rate hike and bond purchase tapering in view of the high levels of inflation and tight labour market conditions.

In IG credit, the US dollar market underperformed materially during January, both whether hedged or unhedged for FX risk, with this underperformance having multiple drivers. Most importantly, the Fed has vastly sped up their efforts in catching up with decades-high inflation, with policy rate pricing shifting sharply towards earlier and faster hikes in recent weeks and months. Rates remain the most complicating factor for the US Corporate Bond Index, but widening spread has been a meaningful contributor in its own right. This came at a time when US dollar IG issuance was running fairly hot, creating a technical supply backdrop that was also conducive to wider spreads just as markets were grappling with much higher volatility in risk assets.

Bloomberg fair value estimates for year-end 2022 IG spreads are presently forecast at 125bps given assumptions for incremental treasury curve flattening, reduced volatility and moderating yet still expansionary manufacturing PMIs. Tail risks, namely either a deeper risk-off sentiment or a Fed far behind the inflation curve, could see spreads test as wide as 155bps, while moderating inflation and GDP growth in the 3.5% area could lower spread back to the mid-90bps level from c. 106bps at month-end.



Source: Bloomberg

Fed risk remains high and is the biggest driver for US credit in the near term and therefore, given the potential for continued volatility in the near term, we do not yet believe it is time to buy the market overall, but there are pockets of value after significant underperformance, such as in BBs. Although the Fed's hawkish signalling was the main driver of the recent bout of de-risking, we do not think we have crossed a threshold in terms of downside scenarios from central bank policy. Credit spreads are likely to remain relatively weak and volatile ahead of lift-off, and the biggest risk to credit spreads remains whether the Fed's actions stifle growth. We continue to prefer a short duration profile for any US dollar exposure, with relative value duration buckets also pointing to value at the front end of the corporate IG curve.

UK Credit

While corporate bond spreads did widen in the UK, they did so to a lesser extent when compared to their European and US counterparts. In fact, UK IG spreads widened by c. 8bps, while HY spreads widened by c. 5bps. While the yield on the gilt rose to close the month at 1.31%, the sell-off in the corporate bond market drove spreads wider as the market started to price in the effect of higher levels of inflation and rate hikes by the BOE. The MPC was expected to raise rates at its February meeting, with markets pricing in a 90% chance of this occurring, as the rate of inflation rose and as Governor Bailey highlighted the potential dangers of the current mix of high inflation and low unemployment and another MPC member also commenting that further rate hikes would be needed in the coming months.

Expectations remain for sterling credit to trail euro peers in local terms as the unwind of BOE asset purchases is expected to ramp up over the coming months. In the first instance, the £27.9bn in gilts coming due in March will not be reinvested, nor will the roughly £70bn over coming due over the remainder of 2022 and 2023. Similarly, the BOE last week confirmed that it plans to reduce its £20bn of corporate holdings to zero no sooner than the end of 2023 by not reinvesting maturing bonds as they come due and through a sales programme to run simultaneously.

The by-product of rising rates may positively affect the currency which would offset any weakness from widening yields and spreads for investors rebasing portfolios into euro terms. Sterling HY spreads versus euro counterparts hit all-time tights during January following the euro market move, implying that relative upside performance in UK-related credit is tough to see at this stage versus historicals. The UK's Corporate Bond Purchase Scheme was a key driver of sterling credit spreads in 2020, but even with the BOE's absence in 2021, sterling corporate bonds have outperformed European peers in euros.

With the BOE now moving to selling bonds and rate increases, local sterling credit returns are expected to suffer. Part of the underperformance of absolute returns (in local currency) for sterling credit in 2021 was driven by duration differences and the sharp move in rates following the strongly hawkish shift in messaging – note that sterling IG carries a duration of 8.2 (OAD), versus only 5.1 for euro IG, implying far greater index sensitivity for a comparable move wider in rates and spreads.

In IG, the spread to benchmark differential versus euros hit 45bps at the virus peak, subsequently tightening to c. 20-22bp for the majority of 2021 following the Brexit deal and the strong progress made in the UK vaccination drive. A spike in Omicron cases in the UK and a dearth of BOE credit buying versus a very active ECB has led to some relative weakness in recent weeks, pushing the differential a few basis points wider, and we feel there's potential room for more widening on the BOE unwinding £20bn pounds of corporate-bond holdings while the ECB continues to buy through 2022, despite the slower pace and the hawkish surprise on potential rate hikes.

In HY, sterling corporate bond spreads have had a big rally versus euro peers since the worst pandemic levels, and that strength continues. From a high of 250bps in March 2020, the OAS differential compressed to roughly 125bps by the end of 2020, and to 70bps by the end of 2021. As at the end of January, the spread differential stood at 34bps, and has tightened further to 28bps on euro weakness in early February. This differential is now at all-time tights, implying that the riskier credit pools in sterling currently offer historically low premiums relative their euro counterparts at a time when policy support is seen to be unwinding at a faster pace. The current gap indicates that there is little to no relative upside in sterling HY. Similar to our view in euros, the bias for rates to move higher leaves us with a preference to maintain short duration positioning for any sterling exposure.

Defaults and Rating Backdrop

January's spectacular spread widening delivered some of the worst HY returns of the pandemic era. With that said, the backdrop for defaults and rating actions remains supportive.

So far this year, upgrades (19) continue to outpace downgrades (17), though there are signs that trend is beginning to reverse. The health care and real estate sectors have led negative rating actions so far in January with six and four, respectively. However, most negative rating actions in these sectors have been limited to HY issuers. In more positive news, the media and entertainment sector has had the most positive rating actions to date in 2022 with five, three of which were upgrades, as the sector continues to see signs of recovery from a very low base. In 2021, 650 issuers had a negative rating action, and 1,718 issuers had a positive rating action. The largest percentage of rating actions were outlook revisions to stable from positive. This was because the recovery was largely due to stabilization, as over half of the issuers with positive rating actions in 2021 experienced one or more negative rating actions in 2020.

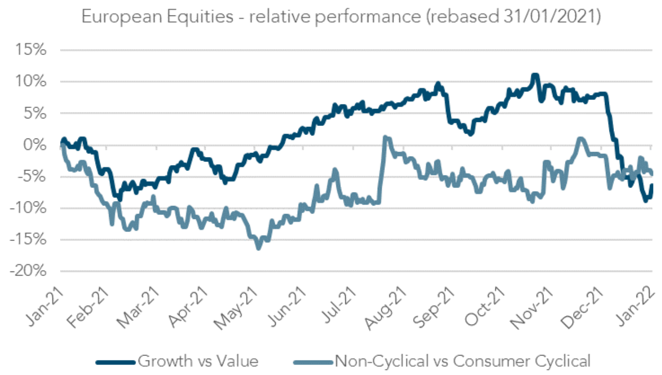
The number of weakest links, that is issuers rated 'B-' or lower by S&P Global Ratings, with negative outlooks or ratings on CreditWatch with negative implications, fell to 207 as of the end of 2021, its lowest level since April 2019 and down 57% from the previous year.

As defaults have slowed since the pandemic highs of 2020, the US trailing-12-month HY default rate has also dropped. It fell to 1.5% as of 31 December 2021, its lowest level since July 2014, while the European trailing-12-month HY default rate dropped to 1.8%, its lowest level since July 2016. So far defaults in January 2022 remain lower than at this point in 2021. If this trend continues, we can expect HY default rates to drop further. Distressed exchanges have been the leading mechanism for default globally since 2017, and in 2021 made up over 50% of all defaults.

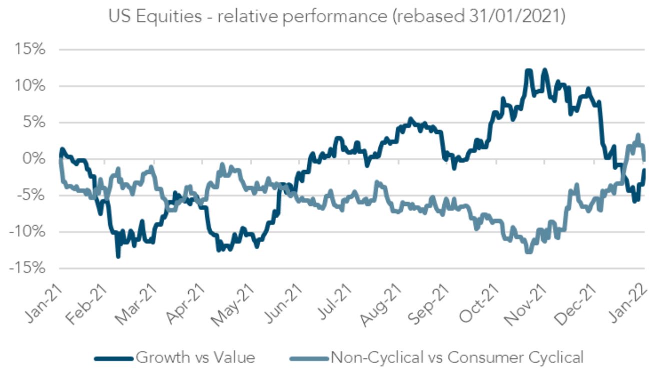
EQUITY

Inflation worries weighed on investor sentiment during January. Most equity indices we follow closed January in the red mainly as a result of a steep sell-off in the second half of the month. Despite the narrative in the closing days of December being that economic growth should remain above trend and that COVID-19 concerns are fading, investor focus shifted firmly on inflation and the potential impact on equity market performance. The situation was made worse following the release of inflation numbers in the US.

The US underperformed Europe during a month characterised by rising bond yields. As expected, the STOXX 600 index generated a total return of -3.1% (€) in January compared to -5.2% ($) for the S&P 500. This reflects the difference in tilts towards value/growth, with the former tilted to value whilst the latter to growth. This divergence of performance between value and growth is much more clear when looking at the FTSE 100 and the Nasdaq. Among the indexes we follow, the FTSE 100 has the highest exposure to value stocks while the Nasdaq has the highest exposure to growth. During January, the FTSE 100 generated a total return of +1.1%



Source: Bloomberg



Source: Bloomberg

(£) compared to the -9.0% for the Nasdaq 100 ($).

Investors were generally selling out from long duration equities and bonds and buying value. Generally investors rotated from growth to value (in both US and EU) and from staples to financials. More importantly, cyclicals underperformed defensives in both the US and the EU, which In our opinion highlights investor concerns for economic growth prospects. On balance, equity investors have rotated out of long duration equities (S&P 500 and Nasdaq) to those that are more value oriented (FTSE 100). Energy was the best performing sector as commodities rallied during the month. Banks were also among the outperformers whilst in the EM space, LATAM (value tilted) was a key outperformer.

Compared to history, current financial conditions remain very loose and still below the 10-year median. We expect this to tighten over the coming months as the Fed starts its hiking cycle. However, this highlights how much work still remains to be done to get back to any sort of normality in terms of monetary policy tightening.

Global economic growth has likely continued to weaken in January. The JP Morgan global Composite PMI hit a three-month low in December (54.3) with the weakness mainly related to weaker increase in services activity which we think is due to the re-introduction of COVID-19 curtailment measures. The Goldman Sachs Current Activity Index ("GSCAI") tells a similar story, with global GSCAI falling to 5.8 in December from 6.0 a month earlier. The situation has likely not improved in January as the global GSCAI fell to 4.0, primarily due to the lower activity the US (where the GSCAI fell to 1.5 in January from 4.3 in December). Again, we think this could be related to the later impact from COVID-19 in the US. Europe's GSCAI was unchanged in January at 3.3.

2022 could be a difficult year for US stocks. The US stock market has generated solid returns for investors over the past decade or so since the global financial crisis. Yet, the outlook for 2022 is rather bleak as the Fed starts to tighten its policy. The current expectation is for the US economy to weaken considerably in the second half of 2022 as the fiscal impulse turns negative. Investors are generally able to digest gradual rate hikes during periods of strong economic growth, but rising yields in a period of economic weakening generally weighs on sentiment.

Europe's performance was also negative but an investment case for the region still stands. European equities were not immune to the weakness seen in January. An ECB rate hike in 2022 is very unlikely, even though consumer prices rose to the highest ever increase on record in December. Despite this, the region's economy should benefit from loose fiscal policy. The disbursements of the EU recovery fund should boost growth in 2022 (compared to the negative fiscal impulse in the US) and equity valuations are less expensive compared to the US.

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 bonds 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 continued to rally through 2021. 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	N	In what was a difficult start for equities this year, the performance of our selection of stocks was helped by our decision to run on overweight position in traditional value sectors, and being underweight sectors that generally underperform during periods of rising rates. Additionally, we reduced our exposure to the developed market equities and established a temporary underweight position before the sell-off on 19th January. We are adding back exposure on a piecemeal basis with the view of re-establishing an overweight allocation to developed market equities given the improving macroeconomic backdrop and our view that earnings will continue to grow at above-average rates this year. The key concerns to our outlook are (1) COVID developments and the possibility of deadlier variants emerging resulting in another emergency scenario in key economies, (2) inflation concerns particularly the risk that cyclical inflation persists at higher levels adding to risks of a policy -induced slowdown/recession and (3) geo-political tensions especially if the Ukraine conflict results in a military response.
Emerging Market Equities	Positive	N	2021 was a struggle for emerging market equities despite the strong expectations at the start of the year. The economic backdrop was favourable but the situation in China weighed on investor sentiment. The expectation at the start of 2022 was that this would be a better year for equity markets, with some stabilisation in China and the commodities rally boosting EM returns. Notwithstanding, EM equities generated negative returns so far this year, albeit an outperformance relative to DM equities. In the absence of a clear catalyst for outperformance we remain lukewarm on this asset class.

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

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