Investment Strategy Update

May 2022

Curmi & Partners Research

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- Activity data has been relatively resilient in the face of increasing concerns to growth across major economies exacerbated by the war in Ukraine and the COVID lockdowns in China.
- PMI data indicate supportive and expansionary conditions as prints for May remain in the mid-50s despite companies outlining the rising costs and supply chain issues.
- Inflation rates remain high with UK's headline rate soaring to 9% in April, while inflation in the US and the Euro Area has remained fairly levelled at 8.3% and 7.4% respectively.
- The impact of higher prices on real disposable incomes is expected to weigh on spending going forward, underpinning expectations of a slowdown or a contraction in the second quarter.
- The Federal Reserve and the Bank of England raised policy rates by 50bps and 25bps respectively to 1% in May whilst the European Central Bank has maintained its policy rate unchanged at –0.50%.
- Current market pricing implies that US policy rates will rise by another c.200bps by the end of 2022 and to peak at c. 3.10% in the course of next year.
- Rate hike expectations in the Euro Area have increased significantly in recent weeks with rates markets now pricing in an increase of 100bps by the end of 2022.
- Increasing growth risks, high inflation and hawkish central banks led to a substantial tightening in financial conditions as the drawdown in equity markets extended lower, benchmark bond yields rose further, while credit spreads continued to widen.
- The uncertainty around the extent of tightening required to bring inflation under control has been a key deterrent to market risk appetite as seen in the poor performance of cyclicals and growth stocks.
- Whilst substantially moderating our call to retain a short duration position, given that duration risks are now more balanced, we see further upside risks in yields with a flattening bias over the medium term.
- As the outlook on defaults and rating downgrades remains benign, higher spreads and wider dispersion in investment grade and high yield credit underpins our positive view on credit as we see potential in boosting excess returns through selection.
- The key risk to equity valuations is that a prolonged war in Ukraine leading to persistently high energy prices coupled with the ongoing supply chain issues will weigh on margins and corporate profitability.
- Our outlook on equities is unchanged, despite the increased uncertainty, as we continue to hold a diversified portfolio of companies with reduced tilts in value versus growth and cyclical versus defensive stocks.

Macro risks have shifted from inflation to growth, leading to a change in the underlying dynamics determining market movements and correlations across asset classes. The downgraded growth outlook has been driven by a number of factors including: the reduced/negative fiscal impulse as governments are scaling back spending compared to last year, the supply shock limiting the availability of goods, the direct impact on trade as a result of the war in Ukraine and more recently, the drop in China's activity as a result of a large COVID shutdown.

Alongside these growth concerns, we have increasingly hawkish comments from key central banks which have continued to boost market expectations of a steep tightening cycle in response to the high levels of inflation. The expectations have exacerbated the weakening growth outlook. More notably, markets are pricing a further 200bp increase in the policy rate by the US Federal Reserve by the end of the year and a peak of c. 3.1% in June 2023. Whereas in the Euro Area, the market has increased pricing of a rate hike to just over 100bps in 2022 and for the policy rate to peak at c. 1.4% in 2023.

Whilst the market focus has been on growth concerns, there is the potential of a shift on the inflation side, although it is still too early to tell. With some stabilisation in commodity prices after the sharp surge following the Russian invasion of Ukraine, signs of a deceleration in average hourly earnings and the expectations of a moderation in spending and central bank action have started to increase the prospect of inflation rates reaching a peak.

This environment of high inflation coupled with growth concerns have led to a substantial tightening in financial conditions. Yields rose as markets priced in a faster or higher rate hiking cycle by central banks, equity markets dropped and credit spreads widened. The key question now is whether the current level of tightening in financial conditions is enough to cool the economy and labour market conditions to reel in inflation. More recently, the growth concerns led to further tightening in financial conditions as equity markets continued to fall, credit spreads continued to widen whilst benchmark yields at the long-end of the curve have come off their recent peaks.

Breaking out of this dynamic can resolve in either the market moving towards pricing in clear risks of a recession or in a more benign outcome where the inflation trend is coming back under control and reversing, while the market sees the central banks' degree and speed of tightening as adequately achieving this objective.

Under the first scenario, risky assets will remain under pressure whilst the scope of an inversion in yield curves becomes more prevalent. Short-end yields would remain propped by high inflation premia and central bank action, while long-end yields are weighed down by safe haven flows.

In the second scenario, with more evidence of peaking inflation, we expect to see a relief in equity and bond market price action on the back of reduced uncertainty on the inflation trend and a clearer outlook on the central banks' tightening policy path.

Given that the tighter financial conditions dynamic will remain dominant in the near term due to the backdrop of growth concerns and the possibility of peaking inflation, the outlook on rates remains complicated. The scope of a further move upwards in bond yields has clearly diminished, but we are equally less convinced about adding duration for the time being.

On the other hand, equity valuations have come significantly down and could offer room for a further deterioration in upcoming data, possibly to validate such pricing. This is mostly apparent in the relative underperformance of US cyclicals versus defensives which in the US has gone down to -23% from January up to mid-May. This relative underperformance is generally consistent with survey indices printing in contractionary territory which has not materialised yet. While this suggests that market pricing already reflects a material probability of a recession (several analysts have estimated a 35% chance of a recession in the US), we could move further lower if we are indeed heading into a recession. The increased cyclical risks will continue to weigh on risk sentiment and support a further decompression in high yield spreads for the time being.

With that said, we continue to hold relatively high cash balances across fixed-income focused strategies which, combined with a relatively short maturity profile in our bond selection, underpins our short duration position. At the same time, we recognise that the rise in yields and spreads has materially improved breakeven levels for investment grade bonds, offering substantially more return protection against further rises in benchmark bond yields.

We remain constructive on high yield credit as we continue to take advantage of greater dispersion by focusing on bottom-up selection, primarily identifying names with limited margin sensitivity to rising input costs, a strong cash generation profile and adequate liquidity levels.

Our stance remains unchanged in equities, even as uncertainty has increased, as we continue to hold a diversified portfolio of companies with reduced tilts across value versus growth strategies and cyclicals versus defensives strategies. Having said that we acknowledge that risks from a prolonged war in Ukraine and high inflation to weigh on margins and profitability. In the near term, we see scope in continuing to add defensive names that can deliver results which are positively correlated to inflation whilst at the same time reducing exposure to growth stocks given the headwind from rising real yields. In the eventuality that a deterioration in economic data bottoms out and the downside risks to the growth outlook fade, we see the opportunity of identifying cyclical names to take advantage of the current depressed valuations.

MACROECONOMIC

Euro Area

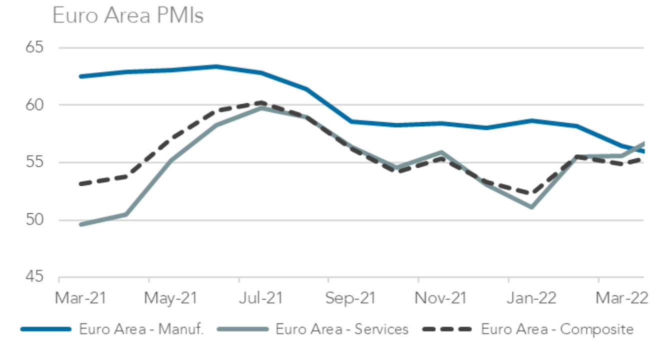
The flash estimate for the Q1 GDP growth rate in the Euro Area was at 0.3% quarter-on-quarter, slightly higher than the initial estimate of 0.2% and in line with the market expected 0.3% quarter-on-quarter growth.

GDP will potentially contract in Q2, as rising inflation and the fallout from the Ukraine war takes its toll on households' real incomes and consumer confidence, while also making it difficult for the industrial sector. Manufacturers in Germany will take a bigger hit than those in other parts of the Euro Area, but the increase in energy prices will affect the entire region, as will the fall in export demand and business confidence.

Industrial production for March dropped by 1.8% month-on-month, showing a substantial decline from the 0.5% advance in February, but coming in slightly high than expectations of a 2% decline. Industrial production is expected to remain subdued (as witnessed in April's

PMI data) due to renewed production curbs and supply disruptions emanating from the Ukraine war and the fresh lockdowns in China.

Retail sales in March declined 0.4% month-on-month, compared to the prior increase of 0.4% month-on-month and the market expected decline of 0.1% month-on-month. This is the first indication that the war in Ukraine and the soaring consumer prices are weighing on purchasing power and consumers have started to cut on some spending. The March data shows that sales are even further below their pre-pandemic trend.

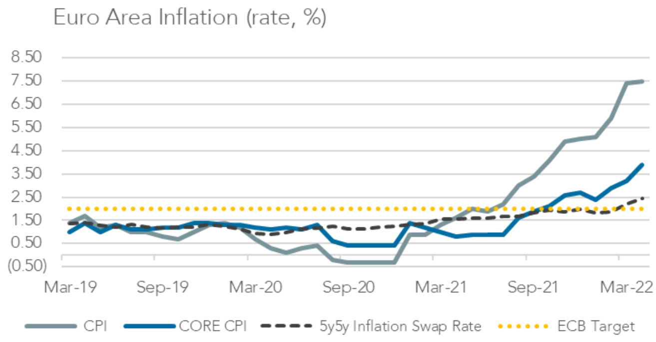


Source: Bloomberg

Looking ahead, the fall in consumer confidence in April, to its lowest level since April 2020, suggests that further falls in spending are to be expected, probably because higher inflation and the squeeze on real incomes have reduced households' willingness and ability to spend.

The April final Composite PMI stood at 55.8, compared to the prior 54.9, in line with the flash estimate of 55.8. The reading pointed to a rebounding service sector, benefitting from eased COVID-19 restrictions and pent-up demand, which helped to offset a slowdown across manufacturers from ongoing supply constraints. The strong trend in job growth that has been seen since around mid-2021 continued in April, with employment rising at the fastest rate in five months. Still, prices charged for goods and services rose at an unprecedented rate in April amid another near-record rise in firms' costs, hinting that inflation has further to rise. Finally, business expectations remained relatively subdued.

The April headline inflation rate was in line with the previous print of 7.4%, coming in marginally lower than estimates of 7.5%. The war in Ukraine and sanctions on Russia continued to push prices of commodities higher. Inflation is now estimated at more than three time the ECB target of 2%. On the other hand, the April core inflation rate stood at 3.5%, up from the prior 2.9% and the expected 3.2%. This higher-than-anticipated surge was due to big increases in both the services and non-energy goods component. The high core inflation rate means that the upside risks to the ECB's assumption (that inflation will come down to the 2% target over the medium term) may be rising. Economists do not believe that core inflation will come down rapidly, as PMI data is pointing towards intense inflationary pressures.



Source: Bloomberg

The unemployment rate for March came down to 6.8% from the prior 6.9%, however remained above the market expected 6.7%. The number of unemployed persons came down by 76,000 from February, leaving the labour force at slightly above the pre-pandemic level. April PMI data shows that employment will continue to increase at a decent pace. However, the labour market is still exceptionally tight, with the proportion of companies reporting labour shortages rose to a new record of 27.8% last month. Therefore wage growth is expected to increase over the near term, especially given the high inflationary environment eating at consumers' real income. In fact, unions have stepped up demands for higher wages to offset soaring energy and food prices.

European Central Bank ("ECB") policymakers said during the April meeting that incoming data reinforced expectations that net asset purchases should be concluded in the third quarter. Monthly net purchases under the APP will amount to €40bn in April, €30bn in May and €20bn in June, the same as defined in the previous meeting and that any adjustments in the interest rate will take place some time after the end of the asset purchase programme and will be gradual.

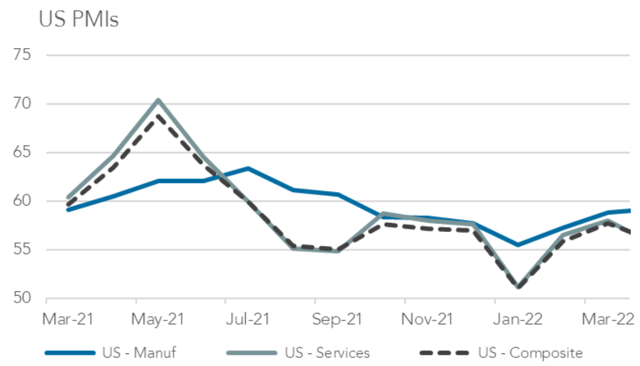
During the regular press conference, Lagarde said the exact end-date for the APP has not been determined, nor has the timeline for potential increases in interest rates. However, momentum is building for the ECB to raise interest rates in July to fight soaring inflation, after hawkish policymakers indicated they are ready to accept an end to almost eight years of negative borrowing costs. ECB's Lane and Panetta have signalled they are now more open to raising rates in the coming months, following calls from the governing council's hawks to make the first rise in more than a decade sooner rather than later. Policymakers such as de Guindos and Schnabel have said that a series of rate rises could start by July. In fact, many economists expect a 25bps rise in the deposit rate to -0.25% at the July meeting with further increases to follow thereafter.

United States

The second estimate for Q1 GDP growth showed that the economy contracted by an annualised rate of 1.5% quarter-on-quarter, below the market consensus of a 1.1% growth quarter-on-quarter and following a 6.9% quarter-on-quarter growth in Q4. GDP is set to continue to remain subdued as retailers try to rebuild depleted inventories during a further disruption from Chinese output and renewed transportations congestion.

April retail sales were up 0.9% month-on-month, compared to the prior increase of 1.4% month-on-month, in line with market expectations. This increase was however due to the price-related surge in the nominal value of gasoline sales. Although that implies consumers responded by cutting back on their gasoline usage in real terms, the hit to purchasing power would still have left them with less to spend on other good and services, and therefore, consumption in real terms fell. This energy price-related effect is expected to keep consumption low over the coming months, as consumers dip into savings. Together with this, slowing employment growth may also keep consumption subdued.

Industrial production for April grew 1.1% month-on-month, above the prior month's growth of 0.9% and above the market expected growth of 0.5% month-on-month. This is a result of a surge in output as bottlenecks clear. It must be noted that the US will not be immune to the global slowdown in manufacturing stemming from China and the war, and therefore production is set to slow down over the rest of the year. But, at least up until April, supply constraints which were already easing kept factory output growth strong.



Source: Bloomberg

The April final Composite PMI stood at 56, compared to the prior 57.7 and the flash estimate of 55.1. This reflected a faster expansion in manufacturing production, offset by softer service growth. The overall expansion in new business eased following a slower upturn in service sector new orders. Nonetheless, the rise in new sales was sharp as domestic and foreign client demand strengthened. Meanwhile, inflationary pressures intensified further and both input prices and output charges increased at sharp rates due to material and labour shortages and greater transportation costs. Although firms registered a further rise in employment, labour shortages continued to be highlighted. As a result, backlogs of work grew at a sharp pace.

The headline inflation rate in April dipped to 8.3%, compared to the prior 8.4%. The print was still above the market expected 8.1%, mainly driven by more expensive energy as the Russian invasion continues to push oil prices higher. On the other hand, the core inflation rate for April was reported at 6.2%, down from the prior 6.5% but above the market expected 6.0%. The tentative easing of goods supply shortages was the key driver of this moderation, with core goods prices falling by 0.4% month-on-month. Admittedly, core services prices rose by 0.6% month-on-month, however this mainly reflected a temporary post-omicron burst of reopening inflation.

The unemployment rate for April remained stable at the prior 3.6%, above the market expected 3.5%. Meanwhile, the participation rate for April stood at 62.2%, down from the prior 62.4% and remaining 1.2pps below its pre-pandemic levels.

April's non-farm payrolls report showed that 428,000 jobs were added, in line with the prior month's level, beating expectations of 391,000. The gains in employment were widespread, with leisure and hospitality up 78,000, manufacturing up 55,000 and retail up 29,000. Still, this leaves the economy down by 1.2m from its pre-pandemic level (main deficit is in the leisure and hospitality sector, which is 1.4m below pre-pandemic levels).

Labour market conditions are showing to be tight at present, which is driving wages higher. The average hourly earnings for April grew by 0.3% month-on-month, compared to the prior +0.5% month-on-month and the market expected +0.4% month-on-month.

Analysts are viewing the non-farm payroll print as positive, highlighting that the move by the Fed in ignoring the misleading contraction in Q1 GDP as correct, with the economy still on a firm footing. Economists believe that the labour market could soon start to slowdown as the economy gets close to full employment, which would provide some relief to hot wage growth at a time when inflation is running at levels not seen since 1981.

The Fed raised the target for the fed funds rate by 50bps during its May meeting, aiming to tackle soaring inflation. Powell volunteered that "there is a broad sense on the [FOMC] that additional 50bps increases should be on the table at the next couple of meetings". However, he added that a 75bps rate rise was "not something that the committee is actively considering", which on balance could be interpreted as marginally dovish given the growing evidence that the Fed is behind the curve. It was also indicated that the committee could be looking at dialling the pace back to 25bps if it saw evidence of sustained progress on inflation.

The Fed will also begin reducing asset holdings on its $9tn balance sheet on 1 June. The plan will start with a monthly roll-off of $30bn of treasuries and $17.5bn of mortgage-backed securities for 3 months and will then increase to $60bn and $35bn respectively per month.

Officials have suggested a neutral federal funds rate is somewhere between 2-3%, but many economists believe it is much higher, given how much inflation has overshot the Fed's 2% target. If the Fed delivers 50bps rate rises in June and July and then raises rates by 25bps at each of the remaining meetings in September, November and December (the reduction a result of the underwhelming GDP growth, the slowdown in employment and the expected drop back in inflation), the fed funds rate would hover between 2.5-2.75% by the end of the year.

United Kingdom

The UK economy grew by 0.8% during the first quarter, slowing from the previous quarter's growth of 1.3%. The print came below consensus estimates of 1% however output has continued to grow remained above the pre-pandemic level.

Industrial production for the month of March declined by a further 0.2% month-on-month after falling by 0.3% in February. Manufacturing output was down 0.2% month-on-month, mostly due to manufacturing of transport equipment (fell by 5.4%) and due to manufacturing of chemicals and chemical products.

Retail sales in April grew by 1.4% month-on-month, compared to prior month's decline of 1.2, beating the market expected decline of 0.2%. The increase was driven by higher sales in food stores, primarily alcohol and tobacco ad non-store retailers. Despite the surprise print, retail sales ar expected to come under pressure given the weak outlook on consumer spending as the sharp increase in inflation is expected to impact disposable incomes.

With inflation already high and expected to keep rising, there is a real risk of outright falls in consumer spending in the coming quarters as the cost of living crisis intensifies. In fact, the GfK Consumer Confidence reading crashed to its lowest level since 2008, at -38 for April from the prior -31, showing clear evidence that consumers are thinking twice about shopping.

The April final Composite PMI stood at 58.2, compared to the prior 60.9 and the flash estimate of 57.6. The reading pointed to a sharp growth although it eased to a three-month low given that services slowed while manufacturing increased slightly faster. New order growth was the softest year-to-date as new business rose at a much weaker pace. The slowdown reflected intense cost pressures and the war in Ukraine. Strong inflation was seen across both sectors but was more pronounced in manufacturing. Companies continued to expand staffing levels rapidly, albeit at a softer pace. Finally, business confidence dropped to the lowest in a year-and-a-half.

The April inflation rate surged dramatically to 9% from 7% in March. The largest upward contributors were the higher prices for electricity and fuels. Economists are suggesting that April could mark the peak, however inflation is expected to remain above 7.0% in 2022 and above 3.0% in 2023.

The core inflation rate for April similarly soared to 6.2%, compared to the prior 5.7%. Rises in global costs and the influence of product shortages are still boosting pipeline price pressures, which will continue to feed into the core rate of inflation.

The unemployment rate for the three months ending February stood at 3.8% in line with expectations, and down from the prior 3.9%. It has now returned to pre-pandemic levels, with 655,000 fewer available workers than in February 2020. The number of job vacancies at 1.288m in 1Q2022, a new record high, reflecting the mix of decent demand for workers and a diminished supply of workers. Moreover, average earnings (including bonuses) increased to 5.4% year-on-year in line with expectations in February, compared to the prior 4.8%.

With the unemployment rate having fallen to pre-pandemic levels, job vacancies at a record high and wage growth rising, the labour market is very tight.

The Bank of England ("BOE") raised the key Bank Rate by 25bps to 1% during its May meeting, pushing borrowing costs to the highest since early 2009. The decision came in line with expectations, although three members voted for a bigger 50bps increase. But two members thought the worsening growth outlook made it unclear if any further moves would be needed. BOE's Pill said that these differing opinions on the committee reflected the "narrow path" it was trying to steer "between the inflationary risk . . . and the risk of unnecessary weakness in activity and employment on the other side".

The BOE said that it will not make a decision until after August on whether to shrink its balance sheet quicker by selling gilts.

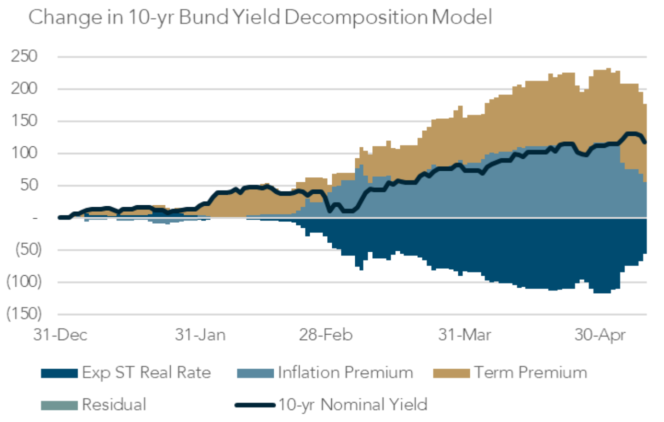
Policymakers said global inflationary pressures have intensified sharply following Russia's invasion of Ukraine which has led to a material deterioration in the outlook for UK growth. The BOE is estimating that the economy rose by 0.9% in Q1, but GDP is expected to be broadly unchanged in Q2 and to contract by c. 1% in Q4, due to a decline in households' incomes. In 2023, the BOE are estimating GDP to shrink by 0.25%. Meanwhile, the BOE is expecting inflation to rise further over the remainder of the year, to just over 9% in Q2 and averaging slightly over 10% at its peak in Q4.

RATES

Euro Rates

While economic data has been generally resilient so far, it is expected to show signs of weakness as the war in Ukraine will start weighing on trade numbers and business confidence. Very recently, headlines are showing the first news of gas supply disruptions from Russia which, combined with the slowdown in China, is expected to lead to weaker data. Therefore, growth risks have intensified materially, which have simultaneously worsened inflationary risks.

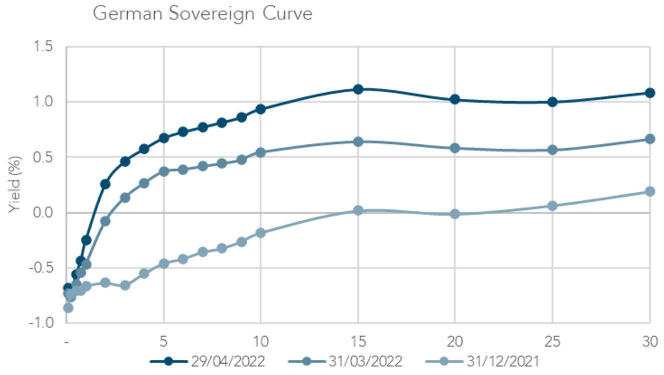
Generally, growth concerns weigh on long-end yields. Goldman Sachs estimates that the revisions lower following the invasion in Ukraine would have depressed bund yields by c. 20bps. This means that a de-escalation scenario, even if this could be disinflationary in the short -term, would result in a further sell-off in the long-end. Looking at this differently, receding risks on the growth outlook should provide further support for the ECB to normalize monetary policy.



Source: Bloomberg

A rise in nominal yields during April was primarily driven by higher inflation breakeven rates, reflecting both higher levels of inflation expectations as well as higher inflation risk premia. Given these inflation risks, real yields are too low and the market has been increasingly anticipating a more hawkish tilt in ECB comments.

In fact, the uptick in real yields since April is clearly driven by increased rate hike expectations which were supported by comments of ECB officials that a rate increase may be on the cards earlier than expected. The latest comments indicate a potential lift-off in July. This is coming despite the weaker German industrial production in March which dropped by 3.9% month-on-month (versus estimates of -1.0% month-on-month) which signals a weak momentum into Q2, and a continued widening in sovereign spreads.



Source: Bloomberg

European curves have steepened, in a correlated move with other G10 curves, despite the worsening growth and inflation outlook. Given the expectations of earlier rate hikes and that the focus will then shift on the impact of rate increases, there is material scope for higher front -end pricing, while the hit to growth will weigh on long-end yields. Therefore, a flattening bias should be expected going forward.

Given the swift change in the monetary policy stance, the high uncertainty on the growth outlook, and the worsening inflation dynamics, it is too early to add duration at current levels.

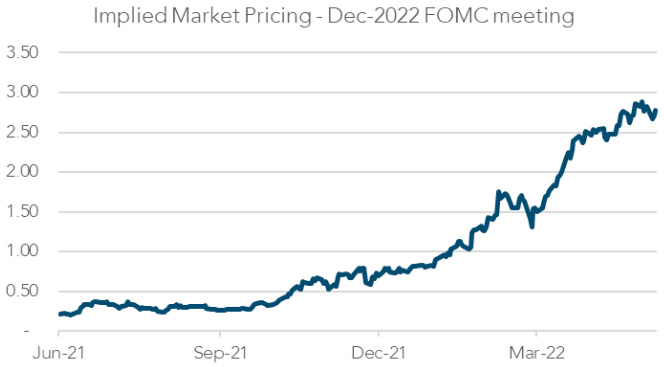
Sovereign spreads continue to widen on the prospect of lower ECB support. Particularly BTPs came under pressure, with the 10-year BTP-bund spread now rising above 200bps. Whilst sovereign spreads generally widen with growing duration risks, the combination of higher bund yields and lower growth expectations result in a disproportionately higher impact on weaker sovereigns.

Italy is particularly vulnerable given the energy security risks, especially since the EU is discussing banning Russian oil and the headlines of first disruptions in gas supply. Italy has a heavy reliance on Russian gas which could worsen the growth picture for Italy further. The concern here shifts to debt sustainability since Italy is highly sensitive to growth risks in maintaining a sustainable trajectory in its debt-to-GDP profile.

ECB officials have hinted to a possible backstop tool for sovereign debt markets which would be aimed at deterring a speculative attack on sovereign debt. This would also assist the ECB in remaining on course with their rate hiking plans. Such a backstop could ensure that any fragmentation risks are limited and could be a strong catalyst for a reconvergence in sovereign spreads.

US Rates

During the May meeting, the Fed announced a 50bps rate increase (current upper bound is 1.00%). Current market pricing is implying another 50bps hike in June and July and slower rate increases in the following meetings to reach an implied overnight rate of 2.80% in December 2022 – that is, a further 190 bps increase is priced in.

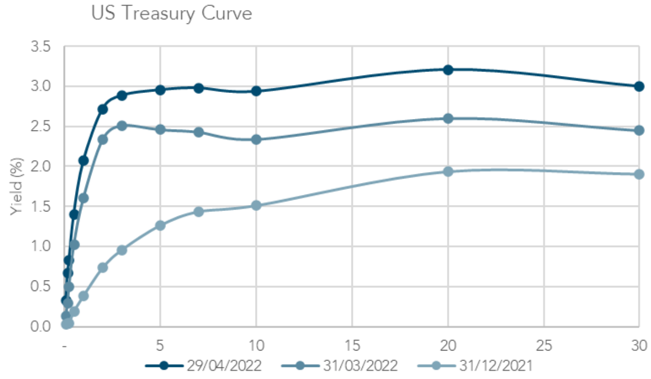


Source: Bloomberg

Implied forward rates top-out at close to 3% in 2023. The level is in-line with FOMC median projections showing that the Fed Funds Rate will reach 2.875% by end-2023 (the market is implying a slower rate hike trajectory next year).

US yields climbed further in April, as the 10-year rose by another 60bps, coming on the back of higher price levels and increasing evidence of broadening price pressures leading to a repricing higher of the Fed's policy path. The difference this time is that the sell-off was amplified at longer tenors, which led to a re-steepening of the curve. 2s10s rose back up to 40bps, after dipping into negative levels briefly in early April. The steepening is primarily driven by a steepening in the inflation curve, whereas the real yield component saw a fairly even increase along the curve.

Secondly, following Powell's comments that a 75bps increase is unlikely, implied rate increases at the very short end have been repriced against a slower peak



Source: Bloomberg

pace of 50bps. Historically, a lower peak pace was correlated with more aggregate tightening. Therefore, going forward, if the expectation holds that 50bps will be an upper bound to rate hikes, the vulnerable pricing point will be further out in the forward curve, primarily the terminal rate.

One thing to keep in mind is that when the Fed launched quantitative easing and increased the money base, there had been a notable increase in excess reserves and deposits on the repo facility which should shrink again as liquidity is drained from the system. Therefore the quantitative tightening impact on funding, liquidity and the US treasury market will be limited. It is more about rate hikes at this stage.

We seem to have reached a cap as to how large incremental hikes are expected to be. The key question remains what level interest rates need to reach to bring inflation back down towards target, and what does this mean for financial conditions, asset valuations and the growth outlook.

Tight labour market conditions and wage growth show risks of a wage-price spiral. Moreover, we have had sharp shifts in demand as a consequence of the pandemic, following which we are seeing persistent supply-chain disruptions, exacerbated by the war, and the lockdowns in China weighing on growth. All these factors point towards a higher neutral short-term rate to bring inflation under control.

The re-steepening of the curve could continue in the near term but it is expected to reverse given the high inflation environment and the requirement for the Fed to possibly overshoot the long-run rate to bring inflation under control. Therefore, we retain a flattening bias in our medium-term outlook.

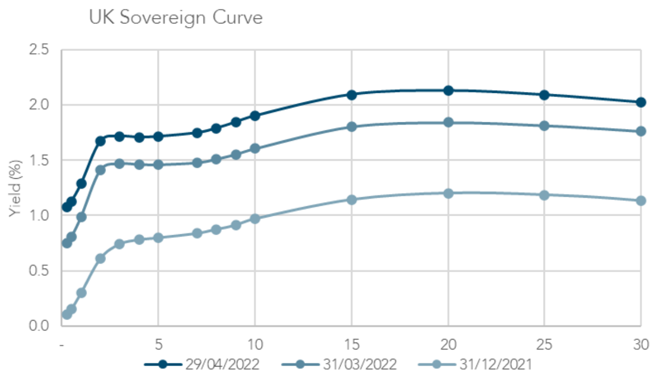
Secondly, given underlying economic conditions including inflation dynamics and the starting position of the Fed's monetary policy (the large balance sheet and all-time low policy rate), upside risks to the current implied terminal rate of 3% should not be underestimated. The sell-off in nominal yields has been substantial and requires a moderation in our short bias on US rates. However, the risk of a further sell off remains given the possibility of a repricing higher of the terminal rate – this will highly depend on the inflation trend.

UK Rates

The BOE seems to be diverging from peers as the communication given in the last MPC meeting shows a significant disagreement amongst committee members as well as a shift in focus towards the risks to the growth outlook. Moreover, the plan to start active selling gilts purchased under the BOE's quantitative easing programme when the policy rate reaches 1%, was postponed until the August meeting. UK bonds have outperformed given the softer message provided by the BOE

The UK economy is expected to see a weaker growth outlook given the surge in prices which is expected to deter spending, while the war in Ukraine will weigh on trade. Given this thinking, the BOE's assessment seems to be that an inflation-induced slowdown in consumption is what will put pressure on prices and bring inflation back down. This means that the reaction function of the BOE is expected to be much lower. This in turn increases the scope of a weaker sterling which in itself could lead to imported inflation.

Market pricing implies a further 110bps increase in the overnight rate by the December meeting, bring the overnight rate to just above 2%. Before the BOE meeting, market pricing was implying a year-end rate of 2.30% (c. 25bps higher).



Source: Bloomberg

Given the BOE's focus on the increased risks to growth and recession risks, the possibility of further delays in asset sales and the light issuance calendar, there is less scope that UK gilt yields will move higher at the same pace as other markets. To the contrary, there is the scope for a moderate repricing lower at the front-end, which also suggests the possibility of further steepening in the UK curve.

CREDIT

Euro Credit

The higher yield levels across both sovereigns and corporates was predominantly driven by monetary policy expectations. The persistently higher levels of inflation has driven market expectations on rate hikes as the ECB is expected to start raising rates at its meeting in July.

The disruption in supply chains and sanctions imposed on Russia due to the ongoing conflict in Ukraine also had a negative effect on European corporate issuers, due to their proximity to the conflict, with the sell-off that occurred in corporate bonds also being affected by such factors.

Besides comments from the ECB's President Lagarde that the central bank will be sticking to its gradual timetable for removing monetary stimulus as indicated during the April Governing Council meeting, corporate bond yields also moved higher due to the negative relationship between higher interest rates and corporate bond values.

The market narrative is not too dissimilar today than it was a month ago, except the majority of concerns we had then continue to prevail and have arguably escalated as in the case of the Russia-Ukraine conflict. Against this backdrop, and recognising that valuations and breakevens are much more compelling at these levels, we remain cautious on spreads, and continue to focus efforts on strong relative value trades and duration positioning to mitigate – to the extent possible – any fallout from further negative headlines around growth, supply chains, or the conflict.

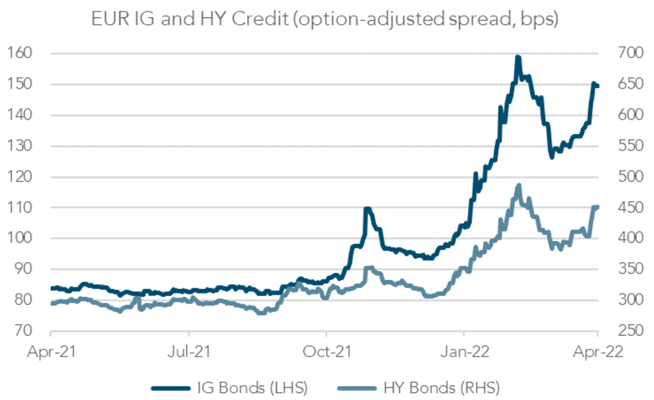
In the investment grade ("IG") space, breakevens have hit a QE record high, as rising yields due to the Ukraine War, inflation and ECB tightening have taken current buffers to beyond the pandemic peak. High grade duration rises with tighter yields and with index expansion every month even if yields do not move, as bonds maturing within a year drop out. Yet the surge in rates and spreads ensured duration has dropped markedly, to just 4.9 from 5.3 in November. Such record breakeven highs of c. 44bps provide a never-seen-before cushion against future rate or spread widening before negative total returns. This persuades us that high grade is the most protected it has been in two years.

In terms of curve positioning, we continue to prefer the short end of the curve given concerns on benchmark rates and the expected continued drift wider in spreads, particularly in non-financial credit.

Sector-wise, we prefer adding exposure to basic materials which screens cheap relative to other areas of the market and a) may be less directly impacted by the current Ukraine conflict and b) is not already heavily prevalent in model portfolios.

One key takeaway recommendation for IG portfolios at this stage is to highlight the need to evaluate on which side of the ECB eligibility spectrum existing holdings in the book currently sit and to evaluate what sort of eligibility premium we are currently enjoying on these names in order to properly steer portfolios through an eventual wind-down of asset purchase programs later this year.

Similarly for high yield ("HY"), breakevens have widened, and whilst not breaking through the pandemic peak levels, continues to trade at multi-year highs (barring March 2020). We had highlighted last month that March HY primary issuance was low, and that April was likely to be worse. In fact, primary markets for HY ground to a complete halt given market volatility, which provided some respite for investors despite a 54bp widening in OAS during the month. We continue to like the HY space in euros though remain cautious on spreads moving wider, highlighting the need for singling out issuers with strong fundamentals that may be trading at a discount to broader benchmark spreads.



Source: Bloomberg

US Credit

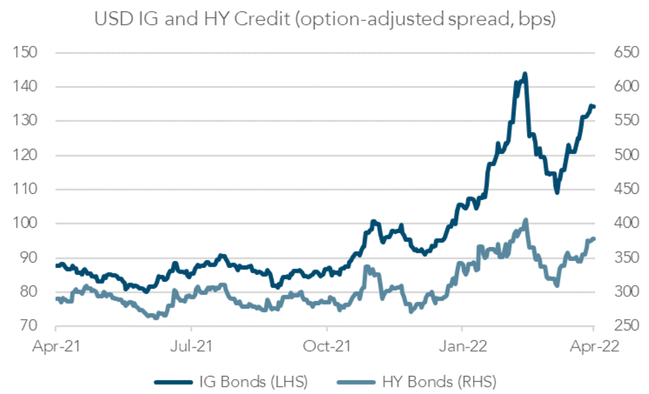
The wider US corporate credit spreads and higher US treasury yield have been similarly affected by rate increases communicated by the FED and the increased expectations of further hikes going forward.

Given the backdrop of ongoing price pressures and elevated supply chain issues driven by lockdowns in China and the conflict in Ukraine, with little signs of abating, spread forecasts by both Barclays and Goldman Sachs analysts have been revised wider for the year. Having said that, credit conditions remain supportive for the time being in terms of supply, demand and fundamentals and as such, we think that the expected widening in spreads for the rest of the year can be managed by maintaining exposure in short duration positions or outright floaters.

At this stage in the cycle, we prefer adding exposure to non-cyclicals and senior financials, and would look to expand exposure in the A-/BBB+ rating cohort. Similarly, we prefer maintaining short duration exposure to minimise interest rate risk.

Overall, corporate supply has been largely in line with last year's levels, though the distribution has shifted meaningfully, with industrials supply down c. 15% year-on-year, whilst financials issuance is up 26% year-on-year. The expectation is for lower supply into year end (particularly for financials) given the view that supply from large US banks was likely pulled forward ahead of rate hike expectations, implying lower H2 funding requirements, supporting the preference for senior financials.

In HY the story is largely the same, though the distance from current spread levels to year end forecasts implies a slightly weaker excess-return forecast for the remainder of the year, leading us to prefer IG credit over HY in the US dollar space. Looking to current versus historical breakevens reinforces this view, as the buffer on IG US dollar credit screens significantly better than the comparatively still relatively exposed HY space.



Source: Bloomberg

UK Credit

The dispersion in credit spreads was also prevalent in the UK despite the rise in the gilt yield. However, UK corporate bond spreads widened by a lesser degree than that seen in both the Euro Area and the US. Monetary policy also played a central role in the UK corporate bond market and the movements that occurred as the BOE hiked rates further to tame the persistently high levels of inflation.

Selling £20bn of corporate bonds is no small feat, even in the best of conditions. Based on the current size of the sterling IG corporate bond market, analysts believe that sales would need to remain under £100m per week to avoid market disruption, in which case, the unwind would take at least four years to complete. The BOE's stated intention as of it's latest meeting is to begin the process of selling off it's £20bn corporate bonds portfolio in September 2022 and to have completed the process by early 2024, implying roughly a 16-19 month horizon and a minimum of c. £1bn in corporate bond sales per month through secondary markets. When coupled with the current weak macroeconomic backdrop impacting investor appetite, the implication is for a potentially more meaningful impact to sterling corporate credit spreads.

The bank has stated that given the aim of limiting any market disruption, sales are intended to be gradual, but responsive to conditions, implying that the pace of sales is likely to fluctuate over time. The corporate bond portfolio represents roughly 4.5-5.0% of the total sterling market (depending how the universe is defined) though, more pertinently, the amount available for sale represents c. 35% of gross issuance, or c. 100% of overall net issuance in a typical year for the sterling IG market.

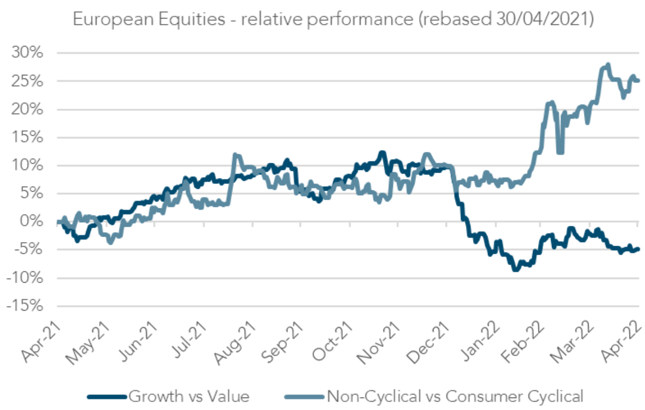
Based on the size and pace of the unwind, the BOE is likely to crowd out non-financial issuers, most acutely in housing and utilities where it is believed the BOE holds more exposure, creating a sharp overhang for sterling supply going into H2. Despite this overhang, the expectation is not for sterling IG credit to entirely decouple from the euro and dollar markets, though for the weak technical backdrop to exacerbate a weak macro backdrop. The BOE itself sees the UK economy contracting 0.25% in 2023, whilst the Barclays Global Manufacturing confidence indicator fell into contractionary territory in April. Global Manufacturing output and new orders were adversely affected by lockdowns in China and the Russia-Ukraine conflict, and supply chain disruptions and production price pressures showed no signs of easing.

We caveat these comments by highlighting that members of the BOE's monetary policy committee have recently expressed increasing concern around the weak macro backdrop, implying that there may be less scope for UK gilts to continue drifting wider given a potential change in narrative, which may prove somewhat supportive for the asset class in the short term. On a purely spread basis however, the overhang created by the impending Corporate Bond Purchase Scheme unwind leaves us preferring euro and dollar paper for the time being, more so in IG credit than in HY given that the impact will be more secondary in nature.

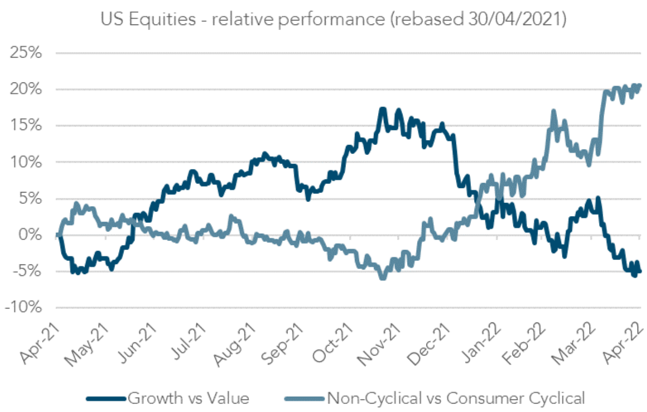
EQUITY

The surge in yields has weighed on investor sentiment during April. The US 10-year real yield surged 100bps to 0% by the end of April from 7 March, and 50bps since the end of March. Such outsized moves tend to weigh on investor sentiment, which explains the performance in the major US equity indices. The S&P 500, which we see as more growth oriented than the DJIA but to a lesser extent than the Nasdaq, generated a total return of -8.7% ($ terms) in April, the worst performance since March 2020. Unsurprisingly, the Nasdaq 100 fared even worse with a total return of -13.2% ($ terms), the worst month since October 2008, while the DJIA was the best performer in the US with a total return of -4.8% ($ terms).

Investor anxiety around rates outweighed a surprisingly good 1Q2022 earnings season in the US. According to data published by Factset (so far, 87% of companies listed on the SPX have reported earnings for 1Q2022), 79% of companies have reported EPS above expectations which is above the 5-year average of 77%, whilst 74% have reported a positive revenue surprise. As for guidance, 69% of companies (50 out of 72) that have issued EPS guidance for 2Q2022 have issued negative guidance. This percentage is above the 5-year average of 60% and the 10-year average of 67%. In terms of revisions to EPS estimates, analysts have cut EPS estimates in aggregate for S&P 500 companies by 0.4% since the



Source: Bloomberg



Source: Bloomberg

end of March, which is a smaller decline than average but the second time in the past seven quarters in which analysts have revised earnings lower.

Europe outperformed the US but investor anxiety is rising. The STOXX 600 index delivered a total return of -0.7%, well ahead of the US indices as the overhang coming from policy risk was lower in April in Europe when compared to the US. The uncertainty brought about by the war led to a -8.4% slide (between 23 February and 8 March) for the STOXX 600 index, followed by a strong rally of +12.1% (between 8 March and 21 April), reaching a post–war high on 21 April. Since then, investors have been more nervous around the growth/inflation mix, as the impact from the war and the zero-tolerance for COVID-19 cases in China skewed risk to higher inflation and lower growth.

Earnings and revenues for companies included in the STOXX 600 that have reported earnings have so far surprised to the upside on average. According to Goldman Sachs, 40% of the companies have reported earnings so far, with EPS 10% ahead of estimates on average. At least 65% of the companies have reported a beat compared to analyst expectations by at least 5% whilst 15% have missed by the same amount. These are, respectively, among the highest and lowest fractions of beats and misses since the Global Financial Crisis, but in line with the post COVID-19 recovery. Energy and basic resources post an average EPS beat of 15% and 20% respectively, whilst banks have surprised 15% to the upside. Travel and leisure (12%), real estate (-6%) and construction & materials (-6%) were the worst performers.

Markets have likely priced-in a modest downturn, but inflation pressures might lead to a deeper one. Both the S&P 500 and the STOXX 600 are down significantly year to date at -13.1% ($ terms) and -10.4% respectively. Yet, both have reported some degree of improvement in earnings growth expectations since the start of the year. The consensus P/E multiple has declined by over 20% for both the S&P 500 and the STOXX 600. Since the start of the year, the real 10-year US treasury yield has ventured into positive territory for the first time since 2020, surging from -1.0% to 0.0% or c. 110bps. During the same period, the earnings yield (inverse of the P/E ratio) has risen by 110bps (from 4.9% to 6.0%), matching the move seen in real yields, leading to a yield gap, a proxy for the equity risk premium, of 6.0%. The current yield gap of 600bps matches exactly the 10-year median and is 20bps above the 5-year median, but is far wider than it was 20 years ago.

The key concern around inflation is whether central bank action will lead to a global recession. Some investors argue that a recession is inevitable when both inflation overshoots and the labour market is tight, but there are a number of unique features in this cycle. The probability of a global recession increases if inflation remains at the current high levels for much longer, and persisting supply-side issues are not helpful against a backdrop of high pent-up consumer savings. This explains the volatility we are seeing in equity markets, especially the sell-off in the US market where inflation is more pronounced. Europe has so far avoided such concerns but we are seeing inflation concerns rising. Some market participants are calling for a July rate hike, compared to no rate hikes expected at the start of the year. Despite this, a recession is still not the base case and we remain positive (to a lesser extent) on equities for the year.

Inflation moderation will probably be a key driver of performance in the coming months. The main purpose of a rate hike is to slowdown the economy enough to get inflation into control. The extent by which the economy needs to be slowed down will have a direct impact on the prospects for the equity market in FY2022. We could see equity risk premium rising in the event of aggressive tightening as the probability of a recession would rise.

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. This has been confirmed in recent meetings and communications of key policymakers despite the increased uncertainty on the growth outlook as a result of the war in Ukraine. In the short term, growing recessionary fears may act as a tailwind for the asset class, though 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 shifts in the benchmark curve. The outlook for periphery credits in Europe has deteriorated following the cessation of the PEPP, effectively removing a key pillar maintaining tighter peripheral spreads in Europe.
Investment Grade Corporate Bonds	Neutral	O/W	Investment grade returns will continue to depend on movements in benchmark rates and corporate spreads, though following the material widening since the onset of the Ukraine conflict, the asset class has begun providing reasonable opportunities to add risk on a selective basis. The default and rating environment for global credit has continued to remain stable for issuers and regions not directly impacted from developments in Ukraine, though cracks are beginning to form for more exposed entities. Recent spread widening offers a significantly better cushion against adverse movements in benchmark bond yields than we have seen for a number of years. Whilst our medium-term outlook is that benchmark yields are biased to move higher, we are taking the opportunity of the recent spread widening post-Ukraine-invasion to increase our exposure to IG corporate bonds, though maintain a preference for a low-to-neutral duration stance versus the broader corporate benchmark.
High Yield Corporate Bonds	Positive	O/W	The elevated uncertainty on the growth outlook and higher inflationary forces as a result of the war in Ukraine has led to a substantial widening in credit spreads. A stable credit rating environment provides a solid underpinning to seek opportunities on a selected basis, though with underlying economic conditions beginning to show some signs of weakness, we place additional focus on names and sectors less exposed to a potential slowdown. We remain selective in holding high yield positions as we focus on identifying new positions on a name-by-name basis, screening for names based on resilience of cash flow and strength of balance sheets that should see limited drag on operational performance as finance costs and input costs increase.
Developed Markets Equities	Positive	O/W	The correction in the equity market started in February, as persisting inflationary pressures led to a re-pricing of interest rate expectations. In the summer of 2021, the market was pricing no interest rate hikes for 2022 in the US, but by February this had moved to 7 rate hikes. The invasion of Ukraine at end-March has changed the landscape, with a surge in energy prices leading to downward revisions in growth outlooks. We have moved away from the reflationary concerns to stagflation concerns. Yet our stance on the asset class currently remains unchanged, even if uncertainty has increased significantly. A key risk is a prolonged conflict leading to high energy prices persisting for longer than expected and supply-side concerns to weigh on margins and corporate profitability.
Emerging Market Equities	Positive	N	The backdrop for EM equities was favourable during 2021, with strong synchronized global economic growth, higher commodity prices and positive investor sentiment. However, country specific concerns (like regulation and property concerns in China) weighed on performance. Going into 2022, we expected the asset class to deliver a strong performance, especially in certain regions within EM. The invasion of Ukraine and the impact this had on inflation has presented a challenge for certain EM countries, but our larger exposure to commodity exporting countries should boost performance.

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

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