Investment Strategy Update

June 2022

Curmi & Partners Research

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- Activity data is starting to show signs of weakness as inflation weighs on personal incomes and demand.
- June Purchasing Managers Index releases disappointed market expectations, showing a far slower rate of expansion across both manufacturing and services sectors noting a decline in orders, concerns on rising input costs and a weaker growth outlook.
- According to survey data, hiring intentions are starting to moderate as businesses are scaling back expansionary initiatives in view of the slowing pent-up demand and worsening outlook.
- Central banks have pledged their commitment to fight inflation, with the Federal Reserve and The Bank of England raising rates by 75bps and 25bps respectively in their June policy meetings.
- The ECB has announced the halt of its last asset purchase programme and has substantially changed its forward guidance towards a more hawkish trajectory signaling that it would raise rates to zero at upcoming meetings, possibly by September, and hike rates further thereafter.
- Markets went from assessing the Fed Reserves's stance from hawkish to borderline fearful as Fed Chair Jerome Powell testified in Congress that a soft landing is unlikely given the extent of monetary tightening required.
- Given the persistent inflationary pressures, central bank policy will remain a key driver for risk sentiment along with the growth outlook for the time being.
- The current period of increased pessimism comes with high uncertainty given the unknown extent of monetary tightening required to curb inflation and speed with which it will be delivered.
- Our assessment is that markets will remain vulnerable to further downward revisions in the growth and earnings outlook as economic data remains soft.
- Investor confidence can start to rebuild if we reach a nadir in economic data, particularly with a stabilization in inflation and as the endpoint of central bank tightening becomes clearer.
- We have implemented a defensive reallocation across our portfolio strategies given the worsening economic and financial conditions.
- We have added some exposure to sovereign bonds as yields came off recent peaks to reduce the short duration positioning in our fixed income allocations.
- We plan on increasing the overall quality in our credit exposures by focusing on strong balance sheets and less cyclical profiles.
- In order to reduce overall risk in our portfolios, we have reduced our equity allocation to underweight, added defensive positions and reduced our exposures to sectors with a high economic beta, mainly banks and energy.

The sell-off in financial markets has deepened in recent weeks reflecting an accelerated and higher rate hiking trajectory expected by major central banks and the intensification of recession fears with the recent slew of softer economic data releases. The reprising in bond markets has been remarkable by historical standards as a result of the unprecedented degree of monetary accommodation introduced in recent years and the inflationary pressures which became more acute with the war in Ukraine.

Benchmark bond yields have continued to soar with the 10-year Bund yield peaking at 1.93% and 10-yr US Treasury yield peaking at 3.49% up from -0.19% and 1.50% at the start of the year. We have seen some moderation since then with the benchmark yields now trading at 1.60% and 3.21% respectively. The movement in benchmark yields is reverberating across the rest of the market. In corporate credit, the volatile movements in benchmark yields led to wider credit spreads and wider bid and offer price spreads in secondary market trading. In equities, we have a seen valuations coming down further in reflection of the higher cost of capital and increasing growth concerns.

These weak market conditions are not unjustified given that the main challenge is that central banks are committed to tackle inflation and tighten monetary policy at the cost of a growth slowdown. The key questions are (a) how much tightening is required to bring inflation back under control and (b) have equity markets adjusted enough for the resulting economic slowdown?

On a fundamental basis, bottom-up forward earnings estimates have remained resilient for 2022 implying a 14% growth rate over last year, or 4% when excluding commodity-related stocks. And in fact, most of the drawdown in equity markets has been explained by multiple contraction as opposed to downward revisions in earnings, which in turn was highly correlated to the move higher in real yields.

But we argue that the compression in multiples is already a reflection of a deterioration in earnings growth. Of relevance is the notable underperformance of cyclical stocks versus defensives to an extent which is generally represented by contractionary economic conditions. The upcoming Q2 results will be crucial in shedding light on the companies' own assessment of current challenges of what the near future holds which may be a catalyst for market analysts to revise earnings expectations downwards.

Macro-economic data shows that activity is starting to slow, as reflected by the recent slew of survey data which came in lower than expected but still in expansionary territory. However, labour markets remain resilient with vacancy counts generally high(er) in relation to the number of unemployed persons, showing that demand for labour is still strong despite reaching low levels of unemployment. Household balance sheets are robust given the deleveraging seen over the last decade or so. Such conditions limit the possibility of a severe economic recession.

This macro picture suggests that the sell-off in equity markets is more reflective of a cyclical bear market rather than a structural one. In other words, it is being driven by the expectations of an economic slowdown and not because of an economic crisis brought about by a surge and implosion of systemic risk factors (such as the 2008 great financial crisis). Cyclical bear markets generally see a shallower and shorter drawdown in equity markets which is also quicker to recover compared to structural bear markets.

In attempting to answer the two fundamental questions outlined at the beginning of this opening statement, we find that investor sentiment can start recovering when sequential data releases show a stabilisation in the inflation picture. Only then can monetary dynamics start to shift as the endpoint to the tightening cycle becomes more visible. Until then, we expect any risk rally to be short-lived given that pricing of tail events cannot be contained.

Secondly, analysts have continued to increase the probability of a recession but there has not been any material downgrades in the earnings outlook. Typical cyclical bear markets see a 30% drawdown in equity markets which suggests that there is still some room to go down further. Price multiples are on balance fairer today, particularly given the derating on the back of the new interest rate environment. But we could see further pressure on prices especially on the back of downward revisions in earnings guidance.

Given the scope for continued weakness in risk sentiment in the very near term, we have reduced our overall equity allocation. We are holding onto our defensive positions with positive earnings correlation to inflation, whilst scaling down our overweight positions in banks and energy stocks. Secondly, as the front-end pricing of the policy rate trajectory got firmer following the June central bank meetings, we have started to moderate our short duration stance by adding some sovereign exposure. We see less potential of further curve losses at this stage and the narrative that weakening economic prospects will require less monetary tightening will cap large spikes in yields going forward.

Whilst introducing a defensive allocation in our portfolio strategies, we are looking for the nadir in economic data to potentially reintroduce a pro-cyclical allocation. We maintain a preference to pick up opportunities on a selective basis given the fatter and flatter market profile expected in a new cycle characterised by higher inflation, greater regionalisation and increased scarcity of resources.

MACROECONOMIC

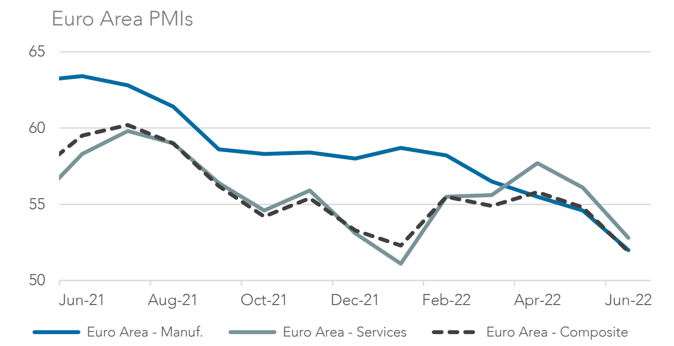
Euro Area

The economic outlook for the Euro area is subdued as the war in Ukraine remains underway and continues to exert further upward pressures on commodity prices, causing renewed supply disruptions and increasing uncertainty. At the same time, the European Central Bank ("ECB") is set to end negative interest rates in an attempt to curb record inflation. The ECB is expecting the Euro Area GDP growth to be 2.8% in 2022 and 2.1% in both 2023 and 2024, revised downwards from the March forecasts of 3.7% and 2.8% for 2022 and 2023, and upward from the March forecast of 1.6% for 2024.

April retail sales declined by 1.3% month-on-month, compared to the prior and market expected growth of 0.3%. Consumer demand is in decline, as evident in the June Services PMI data (June: 52.8, May: 56.1; market consensus: 55.5), which shows that overall demand rose at a slower rate when compared to May due to higher inflation pressures and that the post-lockdown rebound was losing some strength.

Industrial production for April increased 0.4% month-on-month, rebounding from the prior month's decline of 1.4%, however coming in just below the market expected 0.5% increase. Therefore, the increase only partially reversed the decline in March and shows that the economic fallout from the Ukraine conflict is still holding back production.

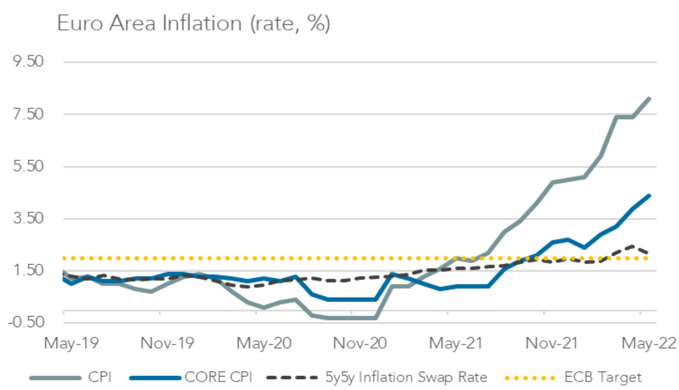
Supply chain constraints worsened due to the conflict, Russia limiting exports and lockdowns in China, and we suspect that these will only get worse with the Russian energy import bans and with major Chinese cities still in lockdown. It is possible that the EU will experience the start of a manufacturing recession which could cause the GDP to stagnate. This is evident in the decline in the



Source: Bloomberg

Manufacturing PMI for June (June: 52.0; May: 54.6; market consensus: 53.9), which suggests that output is struggling as the industry is being impacted by the high inflation environment and as consumer demand began to fall due to higher product prices.

Headline inflation for May surged to 8.1% from the prior 7.4%, with the main contributor to the increase being energy inflation. Similarly, core inflation for May increased in line with the flash estimate to 3.8% from the prior 3.5%. The recent surge and the likely further increases in gas and agricultural commodity prices due to the Ukraine war will keep the headline rate elevated. Moreover, rising price pressures from ongoing supply chain disruptions from Chinese lockdowns and the war, and economic re-opening effects suggest that core inflation will also rise further.



Source: Bloomberg

The evidence is continuing to support the notion that the Euro Area is experiencing a broadening and growing inflation problem which looks set to force the ECB to move faster to a neutral setting and perhaps to go beyond that next year. The ECB raised their inflation forecasts to 6.8% in 2022, 3.5% in 2023 and 2.1% in 2024, from the March forecasts of 5.1%, 2.1% and 1.9% respectively.

The April unemployment rate was unchanged at 6.8%, in line with expectations. The June PMI data suggests that growth in jobs is moderating as firms are scaling back hiring plans given the worsening outlook.

At the June meeting, the ECB announced plans to lift interest rates above zero for the first time in a decade by September, by unanimously signalling that it was likely to raise rates by 50bps in September, in addition to a planned 25bps in July. We believe that the September hike of 50bps will likely occur unless inflation improves significantly by then. Lagarde expressed that risks to the inflation outlook were now "primarily to the upside", and officials are increasingly concerned that higher wages and disruption to global energy markets and supply chains will lead to inflation becoming entrenched.

Further, the ECB announced that it would end its remaining €20bn-per-month bond purchase at the start of July. However, the sell-off in bond markets underlined how the ECB's plans to ditch its crisis-era stimulus could cause problems for countries with higher debt burdens, such as Italy. As a result, the ECB held an emergency meeting less than a week after the June policy meeting, were it decided to accelerate the completion of the design of a new anti-fragmentation instrument aimed to prevent unwarranted jumps in Euro Area bond yields. Policymakers also decided to apply flexibility in reinvesting redemptions coming due in the PEPP portfolio, with a view to preserving the functioning of the monetary policy transmission mechanism.

United States

The second estimate for the Q1 annualised GDP growth rate showed a contraction of 1.5% quarter-on-quarter (first estimate: -1.3%) due to a big drag from trade. Real disposable income is being estimated to have fallen at a 6.7% annualised pace in Q1, mostly reflecting stronger than expected tax payments, meaning that the personal savings rate declined. This is only expected to decrease further, in line with the growth in retail sales and the PMI data results, which therefore points to a slower growth in consumption in Q2.

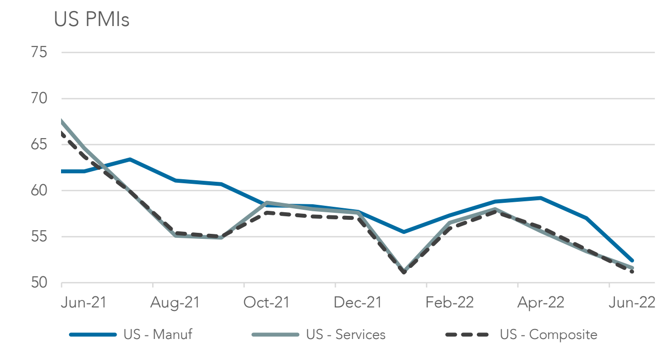
The updated projections provided for the June meeting show that the Fed is forecasting GDP growth to slow to 1.7% by the end of this year (March forecast: 2.8%), maintain this level in 2023 (March forecast: 2.2%), and increasing slightly to 1.9% in 2024 (March forecast: 2%).

Industrial production for April grew 1.1% month-on-month, higher than the market expected growth of 0.5% and the prior month's growth of 0.9%. The 0.8% month-on-month rise in manufacturing output underlines that it is not just consumer spending powering the economy forward. The rise in manufacturing output was helped by a 3.9% month-on-month increase in motor vehicle production, which is now back above pre-pandemic levels as semiconductor shortages continue to ease.

However, the industry is also being helped by a broader easing of intermediate goods shortages as well as the easing congestion at ports. The fall in Manufacturing PMI data for June (June: 52.4; May: 57; market consensus: 56.0) suggests that global manufacturing demand is cooling (due to a slowing economy and strong dollar), the gradual easing of input shortages over recent months is helping to keep output growth strong. However, higher operating expenses were suffered due to hikes in commodity and transport costs, with some firms mentioning that the war in Ukraine and China lockdowns have exacerbated surging prices.

Retail sales in May have declined 0.3% month-on-month, compared to the prior increase of 0.7% and the market expected increase of 0.2%, as high inflation, gasoline prices and borrowing costs hurt spending on non-essential goods. The biggest contributor to the decline was auto sales (-3.5% month-on-month), but the drop reflects the impact of China's lockdowns on Asian manufacturers rather than a weakening demand.

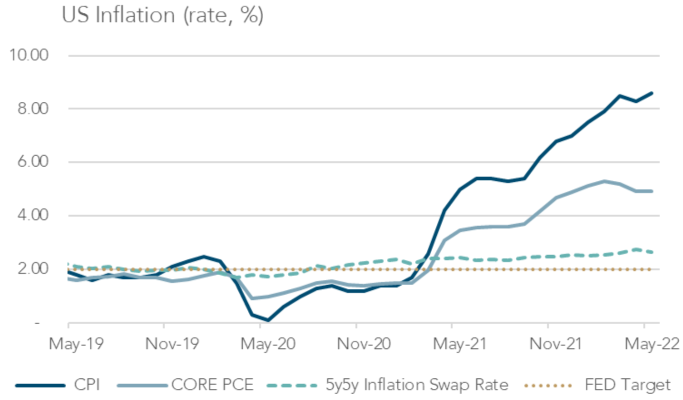
Services PMI data drop markedly in June (June 51.6; May: 53.4; market estimate: 56.0) showing a slower increase in services output. This suggests that overall real consumption edged lower in June and, with prices likely to see another strong rise in June, a rebound in real spending looks unlikely.



Source: Bloomberg

Headline inflation surged to 8.6% in May from the prior and expected 8.3%. Markets saw the downward move in April from 8.5% to 8.3% as a signal that inflation had peaked, while the May reading surprised to the upside, showing that inflation is still broadening. The main contributor to the surge was energy (34.6%) and agricultural products (14.2%), with fuel oil alone increasing by 106.7% over the prior month.

On the other hand, core inflation in May declined to 6% from the prior 6.2%, however remaining above the expected 5.9%. This reflected higher jet fuel prices which contributed to a 12.6% rise in airfares, together with renewed increases in goods prices, such as of new vehicle prices (+1.0%).



Source: Bloomberg

During the June meeting, Fed officials announced that they expect core inflation to settle at 4.3% this year (March forecast: 4.1%), and 2.7% in 2023 (March forecast: 2.6%), while the 2024 was not revised from 2.3%.

The unemployment rate for May stood at 3.6% for three consecutive months, though was above the market expected 3.5%. Meanwhile, the labour force participation rate edged up 62.3% from the prior 62.2%.

The May non-farm payrolls amounted to 390,000, which was below the prior 436,000 however higher than the expected 325,000, despite employers grappling with a historically tight labour market. This better-than-expected gain adds to the signs that the economy is still strong while, amid a rebound in the labour force, wage growth is beginning to moderate.

Average hourly earnings for May increased in line with expectations at 5.2% year-on-year, below the prior growth of 5.5%. This is in line with PMI data for May, which showed that firms filled long-held vacancies, and that there are greater staffing numbers. However, with roughly 1.9 vacant positions for every unemployed worker, there are also concerns that a prolonged shortfall of people willing to join the labour force will keep upward pressure on prices as employers are forced to continue raising wages and improving benefits in order to attract new hires and keep those already on payroll.

As a result of the further tightening, the Fed are forecasting the unemployment rate to rise more substantially from the 3.5% projection in March. The Fed have pencilled in an unemployment rate of 3.7% by year end (March forecast: 3.5%), to 3.9% in 2023 (March forecast: 3.5%) and to 4.1% in 2024 (March forecast: 3.6%).

The Fed has raised its benchmark policy rate by 75bps to a target range of 1.50-1.75% during its June meeting instead of the initially expected 50bps after the inflation rate unexpectedly accelerated. Chair Powell signalled a similar move could come at the next meeting, but that he does not expect 75bps moves to be common.

Fed officials also sharply raised their rate forecasts compared to three months ago, when they pencilled in that the federal funds rate would reach 1.9% by year-end and 2.8% in 2023. The dot plot now suggests that the policy rate will rise to 3.4% by the end of 2022 (a level that suggests that the Fed may implement at least one more 75bps increase this year). Additional interest rate increases are also anticipated in 2023, with officials indicating the policy rate could reach 3.8%. Notably, the median forecast for the federal funds rate for 2024 was 3.4%, suggesting that the Fed will need to reverse its rate rises in recognition of the fact that the economy is likely to have slowed considerably by that point.

United Kingdom

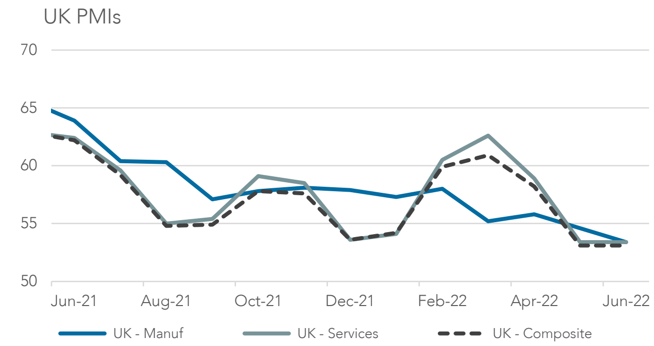
The UK economy contracted 0.3% month-on-month in April following a 0.1% contraction in March and missing market expectations of a 0.1% expansion. This increases the chances that the economy slips into a recession, as price pressures continue to impact consumer spending on non-essential goods, together with businesses being impacted by high inflation and supply chain disruptions.

Despite this, output in consumer-facing services, where we expect households to rein in their spending due to higher inflation and interest rates, rose by 2.3% month-on-month. This is because the entire impact of inflation and interest rates has not been felt fully. So GDP will likely stay weak over the coming quarters, and therefore, a recession is a real risk.

May retail sales contracted by 0.5% month-on-month, after the increase of 0.4% in April, which was slightly better than the market expected contraction of 0.7%. The impact of the rise in the cost of living and food prices has weighted on food store sales. On the other hand, non-food stores sales were unchanged as the decline in household goods was offset by increases in clothing sales and automotive fuel sales.

The cost-of-living crisis will continue to weigh on retail sales particularly as the full effect is filtered through the data given that the squeeze on households' real incomes from higher inflation is set to intensify. In fact, June Services PMI data (June 53.4; May: 53.4; market consensus: 53.0) shows that services continues to grow at the weakest pace since February 2021, as some services providers are seeing lower demand due to the higher prices charged, while others stated supply shortages hampered spending.

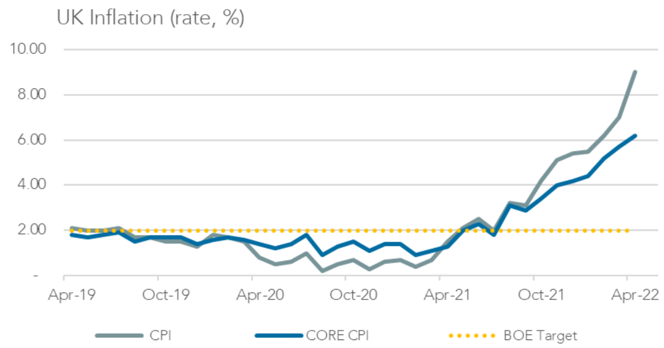
Manufacturing PMI fell further in June (June: 53.4; May: 54.6; market consensus: 53.7) as manufacturing output is expected to decline further given that factory activity slowed due to weaker growth in domestic demand, lower intakes of new export work and ongoing disruptions caused by stretched supply chains, rising cost pressures and the war in Ukraine.



Source: Bloomberg

Headline inflation for May stood at 9.1%, in line with market expectations but marginally higher than the prior 9.1%. The surge was prompted by rising prices for electricity, gas and other fuels following the increase in the Ofgem cap on energy prices. This is another sign that the consumers' living standards continue to squeeze.

On the other hand, core inflation for May eased to 5.9% in from the prior 6.2%, coming in lower than market expectations of 6%. Some of those rises were due to businesses passing on higher product and wage costs and some were due to the reversal of the government's pandemic temporary VAT cut for the hospitality sector. Therefore, some of the moves are due to global factors, but there are clearly domestic drivers too.



Source: Bloomberg

Things are going to get worse before they get better. Analysts are seeing inflation to rise further to 10% in October and to then fall back to the 2% target slowly thereafter as the boost from global factors unwinds, the boost undermined by the high wage growth from the tight labour market. Analysts believe (1) the Ofgem utility price cap may rise by a further 30% in October, (2) the previous rises in agricultural commodity prices may yet raise food inflation to 9%, (3) the further rise in core goods producer price inflation from 11.8% in March to

13.0% in April suggests that core goods CPI inflation will rise further and (4) the fast rate of wage growth implies that services CPI inflation will increase too.

The unemployment rate for the three months to April edged higher to 3.8% from the prior 3.7% and the market expected 3.6%, driven by a decline in the number of students and an increased supply of workers. Single month data for April showed that employment fell by 254,000 and the unemployment rate rose from 3.5% in March to 4.2% in April, while the upward move in the number of job vacancies slowed to 1.3m. The three month average weekly earnings (including bonuses) increased by 6.8% year-on-year from the prior 7% and below the market expected 7.6%, due to a 6.7% month-on-month drop back in bonus payments following the 7.1% leap in March.

This data suggests that the labour market is still very tight, as the unemployment rate is still close to its recent 47-year low, the three-month average of vacancies is still at a record high (there is exactly the same number of unemployed persons as vacancies) and nominal wage growth remains strong. However, it is possible that the weakening economy since the start of the year is starting to filter through into a slightly less tight labour market.

The Bank of England ("BOE") raised interest rates by 25bps to 1.25% in the June meeting, moving more cautiously than other central banks while warning that inflation will climb to above 11% by year end reflecting a new rise in oil prices and recent estimates of the likely increase in regulate energy prices. The MPC dropped previous guidance that "some degree of further tightening" might be appropriate. Instead, it said the scale, pace and timing of any further increases would reflect the evolving economic outlook.

While MPC members warned price pressures were becoming more embedded, the majority judged that the economy was already weakening enough to bring inflation under control without more drastic action. Further, the MPC acknowledged that excess inflation was no longer due only to global events. Core consumer goods prices were rising faster in the UK than the US or Euro Area, and there was a risk that "self-sustaining momentum" in inflation would persist even as the economy weakened.

RATES

Euro Rates

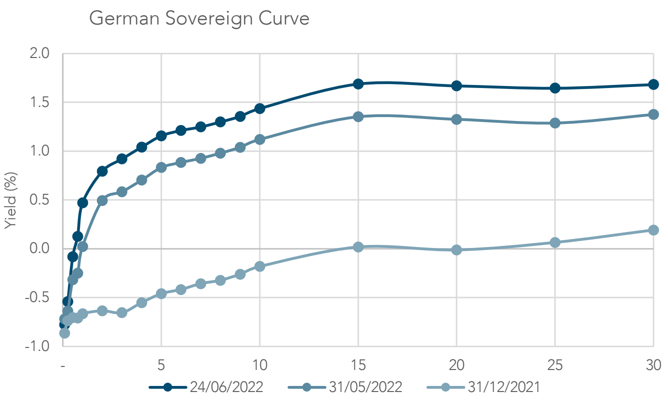
ECB officials have become decisively more hawkish joining other peer central banks, guiding towards rate hikes starting in July. The yield curve shifted upwards given these prospects and the record high inflation print in May. The uncertainty around the policy path of the ECB has led to sovereign spreads coming under pressure to widening in spreads as QE is withdrawn.

The ECB confirmed in June that it plans to hike rates to zero, possibly by September, and beyond as required thereafter. It also announced the earlier stop to asset purchases at the end of June. The ECB is expected to announce any further policy steps, given the emphasis by members on gradualism, but could provide additional hawkish hints in upcoming meetings particularly on having a more open discussion on the potential of a 50bps hike.

Markets seem to expect such an outcome to be broadly balanced. This suggests that a 50bp hike is partially already reflected in market pricing, and we could see some modest relief rally and tighter sovereign spreads on the back of the absence of a further hawkish shift by the ECB.

The ECB also held an emergency meeting following the swelling of sovereign spreads to discuss a policy tool to improve monetary policy transmission across member states and effectively reduce the volatility and widening in peripheral sovereign spreads. This new backstop facility would increase the Governing Council's latitude to increase rates more rapidly (with the backstop protecting against excessive Euro Area financial fragmentation from occurring), but could also allow for sovereign spreads to tighten. On the other hand a hawkish outcome with no news on a backstop facility would likely lend to wider peripheral spreads.

The ECB will most likely retain a high degree of data dependency to support any further hawkish moves and will continue to emphasise optionality and flexibility. We expect that the market reaction under a more hawkish



Source: Bloomberg

scenario to be a more acute rise in yields, steeper curves and widening peripheral spreads.

The key triggers that we were looking for when introducing a short duration bias have materialized. Firstly, we highlighted the inflation risks which have been proving scope for yields to rise on the back of higher inflation premia - inflation data has continued to surprise to the upside reaching a record high in May. Moreover, we have highlighted that the ECB has been lagging behind and that we will eventually be moving closer to a potential lift-off. To this end the ECB has caught up to an extent with other central banks in providing a clearer and swifter path to end-QE and hike rates. Although admittedly this has happened more rapidly than anticipated, it was for the right reasons. Lastly, even though downside growth risks appeared muted at the time and a substantial deterioration in the growth outlook was not our base assumption in Q1, the risks to the growth outlook have intensified with the prolonged war in Ukraine resulting in increased recession risks.

Despite the decisively more hawkish stance of the ECB, the current market pricing today and spread levels offer a more balanced risk/reward trade-off given the downside risks to growth.

Whilst we cannot exclude the possibility of a further move higher in long-end yields, particularly given the uncertainty in inflation and the possibility of further upward surprises, we are more cautious about maintaining a short duration position. This is particularly underpinned by the increasing recessionary risks which provide the potential for support in benchmark yields.

Sovereign spreads have continued to widen on the prospect of lower ECB support. Particularly BTP came under pressure with the 10-year BTP-bund spread peaking just above 240bps. Whilst sovereign spreads generally widen with growing duration risks, the combination of higher bund yields and lower growth expectations results in a disproportionately higher impact on weaker sovereigns.

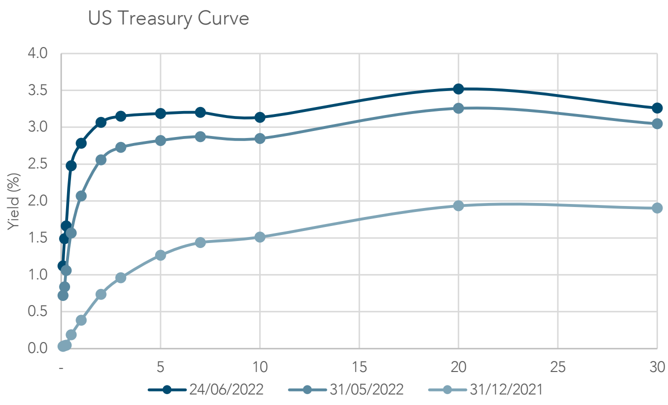
ECB officials have hinted to a possible backstop tool for sovereign debt markets which would be aimed at deterring a speculative attack on sovereign debt. Such a backstop could ensure that any fragmentation risks are limited and could be a strong catalyst for a reconvergence in sovereign spreads. Given that spreads are much wider today, we expect more concise communication by the ECB on a new backstop tool. The absence of more proactive communication by the ECB on this front, coupled with the reaffirmation of tightening plans would lead spreads to widen further.

US Rates

The US curve has steepened towards the end of May driven mainly by front-end buying, with the 2s10s moving higher during the month. Moreover US treasuries outperformed other benchmark curves given that yields were overall stable or lower during the year, whereas bund and gilt yields rose further during the month. The relative outperformance in US treasuries is explained by the softer data prints when compared to expectations showing signs of slowing growth as well as inflation break-even rates moving lower on the back of the lower inflation print in May, reflecting increased market expectations that inflation is peaking and that the Fed will possibly need to be less aggressive.

However, the June inflation print and subsequent Fed policy outcome pushed markets to revert back to the regime of high inflation uncertainty and further hawkish tilt by the Fed raising the market pricing for the peak policy rate for this hiking cycle.

The Fed communication has been clear that their focus is on bringing back down inflation with far less sensitivity on the potential impact to growth. Jerome Powell stated that "we need to see inflation coming down in a convincing way. Until we do, we'll keep going". He also acknowledged that the neutral point was not a stopping point but that to bring inflation towards their 2% target they will have to slow growth. This suggest further scope for breakevens to compress further.



Source: Bloomberg

Having said that, the inflation path remains highly uncertain given the extended lockdowns in China and the war in Ukraine. The expected growth slowdown as a result of tighter financial conditions may still not be enough to bring inflation back towards target levels. This would mean that the pullback in inflation breakeven rates has been pre-mature and that the rally at the front-end could reverse. If the combination of high inflation and slowdown in growth exacerbates further, we should see the curve flatten and possibly invert. On the other hand, with greater evidence of peaking inflation, long-end yields should move lower as a result of increasing expectations of an earlier halt to the rate hiking cycle, whilst growth concerns should eat into long-end real yields.

Economic data has been disappointing, business surveys showing a slowdown in activity while durable goods have also come in softer than expected. Labour market data remains robust overall, but we are seeing the rolling average claims starting to pick-up from the lows seen earlier this year, possibly pre-empting an inflection point in the streak of labour market statistics. The view around duration is balanced and we are considering moving to neutral in US duration on the basis that:

- Given the low probability that data will surprise to the upside, the scope for growth forecast to be revised further lower has increased as financial conditions continue to tighten.
- Long-end inflation breakeven levels are still at elevated levels, suggesting that there is further room for inflation premia to compress.
- Real rates could also come under pressure given renewed focus by the Fed on inflation and lower emphasis on the impact on the growth outlook.
- At this stage, if inflation remains at peak levels or ticks higher, we see greater scope of inversion given the more acute pressures on growth weighing on long-end real yields, the inverted inflation swap curve and firmer front-end pricing given the Fed's commitment.

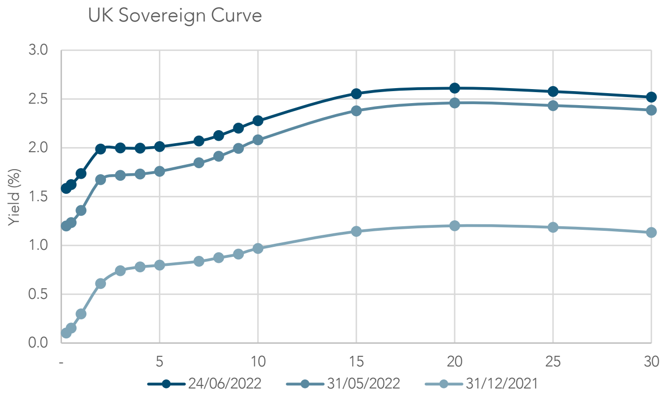
The main risks to this outlook is inflation uncertainty. If inflation had to normalize at a faster pace, this would suggest that the extent of tightening already priced in markets has been too aggressive and that the Fed may also stop its rate hiking cycle at an earlier point. This should lead to continued support for the front-end rally and increased scope for the re-steepening of the curve.

Secondly, if incoming growth data surprises to the upside, we could see the rebuild of real yields at the long-end of the curve on reduced growth concerns.

UK Rates

Weakening economic data and political instability has worsened the macro backdrop and outlook for the UK economy. The surprise fall in PMIs and weak consumer confidence are pointing towards a stagflationary economic outcome towards the end of the year. The impact on spending from the higher cost of living is yet to materialize pointing towards expectations of a contraction in the second quarter.

The BOE has raised rates to 1.25% in June given the continued rise in inflation. However, Governor Bailey has balanced the tone of the BOE, highlighting that they are equally concerned with recession risks as a result of weaker spending given the impact of high energy bills on household income. With this, the BOE has notched down expectations of continued and gradual hikes in the policy rates as the bank will continue to reassess on an ongoing basis.



Source: Bloomberg

The fiscal boost announced by Sunak to prop up household income (£15bn spend and £5bn tax rise on energy sector), primarily with the £400 energy bill discount, could be well placed as a handover policy tool that allows the BOE to focus on inflation first and provide the central bank with more latitude to hike rates. The fiscal support should remove the tail risks of a substantial decline in activity coming from the real income squeeze.

The pullback in yields a the front-end has been driven by the softer stance by the BOE and the falling PMI surveys since it underscores the expectations of stalling or contracting output on a month-on-month basis.

The market is pricing in 25bps of hikes per meeting going forward this summer, with some risk of a 50bp hike in August. Notably this coincides with the updated MPR forecasts which may prove the August meeting to be more pivotal.

Against the backdrop of weakening economic momentum, and given the BOE's pronounced focus on growth risks, we see a low probability of the BOE following through in line with current market pricing. This suggests that front-end yields have more room to come down.

On the flip side, a marginal improvement in the economic outlook if impact on spending is not material (underpinned by fiscal initiatives and drawdown savings), could prompt the MPC to forge ahead with faster tightening. But in any case, this will unlikely be more aggressive than what is currently implied by market pricing at least in the near term.

A stagflationary economy should see the curve flatten as real rates would be expected to retreat. On this basis, we have a neutral outlook on UK duration given that risks are more balanced at this stage.

CREDIT

Euro Credit

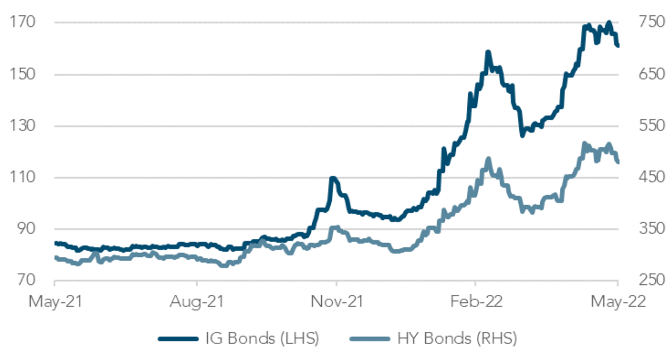
The continued widening in corporate bond spreads occurred despite the rise in the bund yield curve. The widening of corporate bond spreads was driven by (a) the release of economic data which continued to show that inflation remains persistently high, (b) the ECB striking a more hawkish tone and (c) the spill over effects of the war in Ukraine and its effect on supply chains.

There is room for a turn in credit on better news, given very wide spreads and still good fundamentals with rising stars and minimal defaults. Bund yields rising and the war in Ukraine have driven spreads further out in June, delivering further losses for the asset class during the month. New issue supply during recent weeks remained low in high yield ("HY"), somewhat better in investment grade ("IG"), and history would suggest that June is generally a low issuance month.

With minimal changes to the backdrop since our last update, our stance on euro IG credit has not changed materially. The overhangs to the euro IG-space flagged in our previous update remain in place, that is persistently high inflation readings, escalating Russia-Ukraine tensions, and lingering COVID-19 outbreaks in China hampering global growth and supply chains. Nevertheless, given the extraordinary move in spreads and duration since the start of the year, euro IG breakeven rates are currently well positioned to insulate investors from further material downside over the course of 2H2022, and we remain cautiously optimistic.

Focusing on sectors, preference remains within materials, whilst we recommend avoiding names highly exposed to cyclical dynamics. That said, the return profile for IG credit will likely largely depend on how the Russian invasion of Ukraine proceeds, along with inflation prints and ECB headlines following the upcoming governing council meetings. We may see a sharp rebound if inflation eases or if there is some form of respite in Ukraine.

EUR IG and HY Credit (option-adjusted spread, bps)



Source: Bloomberg

Now that the majority of the HY index has reported Q1 earnings, we see leverage at the index level overall increasing to 3.85x from 3.64x over past quarter, after four quarters of recovery covering most of 2021. Simultaneously, interest coverage has improved to 6.26x from 5.7x last quarter and remains well above the 4.3x seen during the pandemic troughs. This is consistent with the overall theme of refinancing taking place over the course of 2021 at a time when rates were at record lows, resulting in higher headline leverage at more sustainable borrowing costs. The belief here is that HY metrics, after having recovered from the pandemic lows, may have reached a peak in 2021 and are starting to slip in the face of margin pressure due to rising input costs. HY index metrics for 2Q could be further hit by the inflation surge across Europe from the Russia-Ukraine war, given the asset class is a levered bet on the economic recovery.

Given this period of macroeconomic uncertainty, we prefer positioning at the upper end of the HY quality spectrum, where balance sheets are generally better capitalised and companies are better prepared to weather potential macro downturns. Adjusting for spread-per-turn-of-leverage, incidentally we find that BBs look the best risk-reward rating, as higher-rated bonds have suffered more compared with their lower-rated counterparts in this rates-led selloff. When BBs offer same SPTL as Bs (+89.8bps versus +91.1bps), the risk-reward is clearly skewed towards BBs. When coupled with the period of uncertainty that markets are heading into, we believe the choice to move up in credit quality is a simple one.

US Credit

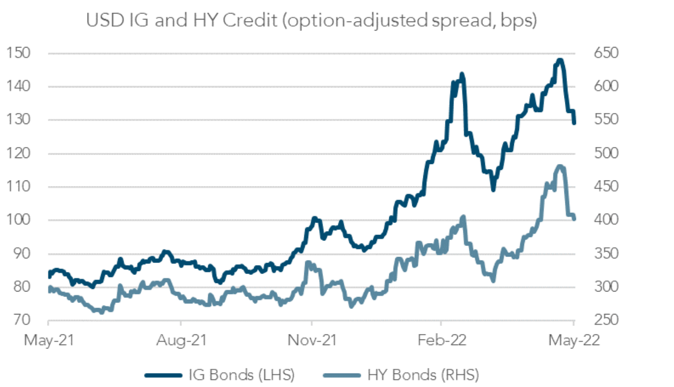
Spreads within the IG corporate bond space tightened while non-IG corporate bond spreads widened by 27bps whilst yields on US treasuries moved higher. The movements seen in the corporate IG segment and the US treasury contrast the decision taken by the Fed to hike rates by 75bps at its meeting held in June.

Having said that, the past three months are in the 95th percentile of the most volatile periods in the past 10 years for both IG and HY indices. The short rallies in this period were triggered by communications from the Fed which, whilst being hawkish, reassuring investors that the Fed was unlikely to implement the most extreme scenarios in a backdrop of weaker-than-expected data, leading to a relief rally much like the one seen in March.

Such rallies however, were not broad based across the IG and HY spectrum, with bonds rated B and lower exhibiting material widening as investors continue to move up in asset quality to BB and better given the still gloomy macro backdrop. The anticipation is for spreads to continue trading at the wide end of their ranges, but not necessarily to slip into recession levels, mainly since corporate balance sheets remain relatively strong and the US consumer, despite facing inflationary headwinds and declining disposable income, is unlikely to disappear entirely.

For the time being, the read-through from activity data has been balanced to weak, whilst inflation data continued to surprise to the upside, which is a combination that implies a lower likelihood for a material shift in the Fed's reaction function, which will likely remain more sensitive to upside surprises in inflation as opposed to downside surprises in growth. For credit spreads, this implies that any relief rallies may be short-lived, and that the compound effect of a highly uncertain outlook for global supply chains, negative signals by cyclical corporate management teams, and elevated macro volatility, leaves an overhang for the recent spread rally to unwind in the near term. Indeed, we have already seen a partial reversal of this rally, at least within the HY space, as global inflation elicited monetary policy tightening abroad, and as Fed speakers continue to pledge to fight inflation at the risk of disrupting economic activity and risk assets.

Overall, we are cautious around a correction in the recent rally in US corporate credit markets, and do not recommend adding US dollar exposure for the time beng as many of the headwinds weighing on spreads continue to prevail in the market. Indeed, a better-than-expected inflation prints going forward would add conviction to the idea that peak inflation may be behind us, and would provide additional comfort for the asset class, where preference would remain in short dated IG exposure. Within the HY space, we continue to prefer euro exposure as we believe the additional spread more adequately compensates investors for the global macro overhang.



Source: Bloomberg

UK Credit

Movements within the UK corporate bond market were similar to those seen in the Euro Area, however the spread widening within the IG space was less pronounced, with the opposite being true for the non-IG segment of the market. The higher gilt yield and sell-off in the corporate bond market were primarily driven by the BOE's decision to hike rates by 25bps at its last meeting and higher inflation prints.

Despite recent sharp moves lower in sterling bond markets, particularly within the HY space, we continue to remain cautious on the space due to the combination of (a) the corporate bond purchase scheme ("CBPS") unwind expected to take place during Q3, (b) an expected contraction in the economy, and (c) potential further upside surprises in inflation releases.

As highlighted in our previous update, the impending unwind of the corporate bond purchase scheme is likely to be a challenge for the BOE even in the best of conditions, let alone under the current macro backdrop which has already driven primary activity across both IG and HY to grind to a halt. Issuance by UK-based, non-financial firms in 2022 is just £3.78bn, the lowest since 2016 and a third of what was sold this time last year.

Rampant inflation and the BOE's string of interest-rate increases to the highest since 2009 have been fuelling the surge in corporate bond yields, but so is the prospect of slower economic growth and concern over weaker corporate earnings. Whilst the government's recent package to help households cope with rising energy prices has reduced the immediate risk of recession, growth will likely be lacklustre for the rest of the year.

Following the sharp sell off in sterling HY credit, this segment of the market now offers investors an premium over benchmark securities within the sterling HY space versus euro counterparts. Whilst this appears attractive at face value, we note that this is roughly in line with the 5 year average OAS premium demanded by investors for sterling HY exposure over euro, and far below the +103bp average over the 2017-2019 period. As such, given ongoing headwinds to sterling credit and still relatively tighter premiums versus historicals, we continue to favour holding euro paper for the time being.

EQUITY

High inflation has been top of mind for investors for some time, but growth concerns have now become more obvious. As 2021 was ending, the main concern for investors was the rising possibility of stagflation. Growth was starting to normalise, albeit still expected back then to come in well above trend. Yet, inflation was showing little signs of slowing. The Ukraine invasion exacerbated such concerns, with Ukraine and Russia considered be key suppliers of certain key components (especially for the agriculture and motor vehicle industries). This meant that inflation remained elevated for longer than many market participants expected at the start of the year leading to a revision of interest rate expectations.

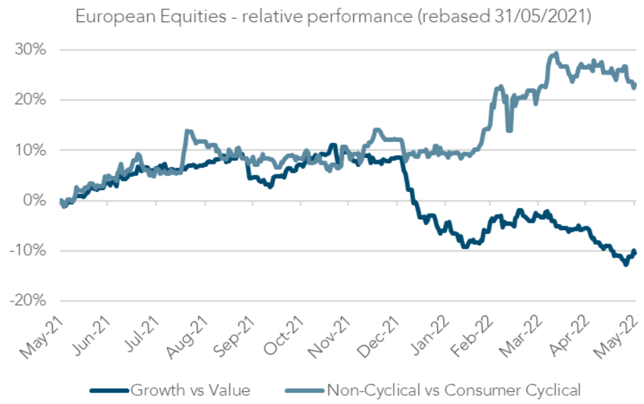
There are increasing signs that inflation is peaking in the US and will peak over the next two or three months in Europe. We see this as a positive development, as it would provide markets with some clarity on price pressures. A recent article on Bloomberg highlighted how Mercedes, Daimler Trucks and BMW were operating close to full capacity, after two years of chip shortages hit production. Therefore there are signs that the supply shortage could be improving, which could help ease price pressures. Yet, a peak in inflation on its own is unlikely to be a catalyst for a significant shift in sentiment.

Central bank action was brought forward to fight inflation. The Fed announced a 75bps hike in its June meeting. We have seen the ECB announcement to bring forward their hiking cycle from November/December. At the same time, the market had to contend with a weakening macroeconomic backdrop which tends to hurt sentiment. Preferably, monetary policy tightening is implemented during periods of respectable economic growth, but this has not been the case, and explains the big moves downwards we have seen in most risky assets.

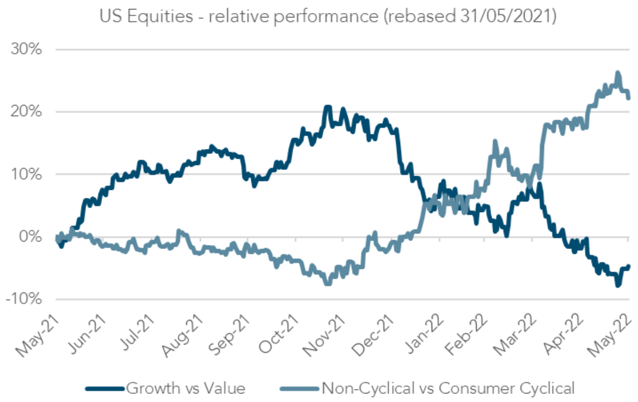
Uncertainty has continued to weigh on equity market performance during May. Global equites (+0.1%) and the S&P 500 (+0.2%) were flat in May ($ terms). European equities (-0.9%) closed the month in the red, the second consecutive month of negative performance, whilst the FTSE 100 delivered a total return of +1.1% (£ terms). Equities were on course for another month of sharp losses, with performance during the sell-off that started in April (20 April to 21 May) of -7.6% for global equities and -8.5% for US equities. Yet, a strong rally in the final week of May was enough to offset most of the weakness during the month. The +6.6% total return delivered by the S&P 500 was the 19th strongest weekly return seen since the 1950. So far in June, global equities dropped further (-6.0%), with Europe (-6.7%) underperforming US stocks (-5.2%). The FTSE 100 (-5.0%) saw the first monthly decline so far in June as commodity-related stocks cam under pressure given the global growth concerns weighing on the outlook for demand.

Cyclical strategies in both the US (-3.4%) and Europe (-4.4%) underperformed during May, mostly due to the growing concerns around the global economy. On the other hand, value strategies outperformed in the US (+1.9%) and Europe (+2.2%) during May. The decline in cyclicals was extended so far in June in both US (-5.2%) and, more notably, in Europe (-8.4%). Value strategies under performed in the US (-6.5%) and but still relatively outperformed cyclicals in Europe (-7.7%). Historically, the performance of value strategies and cyclicals were positively correlated due to their relationship with the economic health. Yet, inflation has led to an outperformance in the energy sector (+29.4% in the US and +11.6% in the EU), so while stocks with high reliance on the macroeconomic health have suffered, stocks that offer some sort of inflation protection have outperformed.

The macroeconomic environment began to show some early signs of weakness. Notwithstanding the narrative around global growth, global macroeconomic surprises have been positive throughout 2022 till mid-May. This was more evident in the US were the very low unemployment have persisted for much longer than in the EU. The sentiment indicators have started to feature con-



Source: Bloomberg



Source: Bloomberg

cerns from consumers around inflation which could impact spending patterns. The key unknown remains by how much will central banks need to tighten policy to control inflation and what will the global economy look like once this is achieved. The Goldman Sachs global growth indicator (a sub-index of the Goldman Sachs Risk Appetite Indicator) started its leg downwards around mid-April, anticipating the negative turn in global economic data.

We turned more cautious on equities over the short term (summer months) until we see economic situation bottoming out, mainly a stabilisation in inflation. We are unlikely to see a sharp rebound in sentiment over the near-term as uncertainty remains high. Investors will probably need some greater clarity on whether inflation has peaked or not and if so, how fast it decelerates. Also, investors would need to see what implications this would have on monetary policy and on the economic growth outlook. We believe that equity market performance over the next 3 months will be flat and volatile as investors await clear signals on the health of the global economy, especially the impact on consumer demand and whether this was impacted by higher prices and uncertainty.

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Developed Market Sovereign Bonds	Negative	U/W	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. Given the recent sharp movements upwards in benchmark bond yields, the scope for further negative curve returns has diminished, particularly in light of the growing signs of an impending economic slowdown. On this basis, we have added some sovereign exposure and reduce the overall short duration bias in our portfolios. Following the decompression in peripheral spreads with the planned reductions in QE purchases, the ECB has communicated that it is due to launch an anti-fragmentation tool which is expected to cap any further substantial widening in spreads. On this basis, we are comparatively more constructive of selected peripheral positions.
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	Neutral	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	Neutral	U/W	Inflation and economic growth concerns have been top of mind since the start of the year. These concerns have been exacerbated by the war in Ukraine, which led to more supply chain pressures at a time when demand remains relatively high. A hawkish ECB and a strong above-consensus US June CPI print has led to another strong sell-off in June. Markets have repriced a more hawkish path in both the US and Europe. An environment where central banks are tightening monetary policy against a backdrop of weakening economic growth is rarely positive for investor sentiment. In addition, the faster the rate hike cycle is, the more likely the economic damage is deeper, consequentially increasing the likelihood of a recession. We are less optimistic about the prospects of DM equity over the near term in the absence of any confirmation that inflation is slowing down, and the economy can continue to grow at a reasonable pace. In the meantime, we recommend that investors hold a diversified equity portfolio to protect against idiosyncratic risk with an overall underweight allocation.
Emerging Market Equities	Neutral	N	There has been a clear divergence in performance within EM equity, as commodity exporting EM countries (mainly LATAM) have outperformed strongly, benefiting from the rally in energy prices. At the other end of the spectrum, China's stock market continues to weigh on the asset class performance, as growth worries for the country overshadow the relatively low valuation levels. Yet, there are some indications that LATAM countries are late in the cycle, with a high current account deficit and high inflation rates, and being early starters in the hiking cycle. This could imply that return prospects are lower when compared to other regions within EM. The current backdrop of weaker global economic growth and higher US yields generally leads to underperformance in EM equities. Yet, we note that during last year's bull market, EM equities underperformed, mainly as a result of China's economic uncertainty. Therefore, we believe that developments in China will be key for EM equities over the next months.

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

DISCLAIMER