Investment Strategy Update

July 2022

Curmi & Partners Research

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- Consumer spending is losing momentum as high inflation is impacting consumption with survey-based indices showing a slowdown in activity in Q2.
- Headline inflation data continues to surprise to the upside with the June releases for the US and the Euro Area rising to 9.1% and 8.6% respectively.
- The rise in price levels is mainly driven by the continued pressure from food and energy prices.
- US labour market is cooling with wages growing at a more modest rate and initial jobless claims starting to rise despite the strong 3-month rolling average of job additions.
- The European Central Bank has delivered the first rate increase of 50bps bringing its key policy rate to 0% at its July meeting ending an eleven-year period of negative interest rates.
- The Federal Reserve met market expectations with a 75bp increase in the policy rate target range in July to 2.25%-2.50%, whilst delivering a dovish message on forward rate increases.
- Central bankers have indicated a higher level of data-dependency and gradualism when deciding on further rate hikes going forward in view of the increased growth uncertainty and risks of a recession.
- Despite the rate increases, yield curves have shifted lower on the back of the reassessment of implied terminal rates following the outcome of the monetary policy meetings.
- Long-end benchmark bonds led the rally as inflation premia and real rates compressed on the back of the expectations of an economic recession.
- Credit spreads saw some respite from the decompression trend which gained traction in the second quarter.
- Equity markets have continued to rebound from the mid-June lows, led by the decline in bond yields, as market participants are carefully eyeing Q2 earnings releases.
- We have moderated our short duration bias given our more balanced view on the direction of rates going forward and sought to add back some duration by adding sovereign exposure during the pullback in yields.
- We believe that current spreads in corporate credit is fairly reflecting the risk of a mild recession in Europe and that the extent of spread widening is largely behind us at this stage.
- We expect the credit rating upgrade/downgrade ratio to deteriorate as we enter a challenging period of business conditions, but we see pockets of value in high quality and liquid names in the credit market.
- The Q2 earnings season is expected to be a catalyst for the overdue downgrade in earnings expectations which, following a multiple contraction-driven sell-off in equity markets, is expected to continue to weigh on stock market performance.
- We prefer to remain underweight equity and overweight cash over the short term given the elevated uncertainty.

As macro risks continue to intensify with the disruption of Russian gas supply to Europe, economists are expecting a mild recession in the Euro Area in the second half of the year which will possibly extend over the winter months. This downgrade is supported by the recent decline in PMI data showing a slowdown in growth momentum across manufacturing and service sectors.

The recent pullback in commodity prices and expectations of a slowdown in demand should provide some relief for central banks who have communicated an accelerated hiking cycle by historic standards. In July, the European Central Bank ("ECB") has surprised markets with a 50bp increase ending an eleven year period of negative interest rates by raising the policy rate to zero. However, the larger-than-expected increase is framed as a front-loaded decision with the expectation that subsequent increases will be at the same level if not lower. In fact, given the deteriorating macro backdrop, President Lagarde moderated the communication around the rate hike indicating that a high degree of data-dependence is warranted given the elevat-

ed uncertainty on the inflation outlook. Markets have marginally lowered the implied pricing of the peak in overnight rates in Euro.

Similarly, in the US, the Federal Reserve has delivered the second 75bps increase bringing the target policy rate range to 2.25%-2.50%. While the increase was widely expected by market participants, the messaging by Chairman Jerome Powell was perceived to be dovish as he played down the possibility of similarly aggressive rate increases going forward. After multiple meetings in which the Fed has had to alter its forward guidance given the ever worsening growth and inflation trade-off, it has decided to move away from providing the same level of clarity in guidance and instead it is looking to make decisions on a meeting-by-meeting basis.

Whilst the Fed was seen to be primarily focused on inflation as the determining driver for monetary policy, it is starting to show increased sensitivity to increasingly vulnerable economic conditions given the initial signs of weakness in internal demand and slowing momentum in the labour market recovery post-pandemic.

The outcome of these central bank meetings has led to a rally in rates markets with curves generally flattening across advanced regions. Following weeks in which valuations have been depressed by the prospects of tighter monetary policy, the increased degree of gradualism indicated by central bankers has supported market risk sentiment. Equity markets have extended the rebound since mid-June reversing some of the losses generated so far this year.

The markets seem to be reverting back to a "bad news is good news" regime where weaker activity data leads to the possibility of a dovish pivot by central banks. Cyclical and long duration assets have repriced higher versus defensives recently as market volatility has decreased.

Whilst we welcome the rebound in financial markets, we do not believe that this is the start of a pro-cyclical shift across asset classes. The macro outlook remains highly uncertain which will cap any compression in risk premia for the time being. Moreover, the risks of continued inflationary pressures may lead central banks to remain on an aggressive tightening path for longer than what the market is currently estimating.

With that said, we continue to maintain a relatively defensive allocation in our asset allocation with an overweight in cash and an underweight in equities. We have continued to reduce our short duration position as the view around duration became more balanced. The compression in inflation premia as well as real rates at the long-end of the curve has been sizeable so far which reduces the scope of adding duration much further at this point.

We are becoming more constructive on high quality credit given the attractive valuations on offer and increased dispersion in the market. Credit ratings are likely to come under pressure going forward given the slowdown in the economy and tighter financial conditions, but the projected defaults are expected to remain fairly low in the context of a contractionary economic environment. Whilst in our view the extent of credit spread widening is largely behind us at this stage, we see scope for another leg of decompression in HY/IG spreads and CCC/BB spreads. We therefore prefer going up in credit quality over the short-term.

On the equity side, earnings estimates are holding up despite the sharp downward revision in economic estimates. We think that the Q2 earnings season will be a catalyst for significant downgrades to earnings making current levels still look vulnerable to another leg lower. Moreover, the risk still exists that persisting inflation for longer, continued shutdowns in China, and a steeper recession than what is currently expected, may contract valuation multiples further. As a result we are running an underweight allocation in equities with a tilt towards defensives.

MACROECONOMIC

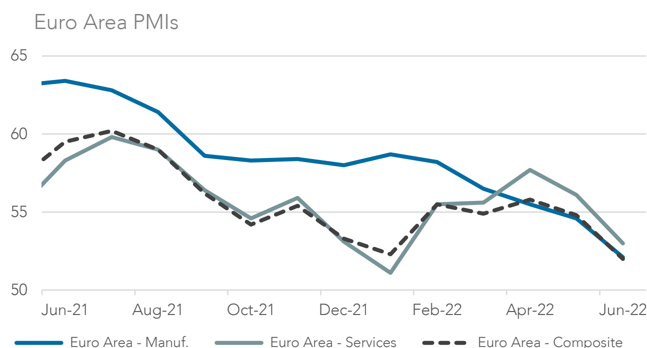
Euro Area

The flash estimate of the second quarter GDP growth in the Euro Area came in at 0.7%, up from the previous 0.6%, beating the consensus estimate of 0.2%. Household consumption is expected to continue to fall, while a number of countries are showing stalling growth or even contraction in the second quarter. The steep drop in consumer confidence since the Ukraine war began points to an even bigger decline in spending. The hit to spending power from high inflation suggests that consumption will be weak for some time.

Industrial production grew 0.4% m/m in April, compared to the prior contraction of 1.4% and the market expected growth of 0.5%. The increase industrial output in April only partially reversed the decline in March indicating that the fallout from the Ukraine war is still holding back production. With PMI data pointing to demand beginning to fall, we think manufacturing output will be a drag on growth for the rest of the year. Even if supply shortages start to ease over the course of the year, the industry will still struggle as high inflation and energy prices weigh on consumer demand.

Retail sales for May grew by 0.2% m/m, compared to the prior contraction of 1.4% and the market expected growth of 0.4%, suggesting that high inflation remains a drag on consumption. The breakdown showed sales of non-food products increased (+1.2% m/m) while sales of food declined (-0.3% m/m), which suggests that higher agriculture costs are causing consumers to reduce their

spending on food. Although re-opening effects may have boosted consumption in Q2, the squeeze on real incomes means the outlook for household spending for the remainder of the year is weak. Indeed, retail price inflation has risen significantly, and PMI data suggest that further increases are to come.

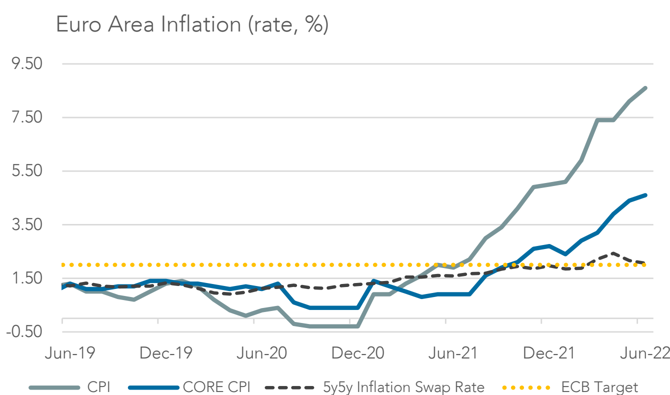


Source: Bloomberg

The June headline inflation rate stood at 8.6%, up from the prior 8.1% and the market expected 8.4%, strengthening the case for the ECB's first rate hike in July. On the other hand, the June core inflation rate came in at 3.7%, below the market expected 3.9% and the prior 3.8%.

The increase in headline inflation was, again, driven by energy inflation and food inflation. Within the core component, non-energy industrial goods inflation edged up while services inflation declined. The reason why core inflation came in below expectations was that services inflation fell sharply in Germany, due to a temporary cut in fuel duties and public transport prices, and not due to an easing of underlying price pressures.

We think headline inflation will remain high until the end of the year as the further jump in gas prices feeds through to retail energy prices and food prices continue to climb. Headline inflation is then expected to fall next year as previous increases in energy prices drop out of the year-on-year comparison, but core inflation is expected to remain above the ECB's 2% target.



Source: Bloomberg

The unemployment rate for May fell to 6.6% compared to the prior 6.7% and the market expected 6.8%. April's and May's declines in the aggregate jobless rate have not been driven by people leaving the labour force; the monthly data imply that the labour force increased in both months. PMI data suggests that firms' hiring intentions weakened a bit in June, presumably reflecting the boost to employment from re-opening fading as well as the deteriorating economic outlook. However, given the lack of spare capacity in the labour market, wage growth is expected to accelerate, especially given the backdrop of very high inflation.

The ECB surprised markets with a 50bp rate hike in its July policy meeting in an attempt to bring inflation under control. Christine Lagarde said a clear deterioration of the inflation outlook and unanimous backing for the anti-fragmentation tool had justified the bigger move. The ECB framed the move as front-loading hikes as they try to anchor inflation, whilst indicating that that terminal rate may not change. Nevertheless, the ECB is adopting a meeting-by-meeting approach, effectively dropping forward interest rate guidance. Overall, Euro rates cheapened meaningfully into and around the meeting, given the broadly hawkish messaging on policy rates. Beyond rates action, the ECB introduced the TPI (Transmission Protection Instrument), which is intended to be enacted if the ECB believes the monetary policy transmission mechanism is impaired across Europe, i.e. if ECB rate hikes/cuts do not affect individual European countries proportionally. TPI purchases would be focused on public sector securities with a remaining maturity of between one and ten years, whilst purchases of private sector securities could be considered, if appropriate.

United States

The economy contracted by an annualised 1.6% q/q in Q1 2022, slightly worse than the second estimate which showed a contraction of 1.5% q/q. It is the first contraction since the pandemic-induced recession in 2020 due to record trade deficits, supply constraints, worker shortages and high inflation.

The Fed's rapid policy tightening will trigger a marked slowdown in economic growth, which means that the risks are likely to build over the coming quarters. Furthermore, consumer spending lost more momentum through the second quarter than the market expected and PMI data suggests a weaker 2Q.

Retail sales for May contracted by 0.3% m/m compared to the prior growth of 0.7% and the expected growth 0.2%, as high inflation, gasoline prices and borrowing costs hurt spending on non-essential goods. This suggests that surging prices might be taking their toll on real consumption, and with prices likely to see another

strong rise in June, a rebound in real spending looks unlikely. This will not only have an impact on retail sales but also on the manufacturing sector. Headline retail sales were dragged lower by a 3.5% m/m slump in auto sales last month, but that drop reflects the impact of China's zero-covid lockdowns on Asian manufacturers rather than weakening demand.

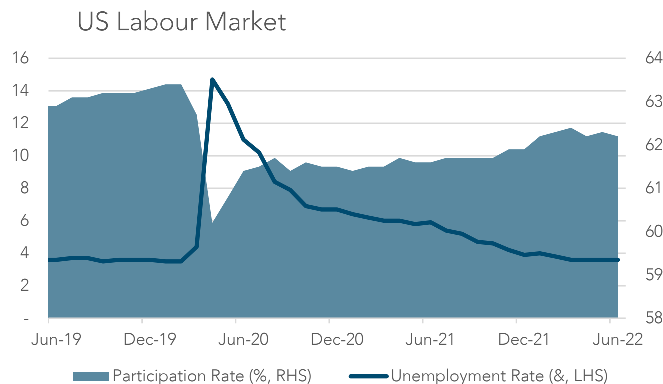
Industrial production for May grew by 0.2% m/m compared to the prior 1.4% growth and the expected growth of 0.4%. The muted rise in industrial production in May adds to the evidence that the economy is slowing. The minimal growth was aided by a 1.0% m/m rise in utilities output as seasonally warm temperatures boosted AC demand, while mining output also rose by 1.3% m/m due to gains in drilling activity and oil and gas production. Despite the continued surge in global energy prices, however, both remain below their pre-pandemic levels. The weakness was concentrated in manufacturing, where output slipped 0.1% m/m, reflecting declines in production, echoing the message that weaker global demand and stronger dollar are now taking a toll on the factory sector.

The final June Composite PMI stood at 52.3 compared to the prior 53.6 and the flash estimate of 51.2. The slowdown in growth was broad based, with both manufacturing and services seeing weaker increases at the end of the second quarter. Business confidence also dwindled to the lowest since September 2020. A weaker expansion in output reflected a renewed contraction in new orders, the first in almost two years. New business was down across both sectors, with new export orders also falling. Rates of input cost and output price inflation remained sharp in June, but eased amid softer demand conditions. Rising wages and increased fuel charges played a key role in higher input costs. The main positive was a further marked increase in employment, with job creation led by the service sector.

Headline inflation accelerated for June at 9.1% y/y, compared to the prior and expected 8.6%, as energy prices rose 41.6% due to gasoline (59.9%), fuel oil (98.5%), electricity (13.7%) and natural gas (38.4%), and also food costs which surged 10.4%. With energy prices trending higher in June, energy-related inflation is expected to increase further.

On the other hand, the June core inflation rate declined from the prior 6.0% to 5.9% y/y, however above the expected 5.7%. Some of this reflects higher jet fuel prices which contributed to an increase in airfares. There were also renewed increases in goods prices and signs that cyclical price pressures are still mounting, showing very little that inflationary pressures are easing. However, PMI data suggests an improvement in supply shortages, and this should feed into core goods inflation over the remainder of the year.

Analysts believe that the stabilisation of labour shortages and the moderation in wage growth have not yet fed through to a levelling off in inflationary pressures.



Source: Bloomberg

Non-farm payrolls for June rose by 372k from the prior 384k and the market expected 268k, still pointing to a tight labour market. Notable job growth occurred in professional and business sectors (74k), leisure and hospitality (67k) and health care (57k).

The June unemployment rate was unchanged at the prior 3.6%, in line with market expectations. The number of unemployed people decreased by 38k to 5.9m, while employment levels fell by 315k to 158.1m. Meanwhile, the labour force participation rate edged down to 62.2% from the prior 62.3%. The share of the population that is working or looking for work remains 1.2pps below their February 2020 values, as individuals that left work during the pandemic are coming back slowly, due in part to childcare and early retirement.

Fed policymakers delivered a second 75bps increase in the July meeting, noting that the economic outlook warranted moving to a restrictive stance of policy, and they recognized the possibility that an even more restrictive stance could be appropriate if elevated inflation pressures were to persist. At the same time, Powell noted that policy firming could slow economic growth for a time, but they saw the return of inflation to 2% as critical to achieving maximum employment on a sustained basis. At the same time, Jerome Powell played down the scope of aggressive rate increases going forward highlighting that policy decisions will be more data-dependent rather than providing the same level of guidance it provided in previous meetings.

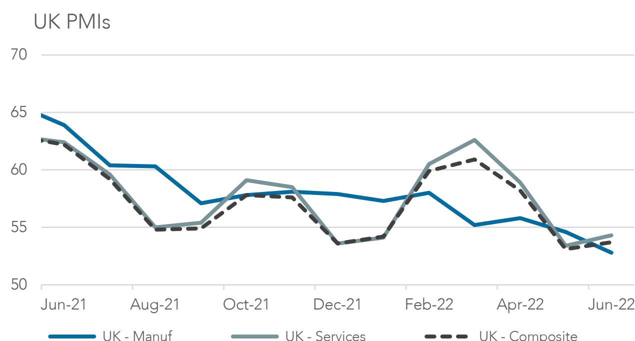
United Kingdom

The final GDP growth rate for Q1 was reported at 0.8% q/q, in line with the preliminary estimates. A chunk of that rise in GDP was due to a bounce back in activity after the drag from the Omicron variant. The GDP figure

leaves households looking a bit more vulnerable to the big fall in real incomes that is going to hit in Q2 and Q3. Although GDP and consumer spending will not fall as far as real incomes, it is pretty clear that the economy is going to be very weak for a while, and a recession is a real risk.

Industrial production for April declined 0.6% m/m, compared to the prior decline of 0.2% and the market expected growth of 0.2%. Manufacturing output fell 1.0% (vs -0.2% in March), mostly due to manufacturing of computer, electronic, and optical products. Downside pressures also came from a drop in mining and quarrying, while water supply and sewerage, and electricity and gas rebounded. Output remained below pre-pandemic levels in all of the production sectors, save for water supply and sewerage.

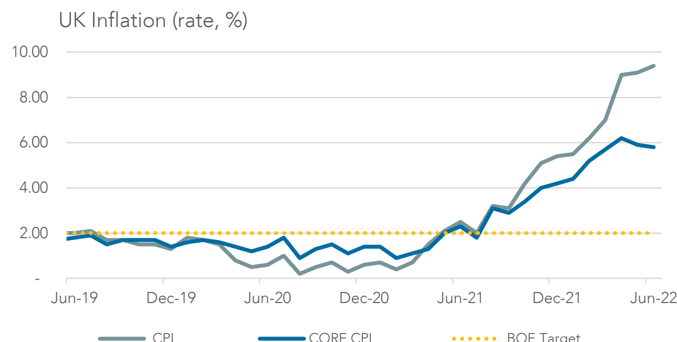
Retail sales declined 0.5% m/m in May, compared to the prior growth of 0.4% and the market expected decline of 0.7%. The fall in retail sales in May suggests that the decline in households' real incomes from surging inflation is starting to hit consumer spending a bit harder, with signs that consumers have cut back spending on non-discretionary items. With a further rise in inflation over the coming months set to exert a bigger squeeze on households' real incomes, retail sales will probably continue to struggle ahead.



Source: Bloomberg

The July Composite PMI stood at 52.8 up from the prior 53.7, slightly above market expectations of 52.5. The rebound in the services sector, underpinned by a sharp increase in business activity amid rising consumer spending on travel, leisure, and events remains sustained. However, manufacturing output growth declined to a near standstill pace and new orders contracted due to less favourable demand conditions. Inflationary pressures remained elevated due to raw material shortages, stretched supply chains, higher prices for commodities and higher staff wages, and these higher costs were being partly passed on the customers. Finally, business optimism dipped to its lowest since May 2020 amid rising recession risks, lower demand, and high inflation.

The headline inflation rate for June rose to 9.4% from 9.1%, topping market forecasts of 9.3%. The increase was mainly due to cost of motor fuels which rose by 42.3% . A further leap in food price inflation from 8.6% to 9.8% also underpinned the increase in headline inflation. With the influence of the increases in agricultural commodity prices yet to feed in full into prices on the supermarket shelves, we think that food price inflation will rise above 10% in September.



Source: Bloomberg

The further rise in inflation will underpin the BOE's upcoming decision in August to raise interest rates further, but it still opt again for a more moderate 25bps rate hike at its next meeting in August rather than upping the ante with a 50bps hike.

The unemployment rate for the three months to April edged up to 3.8% from the prior 3.7% and the expected 3.6%. The move upward was not due to a decline in employment levels (increased by 177k and above consensus of 107k) or an increase in unemployment levels (fell by 47k to 1.3m). The move was due to an 83k decline in inactivity. The move upward in job vacancies slowed, moving only from 1.296m in the three months to April to 1.3m in the three months to May. Average earnings (including bonuses) for the three months to April increased by 6.8%, compared to the prior period's 7% and the market expected 7.6%.

The labour market is still very tight - 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 people as job vacancies) and nominal wage growth remains unusually strong (although it is still falling in real terms). It is possible that this is the very first sign that the weakening in economic activity since the start of the year is filtering through into a slightly less tight labour market.

The BOE has reiterated its commitment to do "whatever is necessary" to contain inflation, but splits on the MPC made it unhelpful to give guidance on the likely pace, scale and timing of interest rate rises.

BOE's Pill said that the "immediate issue for monetary policymakers is whether the pace of policy tightening now needs to change". Although Pill voted with the ma-

jority for a 25bps rate rise in June, he said he would be willing to step up the pace of policy tightening.

Some economists read the last meeting minutes as a hint that the BOE could raise interest rates by 50bps at its August meeting, rather than the more incremental 25bps moves it has favoured until now. However, Pill said the UK's situation was different from that of countries more self-sufficient in energy and so did not face the same medium-term weakening in gross domestic product and inflation.

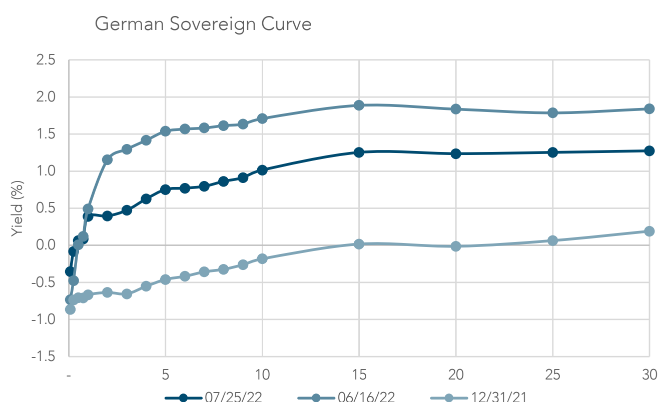
RATES

Euro Rates

German bond yields marked a year-to-date peak on 16th June with the intensification of central bank rate hike expectations on the back of the recent streak of inflation data and hawkish comments made by ECB officials. The German sovereign curve shifted higher with a bear flattening bias driven by the repricing at the front-end.

Yields have pulled back substantially since then on average across the curve end with the curve flattening more recently as a result of the surprise 50bp hike by the ECB in July resulting in a higher short-end yields. On the other hand, the growing concerns on gas distribution to European nations is weighing on growth prospects resulting in a bid for long tenors.

Overall, the movement higher in the European curve has been first explained by increased rate hike expectations, while the move lower in yields was driven by both a repricing in central bank expectations as well as some compression in inflation breakeven rates.



Source: Bloomberg

In terms of central bank pricing, we went from 120bps of hikes expected by year-end, to 180bps at the peak in mid-June and back down to around 150bps by end-June. Current market pricing implies a peak rate of between 1.0% and 1.2% by the end of 2022, i.e. an additional 100bp increase in policy rates. Markets are now pricing another 50bps in September and two other subsequent 25bps hikes in the following meetings of October and December.

These movements at the front-end of the curve display the high uncertainty by market participants on the expectations policy rate path, particularly in the face of growing macro concerns from the war in Ukraine and gas supply from Russia posing a real threat to the European economy.

In contrast to the US, the ECB is expected to be more sensitive to the growth outlook when devising its policy action to fight inflation given that the risks of a recession are now more acute in Europe. In fact, the Euro benchmark curve flattened when shifting lower.

The expected slowdown in economic growth across the Euro Area is expected to be uneven, with increased risk of a recession in some member states. With that said, the overall decline in activity will produce a disinflationary decline in demand which could lead to an earlier halt in rate hikes.

We have moderated our short-duration bias on euro rates given that risks are more balanced around the direction of yields going forward following the sharp sell-off and the recent correction in yields. Having said that, the situation remains very fluid which is reflected in the high degree of volatility in yield movements.

The moderated view on duration is based on:

(a) the stabilisation/compression in inflation breakeven rates showing that the market expects inflation to be under control and decline with central bank intervention;

(b) the risks to the growth outlook have intensified which will weigh on long-end real yields and, secondly, a decline in activity will produce a disinflationary decline in demand over and above monetary tightening;

(c) market pricing of central bank policy trajectory is fairly ambitious and extrapolates beyond the forward guidance currently indicated by the central bank (increased risk of a more gradual/lower policy rate path than current implied pricing).

(d) rate volatility unlikely to fall for the time being, reducing the risk/reward of directional trades.

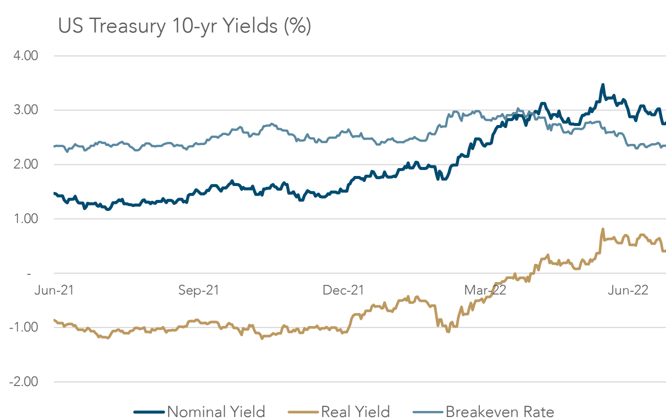
Finally, the risk of upside surprises in growth is unlikely at this stage, which, in turn, will cap any rise in long-end real yields. Inflation breakeven rates have moderately compressed indicating that medium-to-long inflation

expectations remain in check for the time being. Market is fairly convinced that this high inflation environment will resolve to more normal levels in the next 2 years or so. A stabilization (or decline) in inflation rates, or stability/decline in commodity markets, would lead to compression in inflation premia accelerating the rally in rates.

US Rates

The front-end of the US curve continues to be underpinned by the worsening inflation numbers and greater onus placed on the Federal Reserve to raise rates at a faster rate. In fact, market pricing has shifted from implying an overnight rate of c. 2.80% at year-end to around 3.60% by end-June.

Current pricing implies a 75bp hike in September and another 50bp hike by year-end. What is interesting is that the market is already pricing two to three rate cuts in 2023 which is way below consensus forecasts or the latest FOMC dot plot for the year-end rate in 2023. This is consistent with the inflation pricing as the swap curve shifted lower and reduced the degree of inversion – i.e. market pricing suggests that forward inflation will be lower than previously expected and that inflation will come down to more normal levels at a faster pace.



Source: Bloomberg

As a result, 10-year breakeven rates have in fact moderated in recent weeks and has been a key driver in the movement lower in long-end treasury years from their peaks in mid-June. At the same time, we have the inversion of the policy rate path and recessionary fears pushing long-end yields lower.

Economic data is becoming more mixed in the US. Activity data is showing signs of weakness, particularly consumption data which surprised to the downside. This is owing to the higher prices deterring consumption as seen in the recent retail sales data releases.

Since the release of the latest jobs report, the reaction in the front-end has been more pronounced than the long-end. The 2y yield rose by 28bps, the 5y by 25bps, the 10y by 22 bps and the 30y by 17bps. The move higher at the 10-yr point on the other hand was driven by a rise in real yields.

Whilst the headline job figures were positive, the rate of job growth has been moderating, initial jobless claims have started to rise, while the participation rate inched lower and average hourly earnings haver moderated. This, combing with the softened hiring intentions, suggested that we are transitioning from a period of fast declining slack in the economy to a more normal pace of improvement in labour market conditions. The risk now is that the slowing actvitiy data will lead to labour market trends reversing reintroducing slack in the economy.

The view on duration is unchanged from the previous update as we maintain a neutral view of duration in the US on the basis that:

(a) given the low probability that data will surprise to the upside, the economic growth outlook will remain weak, possibly leading to further downward revisions in forecasts, particularly as financial conditions continue to tighten.

(b) long-end inflation breakeven levels are still at elevated levels suggesting that there is further room for inflation premia to compress.

(c) real rates should remain under pressure at the long-end given renewed focus by the Fed on inflation and lower emphasis on impact to the growth outlook.

At this stage, if inflation remains at peak levels u ticks higher, there is the possibility of a deeper inversion given the more acute pressures on growth weighing on long-end real yields and the inverted inflation swap curve.

Whilst delivering the expected 75bp hike in July, Fed Chair Jerome Powell has retreated from reiterating a hawkish guidance on rate, signaling that further rate increase will be data-dependent and possibly at lower increments. The outcome of the July meeting support the treasury market given the scope of reassessment in the terminal rate.

UK Rates

Political uncertainty has not materially effect gilts for the time being. The movement in the UK Gilts curve has been highly correlated with benchmark curves across other developed currency blocs. This muted reaction to political uncertainty resonates the institutional resilience of the developed market which should be strong enough to withstand both economic and political shocks.

The "developed market" status/privilege is evidenced in the muted market reaction when considering that the UK has had 3 different PMs since 2016 which is an unprecedented turnover.

Having said that, we are in an increasingly economically challenging environment characterized by slowing growth, high inflation and fiscal challenges.

Overseas holdings of UK Gilts has been steady and rising in recent years building up towards the 30% market. The ONS data shows that les than 5% of overseas holders are central banks, which means that the greater portion is in the hands of private investors. Should the appetite/demand from overseas start to weaken, it will result with a greater burden for debt to be absorbed domestically.

Under PM Johnson, his vision for higher spending and increased fiscal expansion were somewhat balanced out by a more fiscally-cautious chancellor Rishi Sunak. Therefore we are yet to see what the new Chancellor and PM views on fiscal spending will be and how this will affect the gilt market.

In the meantime, the risks to the growth outlook has led to some flattening of the curve which has been less pronounced than seen in the US given the more growth-cautious BOE.

The BOE so far said that QE sales will be limited and predictable, which on balance supported the market, but the BOE is due to give an update on QE sales in August with the release of the Monetary Policy Report. A change in stance by the BOE does not seem to be ruled out at this stage.

Market pricing of overnight rates by year-end went from 1.40% at the end of May to 1.90% at the peak in mid-June, and declined back to 1.60% at the end of June. Current market pricing implies two 50bp increases in August and September and subsequent 25bps increases to take the target rate from the current 1.25% to a peak of 3.0% in May 2023.

Despite the increasing risks to the growth outlook, MPC members have not played down rate hike expectations. On balance, the risk of any sharp rises in yields is more contained today given the weak growth outlook and current market pricing of central bank expectations.

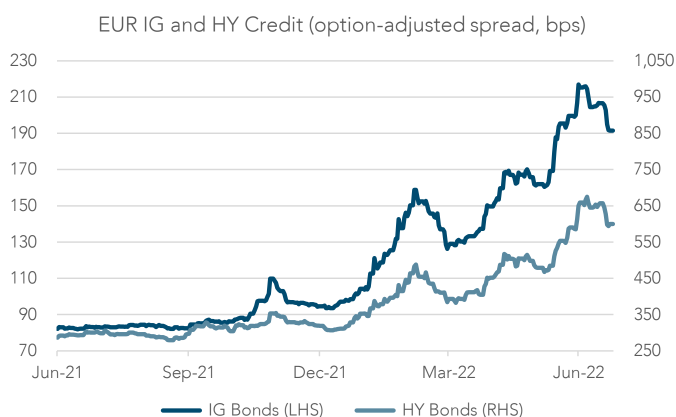
CREDIT

Euro Credit

Overall, a rapid deterioration in global macroeconomic conditions, combined with ongoing geopolitical uncertainty and lingering COVID-19 lockdowns in China continue to fuel persistently high inflation, market volatility, and rising yields, posing an increasingly murky outlook for credit quality that, for now at least, has exhibited a degree of resilience built up during the bounce-back from the pandemic. The key risks relate to a) the outlook for energy and food as supply disruptions linked to Russia's invasion of Ukraine intensify, b) a rapid adjustment of central bank policy rates to counter excessive inflationary pressures, c) stagnant growth weakening the operating environment and financial performance of corporates, d) tightening financing conditions reawakening fears over fragmentation within the eurozone, and e) the debt sustainability of more vulnerable entities that had not fully bounced back from the pandemic.

Credit ratings are likely to come under more pressure into 2023 as supply constraints keep food and energy prices elevated, households increasingly struggle with falling real incomes, and central banks prioritize inflation concerns at the expense of the growth outlook. Tighter financing and operating conditions will refocus businesses and households on cash flow to protect against a highly uncertain outlook and ultimately solvency for the most vulnerable issuers. Expectation is for default rates to increase to c.3% by year-end and into the first quarter of 2023.

Given the strength of balance sheet fundamentals and a supportive technical on the supply side, we think the bulk of this year's spread widening is most likely behind us at this point, noting that at only 4 points (2002, 2008, 2011 and 2020) has the index OAS ever been wider. However, given ongoing market volatility, and the potential for further spread decompression, we think an "up in quality" as well as "up in liquidity" strategy remains justified across sectors and ratings, at least over the short term. As such, we prefer adding BB paper in the HY space and single-A paper in the IG space.



Source: Bloomberg

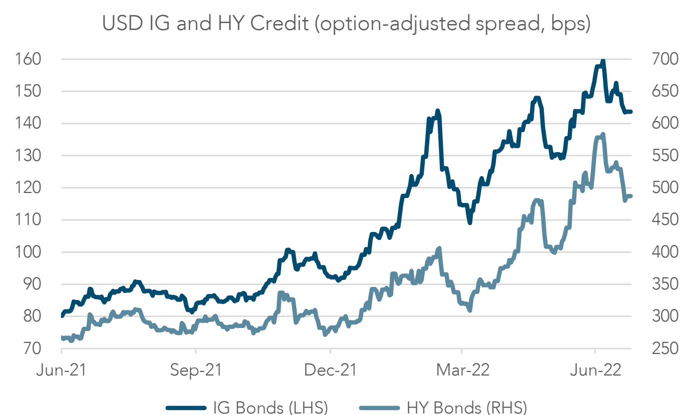
We view the recent underperformance of European credit vs the US, and Eur HY vs IG, as pointing to European recession risk being priced in more fully, with the premium on Euro spreads more than justifying a fair compensation against the upcoming end of CSPP purchases, in our view. Given the shape of the OAS curve, we also continue to prefer the belly of the curve as we do not see the compensation from extending to the 10+yr bucket as sufficient for the associated interest rate risk on a relative basis. Issuers in the Materials space continue to trade wide on a relative basis and offer some premium, though we would remain cautious around issuers particularly prone to cyclicality in the short term. Over a longer term view, we remain more comfortable with this dynamic.

US Credit

The run of remarkably favourable financing conditions has come to an apparent end, and there's a growing risk that sharply higher interest rates and persistent inflation, combined with renewed consumer caution, will push the U.S. into a recession, raising the possibility credit conditions will deteriorate even further. A further slowdown in economic activity could roil credit markets and result in the repricing of assets, raise debt-servicing costs, and tighten financing conditions. If borrowers' cost pressures don't ease, or if inflation continues to weigh heavily on confidence and demand, profit erosion and credit metric deterioration could become more widespread as the 2Q earnings season progresses.

Similar to the Euro space, credit quality is for now proving resilient, but signs of demand deterioration and the impact to the most price-sensitive sectors, such as consumer products and retail may drive default rates higher into year end. Forecasts remain for the U.S. trailing-12-month speculative-grade corporate default rate to reach 3% by March 2023, more than double the 1.4% in March of this year, with risk weighted to the downside.

Within the IG space, we see the spread differential between Euro and USD as having widened a further c.30bp within the last month, which has strengthened our shifting preference toward the end of May to hold Euro exposure over the short term. Within HY, movements in spreads have been more correlated over the last month. Whilst the attractiveness of USD HY paper has absolutely increased, and the scope for positive excess returns into year end has improved, we prefer holding Euro paper on wider spread buffers and slightly better breakeven rates which imply a slightly higher scope to outperform over H2 despite the macro backdrop.



Source: Bloomberg

Consistent with conventional wisdom, higher beta segments of the market have historically underperformed during periods of spread decompression, and again we think that lower rated areas of both the IG and HY markets and more cyclically exposed names should be minimised within portfolios investing over a short term horizon. Over the longer term as the dust settles on overall volatility and the market has a better understanding of the depth of a potential recession, we are more comfortable in adding risk. Higher quality credits should therefore provide better insulation in a downside case.

UK Credit

A mild contraction in GDP over the second and third quarters this year (a technical recession), and potentially weak growth next year. Against this backdrop, to bring inflation back down to its 2% target, the BoE will also likely continue raising its policy rate into early next year, before pausing for a few quarters. While policy tightening is necessary and even beneficial to the growth outlook in the next few years, it comes at a cost now, with these effects being compounded by already tighter credit market conditions both in the U.K. and globally. The resignation of Boris Johnson is just one more item to add to the growing list of challenges the UK faces as the economy grapples with this combination of high inflation and slowing growth. There is currently no clear front runner for the new conservative leader, which implies that the approval of a much-needed fiscal package to help the UK consumer is not guaranteed and unfortunately, the UK economy will continue to wither in the interim as a result.

UK CPI inflation hit 9.1% in May, with the majority of the overshoot relative to the BOE's 2% target explained by rising energy and goods prices. There are growing signs that inflation is becoming more broad-based as the tight labour market pushes up services prices and food costs soar. Looking ahead, expectations are for annual CPI to peak close to 11% in October as energy bills rise further. Inflation is likely to fall back in 2023 as the rise in goods prices this year isn't repeated and the jobs market cools.

The big risk investors currently face is that the current

bout of inflation prompts both workers and firms to lift their expectations of future wage and price gains. Should that occur, interest rates will have to go higher than initially expected and create further repricing in the market. The BOE has raised rates at each of its last five meetings, and started (albeit slowly) unwinding its balance sheet. We expect further clarity on this latter point following the August BOE meeting. The extent of any further tightening will likely be determined by the performance of the jobs market and behaviour of inflation expectations. The BOEs chief concern is that the combination of high realised inflation and a tight jobs market interact to lift wage and price expectations, making inflation all the more persistent. Nevertheless, expectations are now for a 50bp increase in August and for rates to peak at 2.5% early next year.

Given the increased uncertainty over the short term around the progress on the BOE balance sheet and the leadership contest within the Conservative party, we continue to prefer Euro and even USD credit relative to GBP for the time being.

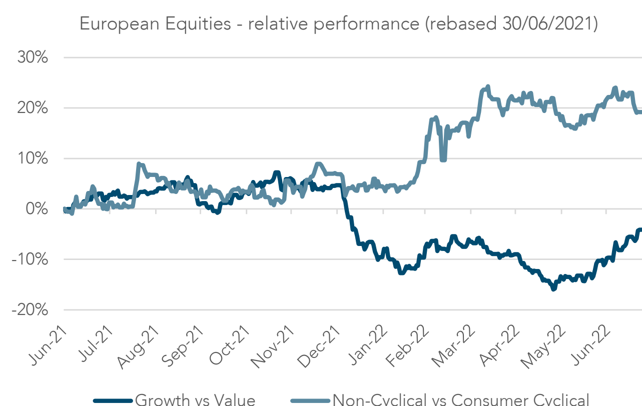
EQUITY

The balance between growth and inflation was a key concern at the start of the year. Back then, the expectation was that growth would remain above-trend with inflation falling sharply but remaining above-target by year end. Yet, the invasion of Ukraine proved to be a gamechanger as regards to the growth/inflation mix. As weeks passed, growth expectations were revised sharply lower while inflation expectations and rate hike expectations kept on rising. The growing risk of recession led to more uncertainty around equity market prospects which led to a -20% pullback in the first six months of 2022.

Risk sentiment (post-COVID-19) peaked in February 2021 and has been on a downward spiral since then (Exhibit 2). This coincided with data that the COVID-19 vaccine was working and that the expected re-opening (which had led to a significant upward revisions in global growth expectations since November) would likely materialise (Exhibit 3). Since rate hike expectations were still zero up to the summer months, loose monetary policy continued to supported risk sentiment whilst the boost from growth expectations started to fade. As high inflation persisted, rate hike expectations also started to change and monetary policy became a headwind for sentiment. During 1Q22, both growth concerns and tighter monetary policy weighed on sentiment leading to a total return of -10.0% for global equities. During 2Q22, the turning point was the higher than expected inflation print in June, which led to a re-pricing of the rate hikes. This led to a total return for global equities of -16.1% during 2Q22.

Economic surprises in developed economies have been negative since April. Economic data in the first eight months of 2021 was largely better than expected as the global economy recovered from the pandemic. Beyond August, we saw a clear deterioration as COVID-19 cases increased and the probability of a China hard landing increased. The impact from the war on inflation has led to a steep deterioration in data beyond April 2022. The FED has hiked at a much faster rate than previously expected and this will have an impact on growth prospects. The deterioration has been primarily driven by weakness in manufacturing PMI. The impact from higher inflation on the consumer is likely to exacerbate the growth impact over the coming weeks.

Defensive and value strategies have outperformed so far this year. The aggressive tightening cycle and revisions



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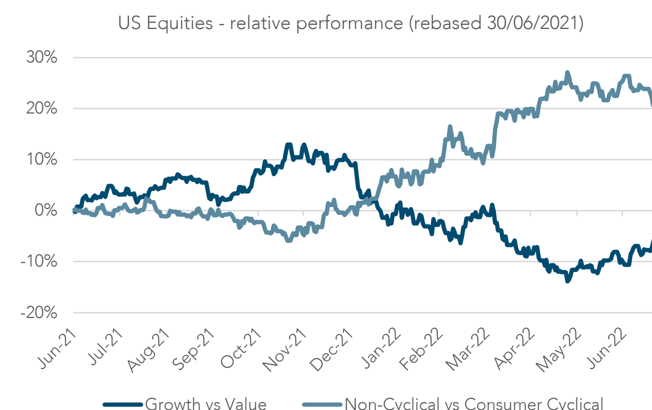

Source: Bloomberg

to the terminal growth rate have weighed on growth strategies during the year. In the US value strategies have outperformed growth by 17.5% whilst in the EU, value outperformed by 14.7%. Yet, much of this outperformance in value has been driven by commodities following the rally we have seen post invasion. As for defensives strategies, the outperformance in the US came in at +24.1% and +7.4% in the EU. The two main factors that have impacted performance in 2022 have been: (1) higher rates (-ve for growth) and softer economic growth (-ve for cyclicals).

Recession is still not the base case for Goldman Sachs. Despite the deterioration in economic data, the impact of the tightening cycle on consumer spending, the housing market and business investment, Goldman Sachs are still not forecasting a recession in the US. Even if the economy avoids going into a recession, the risk of stagflation is growing with inflation still well above target and growth slowing. A stagflation would probably pose a higher risk to equities than a recession, as it limits the array of tools available to help the economy, both monetary (high inflation limits the amount by which interest rates can be cut) and fiscal (higher cost to implement fiscal programs due to higher policy rate).

The macro-economic backdrop has changed significantly since the start of the year and with it, the outlook for equities. In order to reflect the rising risk we have made changes to both the allocation and composition of the equity portfolio. Equity investors are currently in a difficult position with uncertainty rising. Valuations have come done significantly since the start of the year, but this is mostly a reflection of monetary policy tightening by the FED and the potential of a mild recession. The risk that inflation persists for longer (possibly driven by additional supply-chain constraints as a result of China's COVID policy) leading to a steeper recession than currently being expected still exists. Additionally, Europe is facing two primary headwinds (1) Energy and (2) China weakness which could hurt economic prospects.

We started the year with an overweight position in equities. We expected economic growth to remain above trend and inflation to be brought under control by the half year point. Yet, we are now presented with the risk that the global economy goes into a recession. In this respect, we decided to reduce risk, with the allocation to the asset class reduced by c. 15% from the start of the year to 92.8%. This offers some protection should the economic backdrop deteriorate further, but keeps in play if the situation improves. A more defensive stance is more appropriate during periods of heightened risk.

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 CPI print has led to another strong sell-off in June. 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

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