Investment Strategy Update

20th May 2020

Curmi & Partners Research

- Economic output data releases for the first quarter give the first indication of the extent of impact of the crisis after only a few weeks of containment measures adopted across major economies.
- Inflation data published for April across major economic regions show dramatic declines in price levels primarily due to drop in energy prices as well as demand.
- The fallout in labour markets continues to play out with more countries publishing data showing sharp increases in job losses.
- Market economic expectations continue to be revised downwards despite the relaxation of measures being announced across several countries showing a greater realisation of the extent of economic impact and the less likely "V"-shaped recovery.
- Several sovereign states are announcing the second round of fiscal policy response which, combined with the shortfall in budget from automatic stabilisers, is putting more pressure on national debt levels.
- Despite the increased financing requirements by governments, government bond markets remained relatively supported given the high expectations on central banks to ramp up their bond buying programmes.
- The proposal of a European Union recovery fund to support struggling countries through grants has further supported the re-convergence in country spreads across euro area sovereign bonds.
- Corporate bonds have broadly continued to recover as credit spreads remained supported by central bank intervention while new bond issuance tested investor sentiment.
- Pressure on cash flows and liquidity remains the main threat for the survivorship of companies with high leverage operating in the more severely impacted industries, with more corporates seeking to increase access to credit facilities and working capital financing.
- With more releases of financial results, investors are able to assess the impact on operational and financial performance of companies, however, the rising risk of downgrades, defaults and/or debt restructuring remains a key concern in credit markets.
- Equity markets have continued to perform strongly, widening the dislocation in valuations against the severely challenging business and economic outlook, on expectations of too optimistic recovery rates in corporate earnings.
- The recent rotation into value stocks and cyclical stocks seems premature and is likely to be temporary given the inherent uncertainty in economic outlook and the extent of damage in economic productivity capacity.

The output data releases for the first quarter of the year show contraction rates at or even below the already depressed market expectations across major economies. This has brought about the start of the realisation of the potential extent of the economic downturn, even though the downbeat first quarter data is capturing only a few weeks of lockdown conditions. Because of this, consensus forecasts around the contraction in economic output for 2020 across major economies, and the world as a whole, have been revised further downwards in mid-May compared to April.

On the other hand, the relatively unchanged economic estimates around the pace of economic recovery implies a longer time period expected to fully restore economic output to pre-COVID-19 levels. In line with our previous assessment of economic conditions, we are now seeing weakening market perception about the likelihood of a "V"-shaped type of recovery.

The dramatic decline in inflation rates reflects the decline in energy costs but also weak demand which is prevalent across major economies. The rising risk of deflation is becoming a key concern for policy makers as it threatens the inherent ability for the economy to bounce back rapidly from the crisis.

Developments in labour markets are showing similar signs of concern. The broad-based nature of job losses can risk the loss in the economic production capacity, undermining the speed as well as the ability for the economy to reach full potential without first repairing labour market conditions in order to re-strengthen pass-through effects.

With the stabilisation in the number of daily confirmed cases, we are now moving into the next stage of the pandemic whereby governments are starting to roll back the highly restrictive containment measures. At the same time, we are seeing the second round of fiscal policy response across developed economies, primarily in the form of additional discretionary spending initiatives, on top of the existing assistance measures announced earlier on.

The strain on public finance is further exacerbated when considering the expected shortfall coming from automatic stablisers which is pointing towards a more vulnerable end position in national debt levels coming out of the crisis across sovereign states.

In view of the heightened downside risk factors, the risk of deflation and the pressure on financing conditions, we are increasing anticipating further action by monetary authorities primarily in the form of expanding the sizes of their quantitative easing, particularly in the case of the European Central Bank (ECB) and the Bank of England (BOE).

The deteriorating economic conditions however, did not seem to dent the positive market sentiment visible in the sustained upward momentum in the riskier asset classes, particularly high yield bonds and equities, which gained significant ground from the lows seen in mid-March.

While a concerted policy response remains crucial to mitigate economic risks, it has also provided supported investor sentiment in financial markets. However, the extent of appreciation in asset valuations and the expected rebound in corporate profitability is potentially too optimistic given the challenging business conditions and the obscure economic backdrop which is expected to result in weak operational performance and cash flows.

On balance we remain cautious in navigating the higher end of the risk spectrum. We continue to prefer non-cyclicals and growth stocks with strong quality characteristics despite the very recent market rotation into value stocks and cyclical stocks.

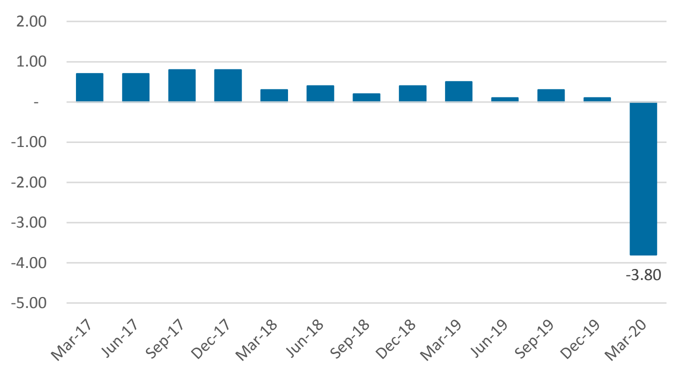
On the other hand, duration risk seems to be attractively compensated for at current yield levels given the outlook on interest rates and inflation. Similarly, careful selection in credit can present attractive opportunities given the degree of dispersion in corporate bond markets after the sell-off in March and the stabilization in credit spreads which followed in April.

MACRO

Euro Area

The GDP results for the first quarter show the impact of March 2020 when containment measures were being adopted on a broad scale across member states. Euro Area GDP in Q1 contracted by 3.8%, the sharpest contraction since the series was first measured in 1995. The quarter-on-quarter growth in Q4 2019 was of 0.1%. The result is broadly in-line with expectations of -3.5% consensus estimates for Q1.

Euro Area: Real GDP Growth (QoQ rate, %)



Source: Bloomberg

Germany, France, Spain and Italy experienced the worst contraction in Q1 with German, Italy and France recording a technical recession given the negative growth rates recorded in the previous quarter.

The contraction is due to broad economic effects brought about by the spread of the coronavirus which primarily impacted consumer spending, industrial output as well as investment, trade, capital flows and supply chains. The relaxation of restrictive measures is expected to bring about some normalisation in activity. However Q2 economic results are expected to be the worst yet. In any case, give the latest revision in economic forecasts, the level of output is not expected to be restored at least until 2023.

In the European Commission's Spring Forecast published in May, the estimated contraction in 2020 Euro Area GDP is -7.75%. This is broadly in line with the April IMF forecast of –7.5% and consensus market estimates expecting a contraction of –7.4%.

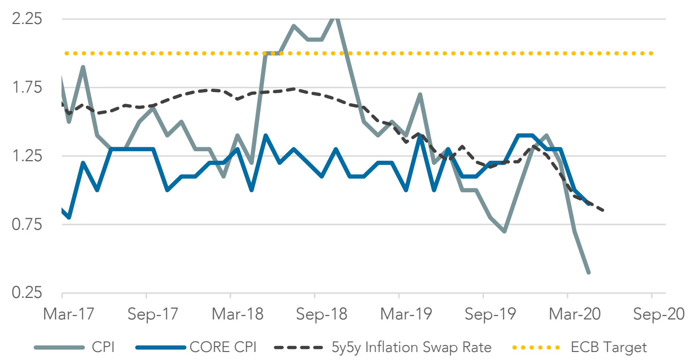
Similarly, according to various growth scenarios considered by staff at the European Central Bank, the GDP could fall by between 5% and 12% in 2020. However, in a more recent communication, Christine Lagarde mentioned that the revised outlook points towards the weaker end of the range.

The impact on labour markets was also expected to show asymmetric effects across member states displaying a greater divergence between southern and northern states across Europe. This has been partially reflected in country-specific labour data published so far, despite Euro Area headline figures showing only marginal deterioration. Notably, Italy and Spain saw a drop in employment rates reflecting the extent of job losses and an increase in the number of inactive people.

Employment rates in France and Germany remained stable, however the first signs of deterioration is seen in the increase in inactive people in France as well as the increase in the number of claimants for jobless benefits in Germany.

Looking at inflation, we have noted in earlier updates that we anticipate the impact on price levels, due to the drop in demand and the sharp fall in energy prices, to more than offset potential inflationary pressures from supply disruptions since the latter are expected to be more isolated occurrences.

Euro Area: Inflation (rate, %)



Source: Eurostat, Bloomberg

The inflation data reported for the month of April is the first confirmation of such expected effect, showing the inflation rate declining to 0.4% from 0.7% in March, while core inflation has declined to 0.9% from 1% in March.

The drop in inflation is driven by the fall in energy prices of -9.6% (vs -4.3% in March) and softer price increases in service prices of 1.2% (vs 1.3%) and non-energy industrial prices of 0.3% (vs 0.5%). Conversely, food prices are increasing at a faster rate of 3.6% (vs 2.4%).

Inflation is expected to weaken further this year. Consensus forecasts project Euro Area CPI to increase by 0.4% in 2020 while the EC forecast inflation to go down to 0.2% in 2020. This is in line with the forecasts provided by the IMF in April.

The weakening economic conditions in Europe further underline the importance of continued effort by member states and, more importantly, at pan-EU level to mitigate the risk of structural damage and safeguard productivity capacity in Europe.

To this end, Angela Merkel and Emmanuel Macron held a joint video press-conference on Monday 19th May to present a joint initiative on the launch of a European recovery fund of EUR 500 bln to assist sovereign states.

The adoption of such an initiative has a number of material implications both for the current state of the crisis at national or at EU level but also for the broader European story. As indicated in the Franco-German proposal such a mechanism would, for the first time, allow for fiscal transfers across member states from a common EU budget. This would imply a far greater degree of risk sharing especially since distributions will be in the form of grants as opposed to loans, as is this case with the current facilities available by the European Stability Mechanism (ESM).

Secondly, and equally important, the recovery fund is proposed to be funded via direct injections from member states depending on national budgets and income as well as external financing from capital markets through the issuance of bonds, possibly by the European Commission itself. This would inherently imply a degree of debt mutualization across member states.

In the current situation, if an agreement is reached by all member states, the recovery fund can provide much needed relief on the national debt and fiscal budgets of the highly-impacted member states, allowing them to meet their immediate spending requirements without putting excessive pressure on public finances.

At EU-level, greater coordination in fiscal efforts to combat the crisis will lead to a more congruent effect across member states which is set to improve the collective state of the union in preparation for the economic recovery given the interlinkage and spillover economic effects across member states.

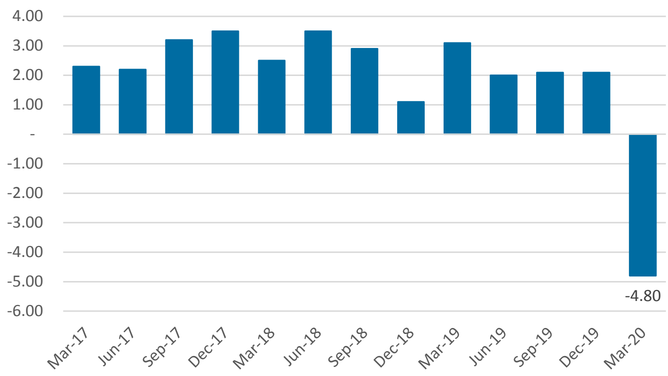
While the initiative has already seen some pushback from some conservative states, namely Austria, Denmark, Netherlands and Sweden, the adoption of such a mechanism would mark a significant step towards fiscal integration.

United States

The US has also published the Q1 GDP results at the end of April showing a contraction in output of 4.8% (on an annualised basis) marking the first decline following the longest period of expansion for the country's economy. This also marks the steepest quarterly contraction on record.

The contraction was mainly driven by fall in personal consumption expenditure while business investment remained weak. Exports and Imports have also dropped due to the widely reported disruptions in supply chains as well as the drop in global trade. On the other hand, residential investment and government spending increased.

US: Real GDP Growth (QoQ annualised rate, %)



Source: US Bureau of Economic Statistics

Consumer spending is still very weak, despite some improvement over the last couple of weeks in air travel and restaurant diners' numbers. Retail sales dropped by 16.4% in April (-8.7% in March) while consumer sentiment improved slightly to 73.7 in May (vs. 71.8 in April). The improvement in sentiment is attributed to relief benefits under the CARES act. However, the consumer expectations sub-index shows the weakest prospects yet on the state of personal finances.

As several states have started to scale back lockdown measures, high frequency indicators are showing some return in activity with the level of land traveling activity improving from circa 50% to 75% of normal levels from a month ago.

Having said that, the worst contraction is still expected to seen in Q2 of this year. Full year GDP consensus forecasts have likewise been revised downwards to –5.7% for 2020 from a month ago.

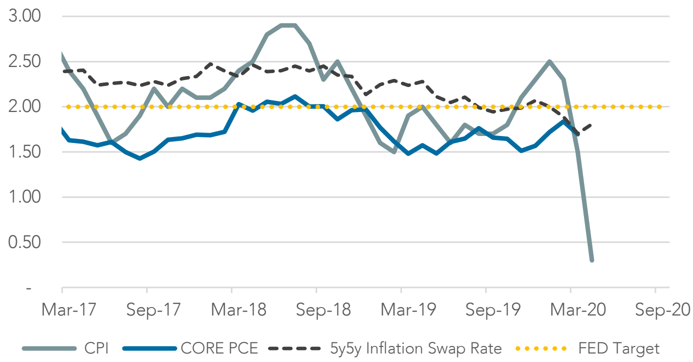
Labour market data has continued to weaken with the unemployment rate reaching 14.7% in April, already exceeding most forecast estimates. Moreover, given the continued trend in initial jobless claims, unemployment is expected to reach 20% in May and could weaken further to 25%.

Job losses have been relatively broad-based across sectors. The most effected industries, including accommodation and food services, non-essential retail, transport, entertainment, personal services and child care accounted for 50% of job losses. However, spillover in job losses is seen in manufacturing construction, professional services as well as state and local governments, which saw huge layoffs. This is increasing concerns around potential loss in economic productive capacity should the high level of unemployment become more structural.

Having said that, so far the majority of job losses are in the low-skilled jobs which do not generally require extensive training. Therefore the productivity in the highly impacted industries would be expected to be restored without significant drags, but much will depend on the normalization of conditions and consumer demand in these industries.

US inflation data has also come dramatically lower the month of April at 0.3% from 1.5% in March. The drop is mainly attributed to decline in gasoline prices. However, prices for apparel, motor vehicle insurance, airline fares and lodging all dropped considerably. Conversely, food indices actually increased in April. Excluding food and energy, CPI declined to 1.4% from 2.1% in April.

US: Inflation (rate, %)



Source: US Bureau of Economic Statistics, Bloomberg

Core PCE inflation, the Fed's preferred measure to assess its inflation target, is expected to be published later this month. Expectations are similarly pointing towards a sharp drop from 1.7% in March to 1.1% in April.

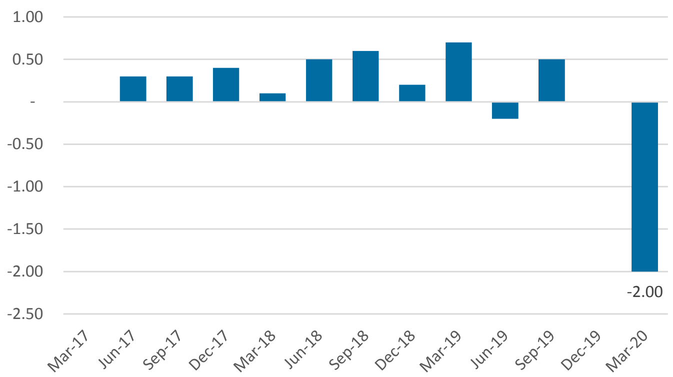
The weak consumer demand and rate of job losses is expected to sustain the downward pressure on prices over the medium term. Consumer estimates for 2020 inflation have likewise been revised slightly downwards to 0.8% in May from 1.0% in April.

United Kingdom

The UK has published preliminary estimates of Q1 GDP growth showing a contraction of 2%, compared to 0% growth in Q4 2019. This comes as lockdown measures were introduced in mid-March bringing business to a halt. The decline has not been as deep as other European countries, however this is mainly because lockdown measures were introduced earlier on elsewhere in Europe.

Household consumption dropped by 1.7% given declines in spending on transport, restaurants and hotels, clothing and footwear. Fixed investment declined by 1%, government expenditure declined by 2.6%. Exports and imports declined by 10.8% and 5.3% respectively given the shock in global trade.

UK: Real GDP Growth (QoQ rate, %)



Source: Office of National Statistics

Similar to other major economies, April is expected to mark the lowest point in the UK given the lifting of measures in mid-May. Having said that, with a long road ahead to restore normality, output levels are not expected to be recovered before 2023.

The Bank of England (BOE) and the Office of Budget Responsibility (OBR) have issued significantly weak forecasts for 2020 showing a contraction of -14% and -13% respectively for 2020 compared to consensus estimates of –7.5%.

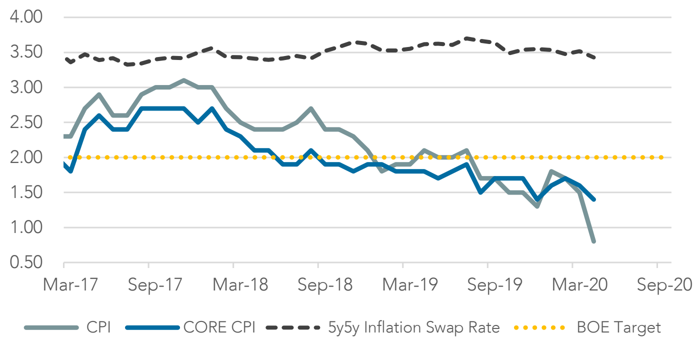
Unemployment data available so far in the UK does not yet show the impact of the coronavirus on the UK labour market. The unemployment rate published in May for the month of March shows a rate of 3.9%. Individuals claiming for unemployment benefits rose sharply in April by 856.5K compared to an increase of just 12.1K in March. The statistic, however, does not include those workers who are receiving government subsidies of 80% of salary.

Having said that, officials from Office of National Statistics claim that, had the government not launched the furlough workers scheme, the figures would be severely worse, since these still count as employed under the current status.

Conversely, average hours worked show a dramatic drop in the last weeks of March falling from around 32 in February to around 25 at the end of March.

The unemployment rate is expected rise in August when companies need to start contributing to the furloughed workers wages. Various estimates of unemployment forecasts see a potential rise to the range of 8% to 10% in unemployment in 2020.

UK: Inflation (rate, %)



Source: Office of National Statistics, Bloomberg

Similar to other economic areas, the impact on inflation has been substantial with April headline inflation dropping from 1.5% in March down to 0.8% in April. The main contributors for the decline in inflation were the softer increase in housing costs as well as the fall in energy and fuel pump prices and transportation services brought about by the lockdown measures imposed since 23rd March.

Inflation in the UK is expected to remain weak for the rest of the year with consensus estimates indicating inflation to be at 1% for 2020.

RATES

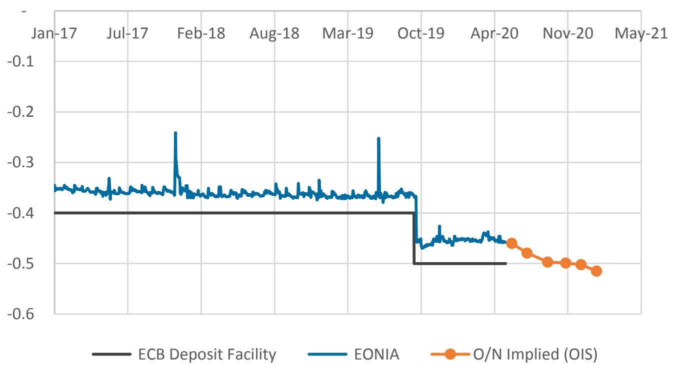
Euro

The ECB policy rates remain at ultra low and negative levels and are expected to remain at such levels for the foreseeable future. At its last monetary policy meeting on 30th April, the ECB responded to tensions in the interbank and short-term funding markets by introducing 12-month and 16-month refinancing facilities titled PELTRO (Pandemic Emergency Longer-Term Refinancing Operations). This allows financing to European banks on a fixed-rate full-allotment basis at a rate of -0.25%. The ECB has also improved the size and terms of financing providing under its TLTRO programmes which is linked to the growth in the loan book of European banks.

Short-term interest rate spreads started to recover from the stress levels seen in end-April with the launch of these initiatives, reflecting some improvement in financing conditions across the Euro Area. The OIS curve indicate an implied gradual decline in overnight rates as well, in anticipation of the cheaper access to short-term financing.

Sovereign spreads have started to re-converge over the past few weeks. However, in view of the expected issuance by sovereign states to finance the expected increase in fiscal deficits, the ECB is expected to step up its QE programme further, to ensure an effective transmission mechanism of its monetary policy and sustain low borrowing costs.

EUR - Short-term rates

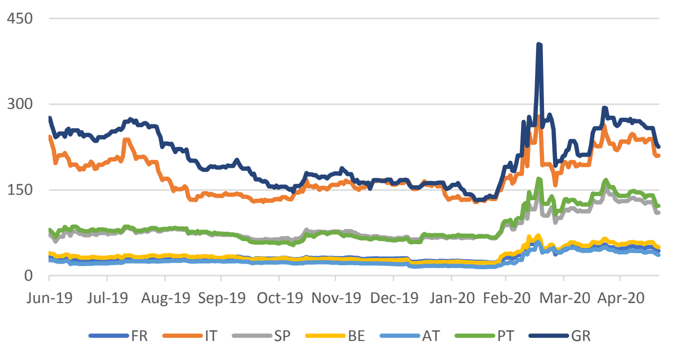


Source: Bloomberg

According to the latest ECB Bank Lending Survey, the demand for loans by firms has increased in Q1 as a result of emergency liquidity needs and is expected to increase further in Q2. The conditions on TLTRO III were eased further by reducing interest rates to 50 bps below the average interest rate on the Euro system's main refinancing operations (i.e. at negative 50 bps) as well as reducing the interest rate for those counterparties whose eligible net lending reaches the lending performance threshold to 50 bps below the average deposit facility rate (i.e. negative 100 bps), over the period from June 2020 to June 2021. By doing so, the ECB aims to provide an incentive for banks to meet credit demand by lending money to banks at rates as low as -1%.

The rise in the Euribor and stress in funding markets may be signaling concerns in the Euro Area's money markets also given the uncertainty around whether current levels of debt sustainability in peripheral markets will be maintained as fiscal spending increases.

Euro Area 10-yr Sovereign Spreads (vs De-10yr, bps)



Source: Bloomberg

The concern surrounding debt sustainability was also reflected in euro area sovereign markets as spreads on 10-year sovereign bonds versus the German Bund increased significantly prior to the measures announced by the European Commission and the ECB.

Spreads have continued to tighten on news that Germany and France have come together to push for a EU recovery fund in an effort to create a united fiscal response to the pandemic; a "transfer of real budget money to the worst-affected regions and the worst-hit sectors".

Despite this recent tightening, most peripheral spreads are still higher than pre-Covid-19 levels.

The increase in fiscal deficits will require an increase in the supply of sovereign papers, with the ECB expected to absorb a significant amount of the new issuance in an effort to support country spreads. In view of the increased net issuance, as well as the downward revisions in the economic outlook as assessed by the ECB, markets are increasingly expecting a considerable increase in the asset purchase programme at its policy meeting next month.

US Dollar

Short term interest rates are expected to remain at the current low levels for the time being as the Fed target rate is expected to be kept unchanged at 0% - 0.25%. Given the extent of job losses seen in the US and the impact in the labour market, the Fed is expected to keep rates at current levels even beyond the first signs of stabilisation in order to sustain the recovery and allow employment to regain the ground lost. This is also supported by the greater propensity expressed by the Fed to tolerate a period where inflation overshoots its target.

Stress in USD short-term funding has been met by significant Fed stimulus primarily through the newly introduced purchasing programmes as well as its presence in offering liquidity in the repo markets.

This shift in risk sentiment driven by the Fed has also contributed to easing demand for dollar which, combined with the introduction of swap lines with foreign central banks, has continued to improve the relative funding pressure seen in the EURUSD and JPYUSD cross-currency basis.

While committing to using its full range of tools, the Fed did not introduce any new measures but rather maintained the ongoing programmes that are currently in place. Moreover, in an interview, Fed Chair Jerome Powell said that it is unlikely that the Fed will use negative interest rates as a tool to respond to the economic impact of the coronavirus pandemic.

The US Treasury market has stabilised compared to the very volatile instances seen at the start of the crisis. However, during more recent weeks the US treasury curve has again experienced some steepening. This reflects the combined effect of the belief that the Fed will for now maintain its ultra-accommodative stance and the expectations of substantial new issuance expected over coming periods.

US 2yr vs 10yr Treasury Yield (bps)

Source: Bloomberg

While in our view treasury yields are expected to remain relatively rangebound in the current environment, should the economy show faster signs of normalisation, we could see increased momentum for yields to climb rapidly. We would expect that this could become a relevant theme once we get over the current slump in economic data.

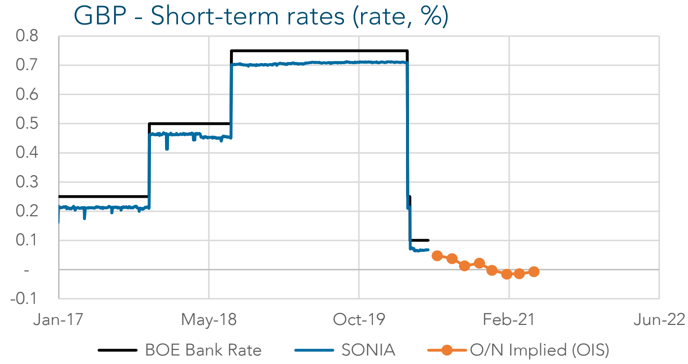
Sterling

The Bank of England (BoE) has not introduced any further measures following the lowering of interest rates and the expansion of its asset purchase program which were announced with the onset of the crisis back in March.

In view of the increasing financing requirement of the UK government, it is likely that the BOE will step up its QE purchase programme to sustain low borrowing costs. This decision has so far been ruled against with only a few members voting in favour of the extension.

Therefore the scope to increase gilt purchase to sooth pressure on borrowing costs given the substantial increase in fiscal deficits is increasing. This is further underscored by the deteriorating expectations of growth and inflation over the last few weeks especially with the severely adverse growth forecasts issued by the BOE and the OBR.

GBP - Short-term rates (rate, %)



Source: Bloomberg

On the other hand, pushing rates below zero remains a big hurdle for the BOE despite OIS swap rates trading below the zero level showing increasing expectations by the market for such a move.

The UK gilt curve has shifted downwards substantially following the introduction of these measures and the demand for the sovereign bonds with the 10-year yield now trading at around 0.20%. Moreover, for the first time we have seen the UK issuing a 3-year gilt with a negative yield at –0.003%.

CREDIT

The newly announced measures by the Fed to intervene in the primary and secondary corporate bond markets have been launched in early May. Although the effect of the introduction of such measures has already been felt across US credit markets, the stabilisation in the pace of contagion in the US as well as the reopening measures announced by several states has continued to have a positive impact on credit spreads.

Due to the introduction of these new measures, which are also very substantial in size, the US credit market has so far been the fastest to recover compared to other developed markets. However, we have seen a similar rebound in Euro credit markets as well, despite the elevated concerns around the credit health of corporates under the current conditions.

Liquidity challenges in view of the sharp drop in revenues and cash flows remains the main concern particularly for highly leveraged companies in the severely impacted industries. This is pushing companies to access credit facilities as well as capital markets to bolster their liquidity position in order to withstand the challenging period ahead.

Following the slowdown in new bond issues during February and March, both the US and European capital markets experienced a resurgence as corporate issuers sought to tap the financial markets in order to access capital.

New issues coming to market increased markedly during the month of April when compared to the prior month. European investment grade debt increased by almost four times over the prior month (€20.9 bln vs €5.3 bln) while US investment grade debt issuance increased by 27% ($186.1 bln vs $146 bln)

US non-investment grade debt issuance increased dramatically in April as $50.7 bln of debt was brought to market in April compared to $5.9 bln in March. On the other hand, issuance within the European non-investment grade market has remained the relative weak spot in terms of capital markets

The positive momentum in capital markets that started in April continued in May as new corporate issues were brought to market.

The recovery in credit markets, following severe turmoil of March, continued into May. However, it is noted that the pace of the comeback has somewhat softened, compared to the strong returns during the weeks that followed the March lows

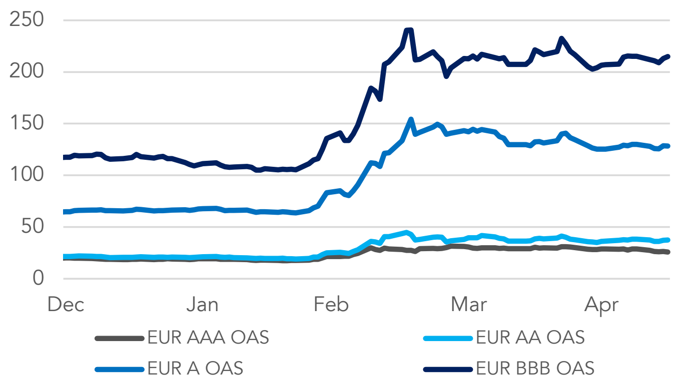
Furthermore, it could also be observed that the relative performance of the different asset classes within credit has showed some divergence in recent weeks.

Corporate fundamentals are expected to remain challenging, with visibility relating to the actual impact on issuers' financial profiles of the economic situation remain unclear. However, as more companies have released their Q1 2020 results and in some cases provided more guidance on prospects for the rest of the year, investors are allowed to begin assessing relevant trends in operating and financial performance.

News on defaults or debt restructuring initiatives is becoming more common, and along with the overall deterioration the ratings scenario, we expect this to remain a recurring factor in the coming months. On this basis, we retain our relative preference to be positioned in the stronger end of the credit spectrum and maintain our overweight position in investment grade credit.

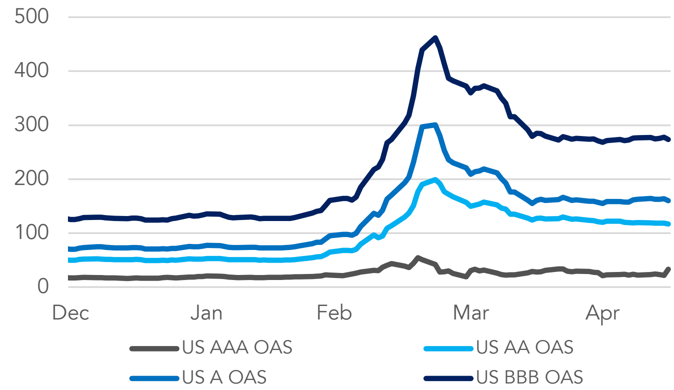
Moreover, our preference for the less cyclical sectors remains unchanged given our opinion that such companies are expected to be the most resilient in the current stress conditions.

EUR IG Corporate Spreads (OAS, bps)



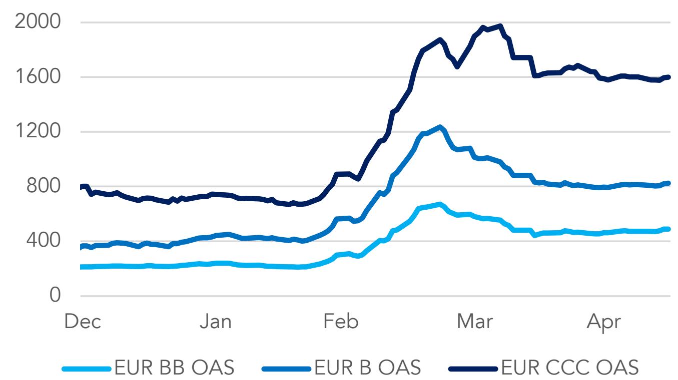
Source: Bloomberg

US IG Corporate Spreads (OAS, bps)



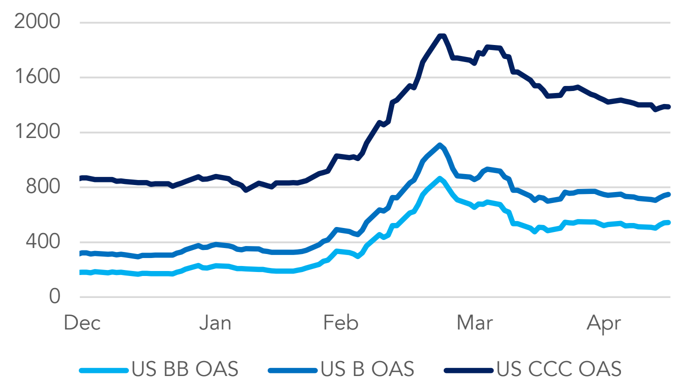
Source: Bloomberg

EUR HY Corporate Spreads (OAS, bps)



Source: Bloomberg

US HY Corporate Spreads (OAS, bps)



Source: Bloomberg

EQUITY

Equity markets have gone through contrasting emotions since the start of the year. Complacency at the start of the year was followed by fear as COVID-19 spread aggressively outside of China. This was followed by greed when unprecedented fiscal and monetary support was announced. There was a time when equities were considered to be highly correlated to health of the economy. As a risky asset, investors wanted to be invested in equities during expansionary periods as cash flows and profitability would grow, leading to higher valuations.

Today, this relationship has seemingly decoupled. As 30 million Americans are trying to find new jobs, the S&P 500 rallied close to it's record highs despite the FY20 earnings forecast being cut aggressively. Investors have looked through the short term noise, and are valuing stocks on the highly uncertain FY21 earnings.

Economies have started to slowly open up, which could bring some respite. However, it does seem that valuations have moved too fast and we think there is room for some adjustment in the near term. If bringing COVID-19 under control was the uncertain part, getting the economies operating at 100% productivity is the tough part.

The economic fundamentals and equity markets have moved in the opposite direction over the past few weeks. In view of the collapse in global growth prospects and the long period it will take for some regions to recover, it seems that valuations are optimistic. The rally in equity markets seems to be partly explained by the improved investor sentiment which has been boosted by the announcement of unprecedented monetary and fiscal policy support. Notwithstanding, the sharp recovery in valuations was too quick, with risks skewed to the downside in the near term.

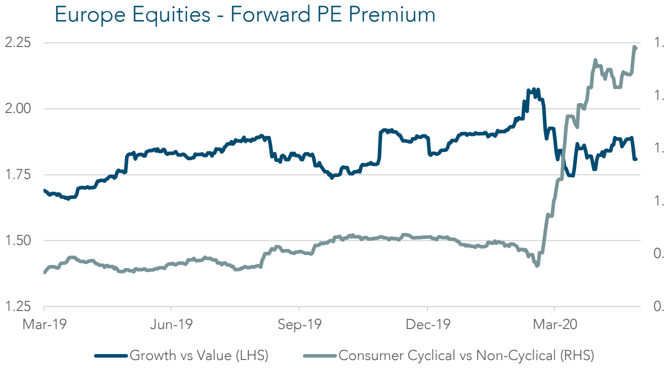
Economic data published so far has not only been weak, but also mostly below expectations. Nevertheless, investors are buying into equities today looking at FY21 earnings despite the clouded outlook and in the absence of any company guidance. Market participants are pricing in a complete recovery in earnings by year-end 2021. On the back of the weak economic data, or assessment is that such estimates are starting to look optimistic and susceptible to negative revisions unless we see a strong pick up shortly which we believe is unlikely. Additionally, investors are currently paying 17.2x for earnings that are 2 years out, despite the real possibility of earnings revisions, which would make equities even more expensive.

On this basis, we prefer to retain an underweight allocation to equities. At the same time, we acknowledged the improvement in investor sentiment which triggered our move to reduce the underweight allocation in April. Our concern over current equity market valuations is the prime reason for our cautious outlook. We think that equities have recovered too fast and that uncertainty remains elevated.

The key risk to our positioning in equity markets at this stage would be a rotation from growth to value stocks or from non-cyclical to cyclical stocks. We have started to see potential signs of such a rotation in equity markets. However, we believe that such a rotation will be driven by short-term market forces such as the expectations around the reopening of businesses and possibly travel with the relaxation of measures announced by governments and the positive news about the development of a vaccine.

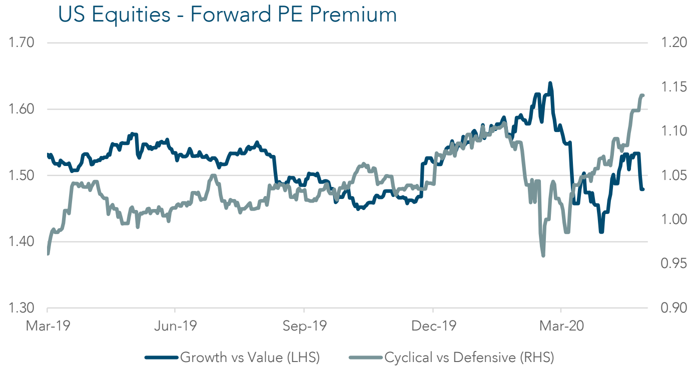
Our current assessment is that such a rotation is expected to be temporary in nature given the unmistaken deterioration in the economic conditions. Nevertheless, we are eyeing potentially attractive opportunities in cyclical equities with a significant discount in price that can benefit from the slow but positive signs of improvement in economic activity.

Europe Equities - Forward PE Premium



Source: Bloomberg, Curmi & Partners

US Equities - Forward PE Premium



Source: Bloomberg, Curmi & Partners

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Sovereign Bonds	Stable	N	Benchmark sovereign curves have been supported by safe-haven buying, the accommodative policies adopted by major central banks and the low inflation expectations across major economic regions. The reality that governments will emerge from the crisis with much larger national debts is not only accepted by market participants but it seems to be the only option for governments to fight the crisis. Nevertheless, the question around debt sustainability remains mostly relevant for the vulnerable sovereigns where the government ability to borrow against the future to guarantee the future can weaken due to the pressure on public finances. In the Euro Area, the increasing expectations of added support by the ECB as well as the plans to launch a pan-European recovery fund to assist the highly impacted countries has led to the re-convergence in country spreads from the highs seen in March. We expect spreads to remain supportive and maintain our positioning in non-core sovereigns with relatively stronger expectations on economic fundamentals and the rate of normalisation in activity.
Investment Grade Corporate Bonds	Positive	O/W	Investment grade corporate bond markets remain relatively attractive on a selective basis both on a relative and absolute basis given that the support in credit spreads is expected to be sustained for the time being. Whilst we are comfortable with holding high cash balances, we continue to increase our exposure to a selection of single-A corporate bonds primarily to improve the credit quality mix within our IG corporate bond selection while entering at a yield level that is considered to be attractive in view of the substantial central bank credit support, lowering inflation expectations and preferred tilt for a longer duration exposure. The risk of downgrades remains prevalent and requires close monitoring in view of the challenging business conditions and general sentiment in credit markets.
High Yield Corporate Bonds	Negative to Neutral	N	We continue to maintain a risk averse approach given the severe economic downturn and pressures across corporate sectors. At this point, and following market re-pricing our approach will remain on monitoring evolving risks on a name-by-name basis and de-risking individual exposures, were necessary. The resilience in price reaction in the more robust credit profiles gives a clear signal of the scope for dispersion across industries and issuers. The scope to remain selective in carrying high yield positions remains while the scope to opportunistically identify unjustifiably discounted bonds is starting to emerge.
Emerging Markets Corporate Bonds	Neutral	N	A risk averse approach is also warranted due to the global economic downturn and the pre-existing vulnerabilities across emerging countries. Having said that, it is noted that the weakness in energy prices and commodity markets as well as the dollar strength has started to recede which could potentially offer some opportunities. Whilst most exposures are centred on conservative financial profiles, our approach remains on monitoring evolving risks and de-risking on individual positions as required.
Equities	Negative	U/W	Our concern over the underlying factors driving the recent equity rebound is the key reason for our defensive stance in equities primarily due the widening dislocation in equity market valuations against the deteriorating company fundamentals and a challenging economic outlook On this basis, we prefer to retain an overall underweight allocation in equities and a relatively low beta exposure (circa 0.85) combined with an overarching factor tilt towards quality stocks and growth stocks. In terms of sector positioning, we prefer to avoid cyclical industries and retain core positions in staples, healthcare and technology. The possibility of short-term rotation in equity markets remains a key risk for our positioning. However, we expect such frustration to be temporary given the underlying business and economic conditions. At the same time, attractive opportunities can be found in severely discounted cyclical equities that stand to benefit from the slow improvement in conditions brought about by the relaxation of containment measures.

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

DISCLAIMER