Investment Strategy Update

22nd September 2020

CURMI & PARTNERS

Curmi & Partners Research

- Following a surprisingly strong rebound in economic activity, the recovery in the Euro Area and UK is expected to slow down given the resurgence in COVID-19 cases and the reintroduction of restrictive measures.
- Survey-based indices are pointing towards a slowdown, or another period of contraction, in the services sector, whilst manufacturing remains on an expansionary path across advanced economies.
- The recovery trajectory in the US seems to be on track, despite a similar surge in infection rates, as the rebound in spending and production is expected to maintain the current positive momentum.
- The fallout in unemployment was more immediately felt in the US, whilst the Euro Area and UK unemployment is yet expected to peak as governments gradually withdraw support from job retention schemes.
- As a result of the economic slack and the persistent output gap given the low level of employment and capacity utilization across advanced economies, inflationary pressures are expected to remain subdued over the medium term.
- Major central banks are expected to retain an ultra-accommodative monetary stance by maintaining very low policy rates and quantitative easing programmes to sustain the flow of credit and ensure easy financing conditions for a prolonged period of time.
- Governments are expected to see sharp increases in fiscal deficits in order to finance the fiscal initiatives launched to combat the crisis.
- Given the substantial monetary intervention and generally low inflation expectations, short-term rates and benchmark bond yields are expected to continue trading at very low levels for the time being.
- The easy financing conditions together with the stabilisation in economic conditions and slow improvement in growth prospects have sustained the compression in credit spreads across investment grade and high yield bond markets.
- Whilst market conditions remain benign, a high degree of selection is still warranted in evaluating credit risk given the strain on corporate cash flows as corporates struggle to reach viable operational levels.
- The key risks expected to drive risk premia going forward include US election uncertainty, Brexit, the ongoing pandemic and US/China trade relations.
- In the absence of material developments in the production of a vaccine or alternative methods to contain the virus, equity market rotations into cyclical stocks are expected to be temporary and a generally more defensive stance in equity selection is preferred.
- We prefer to retain an overweight exposure to growth stocks given our outlook of low growth and low inflation and preference for cash-rich entities.
- On the other hand, we prefer selecting positions in value stocks that stand to benefit from megatrends or that are expected to attract higher valuations for thematic motives.

The resurgence in COVID-19 cases across most parts of the Euro Area and the UK is expected to result in a slowdown in the pace of the recovery. At the same time, the strain on public finances may not allow governments to continue extending household contributions and the much-needed job retention schemes.

The risk is that economic conditions may have not recovered sufficiently by the time when government support is withdrawn from the system. As a result, the impact on employment, in view of the weaker demand outlook and low capacity utilisation may be more severe than expected.

Whilst financial markets have generally benefitted from the substantial buying by major central banks and the tightening risk premia given the improving market sentiment, as the growth trajectory comes under threat once again, the risk of downward revisions in economic forecasts will likely bring about the reassessment of current asset valuation levels.

Conversely, advancements in the development of a vac-

cine, or increased resilience to the spread of the virus either through lower hospitalization rates or more effective, low-cost containment measures, may reduce the fragility of the economic rebound and provide an environment for a steadier rate of recovery.

Despite the sharp expected increases in government deficits across all major economic regions, central bank intervention has ensured that nominal benchmark bond yields trade at relatively low levels with the consequence that real yields particularly in the UK and the US saw dramatic declines.

As economic conditions have stabilized, the low interest rates and easy financing conditions have provided a favourable environment for corporate bonds to trade higher and credit spreads to tighten, gaining most of the ground lost with the onset of the crisis.

Similarly, equity valuations have been supported by the drop in discount rates despite the increased uncertainty on future profitability.

At the current junction, in the absence of any significant set-backs or an increased risk of a double-dip recession, the benign environment of easy financing conditions and slow, but improving, growth prospects, is expected to continue to favour credit markets.

On the other hand, equity markets have been subjected to increased discrimination by investors across stocks categorized as growth or defensive and those categorized as value or cyclical.

The episodes of market rotations from growth stocks into value stocks are expected to be a temporary occurrence as opposed to structural trends as long as the low growth and low inflation outlook prevails.

However as we move closer towards the launch of a vaccine and economic or policy uncertainty starts diminishing, the scope for value or cyclical stocks to gain popularity is expected to increase substantially.

In our view, the key risks that will drive markets in the near-term include the US election uncertainty, Brexit, the ongoing pandemic and US/China trade relations.

MACRO

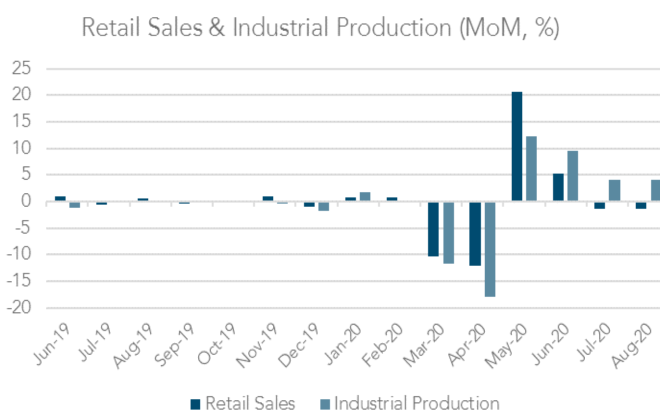
Europe

The rebound in economic activity across the Euro Area is losing momentum as the number of Covid-19 cases resurge in parts of Europe. More notably, in August and September, France and Spain saw sharp increases in the number of confirmed cases, following the easing of many of the containment measures put in place earlier. The rise in cases across Europe is showing signs of an increase in deaths, albeit at a significantly lower level than during the first wave of infections.

Eurozone GDP data for Q2 was revised from -12.1% to -11.8% and showed that the decline in economic activity was broad-based across different sectors, with double-digit contractions in investments (-17.0%), household consumption (-12.4%), domestic demand (-11.2%) and exports (-18.8%), which was largely off-set by the decline in imports of 18.0%. GDP is expected to recover in Q3, as the more frequent economic activity data have generally been pointing upwards in the interim months.

Having said that, given the resurgence in virus cases, the reintroduction of restrictive measures by governments is expected to slow the pace of recovery in economic activity.

Industrial Production rose for the third consecutive month since the start of the pandemic, however the pace of the rebound has slowed while the level of output remains below pre-crisis levels. Eurozone retail sales fell by 1.3% in July following two consecutive months of month-on-month increases, indicating that the recent rebound in consumer spending is moderating. The sharpest decline was registered in 'textiles, clothing and footwear' which was down 10.6%. As noted in previous updates this was likely due to delayed summer sales.

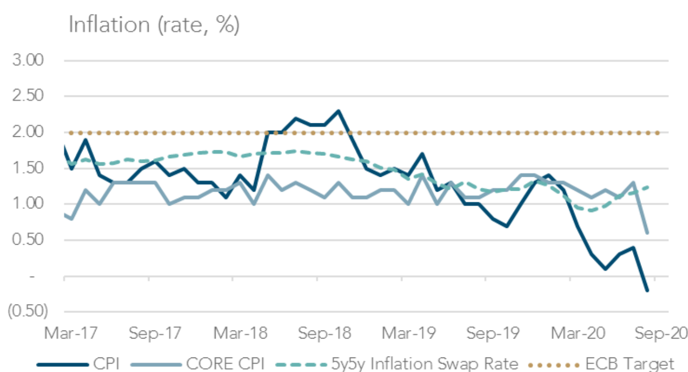


Source: Bloomberg

Whilst the rebound in economic activity data published was surprisingly faster than expected in the first few months after lockdown, the rate of recovery is expected to slow down as activity levels continue to approach "normal" levels. Moreover, in view of several member states reintroducing new measures or some form of partial lockdowns, the services sector is expected to experience contraction in the weeks ahead.

Although risks of national-wide lockdowns remains unlikely at this stage, the rise in new cases across Europe remains the main threat to the recovery. The key risks to economic outlook remains the rising unemployment due to the phasing out of government support schemes and the risk that a sustained increase in the rate of infection will result in broad-based lockdown measures being re-introduced.

Looking at price levels, as expected, Euro area headline inflation came back down from the uptick registered in July, declining to -0.2% in August whilst core inflation fell to a record low of 0.4%, dragged by the delayed discounting in summer sales.



Source: Bloomberg

According to ECB President Christine Lagarde, headline inflation is expected to remain negative over the next few months, mainly due to the price of oil, the temporary reduction in the German VAT rate, the delayed clothing sales which rolled into September and persistently weak consumption demand. The drag from clothing inflation is not expected to impact inflation past September

The inflation outlook remains weak given that excess capacity in the economy is expected to continue to weigh on prices. Moreover, weak labour markets are expected to keep demand low while the surge of virus cases and reintroduction of measures is expected to slow the rebound in activity.

Labour market conditions have also continued to deteriorate as anticipated. Euro area unemployment continued to increase from 7.7% in June to 7.9% in July and is expected to increase further as government furlough schemes are expected to expire in Q4. In fact, unemployment is expected to rise to 9.4% by the end of the year.

Labour cost data recorded an increase in Q2 given that hours worked fell at a significantly faster pace than wages, as companies, aided by government schemes, kept employees on payrolls. The dependence of household income on government subsidies and the potential impact on labour markets as governments withdraw or reduce support (especially in the fiscally-weak countries) remains a key concern for employment and demand;

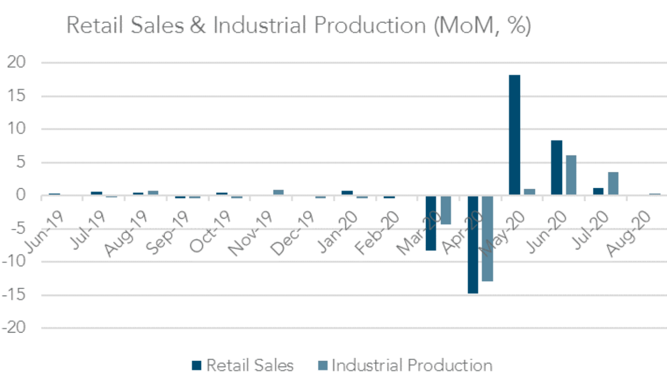
As a result, employment is expected to continue to fall even as the economy continues to recover due to the (a) fiscal cliff effects and (b) weak business prospects and high uncertainty weighing on business investment.

United States

Unlike Europe, the rebound in economic activity seems to have remained on the right track even as COVID-19 cases surged in the US. The low rate of hospitalisations despite a similar surge in cases experienced earlier on was met with generally low cost, or low impact, containment measures.

Retail sales have exceeded pre-pandemic levels in August. The month-on-month increase came in at a modest 0.6% gain but this was expected given the sharp increases seen in earlier months. Service sectors continue to drag the rebound in consumer spending. Having said that, high frequency data, such as hotel occupancy, restaurant diners and air travel are also on the rise.

The decline in unemployment benefits did not seem to impact spending so far. The sustained rate of spending seems to be explained by (a) the increase in personal savings in previous months (supported by the unemployment insurance payments) and (b) the improving consumer sentiment. The latter is reflective of the improving trend in labour markets and expectations of future growth prospects.



Source: Bloomberg

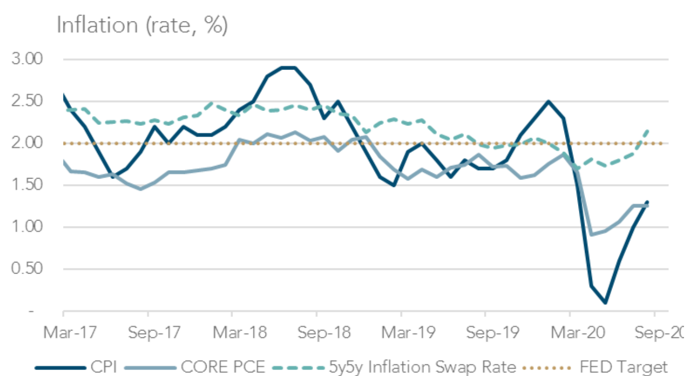
Industrial production continues to lag spending but has nevertheless gained a lot of ground since the sharp drop in April. Manufacturing output has rebounded given the sharp reversal in the auto sector which has almost completely reversed the drop seen in April. As a result, inventory levels have been clearing out, increasing scope for industrial production to gain traction.

External trade has been on the rise as global supply chains are repaired and lines have reopened for business. However, the increase in imports is expected to outpace the increase in exports given the improving

domestic demand. As a result, the trade deficit is expected to widen.

Despite the adverse external trade dynamics, given the sustained rise in consumer spending (which was the main constituent contributing to the GDP contraction in Q2), and the slowly improving manufacturing sector, consensus GDP forecasts for 2020 have been revised upwards to -4.5% in September from -5.0% in August.

Headline inflation surprised to the upside coming in at 1.3% versus 1.1% expected. The increase was largely attributed to slower decline in energy prices and increases in the cost of used cars and trucks. Core inflation has also ticked higher because of these developments.



Source: Bloomberg

Positive price pressures may be sustained given the outlook for spending as well as import prices given that a depreciation of the dollar is inflationary, particularly under a widening trade deficit. The services sector, on the other hand, remains the main drag on prices given the weaker rebound.

Even though inflation may climb higher over the next few months, we still maintain that the persisting output gap, aging demographics, high debt levels, elevated level of unemployment and low capacity utilization and the downward pressure on wages will continue to weigh on prices keeping core inflation at relatively low levels (below target) for longer.

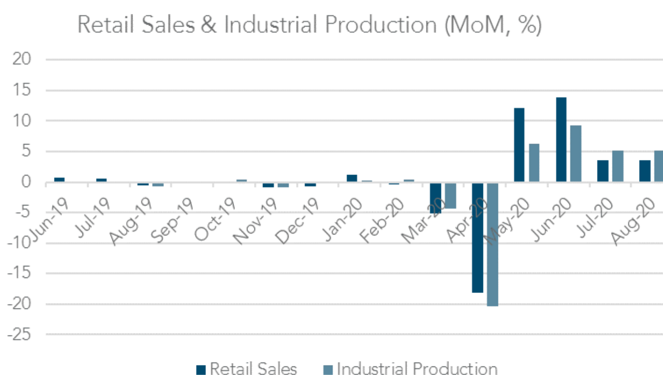
Key risks to the US economic outlook remain (a) the fiscal stimulus overhang (which is expected to be agreed upon in the coming weeks), (b) US election and consequences on growth prospects, (c) global trade dynamics and (d) the path of the virus and development of tools/ measures to combat the spread (vaccine, social distancing, speed testing and more).

United Kingdom

The UK experienced a record contraction in Q2 as GDP declined by 20.8%. The recovery is expected to lag that of other advanced economies. Despite the slow recovery experienced in May, growth in GDP showed signs of improvement as figures for June and July show a month -on-month expansion of 8.7% and 6.6% respectively. Going forward, the recovery is expected to slow down as most sectors have reopened, indicating limited scope for large increases in output. Moreover, the re-acceleration of infection rates and the return of Brexit uncertainty is likely to impact consumer confidence.

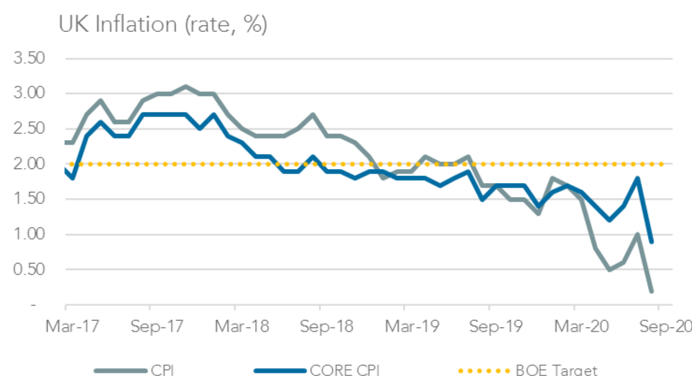
Many restrictions were lifted in July, which is evident in the significant recovery of the accommodation and food services sector. Although the growth in August is not expected to be as significant, the sector is expected to be boosted by the Eat Out to Help Out ("EOHO") scheme.

UK retail sales have continued to surpass pre-crisis levels following a 0.7% month-on-month increase in August, as consumer spending has rebounded strongly. However, consumer spending is likely to be impacted by the winding down of furlough schemes and a drop in consumer confidence due to recently imposed lockdown restrictions



Source: Bloomberg

On the other hand, the rebound in business investment remains weak as firms are reluctant to invest due to uncertainty and risk of further lockdown measures. Business investment is expected to remain low for multiple factors, namely: weak top-line growth, increased indebtedness and ongoing uncertainty due to Brexit.



Source: Bloomberg

Inflation declined to 0.2% in August on a year-on-year basis from 1.0% in July. The largest downward contribu-

tion came from the restaurant and hotel reflecting the effect of the EOHO scheme. To a lesser extent, clothing and footwear also contributed to the decline due the impact of delayed sales which disrupted the typical seasonal price movements of the clothing industry.

Inflation is expected to remain weak and likely to settle at a lower rate closer to 1% over the medium term given the expected deterioration in labour markets and the persistent low demand.

The full extent of the impact on the labour market is yet to materialize even though the extension in the furlough scheme and the rebound in GDP may lead to a less severe effect on employment. Having said that, headline unemployment is still expected to climb to around 7% in 2021 (from 3.9% in February).

Given the weak economic prospects and the high cost to extend furlough schemes further, the OBR has an even more severe outlook for unemployment, forecasting that headline unemployment will reach 11.9% in 4Q 2020. Given the longer-lasting impact on sectors including tourism and leisure, the recovery in the labour market will take longer to recover back towards the 4% level.

RATES

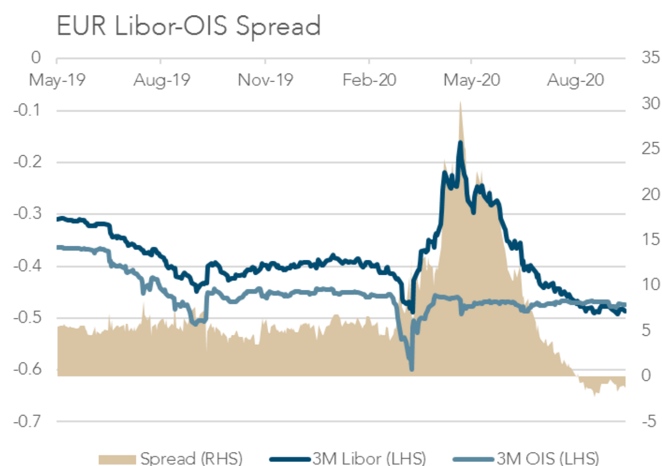
Euro

At the September monetary policy meeting the ECB left interest rates unchanged and have maintained the pandemic emergency purchase programme ("PEPP") to continue till at least the end of June 2021

Interest rate outlook remains unchanged with monetary policy expected to remain highly accommodative for the foreseeable future. This is based on multiple factors including the weak economic demand and growth outlook, general decline in employment which will require substantial time to recover, substantial increase in debt burden (both public and private debt) and, more pertinently, the low price pressures and expected inflation.

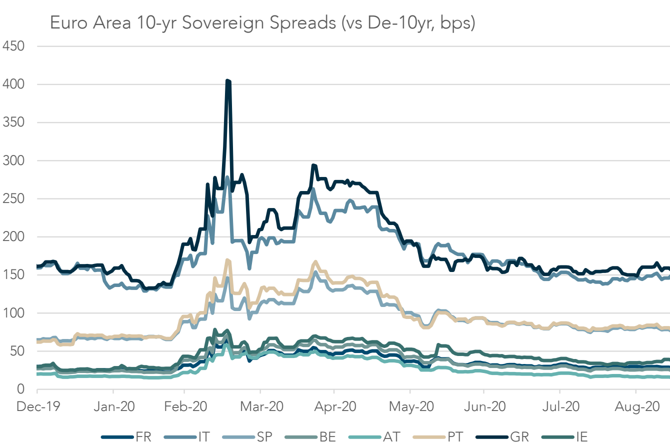
Financing conditions remain ulta easy today given the improvement of short-term financing measures as can be seen in the tightening spreads in money-market rates. Euro interbank market may actually be suffering from too much liquidity as evidenced by the Euribor-OIS spread turning negative in August suggesting that banks have too much cash.

More recent weakness in price pressures has weakened Euro area breakeven rates bringing about a pull-back in real yields whilst nominal yields traded sideways. This is also largely due to the substantial government bond purchases executed by the Eurosystem under the PEPP which kept downward pressure on yield curves.



Source: Bloomberg

Spreads across non-core and peripheral euro-area sovereigns have almost completely closed the widening seen in March given the reconvergence in yields with Italy trading tighter compared to pre-pandemic levels – helped by expanded PEPP programme and launch of the recovery fund.



Source: Bloomberg

Moreover, the unprecedented level of risk sharing across member states and the launch of new EU supranational bonds increases the likelihood for country spreads to trade even tighter than pre-pandemic levels.

However, the effectiveness of the current mix of monetary measures and their size will be questioned once again given the increasing risks of a downward trajectory in the path of inflation. Despite the ultra easy financing conditions and liquidity, the pass-through effect to the real economy remains weak. Adjustments in the type and size of measures will likely become a point of discussion once again. On the other hand, the ECB may

adopt a more of a wait-and-see approach and only announce minor tactical adjustments to measures up until the implementation of new fiscal measures kicks in.

In any case, the substantial repricing in real yields and weak outlook for inflation continues to support maintaining a long-duration position in EUR.

US Dollar

Forward-implied overnight rates in USD continue to trade at close-to-zero levels and, in some instances, even negative. USD funding conditions remain easy as the short-term money market spreads continue to tighten. This is reflective of the stronger forward guidance communicated by the FED to keep rates low for longer. In fact, policy rates are expected to remain unchanged up until 2023.

Moreover, the adoption of average inflation targeting has materially increased the hurdle for the Fed to raise rates or to communicate a change in stance towards a normalisation in policy rates for the time being. The communication of subsequent changes in the approach in rate-setting policy will probably involve a greater degree of data-dependency going forward based more on realised inflation as opposed to expected inflation.

At the longer-end of the benchmark curve, we have seen short-term (intra-week) increases in US Treasury yields. These short-term spikes in 10-yr Treasury yields have been triggered by better-than-expected data around labour market conditions and inflation, in the form of either:

- Reversal of safe haven flows stimulated by risk-on market sentiment (typically when combined with rallies in equities or rotation into cyclicals), OR;
- Pricing in of earlier retreat by the Fed in market interventions and normalisation of policy (typically when combined with pull-back in USD weakness).

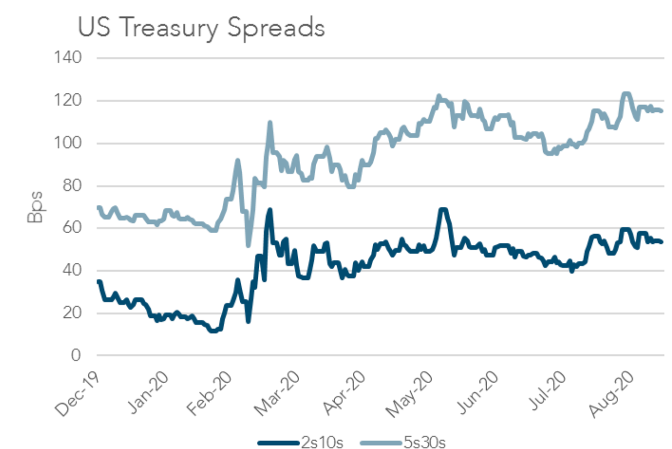
Having said that, the conditions remain for the uptick in (traded) inflation to be cyclical rather than structural – in other words inflation is expected to follow the growth path to a certain extent but more permanent structural issues on productive capacity and demand are expected to cap the rise in actual inflation over the longer term.

In the meantime, the US treasury market has remained supported by Fed intervention and substantial increase in money supply as well as safe haven buying due to uncertainty on the growth outlook.

Despite treasury yields stabilising at very low levels, the Treasury curve has steepened (5s30s and 2s10s trailing higher) primarily since short-end yields (0-2yr) continued to grind lower, after the rate cuts in March, whilst the gradual metabolization by the market of the Fed's strong forward guidance affected the belly of curve as well.

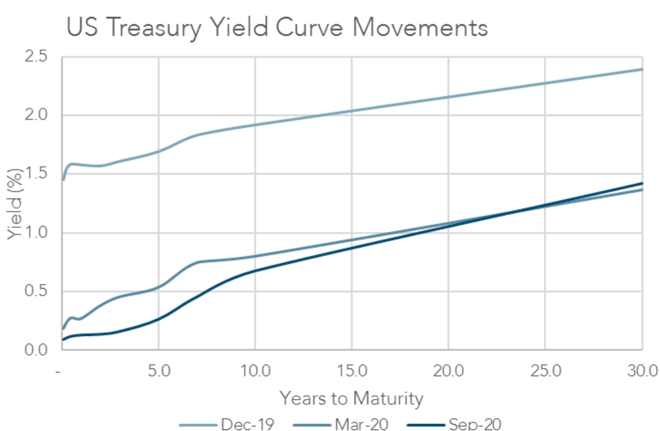
Despite the various structural and technical issues that may trigger a push higher in yields, the UST market is expected to remain supported by a number of factors including the Fed intervention, safe-haven buying on the back of global growth concerns and US politics (pre-election caution).

We expect US benchmark yields to continue trading in a range due to policy measures and expectations thereof, even more so given our assessment that the risks of a "tantrum" (similar to "Taper Tantrum" in 2013) as the economy continues to recover remains unlikely given the method-shift in monetary policy and more convincing forward guidance.



Source: Bloomberg

Given the balance of risks, the preference for longer duration in US yields has somewhat moderated, primarily since the impact from the sharp deterioration in economic and inflation outlook and the changes in monetary policy has likely peaked at this stage. Therefore repricing of US Treasury curve to reflect new monetary environment is by and large completed.

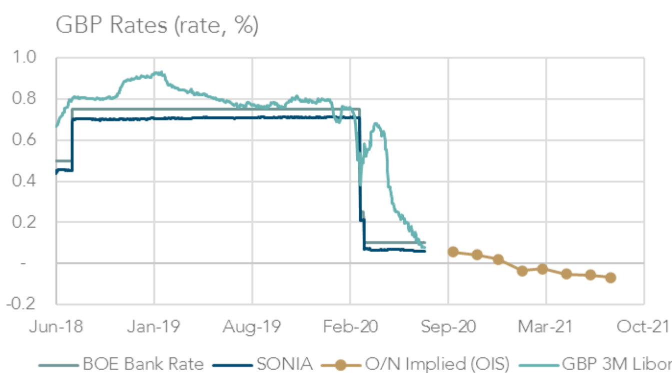


Source: Bloomberg

Sterling

Similar to the other currency regions, the overnight index swap rates have declined further, pointing towards significantly low forward implied rates in GBP, reflecting the increasing expectations of negative policy rates being introduced in 1Q 2021.

Spreads across money market rates continued to tighten as economic conditions stabilised while financing conditions improved.

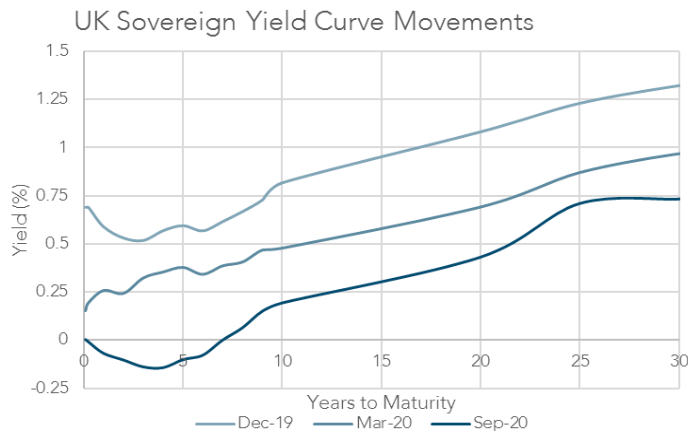


Source: Bloomberg

The BoE kept interest rates and QE targets unchanged, whilst indicating that it plans to explore "how a negative Bank Rate could be implemented effectively". The minutes from the meeting stated that considerations will begin in Q4 2020, and thus we expect QE to continue to be the tool of choice in the near-term.

Similar to US Treasury curve, following the downward shift in yields (post rate-cuts in March), the curve steepened in August due to short-end buying. The inversion that was created at the short-end of the curve has been driven by increasing expectations of further rate cuts taking the policy rate in negative territory.

The MPC has been warming up towards the introduction of negative interest rates with officials indicating



Source: Bloomberg

that the BOE is ensuring that the technical challenges to introduce negative rates are being explored and addressed.

Given the heightened uncertainly around health and the growth outlook and the prospects that unemployment could increase further, if downside risks materialize in the UK, then cutting rates below zero becomes increasing likely.

The central assumptions around the Monetary Policy Committee's (MPC) projections for the UK economy revolve around the gradual dissipation of Covid-19 impact and the move towards a comprehensive Free Trade Agreement with the EU by January 2021.

Nevertheless, in the absence of material economic downturns, GDP growth is expected to continue to gradually increase. However, unemployment is expected to decline given the extent of spare capacity in the economy.

With a substantially weak growth and inflation outlook, elevated uncertainty and the likelihood that the MPC will increase monetary accommodation further, a long duration position in UK rates remains warranted.

CREDIT

Credit markets across investment grade ("IG") and high yield ("HY") bond markets, have continued to rally from mid-August to mid-September although at a noticeably slower rate compared to the prior period. In Investment grade, whilst EUR corporate credit has rallied significantly since the lows seen in March, both USD and GBP corporate bond markets have reached and surpassed pre-pandemic levels on a total return basis. The ongoing monetary support from each respective market's central bank, together with the fiscal policies enacted by Governments to resuscitate their economies, and the prospects of a vaccine on the horizon, have all played their part in restoring faith within the credit markets and the subsequent recovery in bond market prices. Similarly within the non-investment grade space, credit markets have continued to recover, though still trade below pre-pandemic levels within both EUR and GBP markets.

Corporate credit spreads, despite tightening considerably over recent months, also remain wider than pre-pandemic levels across all major markets. This is largely explained by the significant tightening in safe haven sovereign debt driven by the flight to quality and extraordinary monetary support. Both EUR and GBP investment grade credit spreads tightened by similar amounts during the past month, at just below 1.0bp

each, while the USD investment grade debt spreads widened by 0.64bp during the same period. Spreads within the high-yield segment have tightened across the board this last month, though the move was much more muted within the GBP space. EUR and USD high-yield corporate bonds tightened by 25bp and 8bp respectively during the past month while GBP high yield spreads remained unchanged during the same period.

The rise in bond prices and the subsequent spread tightening has come about due the lower level of perceived risk, given the factors explained above, that the market has placed on both investment grade and non-investment grade debt. This lower level of perceived risk can be gauged directly through Credit Default Swap indices which have continued to decline during the period particularly for high-yield debt. Credit Default Swaps for EUR and USD IG rated debt remained unchanged while EUR and USD high yield debt Credit Default Swaps declined by 31bps and 63bps respectively. Nevertheless, weaker metrics today leave spreads wider overall than their pre-pandemic levels.

The past couple of months have seen some compression between cyclical and non-cyclical credits, and the reopening and cyclical recovery themes continue to gain momentum despite the susceptibility of the travel and consumer sectors to a fresh round of lockdown measures or a spike in COVID numbers. The concern with jumping onto this bandwagon is that, in the near term, we may see governments begin to reduce their level of fiscal support, which could impact the progress of recovery among higher Beta credit.

We prefer remaining cautious with respect to the cyclical recovery and would maintain an underweight exposure to cyclical issuers, though this would be better assessed on a name by name basis based on fundamentals.

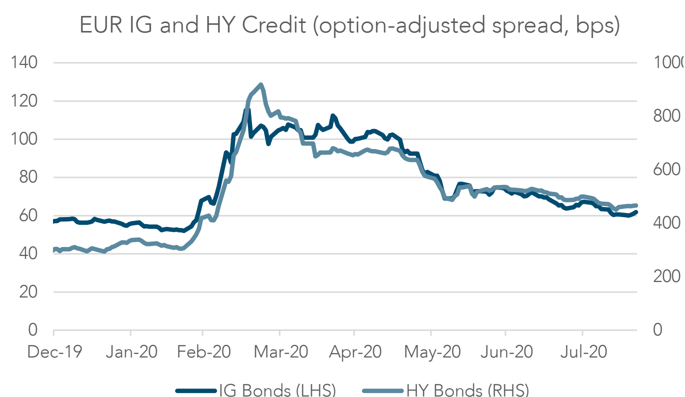
Nevertheless, we can expect asset purchasing programs to continue to be a significant tailwind for all major credit markets. The ECB purchases of corporate bonds under CSPP and PEPP have been larger relative to those of the FED and the BOE, both on an absolute basis and relative to the size of the respective markets. We remain comfortable given messaging from the ECB that asset purchases will continue until at least the end of June 2021. Given these tailwinds for cash bonds, we see scope for the performance of cash to continue in Euro IG and HY and are comfortable moving further down in capital structure or further out in the curve in the search for yield amongst higher quality issuers.

Looking ahead, we expect new issue supply to moderate a little, with historical trends showing average weekly issuance going down to circa €8-10bn in the period right up to end-October as we start hitting third quarter corporate blackout periods, before picking back up again in November.

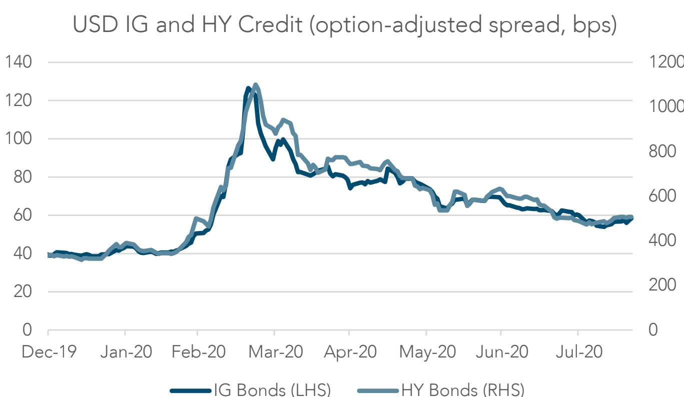
The near-term outlook for defaults remains fairly benign. For Europe in particular, the volume of defaults or restructurings has remained very muted and even when taking into account the currently stressed bonds it is still difficult to see the default rate rising much beyond 3-4% over the course of a year.

Default rates in the US have been higher, due to a much higher weighting towards the energy sector. There remains a greater likelihood that default rates rise again over a more medium-term horizon. Companies in the travel and leisure industry, such as cruise liners that have accessed funding via senior secured financing on unencumbered assets remain at risk. Whilst this emergency funding has provided a runway for cash burn, it does not solve the long-term outlook for the industry, and if these companies are not able to get activity up to sufficient levels within a suitable horizon, there is a high probability that these liabilities will require restructuring further down the road.

Despite some HY/IG compression recently, the HY/IG spread ratio continues to be historically elevated and we would expect to see some further compression into the year-end. Whilst we would expect to see some decompression in a moderate sell-off on more negative COVID headlines, the currently wider spreads would



Source: Bloomberg



Source: Bloomberg

provide some cushion to avoid a sell-off as severe as seen in March.

Moreover, looking at the spread differentials between BB- and BBB-rated paper across currencies, whilst we have seen some compression, spreads remain quite elevated and lenders are receiving more than adequate compensation to be in BBs when compared to the start of the year. We expect this dynamic to support secondary market credit spreads for the time being. Conversely, the spread today between single B and BB paper is far closer to pre-covid levels (though still undeniably wider). We would prefer looking for value within the BB space where available to benefit from wider spreads versus historical and a theoretically better quality credit, although we remain comfortable looking for pockets of value amongst lower quality names also given the tailwinds expected to flow through to credit markets.

EQUITY

This has been an odd year for equities when considering the expectations at the start of the year. In our January strategy note we said that we "expect the global economy to recover slightly during 2020", with the MSCI World Index up 2.9% (measured in Euros) up to 18th February. Then, as COVID-19 started to spread, the MSCI World Index lost 33.9% in just over a month as earnings expectations collapsed. Since then, global equities have delivered a positive return in 5 consecutive months, delivering a total return of 38.6% in the process.

We could see this positive performance, which has bounced off the lows in March, come to an end during September. Global equities (MSCI World) have lost 2.3% in September (till 15th September) after a 6.7% rise during the month of August. On a YTD basis, global equities have delivered a total return of 5.2%. Growth stocks have suffered some sharp losses in September, with the Nasdaq down 5.6% (till 15th September). Growth stocks have outperformed value stocks for most of the past decade and the valuation premium (of growth stocks relative to value stocks) has never been so wide. Therefore, volatility in growth names is to be expected considering the dispersion in valuation and the out performance YTD (Nasdaq +18.5% vs +3.1% for the SPX in Euro terms).

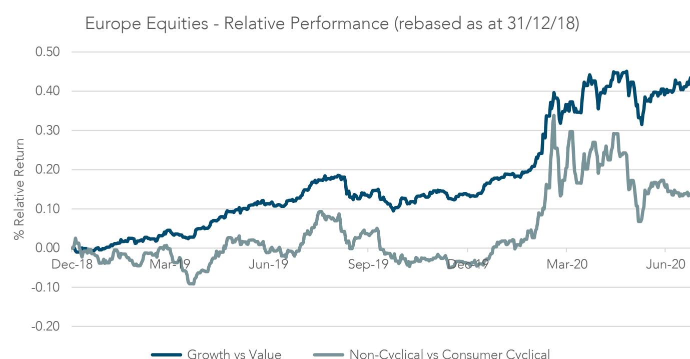
We believe that investors will continue to pay a high premium for growth stocks over the next years. Central bank policy is unlikely to change meaningfully over the short term, with Goldman Sachs expecting the first rate hike by the FED in 2025. The low interest rate environment coupled with low inflation expectations are key reasons for the current high valuation premium for growth companies. We expect this to continue to be the case over the upcoming years.

This does not mean the FAAMG (Facebook, Amazon, Apple, Microsoft and Google/Alphabet) trade will continue to outperform. During the past decade FAAMG grew its top line at a 20% CAGR in aggregate compared to 4% for the S&P 500. Maintaining market leadership is a difficult task. Competition is likely to increase and companies may struggle to find different ways to keep growing at current clips. Regulation can also become a headwind (AMZN, FB, GOOGL and AAPL were all investigated recently).

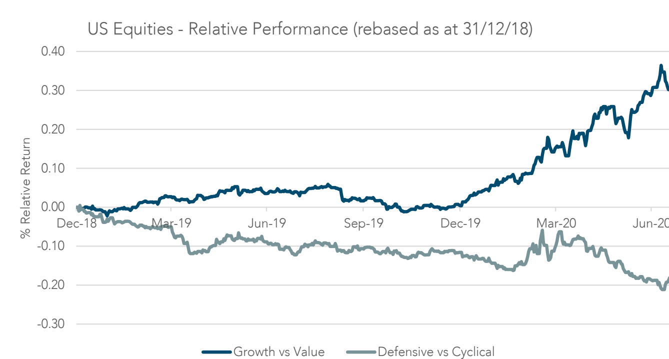
On the other hand, value stocks may outperform if conditions are right. Stocks whose top line growth is dependent on the macro-economic backdrop are generally classed as value stocks. Catalysts for value stocks outperformance includes:

1. rising inflation expectations;
2. improving macro-economic conditions;
3. rising interest rates.

In the current situation we believe that a COVID-19 vaccine could be a catalyst for value stocks to outperform in the near term. A vaccine could lead to an upgrade in global growth forecasts by economists, and consequentially to earnings upgrades for most value stocks.



Source: Bloomberg



Source: Bloomberg

Goldman Sachs expect at least one vaccine to be approved before the year end and that large shares of the US and European populations will be vaccinated by the end of 2Q21 and 3Q21, respectively. We see potential for an upgrade to global economic growth expectations, as well as a less clouded outlook in the near term. Goldman Sachs add that the risks to the vaccine outlook is skewed to the downside, based on the historic distributions of trials and the fact that all major vaccines currently target the same protein, thereby increasing the risk that if one vaccine fails, all the others could fail.

We expect equity volatility to pick up as we approach the 2020 US presential election. Currently, the markets are pricing in a Democratic victory, but we expect the race to be getting tighter. The debates are usually the source of volatility for equities, as investors digest the plan being outlined by both candidates for the next four years.

Against this backdrop, we continue to hold a diversified selection of stocks, with exposure to a number of different strategies. We remain overweight growth relative to the benchmark whilst also recommending some selective exposure to more cyclical names. Key risks that are expected to drive equity market returns in the short terms include: US election, Brexit, COVID-19 (disappointment over vaccine or second lockdown) and US/China trade relationship.

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Sovereign Bonds	Stable	U/W	Benchmark bond yields benefitted mainly from central banks' policies and messaging on the forward path of policy rates which more than compensate for the determination of governments to intervene with substantial supportive measures. Outlook for periphery credits is well supported, but as noted in previous updates, the strong rally has been ongoing for a number of weeks and seems to be showing some signs of fatigue at current levels. However, the agreement on the Recovery Fund could add further momentum going forward. In addition to maintaining exposures as hedge, this could offer marginal tactical opportunities.
Investment Grade Corporate Bonds	Positive	O/W	Investment grade bonds remain attractive, however, on a relative basis, we are becoming more comfortable with maintaining a high exposure given the spread differentials versus sovereigns bonds and the view for stable to tighter spreads. Strong central bank support is expected to continue to sustain the current levels in spreads which underpins the benefits of maintaining a long duration exposure within this space, in order to earn a higher carry, particularly in view of the low interest rates and low inflation outlook. The risk of downgrades remains prevalent and requires close monitoring in view of the challenging business conditions and general sentiment in credit markets even though economic conditions have continued to stabilise.
High Yield Corporate Bonds	Neutral to Positive	O/W	Investors are increasingly able to assess the impact of COVID-19 more specifically with the release of half yearly results. High yield markets have rallied considerably from the mid-March lows. Having said that, improved market conditions may provide scope to pro-actively seek opportunities on a selective basis. 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	Confidence to add exposure in emerging market corporate bonds is starting to increase given signs of stabilisation and the reopening of the global economy. This should improve return prospects from emerging market bonds particularly given that US yields continue to trade at relatively low levels while the EM bond market has not yet recovered to the same extent as other bond markets. While our selection remains tilted towards more conservative financial profiles, the scope to continue to de-risk specific positions may be considered on an individual name basis.
Equities	Negative To Neutral	U/W	Our defensive stance in equities due the widening dislocation in valuations against the deteriorating company fundamentals and a challenging economic outlook offered some protection against the pullback in equity markets in June as fears of a second wave started increasing. We prefer to retain an overall underweight allocation in equities combined with an overarching factor tilt towards quality stocks and growth stocks. However, we have adjusted our positioning to include exposure to renewable energy as well as luxury goods in selected stocks given the strong ability of companies to grow cash flows and retain a strong balance sheet position. In terms of sector positioning, we prefer to remain underweight cyclical industries and retain our core positions in staples, healthcare and technology. At the same time, we remain on the lookout for potentially attractive opportunities in severely discounted cyclical equities that stand to benefit from the slow improvement in conditions brought about by the relaxation of containment measures as well as positions that may benefit from megatrends or for thematic reasons.

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

DISCLAIMER

The information presented in this report is solely provided for informational purposes and is not to be interpreted as investment advice, or to be used or considered as an offer or a solicitation to sell, or an offer or solicitation to buy or subscribe for any financial instruments, nor to constitute any advice or recommendation with respect to such financial instruments. To the extent that you rely on the Information in connection with any investment decision, you do so at your own risk. The Information does not purport to be complete on any topic addressed. The Information may contain data or analysis prepared by third parties and no representation or warranty about the accuracy of such data or analysis is provided. In all cases where historical performance is presented, please note that past performance is not a reliable indicator of future results and should not be relied upon as the basis for making an investment decision. Investors may not get back the amount originally invested. The value of investments can fall as well as rise and past performance is no indication of future performance. The Information is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use is contrary to law, rule or regulation. Certain information contained in the Information includes calculations or figures that have been prepared internally and have not been audited or verified by a third party. Use of different methods for preparing, calculating or presenting information may lead to different results.

Curmi & Partners Ltd. is a member of the Malta Stock Exchange, and is licensed by the MFSA to conduct investment services business.