Investment Strategy Update

June 2021

Curmi & Partners Research

- US economic data is diverging during the recovery with inflation data surprising to the upside and employment data generally disappointing expectations.
- UK and Euro Area activity data is picking up as economic conditions improve with the reopening of businesses, consequentially boosting inflation data prints.
- The risk of virus variants is only delaying government reopening plans now that vaccination rates across advanced countries are close to herd immunity levels.
- Expectations of growing economic momentum in Summer is alleviating concerns on the employment shortfall with hiring set to increase across sectors.
- The divergence in US and Europe's recovery is underpinning expectations of divergent central bank policy with quicker actions anticipated by the FED.
- Benchmark bond yields have retraced lower despite the elevated inflation as underlying price trends suggest that price pressures are due to reopening effects.
- We continue to see higher curve risk to be unwarranted given the view that EUR core yields will trend higher as data across economies continues to improve.
- Given the high inflation risk premia priced in US and UK curves, a move higher in yields is expected to be mainly driven by central bank hawkish communication.
- We continue to prefer holding HY paper over IG in order to benefit from wider spreads with lower duration risk with a preference towards EUR bonds.
- We are bullish on European equities given that we deem the European recovery to be underappreciated by the market.
- We continue to prefer maintaining a tilt towards value stocks given the positive sensitivity of earnings and dividends to the rise in inflation.
- We view the main risk in equity markets to be signs of overheating economic conditions which may lead to the withdrawal, or expectations thereof, in central bank support which has been a key factor underpinning high equity valuations and the strong equity rally.

The surge in inflation has not dented investor confidence despite the increasing likelihood of a reassessment by central banks of their highly accommodative monetary policy stance. The reasons behind the surge in inflation have now been very well documented and understood. What is unclear is whether the high year-on-year increases in price levels are the result of persistent economic forces or the effects of activity and commerce restarting after a sudden stop in the economy.

While the COVID-19 pandemic, and the fight to curb contagion and lift lockdown restrictions, has been the key determinant of price movements in global financial markets, we are now seeing greater sensitivity to unwanted reopening effects, and for good reason.

Investors have shunned inflation risk over the last decade as economies saw a breakdown in the longstanding, textbook relationship between employment and inflation—the Philip's curve—and reestablished a new norm where high employment and low inflation could co-exist. The economic reset, combined with idiosyncrasies specific to the pandemic-driven recession, has brought about the right combination of forces for inflation to surge sharply over a short period of time. Central banks, whose models have come into question given the lack of traction in their policy efforts to lift price pressures in recent years, are understandably dismissing the sudden surge in prices attributing it to reopening effects that will be short-lived.

The rise in inflation following a recessionary environment is overall considered to be good news. It has been widely expected that inflation would rise simultaneously with the return in economic activity. However, the recent overshoot in data releases, which has exceeded levels that would have been normally expected, could signal concerns of overheating economic conditions, mainly in the US. The repercussion of this, if materialised more broadly in economic data and surveys, is a swift or sudden reassessment by central banks to reverse monetary policy towards a tightening stance.

As inflation risks rank high amongst investors, as seen in the drift wider in inflation risk premia, we continue to see a strong rally in equity markets, driven by the growing preference towards value stocks that can offer investor protection, and commodities. In such an environment which has continued to reward higher risk-taking on the back of the improving economic outlook, we are equally concerned about the high exuberance present in the market where participants seem to attribute very little probability to a not-so-unlikely disappointment in the story of the economic recovery or that generally underestimate the fragility of the economic recovery.

At this stage, understanding the inflation conundrum and market positioning remains key to allocate risk in investment portfolios particularly to protect against possible market corrections in an otherwise rallying market.

The outlook remains constructive as economic players continue to benefit from extended government support laid over easy financing conditions which continue to support business prospects. Apart from persisting supply chain disruptions, demand has been outpacing supply resulting in manufacturing and service sectors recording higher levels of backlogs and new orders, leading businesses to increase their efforts to replenish inventories.

Our central thesis is that the overshoot in inflation could take longer to moderate but should in any case prove to be temporary. The cost-push inflationary forces should ease as labour market conditions and supply chain frictions normalise. However, the stronger factors underpinning the reflationary forces in the US could prove to be more persistent compared to the Euro Area and the UK. To this end, we see scope for the Fed to gradually adjust its forward guidance and asset purchases in view of the higher price pressures but will remain reluctant to tighten given the slower recovery in employment.

With this backdrop, we see scope for the value-driven equity rally to be sustained and for credit markets to remain supported by the positive economic growth momentum. Whilst our view for risky assets is positive, given the strong rally since the start of the year, we do not expect an equally generous period of high returns for the second half of the year.

Because of this, we have recalibrated our equity positioning and reduced the overall equity risk in our portfolios. At the same time, we are switching into selected stocks which we deem to be attractively valued and which should benefit from the reopening of businesses.

In high yield credit, we maintain a tilt towards lower-rated bonds but we supplement this added risk by carefully screening for issuers with robust liquidity and access to financing, acceptable levels of indebtedness with low likelihood to increase leverage, and a business model which is expected to remain viable even during this transitory period of economic recovery.

We continue to maintain a substantial underweight allocation in investment grade bonds, particularly sovereign bonds, given the risk for benchmark curves to re-rate higher as economic data continues to come in sequentially stronger. In this case, our opinion is that shifting central bank communication, which would in turn influence expected future short-term real rates, is better suited to drive medium-to-long-end yields higher as opposed to elevated inflation data releases in the near term.

MACRO

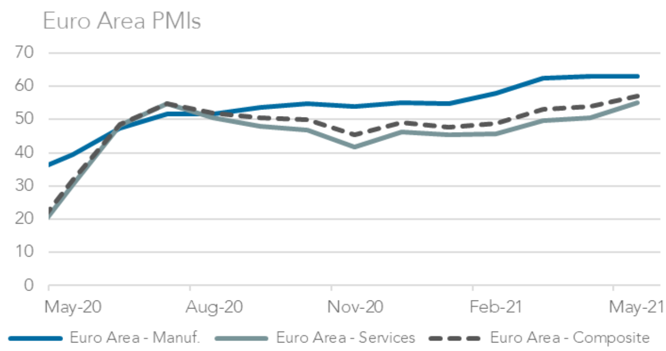
Euro Area

The third flash estimate for the Q1 GDP growth rate showed a revised contraction of 0.3% compared to the prior estimate of -0.6%. This still indicates that the Euro Area was in a technical recession at the turn of the year but the momentum in recent months has been improving. The continued progress in reducing virus infections and administering of vaccines is expected to continue to allow the gradual scaling back of lockdown restrictions which augurs well for the region's economic recovery.

Retail sales for the month of April were down 3.1% comparing worse than the expected decline of 1.2%. This followed the prior month's growth of 3.3%. The decline in sales was mainly attributable to a decline in sales of non-food products of 5.1%. Given that most countries only started relaxing measures in May, the decline in retail sales should just be a blip in the recovery trend.

The final composite PMI stood at 57.1 in the month of May, compared to the market expectations of 56.9 and the prior month's 53.8. This data print is consistent with the economic recovery gathering pace in May. This PMI was supported by the strongest pace of expansion seen in the services sector so far, together with a new record growth in manufacturing activity.

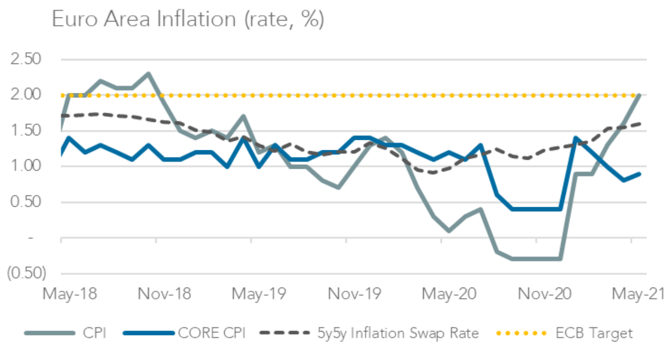
All nations within the Euro Area reported an improvement in services activity since April, mainly as a result of



Source: Bloomberg

the easing of lockdown measures. The new business sub-index rose for the first time since July 2020, while backlogs of work also increased. On the manufacturing side, output growth was the slowest seen in three months, though the level remained close to March's figure, as production remained underpinned by rapid gains in new orders. Firms were forced to utilise their existing stocks wherever possible, as they were faced with delays in deliveries which is explained by the widely reported delays in the transportation of goods and other supply constraints.

The flash year-on-year inflation rate for the month of May was of 2.0% compared to the prior month's 1.6% and beating expectations of 1.9%. The increase was largely due to a further rise in energy inflation, which added 0.25ppts to the headline rate.



Source: Bloomberg

The inflation rate topped the ECB's target of just below 2.0%, but policymakers have kept monetary policy unchanged in the June meeting. The ECB has already stated that the spike in inflation is explained by strong base effects and temporary reopening effects and it has warned that inflation may exceed the 2.0% target by the end of the year. Therefore, it comes as no surprise that the ECB's reaction to the recent surge in inflation prints was lukewarm.

Economists expect that the jump in inflation in May will not be the end of the upward trend, with consensus forecasts looking at 2.5% as the average in the second half of 2021. It is further expected that inflation will moderate early next year as temporary factors, particularly the increase in energy prices, are reversed.

The flash year-on-year core inflation rate, which strips out the volatile price components coming from food and energy, was of 0.9% year-on-year in May coming in marginally above the market expected 0.8%. The increase over the prior month's 0.7% brought core inflation at approximately pre-pandemic levels.

April's unemployment rat edged down to 8.0% from the prior month's 8.1%. This came about as the number of unemployed people fell by 134 thousand from the prior month's 13.0 million. Economists expect hiring to increase substantially in May and June as restrictions are being lifted, however the unemployment rate will not decline rapidly for the year.

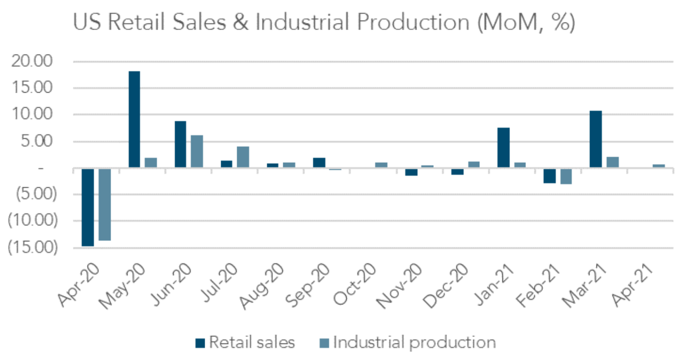
There are some signs of labour shortages developing in parts of the Euro Area, especially in the hospitality sector. However, these shortages are expected to be short-lived and will not put sustained upward pressure on wages. It is expected that those persons who became "inactive" in the labour market during the pandemic will return to look for work in the coming months, particularly as the vaccine rollout progresses.

As economic indicators continue to point towards growing momentum in the economic recovery in the Euro Area, financing conditions remain highly accommodative sustaining the flow of credit to economic players. The ECB President Christine Lagarde put to rest any concerns of tapering, or rather, the slow down in the pace of bond purchases, at the last ECB monetary policy meeting showing a strong commitment, that despite the surge in inflation, it still assesses economic conditions to be fragile and that warrant sustained monetary policy support for the time being.

On this basis, there are no visible concerns to financing conditions in the Euro Area, given the availability of Euros, tight credit and money market spreads combined with the backdrop provided by the ECB with a pronounced sensitivity to movements in yields and credit spreads.

United States

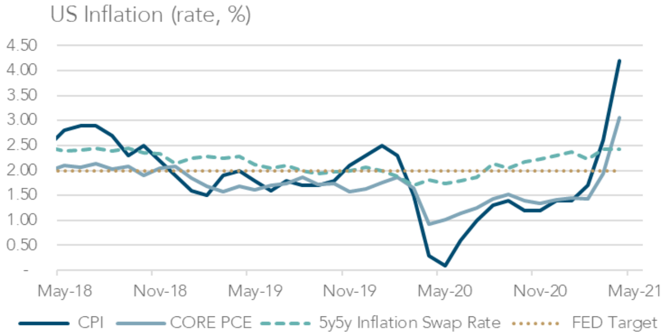
The level of retail sales hardly changed in the month of April suggesting that the boost from the $1,400 stimulus cheques has only partially faded. Nevertheless, as goods spending inevitably drops over the coming months, economists were hoping for an offsetting rebound in services.



Source: Bloomberg

Total industrial production increased 0.7% in April, easing from the prior month's 2.4% and missing market expectations of a growth of 1.0%. Manufacturing output rose 0.4% due to the return to operation of plants that were damaged by February's severe weather which had remained offline also in March. However, factory output was hit by a drop in motor assemblies that principally resulted from shortages of semiconductors. Overall, the recovery in output is still badly lagging consumption and, with shortages becoming more acute and broad-based, this situation is going to get worse in the near term.

The final Composite PMI for May stood at 68.7, an increase over the prior month's 63.5 and also beating expectations of 68.1. This was supported by the steepest pace of expansion in the services sector, together with another record growth in factory activity, supported by stronger expansions in output and new orders. Nonetheless, constraints on production capacity were exacerbated further during the month, as severe supply-chain disruptions led to a market accumulation of backlogs and one of fastest rises in input prices.



Source: Bloomberg

The annual inflation rate soared to 4.2% year-on-year in April from March's 2.6% and well above market expectations of 3.6%. This was the highest reading since 2008 given the surge in demand as the economy reopened, the soaring commodity prices and supply constraints. There is a base effect weighing as the pandemic dented economic activity. Core consumer prices rose 3.0% year-on-year in April, compared to the prior month's 1.6% and market expectations of 2.3%.

The unemployment rate dropped to 5.8% in May from the prior month's 6.1% also beating expectations of 5.9%, The release adds to signs that the job market consolidated its recovery as the economy further reopened. Still, the rate remained well above the 3.5% February 2020 level with the gain being partly explained by the decline in the participation rate from 61.7% in April to 61.6% in May. Employers are not finding enough workers to respond to growing demand.

The 559 thousand gain in non-farm payrolls in May was an improvement on the disappointing 278 thousand gain in April. While such increases are welcome, the level of employment is still 7.6 million below its pre-pandemic peak showing that the labour supply is bouncing back more slowly than demand. The biggest gains in non-farm payrolls came from those sectors worst affected during the pandemic, namely a gain of 292 thousand in leisure and hospitality and a 144 thousand gain in public and private education.

Towards the end of May, more than 20 states had voted to end the additional $300 weekly federal unemployment benefits early. These benefits, which are set to expire nationwide in September, will now end in many states as early as mid-June. This is expected to help ease labour shortages in the low-wage leisure ad hospitality sector.

The unconvincing pick-up in employment when considering the strength of the rebound in the US signals reluctance from individuals to return to the labour force. This is reportedly explained by health concerns. However, it has also supported the increase in wage inflation, which is uncharacteristic of the changes we are seeing in the sectoral composition. Such underlying trends in the employment recovery are signalling fatigue in the labour market and pose real concerns on the inflation outlook in the US.

On the other hand, the cessation of unemployment benefits and continued improvement on the health front should quell such pressures and concurrently improve the labour force participation rate.

Looking at financing conditions, the Fed left the target range for its federal funds rate unchanged at 0-0.25% and said it will continue to purchase bonds at a rate of $120 billion a month despite acknowledging a rise in inflation and the improvement in the economy.

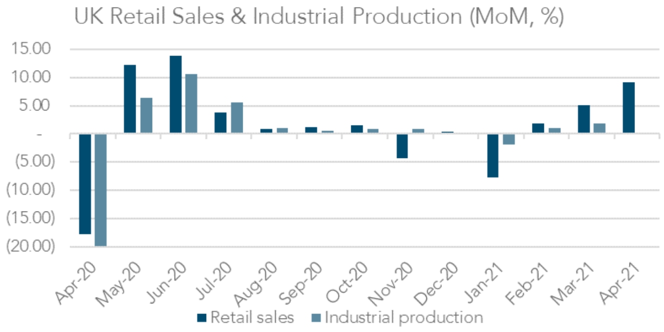
Policymakers have reiterated that the economic recovery is far from complete and that PCE inflation would move above 2.0% due to very low readings from early in the pandemic and transitory effects. After the transitory effects fade, inflation is expected to moderate towards levels that are closer to the 2% level.

Short-term rates reflect the Fed's communication to keep rates low for the time being with the latest job reports generally continuing to strengthen such narrative putting pressure down on long-term rates. Money market spreads continue to trade at very tight levels.

The winding down of corporate bond holdings purchases under the Fed quantitative easing ("QE") facilities, which is immaterial in size in economic terms, has had limited impact on corporate bond spreads which continue to trade at very tight levels as the benchmark curve saw some bull flattening in May. Therefore, financing conditions remain all-in-all supportive for the continued flow of credit to the real economy, with no visible signs of funding pressures with the exception of episodes of volatility in US treasury yields.

United Kingdom

GDP rose by 1.4% year-on-year in March 2021, better than the market expected increase of 1.0%, however not enough to offset the overall contraction of 1.5% in Q1. Output increased by 2.1% month-on-month in March marking the fastest monthly growth since August 2020 and beating market expectations of 1.3%. The print, which also shows an improvement over the prior month's 0.7% growth, augurs well for the UK economic outlook signalling growing strength in the recovery. Given the reopening of sectors, GDP is expected to increase by 3-3.5% in Q2 and Q3 this year with the level of output expected to recover to pre-pandemic levels by the end of the year.

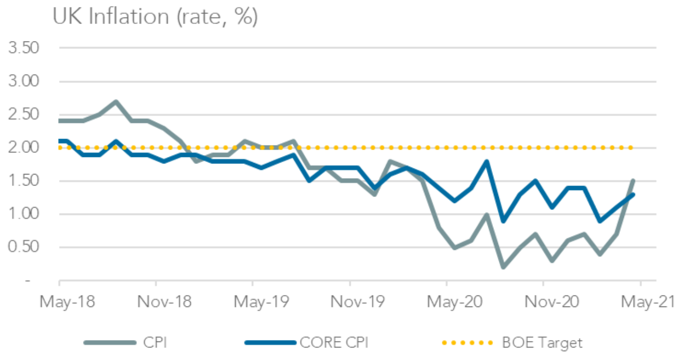


Source: Bloomberg

Retail sales surged 9.2% month-on-month in April from the prior month's growth of 5.1%, at almost double the market expected 4.5%. This was a result of the easing of coronavirus restrictions, including the re-opening of all non-essential retail from mid-April. Non-food stores were the main contributor to this growth, namely clothing stores (69.4% growth). Retail sales are currently at 10.6% above their pre-pandemic level.

The final Composite PMI for May stood at 62.9, compared to the prior month's 60.7 and the expected 62.0, this signalling the steepest rate of expansion in years for both services and manufacturing activity. Business and consumer spending grew sharply in response to looser pandemic restrictions, resulting in the fastest rate of output growth in over 20 years. New orders also rose at the quickest rate in years. Shortages of raw materials and supply-chain disruption fed through to input costs during May, leading to the sharpest rise ever in purchasing costs. This led manufacturers to increase selling prices, with the rate of inflation hitting a survey record.

The jump in CPI inflation from 0.7% in March to 1.5% in April (was almost entirely driven by energy price effects (April 13.6%; March: 3.5%), which are expected to be temporary. This was the highest reading since March 2020, as the economy started to reopen after a nationwide lockdown in the beginning of the year and as the cap on energy bills was lifted (up by £96 to £1,138). The temporary 5% VAT on hospitality, which will last until the end of September, helped keep costs low, contributing to the downward movement from recreation and culture (April: 0.7%; March: 2.3%). Core inflation rose 1.3%, in line with market expectations and compared to the 1.1% reported in April 2021.



Source: Bloomberg

Inflation is expected to breach the BOE's target of 2.0% later this year. But economists doubt that it will stay this way for long as energy-related effects are to reverse next year. It is suspected that it will only be in 2023 that the effects of a strong economic recovery will have a more sustained upward influence on inflation, and hence there is doubt that the BOE will tighten monetary policy until 2024.

The unemployment rate edged down to 4.8% in the three months ended March, this coming in lower than the market expected and the prior month's 4.9%. This came about as wage support for furloughed workers remained in place. The country was under a strict lockdown over the months of January to March, however some restrictions were relaxed in March.

However, the unemployment rate may still rise over the rest of the year to c. 6.0%, but this will probably be due to people re-joining the labour market rather than more people losing their jobs.

Employment surged by 84 thousand in the three months ended March, this being the first gain since the pandemic, with the number of people on payrolls increasing by 97 thousand. This jump was however driven by rises in January and February, as employment in March fell by 242 thousand on a single-month basis.

The earnings data print showed a slowdown in the average weekly earnings (including bonuses) to 4.0% (or £558) in the three months ended March, following a 4.5% rise in February and the market expected 4.5%. Excluding bonuses, nominal wages rose 4.6% to £525, this being the biggest increase since the three months ended August 2007, matching market estimates and beating the prior month's 4.4%. Pay growth rates are affected by a fall in the number and proportion of lowerpaid jobs compared to pre-pandemic.

As mentioned in the May's update, the BOE kept its monetary policy unchanged during its May meeting and announced a slowdown in the pace of purchases of British government bonds to £3.4 billion per week from £4.4 billion, signalling it is on course to end emergency support by the end of the year.

The BOE also said it does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2.0% inflation target sustainably. Markets are starting to price in policy rate adjustments in early 2022.

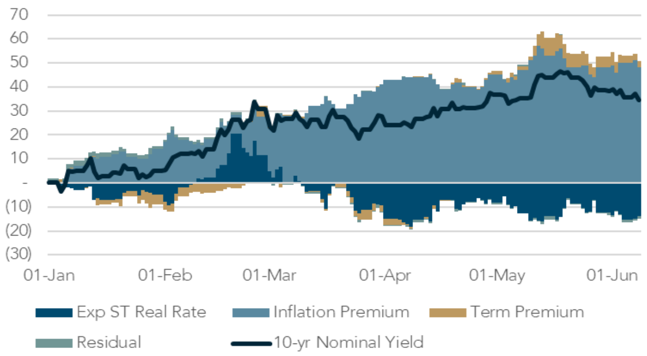
RATES

Euro Rates

We saw some modest compressions in sovereign spreads that accompanied the recent move lower in the benchmark curve towards the end of May in anticipation of the ECB meeting in early June.

We continue to maintain that there is limited scope for further spread compression given the unlikelihood for further action by the ECB at this stage, the improving macro backdrop in Europe and the propensity for a move higher in core yields to resume.

Change in 10-yr Bund Yield Decomposition Model



Source: Bloomberg

Yield developments during May have been mainly driven by the inflation data print which came in stronger than expected, surprising to the upside as economies in the Euro Area progressed with vaccination rollouts allow for the continued withdrawal of restrictive measures.

The 10-year Bund yield rose to –0.10% by mid-May from –0.20% at the start of the month, driven by higher inflation premia and some market expectations of a potential reduction in the ECB's pace of purchase. The move was reversed later in the month, as ECB officials quelled concerns on inflation citing deep-rooted issued on inflationary dynamics in Europe, whilst reiterating the unlikelihood of a reduction in the pace of purchases at this stage.

Given that the ECB has provided a target total amount of purchases under the emergency support programme, an adjustment in the pace of purchases is of limited economic significance. Moreover, the ECB may very well adjust the pace of purchases as it normally does in the quiet summer months, without explicit announcements, and with the market learning of the slower pace of purchases post-event.

In view of the recent move lower in the benchmark curve, despite the higher-than-expected inflation data prints for May released on 1 June, we have not seen a pronounced reaction to the dovish outcome of the following ECB policy meeting where the Christine Lagarde confirmed that the purchases will continue to take place at the "significantly higher" pace.

We maintain the view that core Euro yields will move higher as data across Europe continues to improve. This continues to support our current positioning to bring down portfolio duration through the sovereign bond contribution-to-duration of 0. As a result, we remain cautious with adding further curve risk at this stage given the scope for economic data releases to surprise to the upside and the limited action expected by the ECB in view of improving economic backdrop.

As stated in our previous update, the long-standing dynamics that have depressed inflation rates across Europe over the last decade are expected to resurface once the temporary reopening effects fade, despite a possible recovery in labour market conditions.

At the same time, moves higher in Euro rates are not expected to match the magnitude of the moves seen in the US or the UK benchmark bond yields since the start of the year, despite the impression that economic conditions in the Euro Area are catching up with the recovery seen in the US and the UK as the vaccine gap narrows.

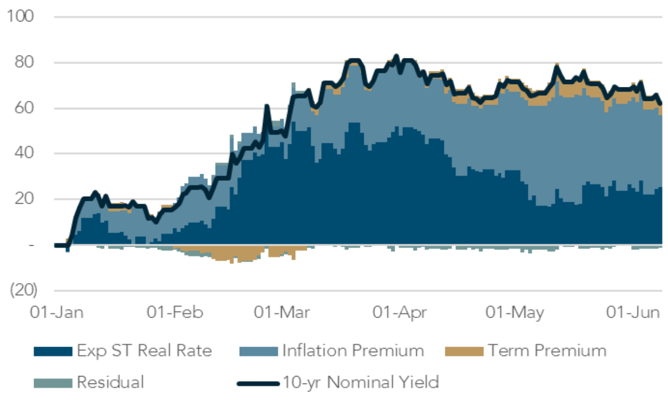
US Rates

US 10-year Treasury yields continued to trade in a range during May, rising to 1.70% from 1.63% by mid-month mainly due to the high inflation prints for the month of April generally beating expectations.

The strong print re-rated the inflation curve in the US, adding 13bps in the 10-year inflation premia by mid-month, marked by a peak in the 10-year breakeven rates at 2.55%.

The release of the FOMC minutes gave us a glimpse into a possible reaction to taper discussions. The minutes indicated that a number of participants suggested to discuss a plan for the adjustment in the pace of asset purchases in upcoming meetings if further economic progress is achieved. The release saw a marginal reaction in nominal yields, but more importantly, 10-year yields rose by c. 8bps, while inflation premia retraced 5bps.

Change in 10-yr Treasury Yield Decomposition Model



Source: Bloomberg

The shift in components indicates primarily that inflation breakeven rates are becoming less sensitive to increasing evidence of improving economic conditions, suggesting that breakeven rates at current levels have better priced in the economic outlook than real rates. Real rates have more room to reprise upwards on the back of the continued positive economic data. Moreover, a reduction in accommodative measures is expected to shift the relative pricing between inflation premia and real rates.

Having said that, given the current reopening dynamics which may continue to see elevated inflation prints justifies high inflation premia.

The weak employment data for the months of April and May have strengthened the Fed's assessment that the inflation boost is transitory, given the extent of economic slack brought about by the pandemic.

The yield curve pulled back, closing marginally lower (at the 10-year point) and flatter (2s10s) by the end of the month given reduced risk of the economy recovering at a faster rate than expected, given the fatigue in the labour market.

Weak employment numbers are expected to postpone discussions on tapering in the US, which should in turn lead to softer front-end pricing. Expectations for tapering are for early 2022.

This is consistent with the outlook that job gains should pick up as labour supply constraints are loosened while economic momentum is sustained, and unemployment benefits are eventually stopped.

The week starting 7 June saw US 10-year Treasury yields move below 1.5% ahead of important price data for the month of May, with the move reportedly being mainly attributable to closing of short positions. Market implied inflation rates are consistent with elevated inflation rates in the near term and a gradual moderation later in 2021 and going into 2022. We therefore did not expect to see an outsized reaction of the 5% inflation data release

Within this context, we see little scope for breakeven rates to reprise lower given the supportive demand-supply dynamics on price pressures. On the other hand, we are now probably past the peak in the widening of inflation premia given that the strong explicit catalysts (such as the household payments) are unlikely to be repeated at this stage.

With real yields still trading at very low levels given the persistency of the Fed to anchor down policy rate expectations, we find limited scope for treasury yields to move much lower from here.

On balance, we retain the view that these opposing forces will likely keep the US 10-year yield trading in a range in the near term.

The key risks to this outlook include:

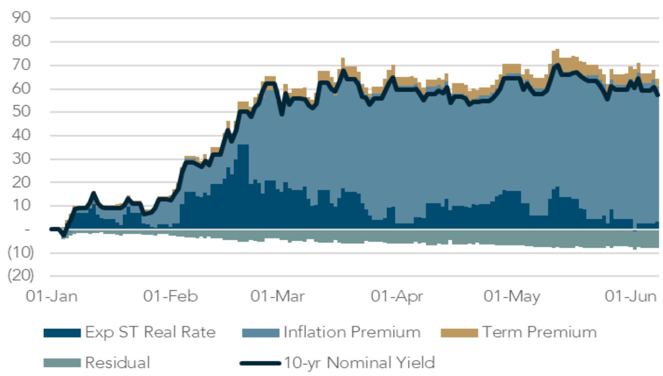
- Increasing evidence that the rise in inflation is structural rather than temporal (such as sustained increases in wage growth at lower employment levels);
- Another round of fiscal stimulus delivering another strong boost to demand;
- Continued sharp surprises in inflation data; and
- Early tapering by the Fed.

UK Rates

The UK 10-year Gilt yields declined by 5bps in May despite the increase in inflation risk premia of 7bps. High inflation premia continue to explain the elevated level of yields since the start of the year which is now supported by strong inflation data prints on the back of the increase in energy prices.

In view of the high levels of inflation expected throughout the reopening phase of the economic recovery, the indications that the BOE will terminate the QE pro-

Change in 10-yr UK Gilt Yield Decomposition Model



Source: Bloomberg

gramme this year and market pricing of a hike in rates early next year, we continue to see a balance of risk for UK rates tilted to the upside.

Concerns on a potential third wave of the virus and the record inflow from foreign demand for Gilts are the main factors that have supported the Gilt market, keeping yields from trading higher in an otherwise improving economic macro backdrop.

Gilt issuance has reportedly been lower than estimated by the DMO whilst strong foreign demand and BOE purchases have provided technical support. Sustained foreign investor demand for Gilts will be crucial to keep yields in check when the BOE exists the market at the end of this year, particularly in a period of higher supply.

The outlook for long-end Gilt yields remains asymmetric with risks tilted to the upside as cyclically supportive data is expected to continue to be released and to dominate the narrative, in line with high inflation data releases and the eventual cessation of BOE purchases.

The latter has been particularly important in exerting pressure on bond yields in a period of higher than average issuance. This will also increase focus on the apparent underestimation by the BOE of the timing of the next rate hike.

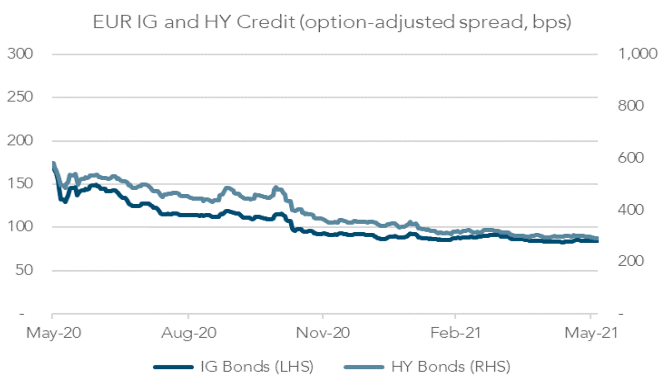
The key risk to this outlook is now primarily the risk of a third wave of contagion in the UK following the intensification of the spread of the Indian variant. Whilst authorities have indicated that vaccines are equally effective against the Indian variant, which should not result in a surge in hospitalisations, it has brought about the delay in the relaxation of measures which were schedule to take place on 21st June.

CREDIT

Euro Credit

Spreads within the Euro corporate bond market contracted during the month of May, seeing a more pronounced move in the high yield ("HY") space. The movements were primarily driven by the ECB's stance that tapering its asset purchases are premature, while the gradual lifting of restrictions across the bloc and a revision of growth forecasts to the upside also supported tighter corporate bond spreads.

June is typically a quiet month for HY index expansion, adding just one bond worth of c. €600 million on average over the past decade. The strong ramp up in supply over March, April and May might relate to corporations scrambling to refinance at favourable rates following the strong Q1 results releases and prior to the summer lull. We suspect June to revert closer to normalised "quiet" issuance years.



Source: Bloomberg

We expect new supply to be well-digested by the market as the default and rating backdrop stabilizes further and many investors continue to seek HY as shelter from rising Bund yields and to benefit from the vaccine-led economic recovery. Leverage for large corporate sectors in Q1 dropped across the board after staying stable in 4Q2020, showing that the turnaround is very broad based and long term. To this end, we expect Q2 index metrics to show continued improvement.

Despite some further compression between breakeven ratios observed for investment grade ("IG") and HY Euro credit, driven predominantly by a combination of the slight widening of IG spreads and tightening of HY spreads, we continue to prefer HY paper over IG within the Euro space. The IG/HY breakeven rate ratio, despite dropping in recent months, remains at multi-year highs, highlighting the relative attractiveness of HY compared to IG in the current environment.

The fundamental and technical backdrop within Euro markets should remain supportive for HY spreads over the coming months and the expectation remains for HY to outperform IG over the course of 2021.

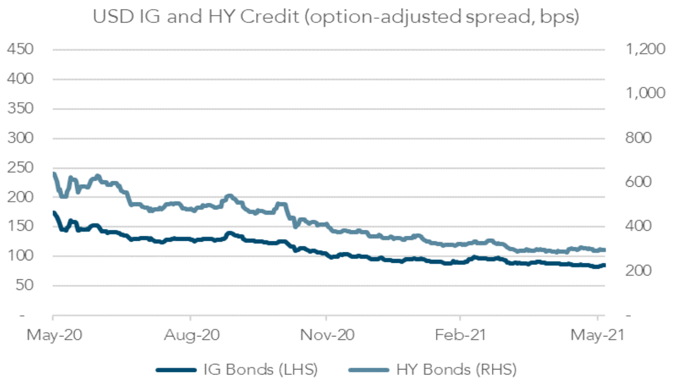
We would prefer to be invested in names with more idiosyncratic risk that may be able to better withstand broader market turbulence in an environment of rising benchmark rates and are considering the addition of potential floating rate notes as a further hedge against rising rates in our portfolios.

US Credit

US corporate bond spreads in the IG segment of the market tightened during the month of June, with HY spreads moving in the opposite direction. Spread movements were primarily driven by the higher inflation prints published during the month, with the possibility of the

Fed tapering their asset purchases also affecting the US corporate bond market.

The positive economic momentum continued in the US with the publication of economic data showing that the economy continues on its path towards recovery as the re-opening of the American economy has released consumer pent-up demand. The five-year inflation breakeven rate rose to its highest in fifteen years partly due to the realised inflation prints and the expected medium-term dynamics that are expected to continue to contribute positively to inflation.



Source: Bloomberg

The key variables in the trajectory for US credit, both for IG and HY, remains the pace for economic growth and the narrative around inflation and, by extension, the impact these variables may have around the Fed's tapering considerations and benchmark rates.

May delivered a robust 0.77% total return for the Bloomberg Barclays US Corporate Bond Index, but left index yields at the lowest levels since February, and spreads at its tightest since 2007. With inflation data expected to continue running hot near term, and jobs growth likely to pick up as incremental unemployment benefits are withdrawn, yields may renew their Q1 climb, resulting in losses for the months ahead due to the inability of this asset class to effectively absorb shocks to benchmark rates at current levels.

Option-adjusted spreads for US HY corporate bonds fell just inside 286bps on 3 May, which, whilst not a record low, was a post-financial crisis low, and could potentially mark the low-point for the current cycle. Alongside a bias higher in Treasury yields, year-to-date returns could be largely offset in the remainder of 2021 if inflation fears were to push spreads materially wider, as was seen on a relatively small scale toward the middle of May as OAS widened back, albeit temporarily, to 310bps, before closing the month at 296bps. Notwithstanding the concerns around inflation, the outlook for HY corporate bonds remains positive.

We prefer holding HY paper over IG in order to benefit from wider spreads available to investors. On a relative basis, we still prefer holding Euro exposure over USD given that central bank support is more likely to remain unchanged in the near term.

UK Credit

Corporate credit spreads in the UK widened during the month of June and were more pronounced in the non-IG segment of the market.

Corporate bond spreads widened despite the upbeat tone on economic growth struck by the BOE's MPC members who expect the economy to reach pre-pandemic levels during the fourth quarter of the current year and with unemployment expected to decline. However, the movement in UK corporate spreads could be explained by the BOE's MPC meeting which occurred during the first week of May, whereby it was indicated that the pace of asset purchases will be slowed down. Furthermore, an MPC member indicated that the BOE could raise rates by 2022, which is earlier than originally expected, if the economy rebounds at a faster than expected rate.

As was largely expected, given its previously stated intention for asset purchases to run until the end of the year and to reach a total size of £895 billion, the BOE announced a reduction in the pace of its asset purchases in May. The reduced level of technical BOE support, in addition to the likelihood of further upside surprises for key economy data and underlying prices, is likely to place further upward pressure on benchmark yields in coming months, whilst simultaneously being supportive for potential corporate credit spread tightening.

As such, on a relative value basis, we continue to prefer HY over IG credit in the UK market given the ability of the asset class to better absorb potential shocks to benchmark rates. Given the greater likelihood for higher benchmark yields in the UK vs Europe, on a relative value basis we also continue to prefer Euro exposure over UK.

Default Rates

As a clear sign of further stabilization in global corporate credit quality, this year's global corporate default tally remains flat at 43, with no defaults for the second consecutive week as at 4 June. With less than half the number of defaults compared with this point in 2020, defaults have slowed considerably this year, as creditworthiness, even at the lower rating levels, continues to improve.

By region, the US leads defaults in 2021, with 24 out of 43 (nearly 56%), whereas at this point in 2020, there were 63 defaults from the US out of 94 (nearly 67%). In Europe, the year-to-date number of defaults remained elevated at 11, in line with the year-to-date tally during

2020, albeit an improvement from a high of 13 in both Q3 and Q4 of 2020.

Just one of these European defaults came from the IG space in the oil and gas sector, due to a missed principal payment, whilst the remaining defaults were all from sub-IG entities and concentrated in the automotive, airline and consumer goods sector, with distressed exchanges being the most common default outcome in the first quarter.

The number of rating actions continues to decline from the April 2021 high, but remains positive. So far in 2021, there have been 339 issuers that have had a negative rating action and 951 issuers with a positive rating action. The largest percentage of rating actions has been due to an outlook revision to stable from positive. Most of these were issuers with ratings that have stabilized after having been lowered at least once in 2020.

EQUITY

The rally in global equities continued during May as global equities rallied +1.5% ($ terms), bringing the total return on a year-to-date basis to +11.6% ($ terms). This headline figure for the month hides the volatility seen in May, as investors fretted on the consequences of rising inflation, following the big surprise in CPI data published by the US, along with the tight labour market in the country leading to a wage inflation.

European stocks posed a total return of +2.7% during May, ahead of the S&P500 (-0.7% in € terms), the FTSE 100 (+2.3% in € terms), Japan (-1.6% in € terms) and emerging markets (+0.7% in € terms). After a horrible start, Europe has started to catch-up with other developed countries in the vaccine rollout race. As we had highlighted last month, Europe's recovery had been largely underappreciated by investors. We remain bullish on the prospects of European equities for the rest of the year.

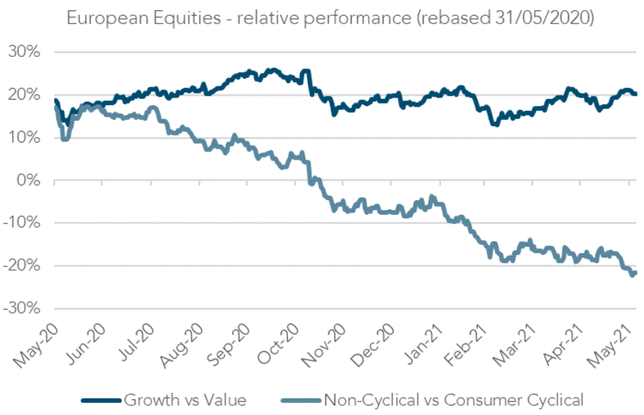
Global value generated a total return of +1.3% during May compared to –1.8% for global growth. This should be expected, as growth stocks are generally classified as long duration equities, and long duration equities tend to underperform during periods of rising inflation expectations. This is due to the possibility of rate hikes, which weighs on growth stocks' valuations.

Interestingly, Europe value stocks (+2.5%) lagged behind Europe's growth stocks (+2.9%) during May. There is less anxiety around inflation in Europe as opposed to the US, primarily explained by the difference in fiscal policy measures implemented by the two countries. Notwithstanding, the situation could change rapidly, as talk of inflation and the possibility of rate hikes are rarely taken well by the market.

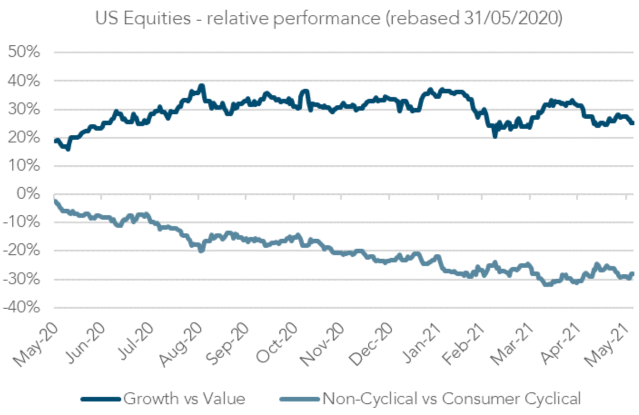
Equities should, at least in theory, outperform other asset classes during periods of rising inflation and underperform when there are fears of deflation. This is because, apart from the fact that the economy is generally doing well during periods of inflationary episodes, earnings and dividends should rise with inflation. However, investors tend to focus on the rise in the discount factor and ignore the higher earnings generated by corporations. This is why during such periods, investors tend to prefer value stocks, as they are more levered to the economic growth and earnings of traditional value sectors, like banks are positively correlated to interest rates.

The biggest risk for equities coming from inflation is the possibility that the policy support, high savings and easy financial conditions could lead to the economy persistently operating above its sustainable capacity. This would lead to a widening in the output gap and potentially forcing the central bank into taking rapid action. In any case, we remain positive on the prospects of value stocks over the near term.

Rising inflation expectations coupled with high econom-



Source: Bloomberg



Source: Bloomberg

ic growth expectations during a commodity bull market should bode well for the prospects of value stocks. Persistently high inflation could weigh on the global economy, but we think the current inflation numbers are being impacted by one-offs related to the pandemic.

As a reminder, the impact on equities from inflation depends on the speed of the rise or fall, what is driving the rise or fall and whether the changes in inflation expectations are impacting economic growth expectations.

Below we revisit the main themes discussed in last month's update:

1. *Value vs Growth and Cyclicals vs Defensives* - The performance for both value and cyclical stocks is mainly driven by economic expectations, which explains the outperformance of cyclical stocks relative to defensives in April, but not the underperformance for value stocks relative to growth. We think that a lot of positivity is now being priced in cyclicals while upside remains for value stocks. The underperformance since the end of the bear market in March last year is unwarranted when considering the current favourable backdrop, especially the potential for rising yields and inflation. European value stocks (+23.4%) are still lagging behind European growth stocks (+26.7%), while cyclicals (+23.0%) are outperforming defensives (+21.5%) since the end of the COVID bear market.
2. *Value vs Growth and the 10-year Bund yield* - We noted in our March update that rising bond yields have generally been associated with periods of value outperformance. Over the past month, the German 10-year yield was largely unchanged (up 4bps) but is a continuation of the move upwards we have seen throughout 2021. The German 10-year started the year at –0.6%, and is now trading at the –0.2% levels. We see this as supportive for value stocks in the near term, as curtailment measures in the region are eased and the economy is re-opened.
3. *Value vs Growth and the Global Economic Uncertainty Index* - One of the main drivers of the growth outperformance since the global financial crisis has been the higher uncertainty around economic growth. When looking at the Global Economic Uncertainty Index, we can conclude that uncertainty has not been consistently at these levels since at least 2018. The growth/value outperformance has tracked the uncertainty index closely since 2016, but a gap has opened over the past months. We think that this gap is more likely to close due to value outperformance than a significant rise in uncertainty.
4. *Value vs Growth and Global PMI* - The global manufacturing PMI rose to 56.0 in May from 55.8 recorded in April, the highest level since April 2020. In addition, new orders also hit an 11-year high, highlighting the increase in activity that bodes well for global economic growth over the summer months.

Economists expect the global economy to peak in the second quarter of 2021 as curtailment measures are eased and the benefit from favourable comps start to fade. We expect inflation and yields to follow suit, and this will provide support for value stocks. Although it is difficult to establish a precise timeline, a lot will depend on what happens with yields once the economy reaches the peak. If yields continue to rise following the peak, then value stocks should continue to outperform.

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Developed Market Sovereign Bonds	Negative	U/W	Sovereign bond exposure was reduced given the low carry and high sensitivity to benchmark curve movements with risks tilted for further steepening. The outlook for periphery credits remains well supported, but as noted in previous updates, the strong rally seems to be showing some signs of fatigue at current levels. However, the launch of the EU Recovery Fund and the additional monetary stimulus could add momentum going forward. We maintain an underweight stance in sovereigns given the predominantly low yields on offer for the bond class. We see a risk of higher inflation in the medium term, and on that basis, we remain tactically underweight.
Investment Grade Corporate Bonds	Neutral	N	Our opinion is that high grade returns will depend largely on movements in benchmark rates, further stimulus and vaccine success. The ECB has pledged to step up purchases for the time being, which has been supportive for spreads. However, unlike 2020, there is currently very minimal cushion against bund movements within IG corporate credit, and the ability to hedge benchmark rates has become a critical factor within IG performance. We are less constructive on IG credit in both USD and GBP given timing differences on the potential withdrawal of central bank support. The default and rating environment for global credit has improved significantly since the start of the year as economic conditions have continued to stabilize, minimizing the risk of fallen angels on both sides of the Atlantic. Whilst we are comfortable with holding high cash balances, it is relevant to continue to seek yield opportunities.
High Yield Corporate Bonds	Positive	O/W	High yield markets have rallied considerably from the mid-March 2020 lows. Having said that, the improved market conditions continue to provide scope to proactively seek opportunities on a selected basis. The scope to remain selective in carrying high yield positions remains as we continue to opportunistically identify unjustifiably discounted issuers. We continue to seek opportunities on a name-by-name basis. In line with our view last month, we view any minor spread decompressions between high yield and investment grade as an opportunity to pick up additional exposure in the space.
Developed Markets Equities	Positive	N	Equities have generated double digit returns on a year-to-date basis, despite rising concerns on the possible impact of inflation on global economic growth. Although we believe that inflationary pressures will be short-lived, given the price moves seen so far this year, we expect a more challenging market in the second half of 2021, where stock selection will continue to determine alpha generation. We had been running an overweight position in developed market equities since March due to our positive outlook for the equity market. At the end of May, we decided to reduce our developed market exposure to neutral across our investment strategies. Our positive outlook is still valid, however we feel that the strong rally since March does not justify an overweight position going into the summer months. Instead, we decided to increase risk by investing in a travel recovery play. We believe that conditions remain in place for value stocks to outperform in the near term. In this respect, we are comfortable with our sector positioning, although we see scope to make some minor alternations. We see Energy as a potential sector where additional exposure could benefit performance. We remain positive on Europe as a region, while our preferred strategy is tilted towards the value end of the market. We believe upside remains for carefully selected equities for the rest of 2021.
Emerging Market Equities	Positive	O/W	We are more positive on emerging markets going into the second half of the year after a lacklustre start to 2021. Emerging market equities have been held back by rising COVID-19 cases and a disappointing vaccine rollout program. We believe that this will change in the coming weeks, with a number of developing countries committing to send vaccines to emerging economies. Emerging economies generally do well during periods of strong synchronized growth, and we therefore expect a strong recovery in 2H2021.

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

DISCLAIMER