Investment Strategy Update

October 2021

CURMI & PARTNERS

Curmi & Partners Research

- The Delta variant and supply shortages are limiting the recovery in retail sales and industrial production.
- Survey-based indices point towards continued expansion in services and manufacturing sectors, albeit at a slower pace compared to the first half of the year.
- Inflation prints remain at elevated levels due to reopening effects and supply shortages, however the high energy prices have led to expectations of a longer period of high inflation than previously expected.
- While high energy and food prices are still considered to be temporary inflationary pressures, evidence of cyclical inflation, including the growth in wages is leading to an uptick in long-run inflation expectations.
- Labour markets remain generally supportive as the unemployment rates in the Euro Area and the UK continue to decline limiting the risk of a fallout in job numbers when government job schemes are fully wound down.
- Despite the disappointing employment reports in the US for August and September, job gains are expected to pick up going forward given the decline in COVID-19 cases and the termination of special benefits.
- Central bank communique became more hawkish given higher sensitivity to unfavourable price developments and the risk of unanchoring in long-run inflation expectations.
- The Fed is expected to announce a tapering in asset purchases in November, while the Bank of England governor suggested that a rate increase before year-end cannot be ruled out.
- Benchmark bond yields trailed higher resulting in some steepening across curves as the German and UK sovereign curves price-in higher inflation expectations, while the US curve reacted to prospects of a faster normalisation in monetary policy.
- Credit spreads remain stable, with the exception of some widening in high yield bonds, while the default and credit rating backdrop remains positive given the favourable rating reviews and receding business risks.
- Stocks continue to rally in developed markets but the momentum has weakened as the feel-good factor is fading, while growth strategies have outperformed value strategies over the last two quarters.
- Despite the unfavourable mix of revisions in growth and inflation projections, we deem the risk of stagflation to be low since economies are expected to grow at above-average rates in the next few years.
- We have lowered our duration profile and selectively increased foreign currency exposures in our fixed-income allocations in view of the growing prospects of tighter monetary policy in certain regions.
- We continue to favour higher allocations to riskier asset classes namely high yield bonds and equity despite the investor anxiety seen in September.
- Our preference for European value stocks remains while we screen for quality of high price-setting power given cost-push inflation pressures.

Recent developments brought about an unfriendly mix of higher inflation expectations and a slower growth outlook across the global economy leading to concerns about stagflation. The surge in COVID-19 cases in the last few weeks of Summer caused by the Delta variant, the slowdown in economic momentum and soft economic data releases from China were the main factors leading to downward revisions in the growth outlook of advanced and emerging economies for the near term.

Supply disruptions, which have been widely evident in transport and shipping costs as well as supply shortages, together with higher energy prices continued to underpin the high inflation prints. The persistence of supply constraints and the generally robust demand continue to point to higher prices going into 2022. Looking at energy, the low inventory levels, the prospects of a colder Winter and low exports from Russia have been the main reasons behind the sharp increases in natural gas prices. Oil prices continue to soar in view of the stronger imbalance in demand and the tight supply and stockpiles.

While energy and food price inflation are generally considered to be temporary factors of inflation, an extended period of higher prices due to reopening effects may lead to more enduring shifts in price-setting and spending behaviour. The risk of destabilization in inflation expectations is of key concern for central banks. This explains the recent pronounced hawkish shift by major central banks, namely the US Federal Reserve (Fed) and the Bank of England (BoE), as well as the rate hikes announced in Poland, New Zealand and Norway. Given the improving economic conditions and the unfavourable price developments, expectations are pointing towards additional central bank action in the months ahead.

While the possibility of further upside surprises in inflation remains, a number of tail risks seem to be receding. COVID-19 trends have improved in recent weeks with the number of cases retreating globally following the Delta surge. Confidence in vaccine efficacy remains strong particularly since effectiveness against hospitalisation remained high in countries which achieved high vaccination rates. Moreover, the antiviral pill developed by Merck reportedly reduces hospitalisation risk by 50% which could provide a turning point for countries with low vaccination rates.

The risks of a slowdown in China, primarily driven by adverse weather conditions and the tighter government controls in the private sector, is not expected to lead to material spillover effects. Growth forecasts for China remain fairly high with bear case scenarios eyeing a 2021 full-year growth rate of around 7% from the baseline scenario of 8.3% growth.

The downgrades in short-term economic growth forecasts were accompanied by upward revisions in medium-term projections indicating that the dead loss in economic output from the slowing momentum is expected to be limited.

While the fiscal impulse, following an unprecedented spend by governments in response to the pandemic, is expected to wane next year as most short-term assistance programmes come to an end, we note that household income, wealth effects and higher levels of savings provide robust conditions to support continued growth in consumer spending.

All in all, we view the possibility of the economic recovery drifting into stagflation territory to be highly unlikely. Expectations still point towards above-trend growth in advanced economies in the next few years and a continued recovery in employment and productivity.

The current high degree of monetary accommodation affords greater credibility to central banks in their ability to combat rising inflation expectations. This reduces the need to make abrupt or sharp changes in response to high spot inflation rates, making a cautious yet steady normalisation process the most sensible course of action.

As we remain in an accelerated expansionary phase marking the start of the new economic cycle, we continue to favour higher exposures to riskier assets with a skew towards sectors that tend to perform well during periods of strong growth. We note that the reopening theme has further room to run in fewer pockets of the equity market which we still think offer the strongest upside potential.

The sequential upgrades in earnings projections, combined with the recent outperformance in growth stocks, underpins our preference to continue to hold value stocks, primarily in Europe. Secondly, given the inflation risks and tighter risk premia, we are focusing on identifying quality names which display higher price-setting power as a shield in our portfolios against unexpected increases in inflation.

The prospect of a coordinated rate hiking cycle across G10 central banks is limiting our appetite for long maturity bonds. The scope of further spread returns has diminished given the tight spread levels in both investment grade and high yield bond markets. We therefore seek to maintain a short-duration profile in our fixed-income exposures focusing on areas which offer adequate premia for the possibility of faster rate hikes and inflation risks.

MACRO

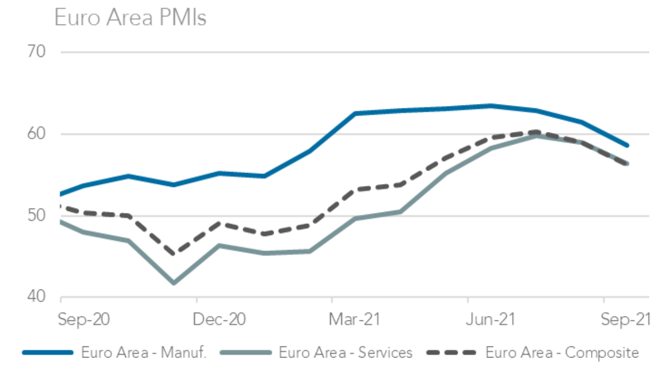
Euro Area

The third estimate for the Q2 GDP growth rate came in at +2.2% quarter-on-quarter showing upward revisions to the first and second estimate: +2.0%, compared to the original consensus of +1.5%. This points to a solid rebound following two consecutive periods of contraction, amid a recovery in activity and domestic demand due to the reopening of the bloc's economies, helped by the rapid pace of vaccinations.

In view of the stronger rebound, official entities have revised upwards the growth projections for the Euro Area for the near-term. More recently, the ECB raised the bloc's growth forecasts to 5.0% in 2021, 4.6% in 2022 and 2.1% in 2023 compared to the June estimates of 4.6%, 4.7% and 2.1% respectively.

Despite the generally uplifted outlook, more recent data shows that economic activity has been slowed down primarily due to supply shortages which have mainly affected production. Industrial production fell by 1.6% in August, following a strong month-on-month increase of 1.4% in July. The increase in July was broad-based across sectors, with only energy production falling. The decline in August was however in line with expectations and was generally weighed down by supply shortages mainly affecting the German auto sector. At current levels, production in Europe was nearly 5.1% higher than August of last year and 1.3% below its pre-pandemic level. Supply shortages are expected to last well into next year, and therefore industrial output is likely to grow only slowly over the coming quarters.

Retail sales for August grew by 0.3% month-on-month following the prior month's decrease of 2.6%. The August report coming in short of the consensus expected growth of 0.5% month-on-month. Total sales have now been more or less unchanged since May, suggesting that the period of rapid growth in goods spending is behind us. Other forms of spending are likely to have performed much better, such as restaurant services.

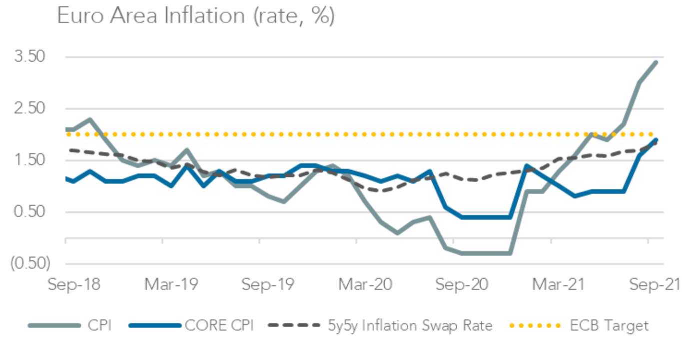


Source: Bloomberg

The expansionary economic momentum is confirmed by the generally strong PMI prints. The September final Composite PMI stood at 56.2, down from August's 59.0, however fairly in line with the market expected 56.1. Despite the decline, the Composite PMI still pointed to growth in both the services and manufacturing sectors, however at the slowest pace in five months and marking a further retreat from the 15-year peak recorded in July as shortages of inputs impeded both sectors. The PMI is consistent with the economic recovery losing some momentum as GDP approaches its pre-pandemic size and as supply shortages take their toll, especially in manufacturing.

Inflation on the other hand continues to tick higher. The flash September annual inflation rate shows an acceleration to 3.4% from the prior 3.0%, beating the market expected 3.3%. This could raise concerns about the ECB's narrative that recent price spikes are seen as temporary. The main contributors to the upward pressure on prices came from energy and food. Similarly, the flash September annual core inflation rate shows an acceleration to 1.9% from the prior 1.6% coming in line with the market expected 1.9%. These levels of inflation mark the highest point since November 2008.

Inflation looks set to continue on its upward trend.



Source: Bloomberg

Economists believe that inflation will hit 4% soon, making it more likely that the ECB will scale back its asset purchases substantially during Q1 2022. However, economists still expect headline and core inflation to fall sharply in 2022 and to settle well below 2.0% in 2023.

During the September meeting, the ECB raised their inflation forecasts to 2.2% in 2021, 1.7% in 2022 and 1.5% in 2023 from the June projections of 1.9%, 1.5% and 1.4% respectively.

The unemployment rate edged down to 7.5% in August in line with market expectations, compared to the prior 7.6%. The number of unemployed persons decreased by 261k to 12.1 million, as the labour market continued to show signs of recovery. Economists do not expect there to be a severe inverse effect on the downwardly moving unemployment rate because of the winding down of furlough schemes as these are not being ended completely. Additionally, hiring activity remains strong. Nevertheless, with employment likely to remain below its pre-pandemic level for some time, lingering slack in the labour market will keep wage inflation subdued.

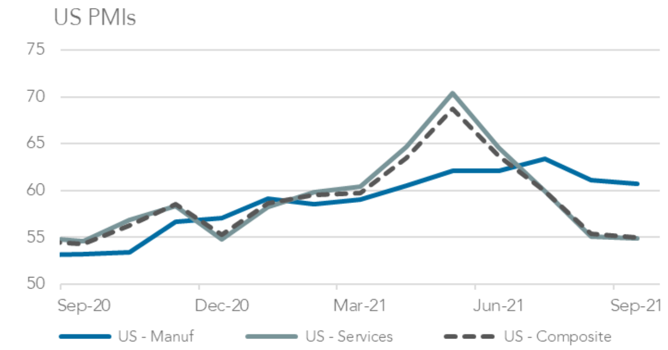
With sustained easy financing conditions, business investment and spending should remain supported. During the September meeting, the ECB concluded that a moderately lower pace of net asset purchases than in the previous two quarters under the PEPP for the rest of the year would be appropriate, amid favourable financing conditions along with an improved medium-term outlook for inflation. This confirmed that the ECB will slow its asset purchases slightly, but is still a long way from a "full taper".

United States

The Q2 final GDP growth rate was of +6.7% quarter-on-quarter compared to the second estimate of +6.6%, the first estimate of +6.5% and the original market consensus of +8.5%. The rapid spread of the delta variant, supply-chain disruptions, shortage of workers and a cooling housing market are seen weighing on the growth for the rest of the year. The Fed recently cut its growth projections for 2021 to 5.9% from 7.0% projected in June, but revised higher that for 2022 to 3.8% from 3.3% and that for 2023 to 2.5% from 2.4%.

Retail sales during the month of August rose 0.7% month-on-month, following the prior month's decline of 1.8% month-on-month, beating the market expected 0.8% drop. The rise in non-store and grocery store spending, which contrasts with the stagnant spending at bars and restaurants, suggests that delta fears are playing a key role. The renewed pick-up in spending on goods excluding autos will potentially add to the widespread shortages seen in recent months, putting upward pressure on prices.

Industrial production during the month of August rose 0.4% month-on-month in line with market expectations, following the prior month's increase of 0.8% month-on-month, lifting production back above its pre-pandemic peak. With the delta variant causing renewed disruption to global supply chains and Hurricane Ida weighing on oil production, a further slowdown looks likely in September and October.

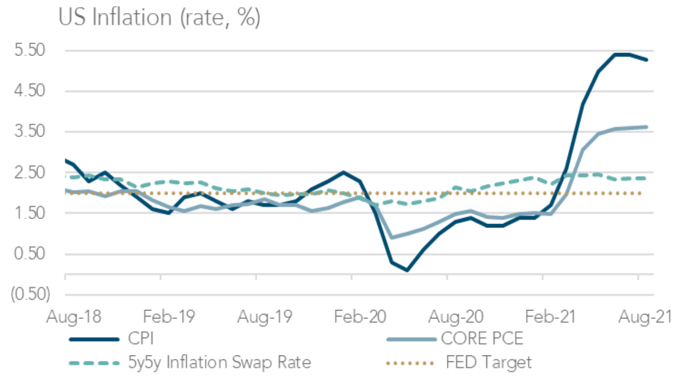


Source: Bloomberg

The September final Composite PMI stood at 55.0 marginally lower than the prior 55.4 but above the expected 54.5. This pointed to the slowest growth in both the services and manufacturing sectors. New business and demand conditions softened from the peaks seen earlier in the year. Output growth was hampered by the severe material and labour shortages, as supply chain disruption worsened. Furthermore, pressure on capacity was reflected in the fastest uptick in backlogs of work on record, as challenges expanding workforce numbers persisted.

The August annual inflation rate stood at 5.3% in line with market expectations and slightly below the prior 5.4%. The monthly rate eased to 0.3% from 0.5% in July, better than forecasts of 0.4%. This occurred as gasoline, natural gas and electricity prices all increased by more than 1% month-on-month as a result of the extreme global weather events, including Hurricane Ida.

The August core inflation rate stood at 4.0%, below the prior 4.3% and the market expected 4.2%. The monthly rate eased to 0.1% from the prior and expected 0.3%.



Source: Bloomberg

This acted as a sign that the recent surge in inflation was transitory after all but, although the spread of the delta variant has put the burst of reopening inflation into reverse, there are still plenty of signs of a building cyclical inflationary pressure.

Economists expect further declines over the coming months, as the reopening inflationary pressures fade, and possibly even reverses a little, but there will be cyclical inflationary pressure continuing to build. The latter means that core inflation could remain above target for the foreseeable future.

The unemployment rate for September dropped to 4.8%, below the prior 5.2% and the market expected 5.1%, marking the lowest rate since March 2020, amid a continued recovery in the job market and as the negative effects of both Hurricane Ida and the delta variant's summer spike started to fade. The rate still remained well above the pre-pandemic level of c. 3.5% due to ongoing labour shortages but is seen declining further in the coming months as companies fill widespread vacancies and as more workers return to the labour force.

The labour force participation rate was little changed at 61.6% in September, down from the prior 61.7%, leaving the participation rate at 1.7% lower than the February 2020 figure.

Labour market shortages are getting worse despite unemployment rate edging down further during September and the elevated wage growth figures. This is evident in the meagre job gains recorded in the month, the lowest so far this year and as the delta continued to weigh on payrolls. However, it is expected that in the coming months, the rate will keep declining as more workers go back to the labour force and meet vacancies.

In view of the improving labour conditions and the high inflation prints, Fed officials gave a heavy hint that the QE taper could be formally announced in November. This is deemed primarily to be in response to concerns that the surge in inflation will not be as transitory as they originally hoped which also led to the notable increases in the median interest rate projections. The Fed stated that "… if progress continues broadly as expected, the

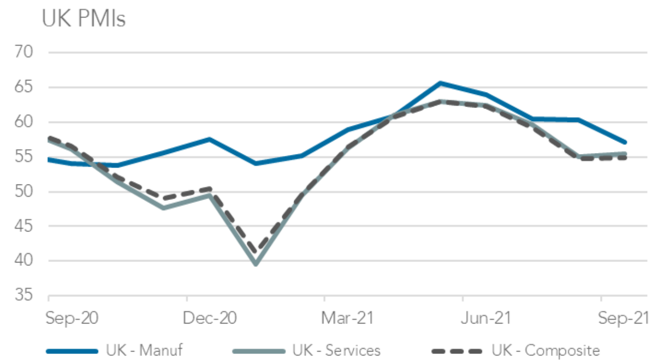
[FOMC] judges that a moderation in the pace of asset purchases may soon be warranted."

United Kingdom

The Q2 final GDP growth was at +5.5% quarter-on-quarter following the preliminary estimate and original consensus of a 4.8% growth. This came about as household consumption made the largest upward contribution following the easing of restrictions. This suggests that the economy is closer to its pre-pandemic level than had originally been suspected by economists and could potentially raise the risk of the BOE hiking interest rates sooner. July GDP grew by 0.1% compared to the prior 1.0% and the market expected 0.6%. This pointed to the rise in COVID cases and the product and labour shortages stalling the economic recovery during July. Economists believe that GDP will unlikely reach pre-pandemic levels until next year.

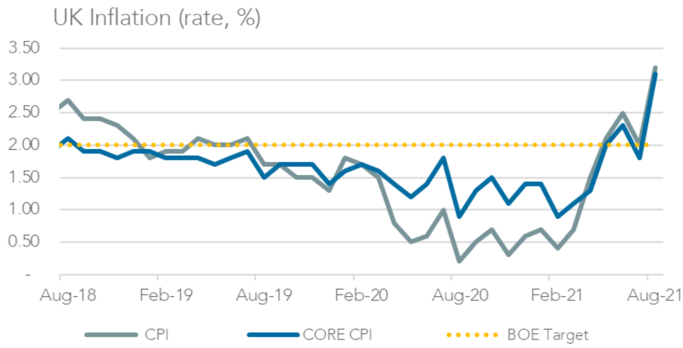
Industrial production for the month of August increased by 0.8% month-on-month adding to the prior month's increase of 0.8%. The release came above the expected 0.4% increase. Mining and quarrying, extraction of crude petroleum and natural gas were the main contributors because of pipelines re-opening after a period of closure for maintenance.

Retail sales for the month of September fell by 0.2% month-on-month following the prior month's decline of 0.6%, this being the sixth consecutive month of declines and coming in below market expectations of a 0.5% increase. This decline is partly a result of households spending elsewhere rather than in retail stores, for instance consumers opting to eat out rather than at home. Economists believe that the drops are still worrying as it does not look as though non-retail spending is surging, as card payments on socialising activities slowed in August and appears to have petered out completely in the first week of September. This could point to consumers becoming more cautious as COVID cases rise.



Source: Bloomberg

The September final Composite PMI stood at 54.9, little unchanged from the prior 54.8 and above the expected 54.1. This pointed to a much weaker growth in both the services and manufacturing sector due to supply chain delays and rising material and labour shortages. Severe supply constraints contributed to escalating inflationary pressures and the slowest rise in new orders since the end of the winter lockdown. Rapid rises in fuel, energy and staff costs were passed on to customers in September. Manufacturers maintained a positive outlook for the year end due to recoveries in both domestic and global markets, reduced difficulties from supply chains, COVID, Brexit and planned new product launches.



Source: Bloomberg

The August annual inflation rate jumped to 3.2%, the highest since 2012, well above the prior 2.0% and the market expected 2.9%. A low base effect from last year had the biggest impact because, in part, of discounted restaurant and café prices in August 2020 resulting from the government's Eat Out to Help Out scheme and, to a lesser extent, reductions in VAT across the sector. This is the first step towards the economists' expected rise in inflation to 4.5% or above by November. This is due to the scheduled 12% increase in utility prices, base effects on clothing inflation and further pass-through of costs on food inflation. But economists believe that inflation will fall back almost as sharply next year. The August core inflation rate increased to 3.1% from the prior month's 1.8% and above the expected 2.9%, this being the highest reading since November 2011.

The unemployment rate for the three months ending July fell to 4.6% from the prior 4.7%, in line with market expectations. This is the lowest level since the three months ending August 2020, adding signs of a labour market recovery. LFS employment rose by 183k in the three months ending July (expectations: 178k; previous: 95k), the largest rise in employment since January 2020 and during a period where firms started to pay 10% of the wages of their furloughed workers in July.

The latest job data shows more signs that labour market slack is declining fast and that labour shortages are contributing to faster underlying growth momentum.

The BOE has so far left its benchmark interest rate at 0.1% and its bond-buying programme unchanged at £895bln by the end of this year during its September meeting. The central bank also said that the case for modest tightening strengthened from August as inflation could persist above 4% well into 2022, although considerable uncertainties remain.

During the meeting, Dave Ramsden joined Michael Saunders in voting to end the bank's net asset purchases, £35bln short of the £895bln target. However, the other seven members did not share their beliefs that continuing with asset purchases could cause inflation expectations to drift up further. But even these members thought that monetary policy would at some point need to start to unwind some of its post-pandemic stimulus.

This suggests that the MPC is getting pretty close to tightening monetary policy. More recent comments from Governor Bailey opened the possibility of a rate hike possibly even in the last two meetings of 2021. Given the recovery in labour conditions and the increasing concern around the high levels of inflation, a rate hike (or more) in 2022 now seems the most likely outcome.

RATES

Euro Rates

Sovereign spreads have been fairly supported in recent weeks given the ongoing economic progress as activity in the Euro Area has generally maintained a stronger momentum compared to other areas, while the higher vaccination rates has enabled various countries to limit any reintroductions of containment measures despite the delta virus threat.

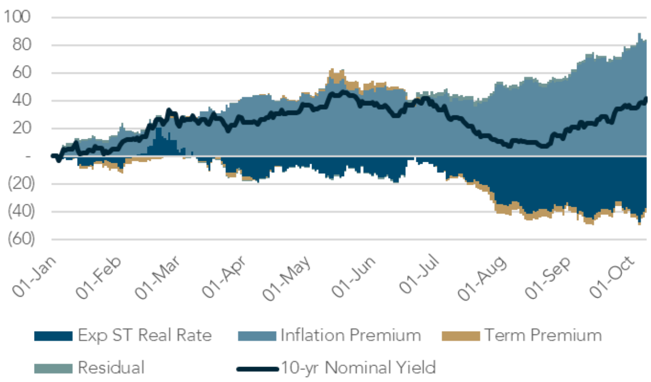
The ECB's recent press conference, following the September Monetary Policy meeting, was on balance more dovish than expected. The highly anticipated announcement regarding a reduction in asset purchases turned out to be a smaller step-down in planned purchases than expected, leading to positive expectations on stock effects. Moreover, the ECB is reportedly assessing the scope of retaining country allocation flexibility even beyond the termination of the PEPP programme. Given the potential tilt to reduce sovereign credit risk, we should see sovereign spreads remaining supported, while German and Dutch bond yields, where net purchases is higher than net issuance, are likely to see a decompression in scarcity premia.

The Euro benchmark curve repriced higher as Euro Area inflation rose to 3.4% in September from 3.0% in August and economic growth momentum remained comparatively strong. Europe has been displaying delayed reopening effects given that inoculation rates took longer to pick up and governments have scaled back containment measures later compared to the UK and the US.

Despite the ECB's upgraded outlook during the September meeting, the ECB's highly anticipated move to reduce the pace of asset purchases under the PEPP envelope was ultimately indicated to be a smaller step-down in asset purchases than expected. Despite this supportive backdrop, the 10-year bund yield climbed higher primarily driven by a rise in inflation breakeven rates. The movement led to bear steepening in the German sovereign curve with the 2s10s widening by 11bps during the month of September. These movements continued to gather pace in the first trading days of October.

Traded inflation has continued to rise higher given the widely reported increase in energy prices which is pushing up spot inflation prints. Despite that a rise in energy prices is generally deemed to be a temporary uplift in inflation, the rise in actual inflation and increased volatility in prices (similar to the US) is resulting in an increase in the inflation risk premium and thus, increase in nominal yields. The 5-year inflation swap rate reached 2%, a level last reached in 2012, while the 5y5y inflation swap rate reached 1.8%, a level which was last reached in 2015 when the ECB's QE was first announced.

Change in 10-yr Bund Yield Decomposition Model



Source: Bloomberg

In any case, long-end yields in the Euro Area remain exceptionally low in absolute terms reflecting the highly subscribed view that current inflationary pressures will subside and that we will return to the inflationary dynamics of the previous decade.

In our previous update, we highlighted the probability of upward revisions in ECB macroeconomic projections and the likelihood that the central bank will continue to express a high degree of patience for the time being. We also said that the constructive economic outlook in the Euro Area, the expected steady (but low) contribution from the pan-Euro Area fiscal programme and the expected change in ECB focusing towards reducing accommodation, signals the scope for a move higher in long-end yields.

Moreover, we mentioned that given the "lower for longer" interest rate path priced in the Euro curves which could see sensitivity to upside surprises in inflation, a repricing higher in Euro curves on the back of higher inflation premia or a decompression in term premia cannot be excluded. This has materialised (or started to) in September with the move higher in nominal rates being mainly driven by higher inflation premia.

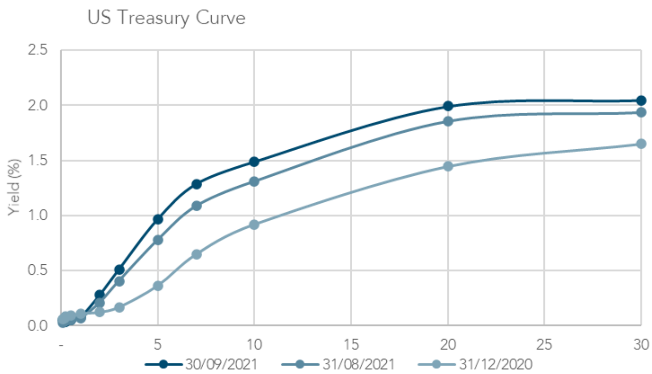
At this stage we prefer to maintain a short duration position in Euro versus the benchmark duration given that the risks are tilted in favour of a sustained move higher in yields.

The supply bottlenecks and limited supply of natural gas and oil are expected to continue to push headline inflation higher over the near term, particularly as we are approaching the winter months. Although such price pressures are generally deemed to be temporary, we could similarly see spill-over inflationary expectations which may continue to uplift long-run inflation estimates.

Despite the risk of upward surprises in current inflation prints, a higher inflation risk premium is also more consistent with the high degree of uncertainty around the persistency of inflationary forces and concerns of stagflation conditions due to the worsening trade-off in the growth and inflation outlook. We note that the belly of the curve is particularly vulnerable given that inflation risk premia is estimated to be negative in this area and the possibility of an eventual lift-off in rates can become increasingly reflected in market pricing.

US Rates

In our previous update, we highlighted that we expect any move higher in US yields on the back of a tapering announcement to result in further steepening of the curve given (a) Powell's effort to decouple asset purchases from policy rate decisions and (b) given the expected moderation in inflation data, the sell-of is expected to be real rates driven with the belly of the curve looking to be most vulnerable for such a move. This has pretty much materialised (or started to) in September.

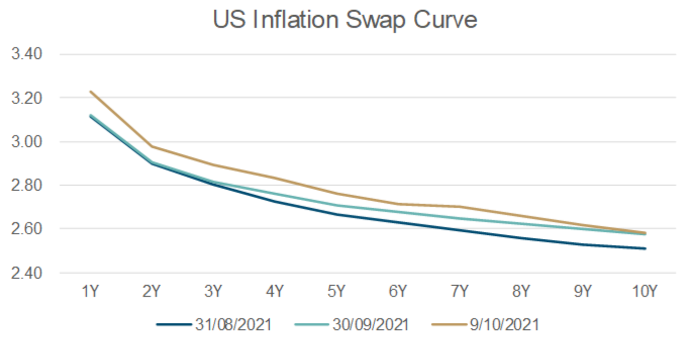


Source: Bloomberg

US 10-year yields rose by 18bps during September, primarily driven by a move upwards in real rates as the 10-year breakeven rate only rose by less than 4bps. Moreover, the 5-year to 7-year area of the curve rose by 20 bps during the month, and 2s10s widened by 11bps.

The outcome of the September FOMC meeting was more hawkish than anticipated. Even though no official change was announced, Powell noted that tapering "may soon be warranted". The "no action" on tapering in September was in line with our expectations, but market expectations remain that tapering will start at the November meeting. Powell also mentioned that most participants favoured concluding tapering by mid-2022. This would imply a $15bln reduction per month from the current $120bln.

The refreshed dot-plot also shows upward revised guidance on policy rates over the forecast horizon which now includes year 2024. The Fed revised upwards its median projection for policy rates from 0.1%, 0.1% and 0.6% (in 2021, 2022 and 2023) to 0.1%, 0.3%, 1.0% and 1.8% (2021, 2022, 2023 and 2024) which imply less than 1 hike in 2022, 3 additional hikes in 2023 and 3 further hikes in 2024. Futures markets moved to price in a 1.4x rate hike by end 2022 from just under 1 rate hike going into the meeting.



Source: Bloomberg

Elevated levels of inflation over the next few years are already reflected in inflation premia which seem to adequately compensate for the risk of an overshoot in the near term. Given the high spot inflation prints in the US over the past few months, the inflation curve has been inverted given that long-run inflation expectations hover close to, but above the 2% target. Current market pricing indicates that reversion to levels that are modestly above the 2% level over the next few years is similar to consensus expectations on the path of inflation, but at slightly higher levels. We deem the pick-up in this inflation premium to be reasonable given the uncertainty around the inflation outlook.

Supply disruptions are proving to be more persistent than previously expected suggesting that a possible upside skew to inflation outcomes is well placed, thus warranting a slightly positive inflation risk premium. However, as we have noted, most of the recent price surge is transitory. Even so, the extent to which temporary forces may spill-over to expectations presents an additional upside risk for inflation.

We think that for inflation expectations to be unanchored, we need to see a longer period of elevated core inflation. Therefore, the upside to traded inflation is limited to movements in premia for the time being as inversion is well-placed compared to periods of high spot inflation.

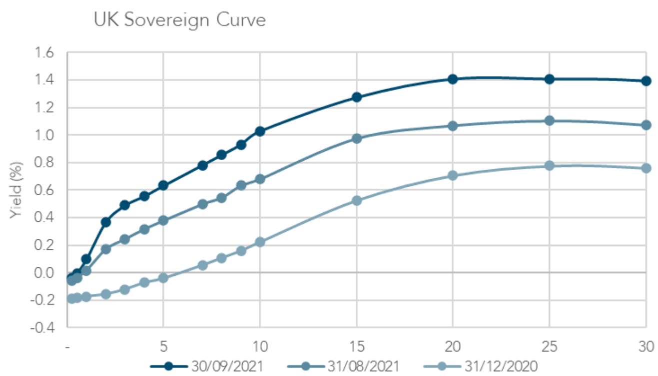
Yields continued to rise, despite the miss in the employment report bringing into question whether the US has achieved "sufficient progress" to warrant a change in policy. We expect the sell-off to lose momentum for the time being, but upside risks remain, especially if inflation prints come in hotter or labour market data show sustained improvement.

Based on the above consideration, we prefer to remain positioned in short-dated USD paper with the currency exposure unhedged. Current yield levels adequately capture a mildly more hawkish lift-off by the Fed, elevated levels of inflation for the short-term tapering down to above-average long-run rates and a positive inflation risk premium given the upside risk in inflation which is acting as adequate insurance against modest upside surprises in inflation print.

UK Rates

The BoE has been on point in revising its assessment around employment, output gaps and less spare capacity and increasing emphasis on price developments and whether these shocks in price levels will destabilise inflation expectations. It will be the first major G10 central bank to end its pandemic QE programme which is assumed to end in mid-December (despite some committee members voicing the prospect of ending QE earlier – but the benefits of doing so are immaterial).

Therefore, we see greater risk of an earlier hike by the BoE despite the slow recovery in labour markets and a possible uptick in unemployment rates which was previously underpinning our expectations that rate hikes could start towards the end of next year. To this end, the increased front-end pricing and the premium of an earlier action (even in November and December) is well placed given that the BoE is not indicating the need to be patient (unlike Fed and, even more so the ECB).



Source: Bloomberg

Market-implied pricing now sees 3 rate hikes by end-2022, with 0.5 of a hike priced in for the November meeting and up to 1 rate hike by the December meeting respectively underpinned by higher spot prices, higher wage growth and higher inflation expectations.

The movement in UK sovereign curve was the most aggressive during September with the 10-year Gilt yield moving up by 30bps. Higher front-end pricing led to a steepening slope in the very short-end of the curve, and a fairly parallel shift upwards with 2s10s widening by 6bps, and 5s30s trading flat. Upward movement was driven equally by higher inflation premia and an uptick in real rates. Moreover, the movement in the curve is in line with our previous observation that the BoE sequencing of the balance sheet run-off with policy rate adjustments should lead to a more parallel movement across the curve.

Front loaded hikes are generally expected to lead to a flattening of the curve, however given that the BoE is equally aggressive on the balance sheet run off, and issuance needs will continue to put pressure on long-end pricing, movements in the curve are expected to remain predominantly parallel with possibly some further steepening.

Given the hawkish shift by the BoE and the risks of rising inflation expectations, the probability is tilted towards earlier rate hikes and an accelerated hiking cycle. The mechanism communicated by the BoE that links the QE portfolio with rate increases (including balance sheet run-off and active sales), combined with a large issuance pipeline will continue to put upward pressure on long end yields.

We believe that the case for a short duration position in UK rates has strengthened given the expectations of a sustained move higher across the curve with the potential of added steepening.

CREDIT

Euro Credit

While the Bund yield rose, the release of German inflation data during the latter part of the month reversed the tightening of spreads as preliminary figures showed that inflation during the month of September was that of 4.1% on a year-on-year basis, the highest since December 1993.

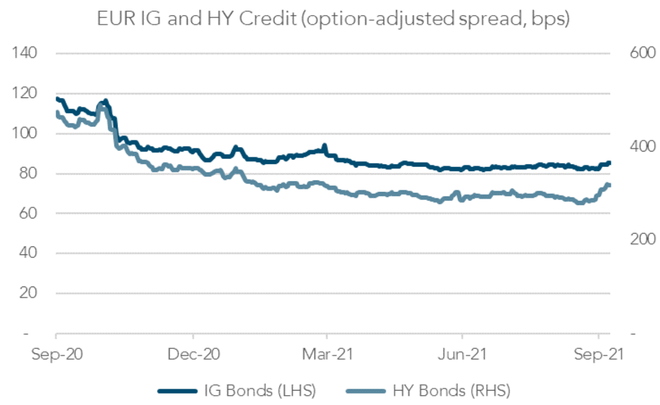
Uncertainty over the recent jumps in energy prices and the general impact of cost-inflation on European corporates will be a focus point on Q3 earnings calls and management guidance this upcoming earnings season. High demand, rising energy prices and supply bottlenecks are driving input costs and inflation higher, highlighting vulnerabilities in global supply chains. If these pressures persist longer than expected, it may materially impact corporate margins in more competitive sectors, and, more broadly, lead to some tightening in financing conditions, particularly if combined with the start of QE tapering. Inflation pressures in Europe remain a low risk than in the US at this point in the cycle, though the region remains exposed to potential financial spill-overs in the US.

The economic recovery and ongoing extraordinary monetary and fiscal stimulus has created some complacency around the large step-up in corporate and sovereign debt over the last 18 months. Though debt-servicing costs remain historically low, fragilities may become more pronounced in the coming years if borrowing costs increase and refinancing risk becomes a legitimate concern.

US debt ceiling negotiations and the general rise in uncertainty has more recently weighed on sentiment and pushed credit spreads wider, creating a sense of unease. Despite rising levels of discomfort, for the time being we maintain a "keep calm and continue" view within European credit.

The other, more relevant, focus for credit will be how central banks respond to continued upside surprises in inflation. Historically, central banks have looked through energy price shocks, which are generally seen as temporary and unresponsive to monetary policy. However, this time, the energy price shocks came both on top of other price shocks and in the context of broadly above-target inflation. Notably, the BOE has responded to rising UK prices by sharpening the hawkish elements of its guidance. If the ECB were to also turn more hawkish, then that would be a concern to credit investors and an event that may not be fully priced in at current levels.

On the other hand, the ECB may reassure markets that energy price inflation is not something they will respond to, and that asset purchases will taper slowly and be in place for most if not all of 2022. If there is no material spike in COVID-19 cases as temperatures drop in the northern hemisphere, activity may surprise positively in Q4. On balance, therefore, risks appear two-sided and the outlook for European credit continues to remain balanced for Q4.



Source: Bloomberg

US Credit

The US corporate bond market followed a similar pattern to that seen in the Euro Area corporate bond market as spreads generally tightened during the first half of September which subsequently widened during the second half of the month following the publication of inflation prints and a more hawkish Federal Reserve.

While the yield on the US Treasury rose during the month, the widening of corporate credit spreads, which was more prevalent in the riskier segments of the corporate bond market, was mostly due to the sell-off in corporate bonds given the possibility of higher rates and a lower demand for such securities once the Fed withdraws its support from the market.

Whilst credit conditions in the US remain remarkably favourable for most borrowers, several factors have increased the chance that investors may soon seek higher returns, which could translate into an increased cost of capital and weaker total returns for investors of riskier credits. Complicating the matter is a fourth wave of the coronavirus pandemic that will likely act as a drag on GDP growth through the rest of the year.

In the US, inflation continues to run hot, to the degree that real yields on all corporate bonds have plunged into negative territory for the past several months. Even corporate debt in the single-B space has had negative real yields since June.

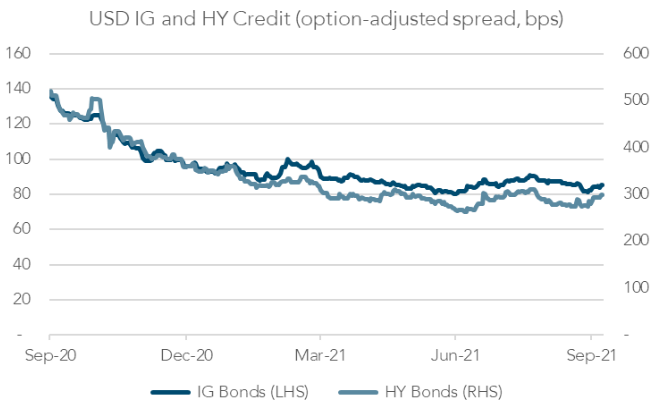
In view of the high inflationary pressures, investors could demand higher returns for the risks they are assuming because of fears of more persistent inflation, escalating credit concerns, or an unexpected adverse event, such as a stalemate around the US debt ceiling (now kicked further down the road) or market turbulence caused by the Fed's planned tapering of asset purchases. This could result in the repricing of financial and real assets, higher debt-servicing costs, and tighter financing conditions.

With corporate debt leverage near record levels, the recovery in demand remains uneven across industries while borrowers in many sectors are dealing with rising input prices and labour shortages. If cost pressures persist/intensify, profit erosion could become more widespread and steeper than expected, weighing on credit quality for some. Ready access to capital markets has eased maturity pressures, with low interest rates mitigating debt-servicing burdens, though the draw-down of government support could expose operational and structural headwinds.

Companies are struggling with inflated input costs, as supply constraints persist and unforeseen labour shortages take a toll. This may eat into profit margins, particularly for those issuers and industries that struggle to pass costs on to consumers. This pass-through may become more difficult as the delta variant and the end of federal fiscal stimulus, coupled with the prospect of tapering of asset purchases, weighs on economic activity and demand.

More recently, the US debt ceiling crisis and the developing situation around the Evergrande group had temporarily pushed investors into risk-off mode. Both of these events seem to have been shelved as immediate concerns, as issues around the debt ceiling have been kicked to the end of the year and fixed income investors have become more sanguine around the risk of contagion from the Evergrande situation.

For now, near-term indicators continue to favour a lower default rate for US corporate borrowers, as rating actions continue to reflect the improving outlook for credit, lending conditions remain favourable, and the economy continues to recover from the pandemic-induced shutdown, albeit at a slowing pace.



Source: Bloomberg

UK Credit

The UK corporate bond market also reacted similarly to its European and US counterparts as spreads tightened during the first half of the month of September which subsequently widened following the BOE's more hawkish stance following its September meeting and the publication of leading economic indicators.

Two BOE officials in early October moved to reinforce signals of an imminent rise in UK interest rates to curb inflation, with one telling households to brace for a "significantly earlier" increase than previously thought. Michael Saunders, one of the most hawkish members of the Monetary Policy Committee, suggested that investors were right to bring forward bets on rate hikes and, on the same day, Governor Andrew Bailey warned of a potentially "very damaging" period of inflation unless policy makers take action.

The backdrop of higher inflation and imminent rate hikes leads us to prefer participation at the shorter end of the curve for UK risk to minimise the knock-on effect of rates volatility on corporate credit markets.

Default Rates

Broadly, credit quality is continuing to recover slowly from a lower base as the global economy rebounds from the pandemic shock. In large part, this is due to the vaccines' success in reducing the sensitivity of economies to COVID-19, continuing lax funding conditions, and supportive fiscal policies in most major economies that has released pent-up demand and boosted revenues and earnings. Strong exports, large order books, low inventories, and high job vacancy rates all attest to the strength of consumer and business demand. This has translated into a moderately positive migration in credit quality, with upgrades exceeding downgrades consistently through the year, although net upgrades so far in 2021 are only about 12% of the number of net COVID-induced downgrades we saw in 2020.

More striking is the improvement in the net negative outlook bias that, at minus 7.9% as of 12th September, is back to pre-pandemic levels in all regions apart from Europe, indicating a clear stabilisation in credit prospects. These credit trends broadly mirror the macro economy where S&P global GDP growth forecasts stand at a solid 5.8% (June forecast 6%) for 2021, declining to 4.4% in 2022, and gradually towards trend growth in later years.

Credit performance has not been uniform across sectors. Looking more closely at the ratings performance in different sectors since the start of this year, there has been quite a sharp divergence in the upgrade/ downgrade ratio. Two of the more COVID-disrupted sectors have experienced particularly high upgrade-to-downgrade ratios year-to-date.

The auto sector's financial performance has held up well as original equipment manufacturers prioritised higher-value models, and their pricing power has been strong given overall lower production, curtailed by the shortage of semiconductor chips. Many rated retailers have protected their balance sheets well through cost reduction and prudent financial management, resulting in positive rating actions despite a sharp drop in revenues in many cases. In addition, the net outlook bias in both of these sectors has improved sharply this year, now standing at close to zero. Some sectors, however, are exhibiting ongoing vulnerabilities, with relatively high net negative outlook biases.

COVID still casts a dark shadow over the travel and aviation industry, with a slow recovery of international travel likely to prevent credit metrics in the industry returning to pre-pandemic levels until at least 2023. The utilities sector also has a relatively high net negative outlook bias. This is more challenged by the energy transition, where we see the substantial capital investment required to produce clean energy contributing to negative discretionary cash flow. This further erodes financial headroom that is weak relative to key rating thresholds for many entities.

EQUITY

Investor expectations at the start of the year for the equity market were elevated following the successful development of the vaccine by Pfizer. Following a lacklustre January, where global equities ended the month flat, funds started to flow into the asset class on the back of higher investor confidence.

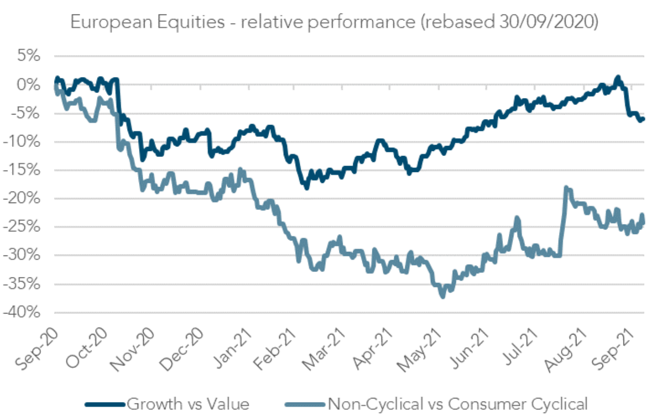
The main driver of performance has been the faster than expected recovery in corporate earnings driven by strong economic growth in developed economies. Investors shrugged off concerns that Europe would fall behind in the vaccine drive as the region failed to gain any meaningful supply of the vaccine in the early months of 2021. Albeit, investors took comfort in knowing that the vaccine was working in other countries, like the US and the UK, both early movers. The risk-on environment that started in February was underpinned by the expectation that the global economy was heading to some sort of normality in the upcoming months.

The general feel-good factor lasted for most of the first five months of 2021. Equities rallied to or near record highs in most regions as sentiment indicators turned bullish. However, the positive performance at index level masks the rising investor concerns and deteriorating investor sentiment.

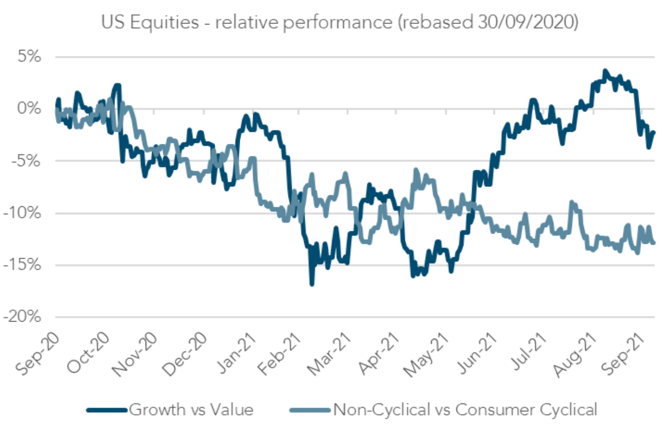
During the first 5 months of 2021, global equities delivered a total return of +11.6%, followed by an impressive +9.8% in the 3 months to the end of August. However, investor positioning had shifted considerably. During the first 5 months, global value (+16.7%) strategies comfortably outperformed global growth (+6.5%), but this reversed in the following three months with value (+4.6%) underperforming growth (+15.1%). Therefore, although the equity rally has continued unabated, the change in strategy performance highlights the market's rising risk aversion.

The rising uncertainty and doubts around the trajectory for global growth weighed on sentiment. This wall of worry led to investors shifting their positioning, looking for quality and preferred growth over the more economic sensitive stocks. Despite this, we remain positive on the value trade whilst acknowledging that it is a closer call today than it was in the previous months.

However, sentiment turned cautious over the summer



Source: Bloomberg



Source: Bloomberg

months as risks to global growth piled up. We have identified three themes that have weighed on sentiment: (1) peak growth narrative; (2) COVID-19 spread and vaccine efficacy; and (3) China's economic slowdown.

A lot of attention has been devoted to peak growth for the global economy. We agree that economic growth has peaked in a number of developed market economies, as evidenced by the deterioration in PMIs. The economic growth rates seen in the first half of 2021 were simply unsustainable helped by: (a) easier comps; (b) reopening impact was more favourable for 1H2021; and (c) fiscal impulse will turn negative in many countries.

The rise in COVID-19 cases over the summer months has raised doubts on the efficacy of the vaccine. Data shows that in countries with a high vaccination rate that have experienced a surge in cases have reported low hospitalisation rates, which reduces the probability of lockdowns. The only exceptions were Israel and US (more specifically in low vax states). In Israel we note that restrictions were eased rapidly, much quicker than the UK for example. We also note that in Israel, Pfizer has been the main manufacturer of choice early on. We continue to expect a low probability of lockdowns in the near-term for developed economies.

We believe that the headlines around China's slowdown are much worse than the reality. It is true that economic activity has decelerated, but in most instances it is either deliberate (regulatory changes which can be relaxed) or related to one-offs (COVID-19 or weather related). We identify four drivers of weakness for China's economy: (1) China's deleveraging policy; (2) climate change pledges; (3) regulation crackdown and (4) zero case policy for COVID-19.

Moreover, apart from the above-mentioned three themes, we could also add the possible tapering in the US before year end. In view of these uncertainties, and the strong performance up to that point, investors ditched value stocks for the "safer" (we use the term safer to describe the lower sensitivity to the macro backdrop) growth stocks. However, we believe that certain sectors within the equity market should continue to do well during 4Q2021.

Earnings for 2Q/1H have come in well ahead of expectations but analysts have been reluctant to significantly upgrade future earnings forecasts. Barclays say that consensus forecasts for future quarters have not been sufficiently revised up in light of the strong earnings released in 2Q/1H. This continues the trend of analysts looking at each earnings beat as a one-off event. The main implication of this is that FY2022 estimates are looking too low relative to Barclays's assumptions. The earnings beats were broad-based in nature and were not just confined to growth stocks.

We think that 3Q2021 will be a challenging quarter for companies, due to supply side constraints (autos etc), China weakness (basic resources, luxury goods) and the rise in the delta spread (travel, retail), but it seems that most of the weakness has now been priced-in. Additionally, we think that supply-side constraints should start to ease and the COVID-19 spread has been brought under some kind of control, but questions remain on China's economic deterioration. This implies that the weakness in 3Q21 could possibly be a postponement to 4Q2021.

We remain positive on value stocks and Europe for 4Q2021. The underperformance over the summer months, whilst understandable, is unwarranted in our view. We continue to see scope for outperformance in the final quarters for traditional value sectors like Banks, Energy and to a lesser extent basic resources.

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Developed Market Sovereign Bonds	Negative	U/W	Sovereign bonds have performed well during episodes of renewed market fears driven by the spread of the Delta variant. However, in view of the elevated inflation risks and the increasing likelihood of faster central bank action, we see the risks skewed towards a further move higher in yields in the near term. We see the belly of the curve to be particularly vulnerable to firmer pricing related to rate hike expectations or higher inflation risk premia. We maintain an underweight position to sovereign bonds, particularly in light of the low absolute yield on offer which offers little compensation for adverse curve movement, and our negative outlook on curve returns. The outlook for periphery credits in Europe remains supported by central bank policy particularly if ECB adopts more flexible modalities around country allocations for its open-ended (APP) purchase programme.
Investment Grade Corporate Bonds	Neutral to Negative	N	We believe that high grade returns will depend largely on movements in benchmark rates, further stimulus and vaccine success. The ECB has maintained its narrative of accommodative monetary policy which provides comfort. However, historically low IG corporate credit spreads continue to offer minimal cushion against bund movements, and the ability to hedge benchmark rates has become a critical factor within IG performance. We are less constructive on long-dated IG credit in both USD and GBP given the expectations of earlier withdrawal of central bank support and prefer holding short-duration positions in USD and GBP credit relative to Euro. The default and rating environment for global credit has improved significantly since the start of the year as economic conditions have continued to stabilise, minimising the risk of fallen angels on both sides of the Atlantic.
High Yield Corporate Bonds	Positive	O/W	High yield markets have rallied considerably from the mid-March 2020 lows. Having said that, improved market conditions and positive credit rating trends provide scope to continue to seek opportunities on a selected basis. We remain selective in holding high yield positions as we focus on identifying new positions 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. We continue to run an overweight allocation to high yield bonds.
Developed Markets Equities	Positive	N	We have maintained our value tilt during the summer months in spite of the rising risk environment. This proved to be a drag for our performance relative to the market, but we maintain the view that value should outperform growth in 2021 on the back of strong synchronised economic growth, loose fiscal and monetary policy, strong commodity prices and rising inflation. Our initial strategy was to start reducing our value tilt as we approached peak growth in Europe, but the value outperformance over growth had evaporated, which was unwarranted in our view. Our selection of stocks delivered a total return of -4.0% during September which was flat with the European index (-3.9%). The portfolio underperformed in the early weeks of September as investors became wary of the global economic growth trajectory. However, the final weeks of September were characterised by fears over inflation which boosted value stocks in the process. Whilst maintaining a tilt towards European value stocks, we are also looking at quality names and profiles which display a high degree of price-setting power given the cost-push inflationary forces.
Emerging Market Equities	Positive	O/W	Our selection of EM positions delivered a total return of -2.5% during September, underperforming the broad EM index slightly by -0.2%. On a YTD basis, the outperformance over the benchmark stood at +1.0%. Performance in September was boosted by a strong recovery in China late in the month, but the weakness in Brazil has weighed on performance. Additionally, the upbeat sentiment in South Asian equities has been a drag on performance for most of the month. India has been an outperformer over the summer months, whilst South Korea and Taiwan have also performed well. We continue to prefer holding an overweight allocation to EM equities with a higher exposure to LATAM.

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

DISCLAIMER