Investment Strategy Update

November 2021

CURMI & PARTNERS

Curmi & Partners Research

- PMI data across major economies have moderated following the peaks in Summer reflecting slower, but more sustainable, rates of expansion in services and manufacturing sectors.
- Persisting supply disruptions and labour shortages is seen to be limiting the expansion in output, despite the surge in demand, resulting in the general increase in prices.
- Inflation rates rose to new highs in advanced economies in October as a result of the surging energy costs and supply shortages.
- US October jobs report shows a stronger recovery in employment as the initial Delta wave started to abate and Federal unemployment benefits have terminated. However, the limited pick-up in labour supply suggests the acceleration in wage growth in recent months has further scope to run.
- Headline unemployment rates in UK and the Euro Area have declined further as job retention schemes expire, however strong hiring intentions is met with limited supply of workers resulting in higher wages.
- October saw increased expectations of a hawkish pivot by major central banks resulting in bear flattening as front-end yields rose across G10 markets.
- The US Federal Reserve announced the tapering of asset purchases in line with market expectations during its early-November meeting but fell short of communicating firmer intentions on policy rate changes.
- The Bank of England surprised markets by not raising rates in its November monetary policy meeting signaling a patient stance despite increasing inflation expectations.
- While moderating expectations on long-run growth rates have led to downward pressure on long-end yields, we continue to reduce duration by repositioning our curve exposure to shorter key rates in markets with wide interest rate differentials versus EUR rates.
- As credit conditions continue to improve, most sectors and regions have experienced month on month decreases in the number of potential downgrades during the month allowing us the comfort to maintain higher exposures to selected lower-rated securities
- Our preference towards value stocks came under pressure due to stagflation concerns, however our view is underpinned by the strong growth outlook for 2022 and 2023.
- We view the risk of inflation persisting for longer to be higher today which is why we have increased our exposure to quality names with pricing power to protect margin as input costs increase.
- Emerging market equities continue to underperform developed markets due to lingering virus risks which slowed the economic recovery in most regions.

The surge in energy prices and the rise in input costs and wages has contributed to the intensification of the inflation debate. Headline inflation prints ticked to new post-pandemic highs across advanced regions with the rise in durable goods prices, energy prices and food prices being the main contributors to the increase in inflation.

At the centre of the debate is how and when central banks will react to the rise in inflation. The higher inflation reports are now showing signs of a broader cyclical underpinning, bringing into question the central bankers' assessment that the high inflation is transitory. Of key concern is the long-run inflation expectations of individuals and businesses given the impact that a de-anchoring of such expectations may have on spending behaviour, price-setting policies and business investment today. Following the recent rise in both spot inflation levels and market-implied pricing of future inflation rates, central banks are being pressured to act and raise rates earlier. The Royal Bank of New Zealand and the Bank of Canada have reacted to such developments by expressing a greater propensity to raise rates to curb inflation and de-emphasized the impact of a tightening monetary policy on the economic recovery.

In view of the risk that other major central banks will follow suit, we saw a notable rise in front-end yields resulting in the flattening of yield curves across G10 markets, as long-end yields were weighed down by a moderation in long-run growth estimates.

Labour market conditions continued to improve, particularly since the rise in cases due to the Delta variant have started to decline, while economic activity continues to increase and hiring intentions remain robust. The termination of Federal unemployment benefits has also contributed to the increase in job gains in October in the US. Whereas the Euro Area and the UK are seeing growing employment numbers despite most wage subsidy programmes coming to an end.

The ongoing recovery in labour market conditions and increase in wages should support consumer spending now that we are entering a period when the expansionary fiscal impulses will start to wane. The transfer benefits through fiscal discretionary spending have led to sharp increases in household income and saving. The risk that a drop-off in fiscal spending could lead to weakness in consumer spending is expected to be largely offset by higher rates of employment, higher wages and increased confidence.

In view of these underlying economic developments, the economic outlook remains positive with real growth rates expected to remain above historical averages in most advanced economic regions over the next two years. In view of the constructive growth outlook, the risk that stagflation forces prevail seems to be a low-probability outcome. As economic conditions continue to normalise, the supply-demand imbalances are expected to moderate, supply chain disruptions should start to ease and the strong price pressures underpinning the current high rates of inflation should diminish. To this end, we see limited scope of further increases in oil and gas prices and we expect energy costs to plateau as demand moderates and stockpiles are gradually replenished. As supply chains normalise, we expect the inflationary boost from durable goods to translate into a disinflationary drag next year. Growth in wages should similarly self-regulate as labour-force participation picks up. On this basis, we expect inflation rates to remain high for the time being but to decline towards more acceptable levels in the second half of 2022.

With public investment set to remain relatively high and focused towards improving long-term productivity, governments are expected to continue to run fiscal deficits over the next few years. In our view, the supply of public debt and, more importantly, the concurrent reduction in central bank intervention is the underpinning dynamic that will see yields continue to climb higher. This explains our preference to bring duration down in fixed income allocations by repositioning curve exposure towards markets which display elevated front-end pricing and exiting longer-dated bonds to limit our risk to rising bond yields.

As real rates are expected to decompress, we continue to maintain a value tilt in our equity selection focusing on names that are expected to perform well in periods of elevated inflation and above-average growth rates. Specifically we are focusing on basic resources, banks and energy sectors identifying profiles with solid price-setting power. We are increasingly eyeing the scope to partially counterbalance our value tilt with growth stocks, primarily in tech, to limit the portfolio's high sensitivity in periods of weak market sentiment.

In the meantime, we have temporarily squared our overweight allocation in EM equities given the sluggish economic recovery in EM ex-North Asia as a result of the slow vaccine deployment and the poor control of spread of the virus. Moreover, while China served as an important driver for growth in emerging markets earlier on during the pandemic, it has now slowed to a record low pace with the growth outlook being weighed down by economic challenges and political uncertainties.

MACRO

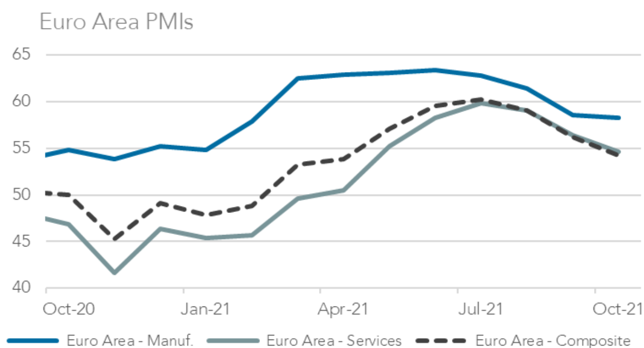
Euro Area

The Q3 flash quarter-on-quarter GDP growth rate stood at 2.2%, compared to the market expected 2.0%, bringing the level of output just 0.5pp below its pre-pandemic level. Growth was mainly supported by strong domestic demand and exports, while supply chain disruptions, shortage of raw material and rising consumer prices weighed on the recovery. Economists believe growth will be slower in the fourth quarter because the boost from reopening has now passed, while supply chain disruption and slowing global demand will take a toll.

Industrial production in September declined by 0.2% month-on-month following a revised 1.7% contraction in August, coming in slightly higher than the expected 0.5% decline. This was mainly due to supply shortages affecting production, particularly in the German auto sector. Economists believe that while demand is still strong, prolonged supply shortages and high input prices suggest manufacturing will continue to struggle in the fourth quarter of the year.

Retail sales for the month of September fell by 0.3% month-on-month, following an upwardly revised 1.0% growth in August and missing the market expected 0.3% advance. This came about as consumers are shifting their spending on other services. Consumers are likely to become more cautious in the months ahead, amid concerns over inflationary pressure and rising corona-

virus infections. Despite consumer confidence being quite high, retailers have become more pessimistic as

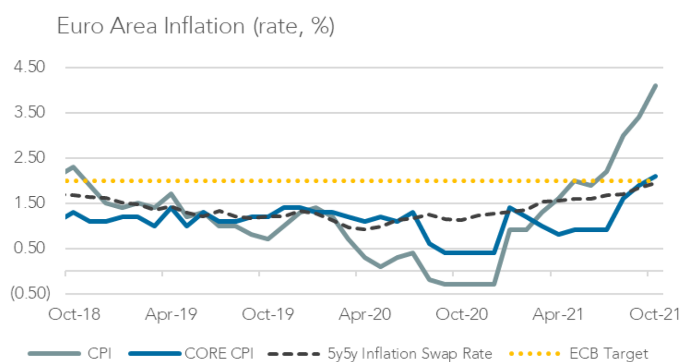


Source: Bloomberg

they are struggling to replenish their stocks of goods.

The final October Composite PMI stood at 54.2 compared to the prior 56.2 and the market expected 54.3, pointing towards the slowest growth in both services and manufacturing activity in six months. Since July, the activity growth has been on a downward trend. New business growth slowed fractionally, although increased tourism and greater flexibility towards international travel reportedly boosted overseas demand. Supply-side issues interrupted production schedules and dented order books, with firms struggling to obtain manufacturing inputs as supplier delivery times lengthened to one of the most severe extents on record. The rate of backlog accumulation was at the slowest rate since April as a result of the strong growth in service sector employment. Finally, although business confidence remained strong, the level of positive sentiment slumped to a one-year low.

The PMI data suggests that the Euro Area's economic recovery will slow in the fourth quarter as supply shortages intensified throughout the region, especially for manufacturers. They also show that price pressures are



Source: Bloomberg

building in the short term.

The October annual inflation rate stood at 4.1%, up from the prior 3.4% coming in higher than market expectations of 3.7%. This is the highest reading since July 2008 as the area battles surging energy costs while supply shortages persist. Energy inflation had the highest annual rate in October at 23.5% as a result of the recent moves in oil and gas prices, compared with the September figure of 17.8%. The October core inflation rate stood at 2.1% compared to the prior reading of 1.9% and market expected 1.9%. Economists believe inflation will rise further before year-end as higher input costs continue to feed through. However, the forces which are currently pushing inflation up are set to fade in the course of next year, in line with ECB expectations.

Lagarde expressed that inflation would "take longer to decline than originally expected", adding that supply chain bottlenecks were likely to last well into next year, although she expressed confidence it would fall below the ECB's 2% target by 2023.

Looking at labour market developments, the unemployment rate edged down to 7.4% in September from the prior 7.5%, in line with market expectations. While the September reading brings the jobless rate back to its pre-pandemic level, employment has not fully recovered. Economists believe the economy is growing strongly and the vast majority of those who left the labour force are set to return, so the labour market is likely to recover further in the fourth quarter. Furthermore, whilst worsening supply shortages and rising COVID cases represent downside risks for employment in the coming months, firms' demand for workers is expected to persist.

During its October meeting, the ECB said its €1.85trn PEPP would continue, although at a "moderately lower pace" than the €80bln-per-month level it ran at until last month. The ECB also kept its deposit rate unchanged at -0.5%, reiterating that it continues to view inflation as being transitory and expects upward price pressures to fade during 2022. The outlook for inflation over the medium term remains subdued and therefore the ECB is very unlikely to raise interest rates next year. Furthermore, Lagarde said she expected the pandemic emergency purchase programme ("PEPP") to end in March, adding that the decision on whether to expand an earlier asset purchase programme ("APP") to offset some of the reduction would not be made until December.

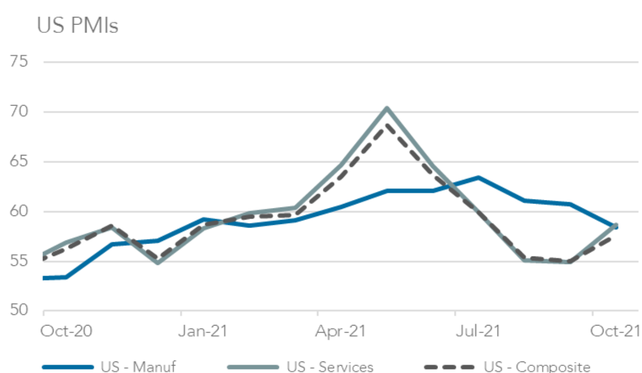
United States

The first estimate for the Q3 annualised GDP growth rate stood at 2.0% quarter-on-quarter, compared to the market expected 2.7%. This shows the weakest growth rate during the pandemic recovery as an infusion of government stimulus continued to fade and a surge in COVID cases and labour and supply shortages weighed on consumption and production. Economists expect a modest rebound in Q4 of 3.0% quarter-on-quarter annualised as any negative impact from the delta variant should be reversed and motor vehicle production will

not be a drag.

Retail sales in October grew by 1.7% month-on-month despite supply chain constraints, coming in better than the market expected increase of 1.7%, showing sequential growth on the 0.8% gain in September. This rise suggests that goods spending held up a little better than anticipated. There were some signs of the lingering impact of the delta virus wave, as spending on food and drink services increased by a modest 0.3% month-on-month. Economists believe that spending on other discretionary services, which are not included in retail sales, also saw modest growth. Furthermore, they believe that services spending may see renewed strength over the next couple of months, as virus cases continue to drop, but with good shortages likely to persist, and the resulting surge in prices, consumption growth will remain subdued.

Industrial production in October grew by 1.6% month-on-month following the contraction of 1.3% in September. This came in higher than the expected 0.7% advance. The production remains impacted by the temporary hit to mining and chemicals output from Hurricane Ida and a drop in cooling demand as the weather returned to seasonal norms. Manufacturing output increased by 1.2% month-on-month given the large gain in motor vehicle production and increase in factory output. Economists believe that the Hurricane Ida disruption and weather effects will continue to fade, the labour and product shortages holding back manufacturing output are still weak and are proving to be longer lasting than originally anticipated.



Source: Bloomberg

The final October Composite PMI stood at 57.6, compared to the prior 55 and the market expected 57.3, reflecting an expansion in both services and manufacturing activity. Services activity saw a sharp overall expansion due to greater client demand and a further rise in new business. However, firms signalled the fastest increase in backlogs of work since October 2009 despite the faster pace of jobs creation. The manufacturing sector is also signalling expansion, however this was the weakest in ten months due to the smallest increase in production levels since July 2020 amid capacity constraints including material shortages. Vendor performance continued to deteriorate sharply due to transportation delays and strong demand for inputs while new orders rose the least in ten months. Finally, concerns regarding labour shortages and unstable supply chains led business confidence to drop to an eight-month low.

The October annual inflation rate soared to 6.2%, up from the prior reading of 5.4%, beating market expectations of 5.8%. The October annual core inflation rate also rose to 4.6%, higher than the previous month's 4% and beating market estimates of 4.3%.

Headline consumer prices increased by a 0.9% month-on-month, with broad-based increases across energy, shelter, food, used cars and trucks. With crude oil and natural gas spot prices correcting lower in recent weeks, economists expect some pull back in the related consumer price index components in coming months.

Economists believe that while core inflation will inevitably decline next year, the probability of it falling to 2.0% on a sustained basis are fading, due to worrying increases in cyclical sensitive components such as rent and food away from home.

Labour market conditions continue to improve with the October unemployment rate declining to 4.6% from 4.8% in September exceeding market expectations of 4.7%. The labour market continued to gradually recover from the pandemic, helped by a surge in demand for labour, record levels of job openings, the expiration of enhanced jobless benefits and the subsiding summer wave of COVID-19 infections.

October non-farm payrolls came in at 531k, better than the prior 312k and the market estimates of 450k. The reading marked the highest gains in 3 months as COVID cases dropped and employers offered higher wages and more flexible hours. The biggest job gains occurred in leisure and hospitality (164k) and in professional and business services (100k). However, employment in public education declined (-65k), with economists suggesting this is a seasonal adjustment. Average hourly earnings for October stood at 4.9% year-on-year, in line with expectations and higher than the prior 4.6%, pointing to a continued acceleration. The labour force participation remained unchanged at the prior 61.6%, remaining 1.7pps lower than February 2020.

Overall, this suggests that the economy is rebounding from the initial delta wave despite easing virus concerns, but there was no sign of a pick-up in labour supply. This suggests that the acceleration in wage growth in recent months has further room to run. The strong jobs report underpins the improvement in the cyclical position of the

US economy and strengthens the argument of diminishing economic slack.

The Fed is emphasising the shortfall in employment as evidence that the economy is still far from full employment, with officials arguing that participation rates will rebound as virus fears and caregiving burdens ease.

During their November meeting, the Fed decided to begin reducing the monthly pace of net asset purchases by $10bln for treasury securities in both November and December (previously at $80bln a month) and $5bln for agency mortgage-backed securities each month (previously at $40bln). If the run-down continues at this pace, the purchases would cease entirely next June, paving the way for a rate hike in 2H2022. Policymakers added that similar reductions in the emergency pandemic support will likely be appropriate but are prepared to adjust the pace of purchases if warranted by changes in the economic outlook.

The Fed noted that inflation is elevated, and supply and demand imbalances related to the pandemic and the reopening of the economy have contributed to sizable price increases. Still, such pressures are "expected to be transitory", with the change in verbiage indicating that Fed officials see the process of moderation in prices taking longer. Fed Chairman Powell added that the central bank can be patient on rate hikes but will not hesitate to act if inflation continues to remain elevated.

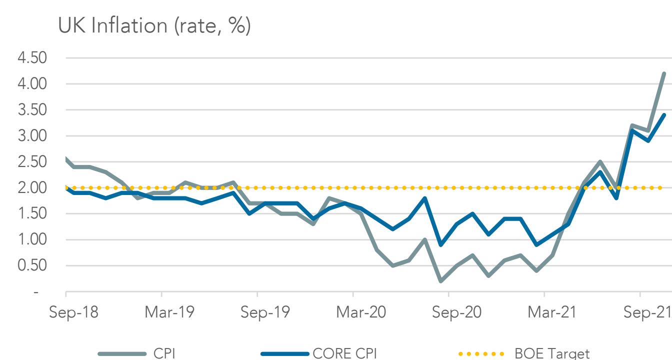
United Kingdom

UK's GDP grew 0.4% month-on-month during August, recovering from the slight contraction in July of 0.1%. The reading came shy of the market expected 0.5% growth. This left the economy 0.8% smaller than it was in February 2020. Shortages, including the energy crisis, may prevent GDP from rising much in the coming months. Economists believe that the improvement probably had a lot to do with the fading of the restraint from July's "pingdemic". Economists suspect that shortages will be a bigger drag on GDP in September and October and do not expect output to rise much in the coming months, before accelerating from mid-2022 and into 2023. The BOE are projecting that GDP will get back to its pre-pandemic level in 1Q2022 as "bottlenecks will continue to restrain growth somewhat in the near term".

Industrial production declined by 0.4% month-on-month in September, following the 1% increase in August, coming in worse that the market expected advance of 0.2%. The fall was a result of a decline in production from all sectors including electricity and gas, oil and gas extraction, mining and quarrying, water supply, sewerage and waste management as well as manufacturing.

Retail sales increased by 0.7% month-on-month in October marking the first increase in six months, beating market estimates of a 0.5% increase. The increase was driven by non-food stores, primarily second-hand stores, games and toys, sports equipment stores and clothing stores. Conversely, auto fuel sales declined by 6.4% as demand moderated to more normal levels while food sales also came in lower.

The final October Composite PMI stood at 57.8 compared to the prior 54.9 and the market consensus of 56.8. The strong reading points towards a strong acceleration in activity, with the services sector outpacing manufacturing for the fifth consecutive month, as the latter was hit by supply shortages and shortages of raw materials, staff and certain skills. The services sector saw a strong pace of recovery, albeit softer than the peak, as the reopening of the economy and looser international travel restrictions helped to boost demand, with new export sales rising at the fastest pace in just over three years. Overall new business volumes increased at a strong pace and the rate of job creation remained close to a recent record high, while backlogs of work were up for an eight straight month and inflationary pressures intensified.



Source: Bloomberg

The October annual inflation rate stood at 4.2%, increasing from the 3.1% in September. The reading came in higher than the 3.9% market consensus. Economists have expected such an increase in inflation given base effects and the rise in energy costs and supply shortages. Conversely, core inflation rose to 3.4% in October from the 2.9% in September marking the highest core inflation rate since October 2011.

During the recent BOE meeting, the central bank said it would probably become necessary to increase rates over coming months in order to return inflation to the 2% target. CPI inflation is now expected to peak at c. 5% in April 2022, before falling back materially from the second half next year, as supply disruption eases, global demand moderates, and energy prices stop rising.

The unemployment rate in September dipped to 4.3% from 4.5% in August. The improvement exceeded market expectations of a 4.4% reading in September as the

labour market continued to recover strongly. The headline unemployment rate remained just 0.2pps shy of pre-pandemic levels. Wages increased by 5.8% year-on-year in September compared to the prior 7.2%, mainly a result of the unwinding of the boosts from the furlough scheme.

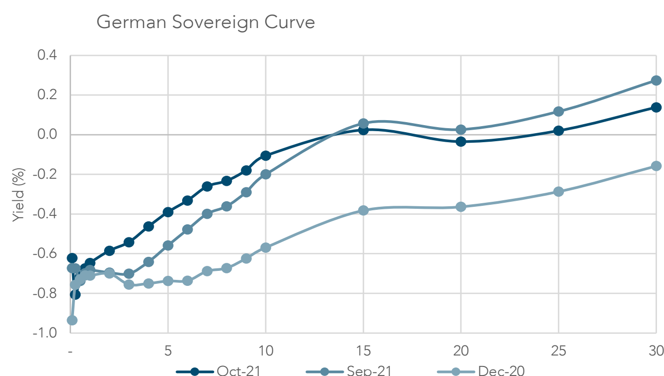
During the BOE meeting, it was explained that the unemployment rate is seen rising slightly in the fourth quarter of this year. Economists believe that shortages will be an issue until at least the middle of 2022, even though the furlough scheme should help to ease labour supply shortages. The BOE voted to hold its benchmark interest at a record low of 0.1% during its November meeting and to leave its bond-buying programme unchanged, as policymakers weighed concerns over rising prices against the downside risks from slowing global growth and a potential upturn in UK unemployment following the end of the furlough schemes in September.

Through this decision, the MPC has shown that it is in fact still placing a lot of weight on the uncertain outlook for activity. The MPC sent clear signals that markets were wrong to price in rates rising to 1.25% by the end of next year. Economists believe that there is a possibility for a first-rate hike to 0.25% in December, followed by a second hike to 0.5% in February, however there is a high level of uncertainty around these expectations.

RATES

Euro Rates

The flattening movement of the German sovereign curve resonated the move seen across G10 curves during October, driven primarily by a sell-off in front-end rates as central banks adopted a more hawkish approach to curb rising inflation rates and de-anchoring of inflation expectations at the cost of reduced sensitivity of economic slack.



Source: Bloomberg

The ECB's communication during the October meeting suggests that there is limited scope to extend emergency asset purchases beyond the existing envelope under PEPP mainly since inflationary pressures have picked up, reducing the risks of deflation, as the economic recovery and improvement in employment continues. Our current expectations are that the PEPP envelope could be used in full, or almost in full, and that the central bank will allow temporary higher APP purchases (beyond the current €20bln a month) to avoid a drop-off in asset purchases when the end of PEPP arrives.

The ECB retains the view that inflation will moderate back down to below target over the medium term. This explains the patient stance expressed by Lagarde on policy rate adjustments. In fact, she was seen as pushing back against the higher front-end pricing going into the meeting. In the meantime, it is still expected that the ECB will first halt net asset purchases before moving to hiking rates. Based on the ECB's projected timeline, current front-end pricing seems to be too aggressive in pricing in an earlier rate hike with 2022 rate hikes remaining highly unlikely.

We continue to favour reducing the duration exposure to European paper. Strong inflation backdrop reduces scope for the ECB to meet stimulus expectations, which are still fairly high in terms of QE. On balance, we believe that yields are biased to move higher mainly at the long-end.

Lagarde commented that she expects asset purchases under PEPP to be terminated in March 2022 which marks a continued receding of policy support by the ECB, increasing the likelihood of under-delivering on quantitative easing ("QE") expectations. Sovereign spreads widened following the meeting as core yields moved higher. Given that further comments on post-PEPP QE policy are expected in the December meeting, we expect spreads to remain under pressure for the time being.

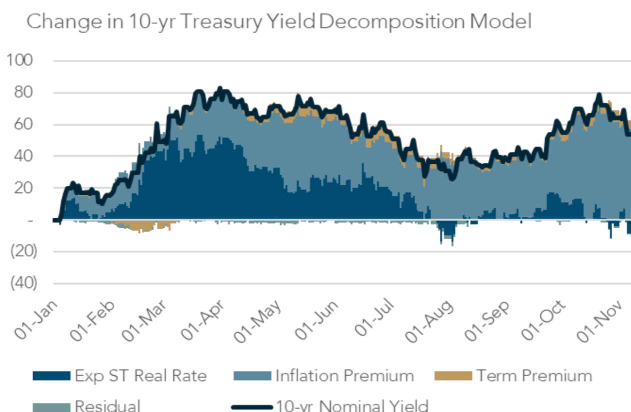
The improvement in economic conditions no longer warrants the degree of accommodation in financing conditions particularly given the buoyant inflation outlook. As a result, core yields are expected to move higher.

While sovereign bond supply is negative for the next few weeks, it is expected to turn positive early next year. This, combined with expectations that the ECB will under-deliver on QE expectations, can push yields and spreads to reprice higher.

US Rates

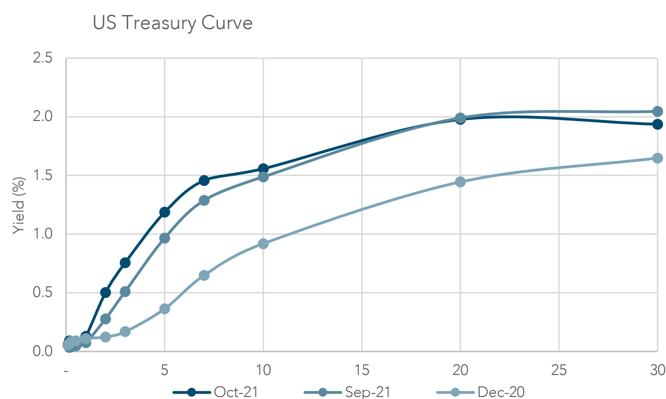
October saw 10-year US treasury nominal yields move higher by just 6bps, with a dip in real rates largely offsetting the 21bps widening in inflation breakevens. The move saw the curve flattening with the 2s10s declining by 15bps as 2-year yields rose by 22bps.

The sell-off in front-end rates was extended given hawkish comments made by the central bank officials in the month of October, raising expectations of a firmer policy change announcement or guidance on rate hikes in November, while inflation rates remain elevated. Yield movements were highly sensitive to the FOMC assessment of risks around tapering and their characterisation of inflation.



Source: Bloomberg

The volatility in front-end rates was mainly driven by price action in CAD and AUD rate markets which saw a more pronounced move upward in front-end rates. Specifically, the hawkish pivot of Bank of Canada, which followed that of the Royal Bank of New Zealand and the Bank of England, led to a higher probability being attributed to other central banks following suit. This hawkish pivot has mainly characterised itself in central banks which have changed the prioritisation of recovering economic slack to emphasising the risk of high inflation, leading to guidance that measures will be taken earlier to counter the rise in inflation.



Source: Bloomberg

Current market pricing implies a July 2022 lift-off in rates and 2 rate-hikes by end-2022. This is fairly in line with the taper timeline indicated by the Fed and our expectations of a rate hike in July 2022, a month after QE purchases are terminated, and a second hike in 4Q2022.

The treasury refunding announcement in November indicated the first cuts in nominal auction sizes. The announcement was fairly in line with expectations around a cut in upcoming refunding cycles by circa 20/25% across the curve as deficits are expected to decline in 2022 to 2024 to around €1.2/1.3trn from €2.8trn in 2021. Based on these projections, fixed rate issuance will decline from €990bln to €717bln per quarter with the net effect more than offsetting the tapering of Fed purchases over the course of next year. This indicates a limited impact on yields coming from supply.

The curve is now flatter on the back of diminished economic slack and a firm inflation backdrop. Long-end yields remained fairly unchanged on the back of continued moderation in growth expectations and greater realisation that the rebound from the crisis will be longer and slower than previously anticipated. On the other hand, concerns around the high levels of inflation (specifically for the US) could now be sustained by more cyclical price pressures. Moderate long-run growth rates led to the dip in long-end real rates, which was the main factor putting downward pressure on long-end nominal yields.

Yields declined across the curve in the first days of November given that the FOMC outcome fell short of a pronounced hawkish pivot. The move was in tune with a broader dovish reassessment of central bank expectations which led to a general decline in bond yields and safe haven flows in the developed market space.

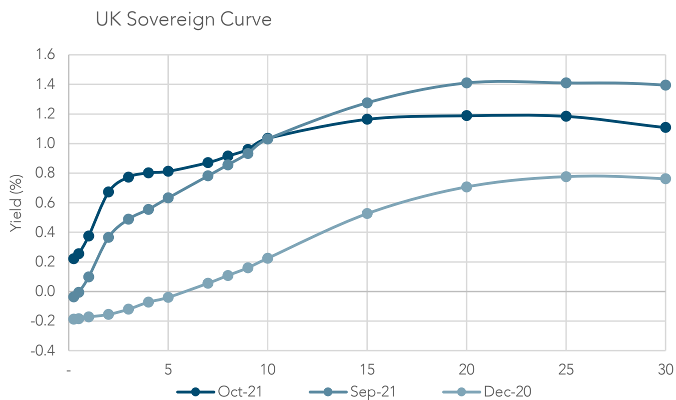
We view the pull-back in yields to be a temporary correction given the global dovish reassessment discussed earlier. Improving economic conditions, evidenced by the strong jobs report, PMI data and the potential passage of the fiscal bill which is currently being discussed, provide the right conditions for yields to reset on a higher path. At the same time, given the elevated pricing at the short-end, and the well-telegraphed monetary policy plan of the Fed, we attribute a low probability of an earlier lift-off in front-end pricing and any further moves higher in front-end rates are expected to be limited.

UK Rates

The UK gilt curve flattened strongly mainly due to continued upward pressure on short-end yields. The 10-year rate hardly moved during the month of October, while inflation breakeven rates continue to climb higher as spot inflation prints continue to show month-on-month increases in price levels. Notably, the spread between 2-year and 10-year yields tightened by 45bps.

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 commit-

tee members voicing the prospect of ending QE earlier – but the benefits of doing so are immaterial).



Source: Bloomberg

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 as a compensation of an earlier lift-off given that the BoE was less vocal on being patient (unlike Fed and, even more so, the ECB).

The outcome of the November MPC meeting fell short of rate hike expectations as the BoE kept rates unchanged compared to market-implied pricing of half of a hike priced in for the November meeting and up to 1 rate hike by the December meeting respectively going into the meeting. The surprise halt led to a short episode of relief on front-end with the BoE taking a dovish tilt in emphasizing risks to demand and economic growth relative to the risks to inflation expectations.

It will have to take a substantially disappointing labour market report to derail the BOE's hiking path. The October employment report due before the BOE December MPC meeting will be crucial in this regard as it will capture the months post-furlough giving a truer picture of labour market dynamics post-reopening.

Current market pricing post meeting implies a 15bp hike in December, +45bps by March 2022, +75bps by June 2022 and +100bps by September 2022.

Given that the COVID recovery is still underway, spending commitments by the UK government are expected to remain higher in the next few years. Goldman Sachs estimates that the government deficit will remain elevated in the next few years: 10.3%, 4.5% and 3.4% for fiscal years 2021-22, 2022-23 and 2023-24 respectively. These levels are fairly in line with continental Europe, however a higher proportion of net supply is already being absorbed by the private sector and is expected to increase further with the reduction in QE purchases.

The updated issuance guidance at the end of October surprised markets by undershooting expectations by around £25bln. The positive effect from lower net-supply led to some near-term relief with yields pulling lower on the news. Having said that, despite the adjustment lower, the expectation is that issuance will remain high in upcoming years which should put pressure on prices as the BOE purchases come to a halt.

Given 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, should lead to upward pressure on long end yields as the curve rerates to higher short-term policy rates.

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

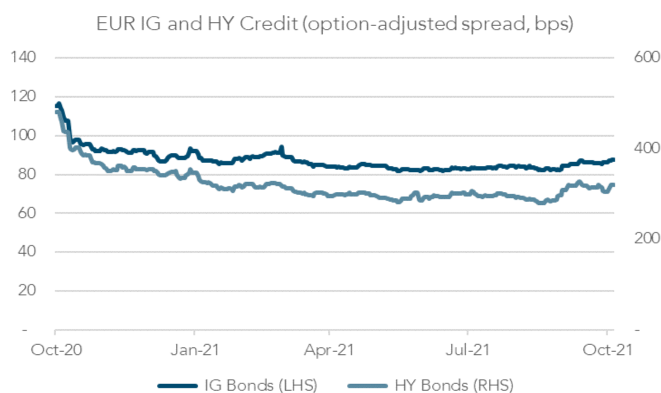
Euro Credit

European corporate credit spreads widened during the month of October despite the rise in bund yields as investment grade ("IG") debt experienced an increase in spreads of c. 3bps while spreads for non-IG debt widened by 9bps against the sovereign benchmark. The most significant movements within the IG space were seen within triple A rated and triple B rated debt, with spreads widening by c. 4bps, while within the non-IG space, single B rated debt widened the most by c. 9bps.

Despite the ECB's decision in its October meeting, the sell-off in European credit markets was primarily driven by the volatility in rates and supply chain disruptions that reduced the appetite for riskier asset classes for investors. In fact, data published during the month of October showed that German CPI on a year-on-year basis was that of 4.1%, the highest in twenty seven years, with the rise due to an increase in energy and food costs while German manufacturing data published for the month of September at 58.4 pointed towards the slowest growth in factory activity in eight months amid supply bottlenecks.

The growth outlook in Europe has been under pressure as inflationary pressures and supply chain disruptions

have remained persistent. Within IG, the yield curve started to flatten – short rates moved up faster than the longer end as the market appeared to price in more "permanent" inflation, led by soaring gas prices as increasing demand met with supply concerns. Nevertheless, despite increased pressure on the ECB to tighten monetary policy, President Lagarde continued to leave forward guidance unchanged. Instead, the PEPP will continue to run at a moderately lower pace with any further major decisions postponed to the December meeting. The ECB continues to believe eurozone inflation will decline next year and is consequently forestalling policy changes, despite the broader market view that supply chain bottlenecks and inflationary pressures will likely continue well into 2022.



Source: Bloomberg

Tight absolute spreads and the prospects for smaller ECB QE imply that IG returns remain largely at the mercy of benchmark rate volatility, following almost the worst month of 2021 as benchmark yields rose, driving total-return losses of 0.74% in a month with relatively strong supply. The move brings year-to-date ("YTD") returns in Euro IG to negative 1.05%. Returns during November have begun on a strong footing, though higher anticipated bond supply and lower QE may well weigh on the asset class for the remainder of the month. Similar to IG, rising benchmark yields weighed on high yield ("HY") during October, with total returns down 0.42% amidst some marginal widening in spreads. Despite the negative return, we continue to believe that the progress on improving credit quality, sufficient rates cushion and low defaults will continue to support spreads for the asset class at close to current levels.

While we do not expect a dramatic sell-off in government bond markets, we think the risk is skewed to yields rising, as markets price in the path to monetary policy normalization over the medium term. We expect inflation to remain high for some time, with year-on-year rates declining in 2H2022, in line with ECB guidance. It is still our view that the surge is mainly transitory, due to technical factors, higher commodity prices, and temporary bottlenecks in the economy.

Looking forward, we see corporate credit as fully valued but likely to consolidate at current levels supported by the expectation that financial conditions will remain easy, supporting low default rates. We also expect economic activity to continue rebounding as vaccinations allow economies to re-open, and strong corporate profitability with conservative balance sheet management to be supportive of spreads. As returns will likely be carry-driven going forward, we continue to prefer the HY space over IG, but see limited opportunities for capital gains from spread tightening.

Going into 2022 we expect a moderate deceleration in Euro IG gross issuance and a more notable slowdown for Euro HY. The volume of issuance in the Euro IG market over the last two years has not been especially outsized relative to history, implying that in general, firms in the Euro IG market have not engaged in aggressive pre-funding/refinancing of upcoming maturities over the past two years, a stark contrast to peers within the USD market. Goldman Sachs forecast roughly €525bn of gross Euro IG issuance in 2022 which, although a notable deceleration from the c.€600bn+ of the last few years, would still remain above the €513bn average of 2014-2018. Scheduled maturity walls over the coming years are fairly steep, though this is somewhat mitigated by high cash balances currently held across firms. The macro backdrop should also remain supportive for corporate access to the debt markets, with a patient ECB and a relatively more supportive growth/inflation outlook in Europe vs. the US, despite some near-term drags.

US Credit

The US corporate bond market delivered a mixed bag of results in October, as spreads within the IG segment of the market widened while spreads within the non-IG portion of the market tightened. Triple A rated debt widened by the largest margin within the IG space as spreads moved by 4bps, while single B paper tightened by the largest degree within the non-IG segment of the corporate bond market as spreads compressed by c. 5bps. The diametrically opposite movements can be explained by the market's expectations that the Fed may taper its asset purchases during the final months of 2021 and perhaps hike rates in 2022.

Market expectations were driven by an improving assessment on the US economic recovery, an improving US labour market, with a lower rate of unemployment, and high persistent inflation prints. However, despite these factors, concerns within the market surrounding supply bottlenecks, labour shortages and a cooling housing market were seen weighing on the Fed's growth projections for the remainder of the current year.

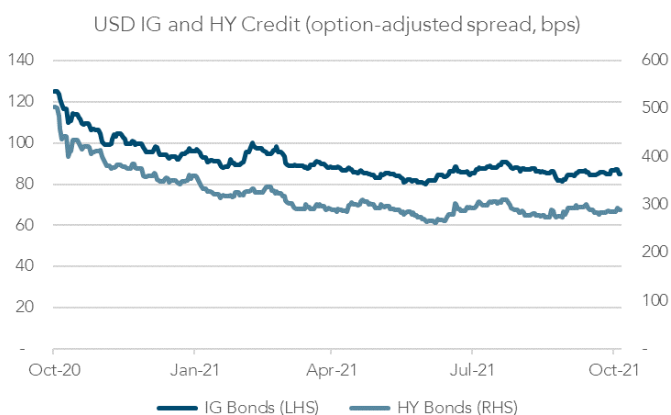
Separately, the US Senate also approved an increase in the Government's debt ceiling by $480 billion until the 3rd of December.

US fixed income returns were mixed in October with IG corporates generating a positive coupon-like return whilst HY and Treasuries declined during the month. IG corporate outperformance in October was primarily a function of the rally in 30-year bonds. As market expectations rose around a potential increase in the Fed funds rate, the yield curve flattened with the short-end rising and long-end declining, as is to be expected when the Fed enters a hiking cycle. October was the first negative return month for the broad US HY market since September 2020 as the market digested issues ranging from early reported earnings, to inflation concerns, to treasury volatility.

The inherent shorter duration of US HY relative to IG was therefore the main contributor to negative returns in light of rising front end rates. Triple-C paper underperformance stood out during the month after being resilient during a fairly muted September as investors appear to have repriced some CCCs marginally wider.

Supply was manageable during the month with many issuers entering quiet periods before earnings. There were no HY defaults during October, representing the fourth consecutive month, and the default rate is now 0.44% as per JP Morgans' default monitor to the end of October. The default rate in the US HY market is at its lowest level since 2007 which, in combination with the low level of distressed bonds, is seen as a bullish sign for an extended period of stable credit spreads.

During the final quarter of 2021, policy is still expected to be a dominant driver of asset performance, but the recovery in the economy to date means that policymakers are eyeing how they will dial back emergency support measures without threatening the economic recovery. We expect global central banks to continue removing excess accommodation as growth and inflation outlook improves over the coming months. While we still expect US inflation to return to the Fed's target by the end of 2022, additional months of above-target inflation raise the risk that inflation expectations accelerate beyond levels consistent with the 2% target – something the Fed will want to avoid. As a result, effectively communicating the outlook for monetary policy over the next few quarters is likely to be challenging for the Fed for this and several other reasons.



Source: Bloomberg

Option adjusted spreads within HY have spent much of the last two months trading between 280-300bps, and is currently at the lower end of that range despite the recent uptick in market volatility, implying that there may be some headroom for spreads to underperform marginally during November relative to euros.

UK Credit

UK corporate credit spreads widened during the month of October with spreads widening by 17bps within the HY segment of the market while widening in IG spreads was more muted at 2bps. The increase in corporate credit yields occurred despite the rise in gilt yields which touched a high of 1.22% during the month. The sell-off in the corporate bond market was fuelled by market expectations of a rate hike being announced by the BOE given the UK economic recovery and the high level of inflation.

At first glance, sterling IG bonds have had a difficult 2021, with a 3.22% total return loss YTD to the end of October. Adjusting for FX provides a different picture, with sterling IG credit denominated in euros delivering 2.60% on a total returns basis following the outsized currency move, which more than offset rate-driven weakness during the year. The majority of the underperformance on a local currency basis vs Euro credit is a function of both the larger move in gilts vs bunds and also the longer duration of UK IG relative to Euro IG as broad asset classes. In spread terms, it is worth noting the YTD compression in OAS differentials between Euro and GBP (much more apparent within the HY space) which has been a driver of excess returns despite rate-driven weakness outweighing the picture.

Similar to the rest of Europe, the combination of rising energy prices as well as persisting bottlenecks in the global supply chain have investors on edge when it comes to the inflation outlook. These concerns were highlighted repeatedly by BOE officials during October, pushing markets to price in close to a 100% probability of a rate rise in the November BoE meeting, which drove the same curve flattening seen elsewhere in Europe and the rest of the world. The MPC subsequently surprised markets by largely sticking to its September messaging, namely that uncertainty regarding labour market developments was still too large, and that a majority of MPC members could wait until enough post-

furlough labour market data were made available.

During October, volatility in rates along with wider spreads across both IG and HY have resulted in mixed returns for UK corporate credit. 2-year gilt yields rose from 0.41% to 0.71% (reversed following BOE meeting), while the 10-year yield was one basis point higher at 1.03%, creating unexpected returns distributions for asset classes positioned at different ends of the curve. Despite the apparent change in tone, the BOE is still widely expected to be among the first major central banks to raise interest rates. IG has managed to eke out 63bp of positive returns, whilst relatively sharper spread decompression within the HY space resulted in negative 79bp on a total returns basis for the asset class.

The key contributor to spread widening has been a resurgence of fears around the potential reimposition of restrictions as COVID infections have picked up, weighing on the UK retailers, which continued to report supply chain disruptions, as evidenced by continued gaps on shop shelves. Signs of a recent recovery in economic momentum and some good news on the outlook for the economy within the Budget were insufficient to lift sentiment into the end of the month. One further growing concern for UK credit, albeit still benign for the time being, is the risk of a form of rerun of Brexit negotiations next year, with the potential for a no-deal Brexit in 2023 as disputes over a post-Brexit Northern Ireland have escalated in recent weeks.

Whilst we feel that a number of overhangs will remain persistent across UK corporate credit markets for some time, we continue to feel that wider spreads on offer in both IG and HY provide reasonable compensation for additional volatility brought about by macro concerns and uncertainty on central bank action which may well escalate into BOE credibility concerns.

Default Rates

According to S&P data to the end of September, the gap between the number of potential downgrades and the number of potential upgrades has declined to 271, that is by nearly 82% over the past 12 months, to its lowest level since February 2019. It peaked at 1,261 in July 2020, when S&P tracked a record number of 1,365 potential downgrades on their coverage list, in contrast to only 104 potential upgrades at the time. There were 18 additions in the potential downgrade count through September, of which five were related to the healthcare sector, primarily driven by mergers and acquisitions, and another three from homebuilders and real estate.

As of the close of September, almost 50% of potential downgrades were from four key sectors: utilities, financial institutions, media and entertainment, and consumer products. Over the same period, the tally of potential upgrades increased by nine, on the back of 35 additions and 26 removals. The media and entertainment sector had six additions, followed by financial institutions with five. From a regional perspective, 60% of these additions were US rated issuers while 23% were European issuers. Potential downgrades had a net decrease of 53, to 561 as of the close of September 2021, from 614 the prior month, as September marked the fourteenth consecutive month with a decline in the number of potential downgrades.

This year so far, downgrade potential among issuers rated 'AAA' to 'B-' by S&P more than halved as economic and credit conditions continue to improve, albeit unevenly by sector and region as highlighted in previous updates. At a global level, 56% of potential downgrades reside within the HY space, with approximately 35% carrying a single-B rating. Despite some sequential improvements, media and entertainment remains the most exposed to potential downgrades amongst HY issuers. By comparison within the IG space, utilities maintain the highest number of potential downgrades, followed closely by financial institutions. As credit conditions continue to improve, most sectors and regions have experienced month-on-month decreases in the number of potential downgrades during the month.

Outside from rated bond markets, the outlook from Fitch highlights that trailing 12-month European leveraged credit default rates appear set to decline rapidly in 4Q2021 and 1Q2022 as legacy pandemic-related defaulted names are unlikely to be replaced by new defaults. Robust operating recoveries, cost-effective capital raisings, and active refinancing in loan and bond markets, even amongst more stressed credits, continues to support a benign credit outlook.

Similar to the upgrade/downgrade momentum exhibited by S&P, Fitch has registered net TTM upgrades for the first time since 2018 across its European leveraged credit coverage. The leveraged loan default rate fell to 3.6% in September (1.8% YTD), down from a February peak of 5.4%, and the expectation is for it to be 2.5% or below by end-2021, down from 3.7% as at end-2020. The TTM HY bond default rate was 1.2% in September (just 0.7% YTD), down from a February 2021 peak of 3.4%. Fitch forecast this measure to be less than 1% at year end, down from 3.3% as at the end of 2020.

Many “amend and extend” restructurings on loan issuers from 2020 and 1H2021 show high leverage and a reliance on speculative operating-recovery narratives that are vulnerable to capital market and economic pullbacks. Fitch forecasts slightly higher bond default rates at YE2022 in comparison to YE2021, towards 1.5%, re-

flecting a few legacy "zombie" credits, rated 'B-' or in the 'CCC' category, notably in the retail, lodging and leisure sectors, as well as the expectation that the volume of outstanding HY bonds will decline following a period of net upgrades of HY issuers to IG status in 2022.

Current fiscal and monetary stimulus should continue to support the operating recovery narratives of most amend-and-extend or partially restructured credits for the time being, however the phasing out of government support schemes, enduring high input prices on goods and labour, or capital markets discounting tapering in monetary and fiscal stimulus policies may compromise operational recoveries and refinancing plans, leading to capitulation among zombies that will need to restructure and repeat defaulters in 2022.

EQUITY

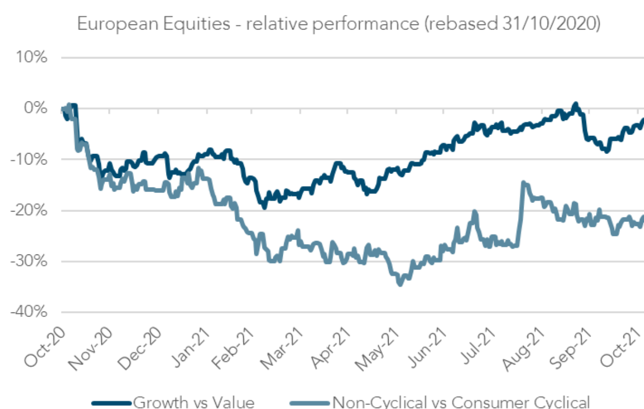
October was a strong month for developed markets equities, recovering from the September wobble. Global equities rallied 6.0% (€ terms) during the month, following the 2.1% drop registered in September. We think the rally in equities during October was partly driven by increased volume following the summer lull. In addition, we believe the positive performance during the month was due to (1) slowing US CPI, which was taken as a possible indication of peaking supply pressures, (2) no further deterioration noted in Evergrande and China's real estate market; and (3) earnings season.

US CPI was unchanged in September, which led to some suggestions that inflation has peaked. Yet, we are of the opinion that it is too early to make that call. Management at various companies have discussed supply chain constraints during the 3Q earnings calls and their expectations on how long this tightness will persist for.

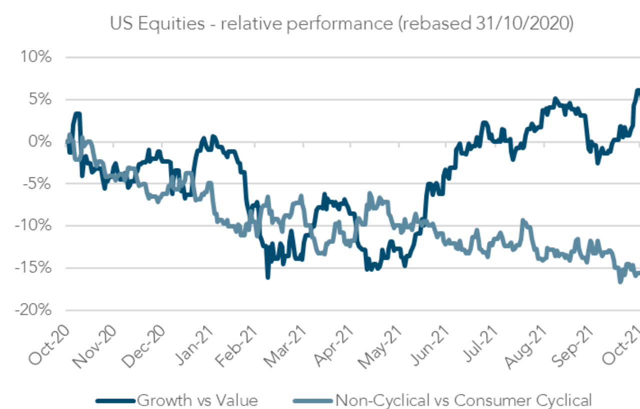
During October, we saw some companies announcing price hikes to offset wage increases and rising supply costs. McDonalds announced a 6% increase in menu prices as their wage costs have increased by roughly 10%, while supply costs for food and paper are anticipated to increase by 4%. Similarly, PepsiCo announced that another price hike is expected early next year, following the raise in the summer. Other companies that have raised prices include Chipotle, Whirlpool and Conagra Brands. Amazon discussed how disruption to the global supply chain and inflation in the cost of materials such as steel and services such as trucking have raised their cost of production. They estimate that labour, labour-related productivity losses and cost inflation added roughly $2 billion (operating costs amounted to €90 billion in 3Q) in operating costs during 3Q. Finally, Volkswagen's management noted that tightness in the semiconductor market will remain for the whole of 2022, while there are signs that batteries, plastics, magnesium and aluminium markets will also tighten next year. All in all, the base case remains that inflation will moderate in the coming months and that aggressive central bank intervention will not be required. That said, we believe that the risk of high inflation persisting for longer is higher today compared to our view before the summer.

The summer months have been tough for China from an economic point of view. Economic data weakened as curtailment measures were re-imposed following an increase in COVID-19 cases and their zero-tolerance policy. This led to concerns over the country's economic growth trajectory with some starting to fear a hard landing scenario. Additionally, the Evergrande debacle put the country's real estate troubles into the spotlight.

Global equities fell during September as investors tried to price-in the impact of an Evergrande default and possible contagion risk. The situation for the world's most indebted property developer remains delicate and uncertain, but there was no apparent deterioration in Oc-



Source: Bloomberg



Source: Bloomberg

tober. Doubts remain on Evergrande's solvency with large principal repayments due in March and April, which will present a much bigger challenge than the interest payments it has grappled with in recent weeks. The less negative news-flow does not imply that the situation has been addressed and we expect more pain in the near future.

In the US, Factset say that from the 56% of companies of the S&P 500 that have reported earnings, 82% have reported a positive EPS surprise with an average beat of +10.3% over estimates, above the 8.4% average beat reported over the past 5 years. The earnings season has also been positive for Europe with half the companies in the SXXP having reported earnings. Earnings for the SXXP have surprised 8% to the upside in 3Q, which continues the trend of above-average but moderating earnings beat (according to Goldman Sachs). Around 50% of companies that have reported beat consensus by at least 5%, whilst slightly more than 12% have missed by the same amount. Goldman Sachs add that the market is not rewarding companies that are surprising to the upside as much as it penalises those that come in below expectations.

Our view is underpinned by the economic growth outlook for 2022 and 2023, which are still above trend for most developed economies. On the inflation front, central banks are still guiding investors that the increase in prices is transitory. Our expectation at the start of the year was that inflation would start to normalise over the summer months, but this has not been the case. However, the re-opening has not been as linear as the market expected at the start of the year. This has led to tightness in several commodities as customer demand remained elevated. Supply chain constraints were an area of focus in 3Q earnings reports as these constraints expected to continue in 2022. On the rising labour costs, particularly in the US, the pandemic relief expired in September, and therefore we see more scope of labour supply to increase in the coming months. This should help stabilise wage inflation. Therefore, we view the risk of inflation persisting for longer as higher today than it was before the summer months.

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Developed Market Sovereign Bonds	Negative	U/W	Improving economic and labour market conditions, along with persistently higher levels of inflation have led to an overall hawkish tilt in global central bank messaging in recent weeks. We continue to favour an underweight allocation to sovereign credit as the risk of rate rises coupled with the withdrawal of monetary stimulus measures places an upward bias on benchmark rates over the medium term and a material headwind for investors on a total returns basis. Any exposure that is maintained should favour shorter duration positioning in order to limit the potential impact from upward parallel shifts in the benchmark curve. The outlook for periphery credits in Europe also remains uncertain at this stage as PEPP, a significant contributing factor to tighter peripheral spreads, is expected to begin gradually unwinding in Q2 2022.
Investment Grade Corporate Bonds	Neutral to Negative	N	We believe that high grade returns will continue to depend largely on movements in benchmark rates, further stimulus and sporadic covid outbreaks remaining under control. The ECB has continued its narrative of sufficiently accommodative monetary policy, which provides comfort, however the tone has shifted to one that is somewhat more hawkish in terms of the potential withdrawal of covid-19 QE stimulus measures in early 2022. The broad Euro market IG corporate credit spread, despite some recent widening, continues to offer minimal cushion against benchmark movements, and the ability to hedge benchmark rates has become a critical factor within IG performance. The default and rating environment for global credit has continued to improve 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, which provides an element of comfort around the overall tighter spreads vs historical. We expect that recent spread widening driven by a resurgence of covid-19 cases to be short lived, though prefer to remain neutral given the upward bias to benchmark rates over the medium term.
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. Wider spreads available in HY continue to provide some additional buffer to movements in benchmark rates, and we prefer holding HY exposure in Euros vs USD where spreads are relatively more attractive and pressure on benchmark rates remains less prominent than alternative currencies.
Developed Markets Equities	Positive	O/W	Our positive view on European stocks has not played out entirely as we expected. Europe has underperformed the US by 9.0% over the first 10 months of 2021, with May the only month where European stocks outperformed their US counterparts. The underperformance during 1Q21 likely reflects the lacklustre start to the vaccine deployment. This led to concerns that curtailment measures would have to be in place for longer, weighing on the region's economic growth. European equities picked up in 2Q21 as COVID-19 concerns started to fade. However, this soon reversed in 3Q21 and in October. In our opinion the underperformance in 3Q21 was driven by rising concerns around global economic growth. The recent surge in COVID-19 cases has amplified such concerns leading to a decrease in investor risk sentiment. We believe that this will be short-lived, unless the situation deteriorates further and national lockdowns are announced in the big-4 European economies. In view of our sector allocation and value tilt, we continue to outperform the benchmark during periods of increased investor optimism around economic growth.
Emerging Market Equities	Neutral	N	Brazil was the biggest drag on EM performance in view of policitical and economic challenges. The sell-off in the EM space seems quite surprising relative to the gradual growth recovery (EPS up +5% over the past three months). We have temporarily squared our overweight allocation in EM equities given the sluggish economic recovery in EM ex-North Asia as a result of the slow vaccine deployment and the poor control of spread of the virus.

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

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