Investment Strategy Update

January 2022

Curmi & Partners Research

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- The US economic data in the first quarter is expected to show the impact of the surge in the Omicron strain towards the end of December as workers are forced to stay home, possibly resulting in supply disruptions, and cautious consumer behaviour.
- The EU ended 2021 on a weak note as December PMI data signalled the softest expansion since March with services output growth slowing amid a resurgence of COVD cases, while manufacturing remained subdued to supply-related disruptions.
- The UK GDP is similarly expected to record a slower rate of growth as Plan B was implemented amid rising Omicron cases, although the fast rate of booster administrations points towards a quick reversal in restrictions.
- We expect the slowdown in economic activity to be short-lived, given fast deployment of booster rates and the decline in cases, and our outlook on economic output in 2022 remains positive.
- Whilst the rate of job growth has slowed down, we view this as a sign of tighter labour conditions as economies move closer to full employment potential while firms continue to report labour shortages.
- Inflation rates soared further in December with the US headline rate reaching 6.8% driven by high energy prices.
- Price developments will remain key this year given the evidence of growing cyclical price pressures and the impact on input costs and profit margins.
- Major central banks have communicated their plans to reverse monetary accommodation in view of the improved economic conditions and the high levels of inflation with the Federal Reserve and the Bank of England initiating a rate hiking cycle.
- Positive growth prospects and rising policy rates underpin our medium-term view of higher rates across benchmark yield curves this year. However, in view of the sharp rise in yields at the start of the year, our view on duration is more balanced in the near term.
- We remain optimistic on high yield credit given the improving credit trends, the supportive economic backdrop and the naturally lower duration in high yield bonds.
- Despite the drag from higher discount rates, we maintain a positive view of equities given the high earnings growth expectations in 2022 which is expected to support valuations.
- We see scope for the relative performance between growth and value stocks to narrow given the supportive economic outlook, high levels of inflation and rising policy rates, but we prefer maintaining a balanced exposure across styles and sectors and focus our stock selection on operational performance.

The sharp rise in benchmark bond yields since the start of the year seems to be a lagged response to the hawkish central bank messaging in mid-December where the Bank of England, the Federal Reserve and the European Central Bank announced their plans on the scaling down of monetary stimulus measures.

As the Omicron threat seems to be abating with advanced economies seeing a rapid rise in booster shot administrations, most countries are laying out exit plans to lift the restrictions imposed in November and December to limit the rise in COVID-19 cases. With that said, economists are looking beyond these few weeks of weaker economic activity leaving growth projections for 2022 fairly unchanged. Developed economies are expected to grow by 3.9% this year according to consensus forecasts, which marks a faster rate of growth in output than historical average growth rates.

The improved clarity on the downside risks to the economic outlook and the plans of major central banks to embark on a rate hiking cycle is leading to a broad-based repositioning in financial markets as investors weigh the optimistic growth outlook against the forces of high inflation and the general tightening in monetary conditions.

In view of the sharp move upwards in benchmark bond yields with US 10-year treasury yields rising by circa 30bps, our view on duration is more balanced in the near term. In order words, we are reluctant to shorten our duration position further in the current environment. We see the strong repricing in yields as increasing the propensity of a correction lower in the weeks ahead on the back of fragile market sentiment as upcoming data releases show the impact of the latest surge in cases and round of restrictions.

Our medium-term outlook on rates, however, is unchanged. We expect yields to move higher across benchmark yield curves as major central banks start hiking policy rates. We expect a fairly parallel move higher in US yield curves, with the possibility of some flattening, as the curve reprices off the higher path of short-term rates while the long-end is lifted by the decompression of real rates which will more than offset any potential tightening in inflation premia.

Benchmark rates in the Euro Area are also expected to see upward pressure on long-end yields given the growth outlook. However we expect a steepening movement in Euro rates given our view that the ECB will continue to anchor down the short-end of the curve by pushing against expectations on policy rate increases in the near future.

Given the expected drag from benchmark yields across bond markets, our primary focus is to limit the impact from negative curve returns through active duration management. At the same time, given the sustained improvement in credit trends, we continue to favour lower-rated securities, mainly high yield corporate bonds as a strong source of positive returns. Our selection leans on names with a strong market standing and a robust cash position whilst seeing scope to increase exposure to cyclical profiles.

Equity markets have historically delivered positive returns during a rate hiking cycle. We believe that it is equally the case this year given the strong underpinning from the expected growth in earnings. A rise in interest rates is generally unfavourable for long-duration equities, such as non-profit-making tech stocks that trade on back-end-loaded valuations which explains the 9% decline in the NASDAQ 100 index since the start of the year. However, the positive economic momentum and accelerating inflation is generally supportive for value stocks.

Our positive view on value stocks is also driven by our expectations that the relative performance between growth and value stocks should narrow. The discount of value stocks to growth stocks is currently around 50%, which is twice lower than the average 25% discount during past rate hiking cycles. Having said that, we prefer holding a diversified portfolio across sectors and styles as we maintain exposure to technology given the growth potential that this sector can offer.

Apart from rising geo-political tensions, we view the key risk to remain COVID-19, particularly the possibility of new variants, which prove to be highly transmissible and more lethal, which can derail the economic recovery.

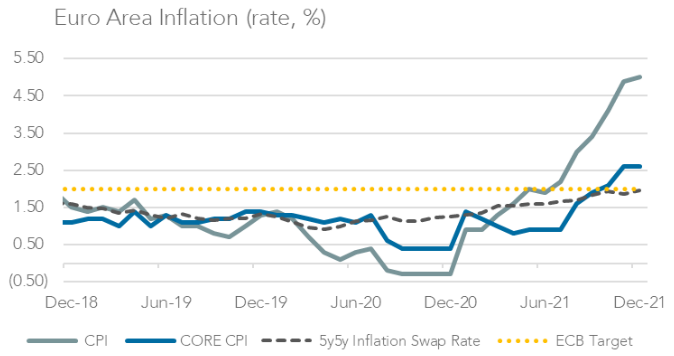
MACRO

Euro Area

The third estimate of the GDP growth rate for 3Q2021 stood at 2.2% quarter-on-quarter, in line with the 2Q2021 figure and unchanged from the second estimate for the third quarter. On a yearly basis, the economy expanded by 3.9%, above preliminary estimates of 3.7%. The Euro Area economy is expected to grow by 5% in 2021, according to the most recent forecasts from the European Commission, although high energy prices, rising inflation, persistent supply constraints and the eventual increase in coronavirus cases continue to threaten the recovery. Moving on to 2022, the ECB revised its forecasts substantially upwards in the December meeting from to 3.2% from the September forecast of 1.7%

The December final Composite PMI stood at 53.3 compared to the prior 55.4 and flash estimate of 53.4. This figure signalled the softest expansion since March, as services output growth slowed to an eight-month low amid a resurgence of COVID cases, while the manufacturing expansion remained subdued due to supply-related disruptions. Demand for goods and services rose at the slowest pace since March and the pace of job creation was the weakest since May, while backlogs of work increased for a tenth successive month. This data point confirms that the Euro Area ended on a weak note, with input and output price pressures remaining intense and a long way above their previous peaks.

The December flash annual inflation rate showed an acceleration to a record high of 5.0%, compared to the prior 4.9% and the market expected 4.7%. On the other hand, the December flash annual core inflation rate remained unchanged at 2.6% from the previous month, coming in slightly hotter than the expected 2.5%. The December's flash annual inflation data marks the 6th straight month where inflation stayed above the ECB's target as supply chain disruptions and high energy costs continue to put upward pressure on prices. Policymakers have been reiterating their view that the current spike is however temporary. The flash core inflation data is expected to be unchanged probably due to the non-energy industrial goods inflation which is expected have increased from 2.4% to 2.9%.



Source: Bloomberg

Headline inflation is expected to fall this year, as the energy component plummets. The energy component of the flash data is estimated to have the highest annual rate of 26.0% compared with the prior 27.5%, this being the highest contributor to the flash inflation estimate. Analysts are forecasting the contribution of energy to headline inflation to fall from 2.5 percentage points in December 2021 to c. 0% in December 2022. With that said, core inflation is still expected to average around 2% as input price inflation remains high and will take time to feed through fully to non-energy industrial goods inflation.

Labour market conditions saw some improvement with the unemployment rate reaching market expectations at 7.2% in November, compared to the prior 7.3% ticking further below the February 2020 level of 7.4%. The number of unemployed persons decreased by 222,000 to 11.8m, as demand for labour strengthened amid the ongoing economic recovery. However, firms are still reporting that labour shortages are constraining productions.

Since November, COVID cases have surged, but employment continued to rise, with the full impact of Omicron unlikely to be captured entirely in December's figures . Analysts are anticipating a pick-up in hiring again in February and March, and therefore, any impact on the pace of hiring should be short-lived.

In its December meeting, the ECB announced it would reduce the pace of its asset purchases under the "Pandemic Emergency Purchase Programme" (or "PEPP") next quarter and halt the programme next March, citing progress on economic recovery and the elevated inflation levels exceeding its medium-term inflation target. Given the shortened timeline, the ECB is not expected to fully utilise the PEPP envelope.

The central bank also said it would ramp up bond buying under the open-ended Asset Purchase Programme (or "APP") from the current €20bn. This is aimed to offset some of the lost stimulus, by increasing purchases to €40bn in Q2, €30bn in Q3 and from October onwards resume the current pace of €20bn-a-month for as long as necessary to support the economy. This means that asset purchases are less front-loaded than what was generally expected. Moreover, these adjustment have resulted in a shortfall of circa €100-150bn of total purchases expected by the market in 2022.

Economists expect the ECB to continue its net asset purchases for two more years, well after other major central banks begin to scale back their monetary stimulus programmes, according to a Financial Times survey published on 3rd January. Economists believe the biggest risk for the eurozone economy is that "supply disruption continues, causing inflation to remain elevated, leading to a complete reassessment of the outlook for ECB policy".

The central bank left its interest rate guidance unchanged, meaning that policy rates will remain at their current levels or lower until it sees inflation at 2% throughout its forecast horizon. The central bank reiterated that it will consider raising rates shortly after the end of purchases but not in 2022.

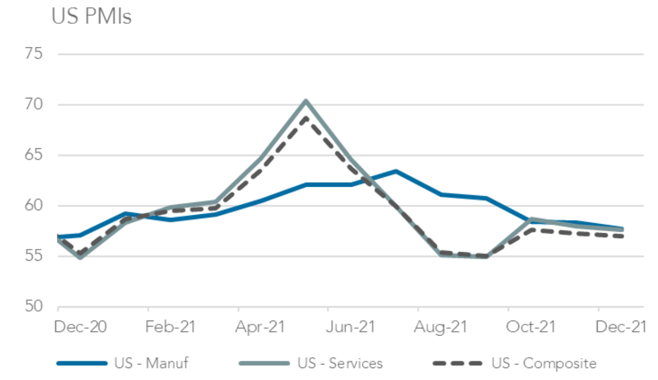
United States

The US economy grew by an annualised rate of 2.3% quarter-on-quarter in 3Q2021, substantially slower than the 6.7% expansion seen in 2Q2021 but above consensus estimates of 2.1%. In Q3, government assistance payments in the form of forgivable loans to businesses, grants to state and local governments, and social benefits to households were all reduced, thus resulting in a weaker fiscal impulse for the period.

A resurgence of COVID-19 cases in December resulted in new restrictions and delays in the reopening of establishments in some parts of the region. The surge in cases from the Omicron variant, even though is less lethal, could deal a significant hit to the economy as workers are forced to stay home, possibly resulting in another bout of supply disruptions. Such effects are more likely to be seen in 1Q2022.

Analysts noted that, with disposable incomes now falling in real terms, as fiscal support fades, surging prices take their toll, and the rapid spread of the Omicron variant will likely exert some drag on high-contact services activity, real consumption looks set for much slower growth over the months ahead.

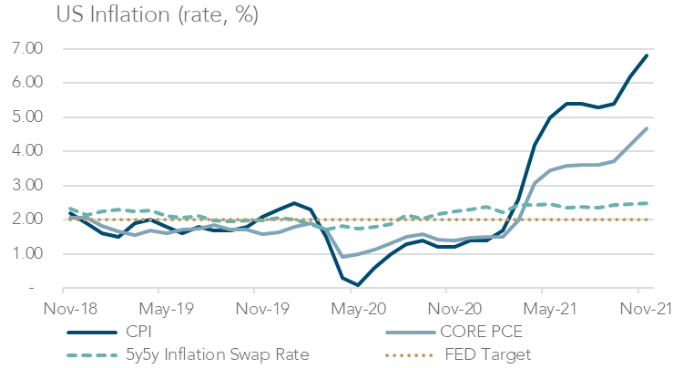
The December final Composite PMI stood at 57.0, down from the 57.2 recorded in the prior month and just above the flash estimate of 56.9. This data signalled a steep increase in both manufacturing and services activity, but it was mainly supported by strong growth in the service sector. New order growth was the quickest for five months, while the pace of job creation slowed marginally amid hiring challenges and difficulties surrounding staff retention. Finally, input cost inflation hit fresh highs, boosted by input shortages, transportation delays and an uptick in labour costs. Efforts to pass-through greater costs to clients were hampered by softer demand conditions, as charges rose at the slowest rate since April.



Source: Bloomberg

The annual inflation rate for November accelerated to 6.8%, up from the previous 6.2% and in line with market expectations. The release marked the 9th consecutive month where inflation stayed above the Fed's 2% target. Energy prices saw the biggest increase year-on-year (November: 33.3%; October: 30.0%), driven by gasoline prices (November: 58.1%; October: 49.6%).

The annual core inflation rate stood at 4.9% compared to the prior 4.6%, meeting market expectations. The core inflation rate is expected to peak at around 5.5% some time in 1Q2022 and then gradually moderate but remain above the 2% Fed target given evidence of increased cyclical pressures in price levels. Fed officials' inflation forecasts are projecting 4.4% at end 2021 and 2.7% at end 2022.



Source: Bloomberg

As the economy continues to recover, the labour market added 199,000 jobs during December. The print came well below market expectations of 400,000 and the prior month's 249,000 increase in jobs. Weakness in job additions was widespread and likely the result of increasing difficulty to find workers. The impact of the Omicron spread on the labour market is still uncertain as the December report only covered the first two weeks of the month, before the worst of the spike which began just before Christmas. Having said that, the shortfall in employment from pre-pandemic levels has narrowed to 3.6m.

The unemployment rate dropped to 3.9%, the lowest since February 2020, compared to the prior 4.2% and the market expected 4.1%. This came about as the number of unemployed persons decreased by 483,000 to 6.3m. The job reports shows a sustained rebound in the job market, helped by a fast-recovering economy and strong demand for labour. Unemployment is expected to decline even further in the coming months as companies fill widespread vacancies.

During the December Federal Open Market Committee ("FOMC") meeting, Powell argued that the economy had made rapid progress towards the labour market goal, that is, for the labour market to be "back at maximum employment", and that all officials agreed that the goal would be met at some point in 2022. The Fed's updated economic projections showed that the unemployment rate is now expected to fall to 3.5% by end-2022, rather than by end-2023. The current unemployment rate is only slightly above the 3.5% low reached before the pandemic, and the projected level at year-end.

The Fed kept their interest rates unchanged while increasing the pace of reduction in bond purchases from \$15bn to \$30bn (\$20bn per month for Treasury securities and \$10bn per month for MBS), beginning mid-January 2022. The Fed also announced that it will end its pandemic-era bond purchases in March, paving the way for rate hikes soon after.

In the FOMC minutes of the December meeting, some policymakers noted it could be appropriate to start reducing the size of the balance sheet soon after the first rate hikes, suggesting this could occur later in 2022. Analysts are now mentioning Q4 2022 for the start of the balance sheet run off.

During the meeting, the Fed also dropped the characterisation of inflation as "transitory", with the statement simply noting that supply problems and reopening "continued to contribute" to elevated inflation. This suggests that given the recent and ongoing economic developments, primarily the improving labour market conditions, FOMC members are judging the objectives of the average inflation target to have been met. The statement also dropped most of the language around the flexible average inflation target, with inflation now described as having exceeded 2% "for some time".

According to the dot plot published following the December meeting, policymakers are expecting three rate hikes by the end of 2022, putting the Federal Fund Rate at 0.9%, a further three rate hikes in 2023 and two more in 2024. However, in the FOMC meeting minutes for the December meeting, policymakers noted that given the outlook for the economy, the labour market and inflation, it may become warranted to increase the FFR sooner or at a faster pace than previously anticipated to tame soaring price levels. Analysts are now mentioning the possibility of four hikes in 2022.

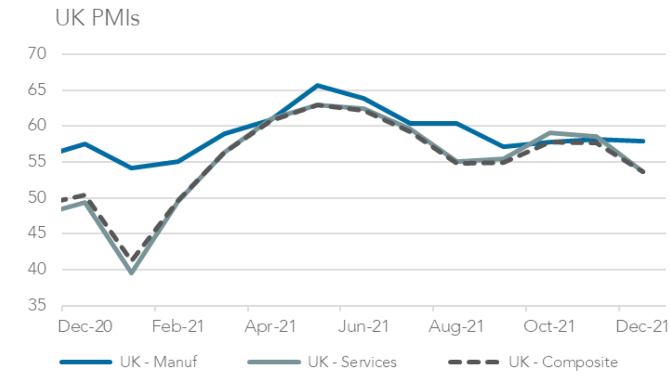
Powell balanced the hawkish message by highlighting that the "Omicron variant poses risks to the outlook", and that the Fed will refrain from rate hikes until the tapering is completed. Analysts expect that the renewed weakness in the economy from the Omicron surge will convince officials to delay the rate hike date to June.

United Kingdom

The UK economy grew by 0.1% month-on-month during October compared to the prior 0.6% growth and the market expected 0.4% growth, marking the lowest performance in three months. Services output grew by 0.4% with the most significant contribution coming from human health activities mainly because of a continued rise in face-to-face appointments at GP surgeries, while output in consumer-facing services grew by 0.3%. However, production output decrease 0.6% and construction contracted 1.8%. This left UK GDP at 0.5% below February 2020 levels. The final GDP growth rate for Q3 stood at 1.1% quarter-on-quarter compared to the preliminary estimate of 1.3% and the Q2 growth of 5.4%.

The Plan B COVID restrictions introduced in December and the continued surge in Omicron cases will likely have an impact on GDP for Q4 and the start of 2022. Economists are seeing a real risk of the economy contracting in December and January, as consumers sought retail shops for Christmas gifts in November amid concerns over shortages and better sales offers during the Black Friday period. The Bank of England ("BOE") revised their expectations for Q42021 GDP by c. 0.5% to 0.6%, leaving GDP around 1.5% below its pre-COVID level.

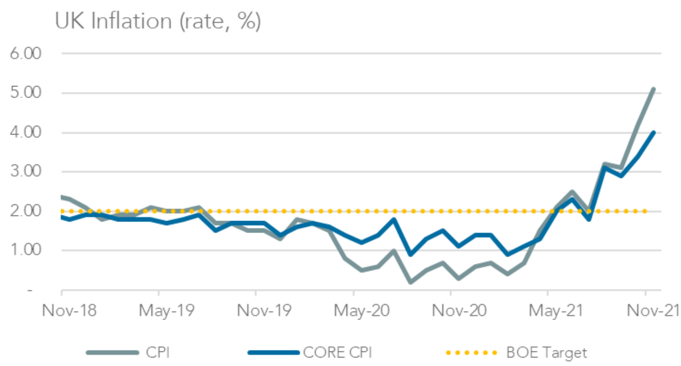
The December final Composite PMI declined to 53.6 from the prior 57.6, while the flash estimate showed 53.2. This pointed to the slowest pace of expansion since the phase of growth that began in March, as weaker momentum in the services sector more than offset a quicker recovery among manufacturing companies. For the first time since May, service sector growth failed to outpace that seen in the manufacturing sector as Omicron led to a steep fall in spending on face-to-face consumer services, escalating business uncertainty and disruptions due to staff absences. New orders fell for a fourth straight month amid a steep decrease at consumer goods producers who were weighed by logistic issues, Brexit difficulties and the possibility of further COVID restrictions. Finally, companies indicated another steep increase in their average cost burdens in December.



Source: Bloomberg

Nevertheless, companies remained optimistic amid expectations of continued global economic growth, hopes for less disruption caused by COVID, fewer Brexit tensions and normalising supply chain frictions.

The annual inflation rate for November rose to 5.1% from the prior 4.2%, coming in sharply above market expectations of 4.7%. This was the highest rate since September 2011 driven by rising energy prices, supply chain disruptions and low base effects from last year. Main upward pressure came from costs for transport, principally from motor fuels and second-hand cars, and housing and household services. The core inflation rate for November stood at 4.0% compared to the prior 3.4% and the market expected 3.7%. The BOE expect inflation to remain at c. 5% through the majority of Winter, and to peak at c. 6% in April 2022, before falling back in the second half of 2022. Economists' expectations on inflation are aligned with the BOE, however, they still think it will start to fall sharply from June 2022 to c. 2.5% by end of year.



Source: Bloomberg

The unemployment rate declined to 4.2% in the three months to October 2021 from the prior 4.3%, marking the lowest rate since June 2020. The number of employed people increased by 149,000 to 32.5m in the three months to October 2021, below market expectations of 228,000. The average weekly earnings including bonuses increased 4.9% year-on-year in the three months to October 2021, the smallest gain in seven months (September: 5.9%) but above market forecasts of 4.6%. The surge in Omicron cases and any further tightening in restrictions may reduce the demand for labour in December and January, but this may also reduce the supply of labour. The BOE expect unemployment to fall to c. 4% in 4Q2021, down from the 4.5% projection in November.

The BOE voted to increase the Bank Rate by 15bps to 0.25% from 0.10% during its December meeting for the first time since the onset of the pandemic, as inflationary pressures mounted in Britain. The hike surprised markets that expected no changes given the new Omicron threat. The BOE added that there were likely to be more interest rate rises to come although these would not be rapid. The Monetary Policy Committee ("MPC") continues to judge that there are two-sided risks around the inflation outlook in the medium term, but that some modest tightening of monetary policy over the forecast period is likely to be necessary to meet the 2% inflation target sustainably. The MPC voted unanimously to end its quantitative QE programme as planned, having created £895bn to purchase mostly UK government bonds.

RATES

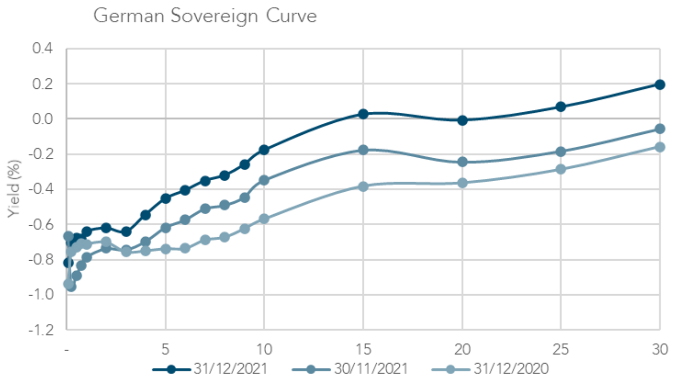
Euro Rates

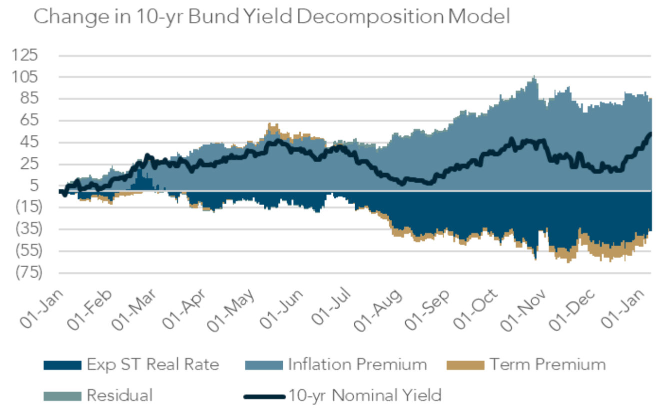
Optimistic market sentiment during the month of December resulted in a general climb in global benchmark bond yields showing some respite from the Omicron fears that gripped markets towards the end of November. The German 10-year bund yield rose by 17bps to -0.18% in December outpacing the rise in Treasury yields of 7bps. However, there was comparatively greater scope for a rebound in bund yields given the deeper decline in 10-year yields in the previous month which saw the 10-year bund yield decline by 24bps and US 10-year declined by just 10bps. The comparatively larger swing in European yields was mainly due to the surge in COVID cases towards the end of November which saw various member states reimposing restrictions to curb infections.

The move higher in the benchmark curve in the Euro Area was driven by both the widening of breakeven inflation rates given the strong inflation print released in December, as well as an uptick in real rates on the back of hawkish messaging by the central bank and the positive developments on the virus front. The move higher led to some modest steepening of the curve. We find this movement to be well-placed given the ECB's announcement on QE purchases falling short of the high expectations. Additionally, research reports that found the Omicron variant to be less-severe than previous variants has led to support in the growth outlook of the Euro Area.

When considering the recent sell-off in bonds, the risks are more balanced around duration for the near term. Having said that, we are entering a period of reduced central bank purchases, high expected issuance by most sovereign members and strengthening inflationary pressures which should all lead to higher nominal rates over the medium term.

In this case, we expect a move higher in Euro rates to





Source: Bloomberg

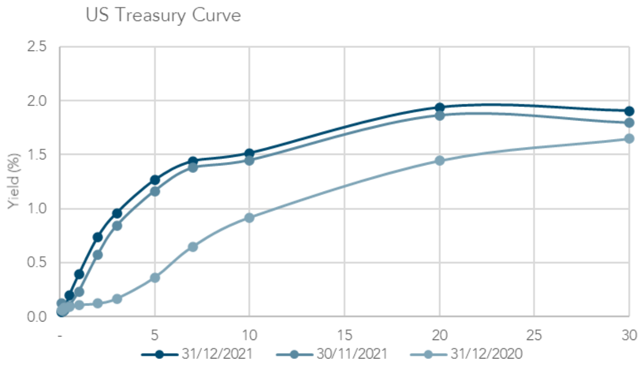
see the curve steepen further given that front-end pricing is expected to see little uplift due to the unlikelihood that the ECB will be bringing forward any rate hike expectations for the time being.

The recompression in sovereign spreads when core rates sold off in December is consistent with the positive news on the COVID/Omicron front, offsetting the scope for widening on the back of the hawkish message of the ECB. Having said that, we similarly expect that lower support from QE purchases and rising issuance should provide unfavourable conditions leading to further widening in sovereign spreads.

Looking at Italian government bonds ("BTPs") specifically, the end-January elections presents some political risk to the BTP-bund spreads, primarily on whether Prime Minister Mario Draghi will be retaining his post or if he will be elected as president. The latter case is one that brings higher loss of continuity and delays in the intended deployment of recovery funds which should put further pressure on spreads.

US Rates

December saw a remarkably dovish reaction to the hawkish outcome of the FOMC meeting of 15th December. The 10-year treasury yields dipped to 1.36%, possibly being weighed down by the Omicron negative prospects, which weighed on yields in the previous few weeks. Within the context of the new Omicron variant and the rise in cases across the world, the outcome of the December FOMC meeting was considered to be on balance hawkish, even though the main changes in policy were broadly in line with expectations.



Source: Bloomberg

US treasuries have really started selling off right around the turn of the year, both on fading variant risks (as new reports limiting the downside risks of the new variant emerged) and what seemed to be a delayed response to the hawkish shift by the Fed in December. This delayed response suggests an earlier underappreciation of the hawkish pivot as a result of (a) initial Omicron uncertainty and (b) low liquidity going into year-end discouraging new shorts.

Current market pricing further out the curve still implies relatively low terminal rates for the impending rate hiking cycle, with the OIS curve showing 1.5-1.7% levels as a terminal rate. This is inconsistent with both the Fed's dot plot as well as what the economic conditions would generally warrant under the current conditions of high inflation and high employment.

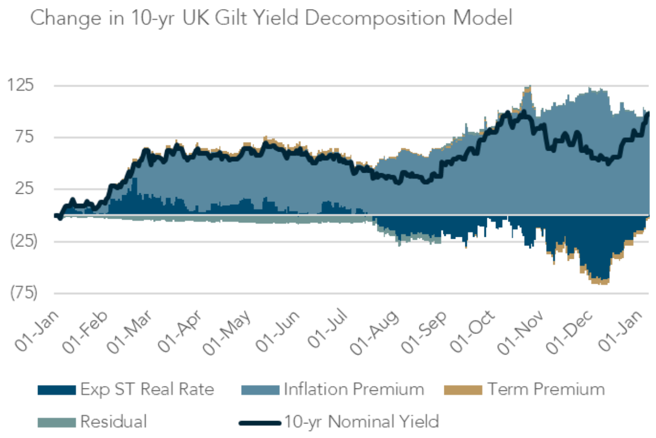
The reluctance to price higher terminal policy rates for this cycle can be explained either by (1) the expectation that this normalisation cycle will be short and that equilibrium can be reach with a modest tightening in monetary policy; or (2) (more likely) a supply/demand imbalance at longer maturities. This mismatch is likely explained by the limited supply or availability, net of central bank purchases relative to demand by investors driven by excess savings, portfolio rebalancing and immunisation flows. This imbalance should clear overtime as policy rates move higher, yield pick-up on an FX-hedged basis is eaten away and the reduction in purchases by central banks. However, this imbalance should remain relatively persistent for the time being which should limit the risk of a material revaluation higher of long-end rates (unless we see an unlikely swift move by global central banks to run down their balances or halt asset purchases much faster than current expectations).

The current economic backdrop features a fast recovering labour market probably reaching peak levels soon, elevated levels of inflation, efforts by congress to launch additional stimulus and the Fed which now seems to have grown anxious to tighten. As a result it is reasonable to expect a repricing higher in front-end rates on the back of (a) risks of a faster hiking cycle; and (b) repricing of implied terminal rate.

Just as we have seen the 2s5s steepen in 2021 given the building up of rate hike expectations, we should see the flattening of this part of the curve in 2022 as the Fed starts hiking rates. We expect to see a fairly parallel shift along the rest of the curve during 2022 with limited risk of very sharp increases in long-end rates, or the 10-year moving substantially higher above the 2% area (unless we see a faster reassessment of the implied terminal rate).

UK Rates

Similar to the movement in Euro rates, the UK 10-year sovereign yield rose by 16bps in December following the 22bp decline in the previous month. The rebound is similarly supported by the positive research reports on the Omicron variant, but in this case, it was primarily driven by the surprise rate increase by the BoE. In fact the move was mainly real rates-driven.



Source: Bloomberg

Despite the renewed virus fears with the emergence of the Omicron variant, the BoE judged a rate increase to be the right course of action given the high levels of inflation whilst citing the strong improvement in labour market conditions.

Current market pricing shows four rate hikes priced in GBP curves with the next increase coming potentially as early as February. This in turn brings in the expected run-off of the BoE's balance sheet through the redemption of QE purchases since the policy would be reaching 0.50%.

Given the backdrop of a more hawkish central bank implying a steeper hiking path, the expectations of an eventual recovery from COVID (here the UK has been remarkably fast with the deployment of the booster shots) as well as the higher net supply expected, we prefer maintaining a short duration in UK rates given the risks tilted towards higher rates across the curve.

With that said, following another 20bps move higher in gilt yields in the first few days of January, the risks around duration are more balanced in the near term where a temporary episode of weak sentiment on worsening COVID numbers can lead to short-term pull-back in gilt yields.

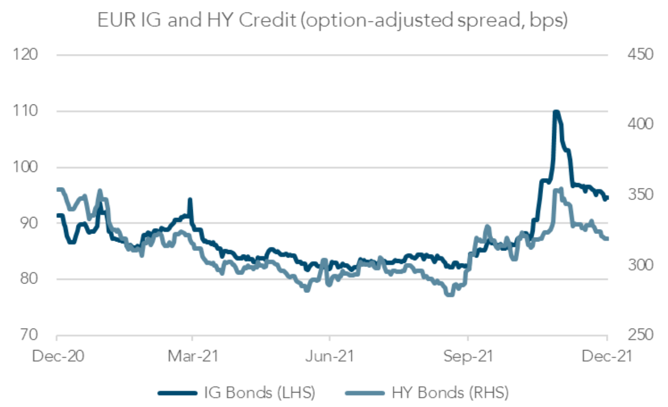
CREDIT

Euro Credit

European corporate credit spreads tightened during December, with investment grade ("IG") spreads tightening by c. 13bps to end the year at a spread of +95bps vs the bund, while non-IG spreads tightened by c. 37bps, ending the year at a +318bps premium to the German 10-year.

Spreads within corporates tightened early on in the month following positive headlines around vaccine efficacy and the Omicron variant despite rapidly rising cases. The other key factor at play during the month driving total returns was the ECB's meeting half-way through the month. During the meeting, policymakers studiously chose not to copy Fed or Bank of England hawkishness saying 2022 rate-hikes are not in sight. Whilst the messaging was supportive for investors, there were also some hawkish undertones to the delivery with a substantial upward revision to the 2022 inflation forecast, which contributed to the 17bp widening in bund yields that followed the meeting into the end of the year.

One of the core themes for 2022 is that the thin level of risk premia in credit markets will likely constrain returns on a forward basis. With spreads still hovering around their 2021 tights, a key question for investors is whether the recent repricing higher in sovereign yields has improved the value proposition of the asset class.



Source: Bloomberg

Looking at high yield ("HY") markets across currencies, all-in yields are quasi-flat relative to their levels at the start of 2021, as the material back-up in rates has been offset by continued strong compression in spreads. In relative terms however, we continue to see stronger policy support for EUR credit markets, and this policy gap is wide enough, in our view, to justify an overweight allocation on EUR spreads relative to their USD and GBP peers. More specifically, we continue to view a rate hike from the ECB in 2022 as highly unlikely, whilst the end of the PEPP and boost to APP will likely have a more manageable impact on corporate bond markets.

Since the beginning of the pandemic, PEPP has accounted for only 11% of the ECB net purchases of corporate bonds, while CSPP has accounted for the rest. Under a conservative scenario where the additional €90bn envelope in the APP is entirely deployed in sovereign bond markets, and assuming the CSPP flow of purchases remains within its 2021 range, the ECB will likely still be adding roughly €50 billion worth of gross corporate bonds to its balance sheet.

Given forecasts that EUR IG net supply will reach roughly €100-€110bn this year, this essentially implies that the ECB will likely absorb c. 50% of the IG market's net supply, lower than 2021 but higher than 2020

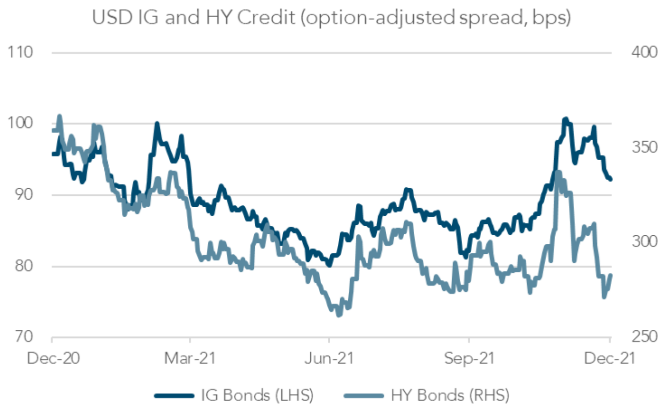
Within the EUR market, we continue to remain constructive on EUR high carry securities such as HY bonds and more complex AT1/hybrids where permitting, which we expect will likely outperform IG bonds on a risk-adjusted basis. Within IG, following the relative movements of duration buckets during December we see a more balanced picture to preferred duration positioning. The implication here is that duration preference at this stage should be driven more by a preference to limit the impact of a gradual spread widening given still tight breakeven rates, rather than the possibility for relative outperformance of maturity buckets.

Whilst forecasts for the year are steadily shifting towards gradually wider spreads, these moves need to be taken within the context of breakeven rates offered by the asset classes, with HY better equipped to withstand a steady drift wider than IG whilst simultaneously generating comfortably positive excess returns.

US Credit

Similar to their European counterparts, spreads within the US corporate bond market also tightened during the month of December. In fact, IG spreads tightened by c. 7bps to end the year at a premium of +92bps against the US treasury, while spreads within the non-IG debt segment of the US corporate bond market tightened by c. 54bps and closed the year at a spread of +283bps to the US 10-year.

Early spread tightening in US corporate credit markets came following the announcement that the US FDA advisory panel had approved Merck's COVID-19 treatment pill. This, however, was essentially offset by wider treasuries following the hawkish shift at the December FOMC meeting, with the market pricing in the likelihood of a withdrawal of monetary support and multiple rate hikes in 2022 in view of rising inflation and a US labour market which had largely recovered from the lows seen during the pandemic. The US treasury closed the year at a yield of 1.51%, up +6.5bp from the close at the end of November.



Source: Bloomberg

Despite weaker fiscal support in the US, we think the growth backdrop is still good enough to keep default risk in check and allow for more positive momentum in rating migrations. That said, the news flow on the monetary side has reinforced the view that the forward path for returns will likely be challenging for USD credit and we continue to prefer EUR paper over USD, both across IG and HY markets.

Forecasts are for the Fed to hike four times this year, and start the runoff of the balance sheet in July. Directionally, the message remains the same, that is a rebuild of risk premium that aligns spreads with the reality of a maturing cycle.

Whilst treasuries have repriced higher over the past two weeks, pushing USD IG corporate real yields back into positive territory (albeit barely), the lack of "carry support" in high quality spread products remains pronounced. Considering low default risk, positive rating migration trends, and improving post-default recovery rates in the US, we continue to prefer moving down in credit quality on a relative value view and continue to recommend being overweight HY versus IG, and BBs over BBBs. Within the IG market, we also reiterate our overweight recommendation on BBB-rated bonds over their higher-rated peers. One notable exception to this preference for high carry instruments remains our less constructive view on CCC-rated bonds, which is largely the result of the thin excess premium relative to the upper end of the HY rating spectrum.

The Omicron variant has had a fairly muted impact on reopening sensitive and cyclical sector spreads over the past several weeks, particularly in the USD HY market, reflecting investors' willingness to look through a short-lived hit to growth. Coupled with still above-trend (albeit decelerating) growth, we remain comfortable with our preference for reopening sensitive sectors at this stage of the recovery. This includes sectors such as Energy, as well as industries exposed to travel and leisure, such as Airlines and Transportation Services.

In both the USD and EUR HY markets, returns were much more dispersed in November and December relative to the first ten months of the year. The combined effect of dwindling policy support, high macro volatility and tighter absolute spreads will likely fuel more dispersion at the single name level. While the Omicron news was the initial driver of this uptick in dispersion, we think the Fed's more hawkish reaction function and the realization that the cycle continues to rapidly mature will be the driver going forward, highlighting the heightened importance of issuer selection going forward.

In primary, January may deliver $130bn in IG new issuance as companies scramble to lock in rates before monetary policy tightens amid still-elevated inflation. Despite record COVID-19 cases in the US, a risk-on tone remains in keeping with federal and state-level reticence to reimpose the lockdowns. In HY, new debt offerings are unlikely to keep up with the year-ago pace in January and for the full year, though Q1 may nonetheless be above the long-term average amid still accommodative conditions and historically low funding costs.

UK Credit

UK corporate credit spreads followed the same pattern seen in the European and American markets, however, to a lesser degree. IG spreads tightened by c. 4bps to close the year at a premium to the gilt of roughly

+114bps, while non-IG corporate spreads tightened by 32bps during the month, ending the year at a spread of +376bps to the UK 10-year.

While the spread tightening within the IG space of the UK corporate bond market can be explained by the movement in gilt yields which rose by c. 14bps to end the year at a yield of 0.97%, the movement in the non-IG market can be explained by both the movement in the Gilt yield and the BoE's monetary policy action during the month of December as the BoE raised rates by 15bps with Governor Bailey stating that the rise in rates was driven by the persistently higher inflation despite the rise in cases due to the Omicron variant.

On a relative OAS basis versus historical over the course of 2021, both sterling IG and HY currently trade tight compared to the larger and more liquid USD and EUR markets. The UK is likely to diverge further from Europe next year considering the BoE is already hiking rates and may end QE reinvestment early, whilst the ECB will still be net-buying European sovereign debt and IG corporate paper for the foreseeable future. Simultaneously, whilst acknowledging that France and Italy face important elections this year which may create some volatility within EUR Markets, the Northern Ireland Protocol and renewed noise around a fresh Scottish Independence referendum remain overhangs for GBP paper.

The BoE's surprise December hike to 0.25% leaves its February meeting as very much "live", with the risk that the bank rate could hit 0.5% at that gathering. That would mean £37bn of gilt QE reinvestment due in 2022 - with 75% of that coming due in March — would not go ahead and implies that scope remains for gilts to drift slightly wider if private investors are tasked with plugging any funding gap. Thereafter the market expects the bank rate to hit 1% by the September meeting. At that point, the BoE has said it will move from not rolling but actively selling gilts held in its QE program.

Given the stark contrast in policy support and the gradual erosion of the relative pickup offered in sterling credit markets, we prefer holding EUR spreads versus GBP, given the choice. Admittedly, the lower beta nature of sterling credit may insulate it from some weakness and volatility (note that the majority of spread compression was driven by the combination of gilt weakness and relatively stable corporate yields), and we expect the asset class to continue to generate positive excess returns during 2022.

Within sterling markets, there is limited value in moving further out the curve. Aside from short-lived periods of curve inversion (at the onset of the pandemic), sterling IG curves below the 10y point have rarely been flatter than they are currently. The main benefit of moving up in duration would potentially be in exposure to benchmark rates, as longer dated yields appear to have been more stable than shorter-dated ones given the volatility of the BoE's communications during Q4. With that said, even within gilt curves, 2s10s currently trade at close to the 2021 lows, whilst the directionality of policy decisions leaves us with little comfort in adding significant interest rate risk in this asset class.

Defaults and Ratings Backdrop

The 2021 corporate default tally of 72 is the lowest since 2014, down nearly 70% from the previous year's total of 226 and significantly below pre-pandemic 2019 levels. The pace of defaults in 2021 slowed with each quarter, dropping to only 12 defaults during Q4 (incidentally also the lowest quarterly tally since 2014), from 26 defaults during Q1.

Distressed exchanges accounted for the largest portion of corporate defaults in 2021 at 51%, while the highest number of defaults were concentrated within the homebuilders and real estate sector at 10. S&P's estimate that the December 2021 trailing 12-month speculative-grade default rates for the US and Europe will be 1.8% and 1.7%, respectively. Post-default recovery rates for debt rated by S&P Global Ratings in the US have improved since the start of 2021, though not by enough to offset the substantial declines in 2020.

Annual recovery rates had already been following a downward trend in the years leading up to 2020, amid rising first-lien leverage, slimmer debt cushions, and weakening covenant protections. Recovery rates remained soft in 2020 as the default rate spiked and as the onset of the COVID-19 pandemic, coupled with volatile oil prices, contributed to the most challenging financing conditions for leveraged finance in a decade.

From the beginning of 2020 through September 2021, recoveries for term loans and revolvers emerging from default fell to an average of 68.1% (from 73.7% among pre-2020 emergences), and bond and note recoveries fell to 31.7% (from 39.5%). In 2021 through the third quarter, recoveries of defaulted term loans and revolving credit facilities averaged 80.4%, exceeding the 73.4% long-term average. Bond recoveries have risen to 40.3% (from 28%) in 2021, modestly surpassing the 39.2% long-term average.

Bond recoveries had fallen sharply in 2020 — brought lower by post-bankruptcy recoveries (particularly from issuers in the oil and gas sector). By contrast, companies emerging from default in 2021 have experienced much more favourable business and economic conditions.

The lower average bond recoveries have largely resulted from lower post-bankruptcy recoveries. Bonds tend to show lower recoveries following a bankruptcy than following a distressed exchange or other non-bankruptcy restructuring, and the gap between bond recoveries following bankruptcy and non-bankruptcy restructurings widened in recent years. However, even though the recovery may be higher following a distressed exchange, the chance of a repeat default may also be higher than following a bankruptcy if the restructuring does not sufficiently address the problems of the firm.

Bonds and notes that emerged following a bankruptcy default averaged a recovery of 25.9% in 2020-2021 (down nearly 10ppts from prior years), while bond recoveries following a distressed exchange averaged 57.6% (up 2ppts from prior years).

Post-bankruptcy bond recoveries in 2020 and 2021 were weighed down largely by defaults from the oil and gas sector. Bonds from the oil and gas sector recovered 23% on average in 2020-2021 — nearly 17ppts lower than the average and down from the recoveries from 2018-2019. Most of these bonds were from issuers that filed for bankruptcy in the second quarter of 2020, during the height of uncertainty around the COVID-19 pandemic, when issuers faced the most pronounced combination of falling oil prices, challenging financing conditions, and falling demand.

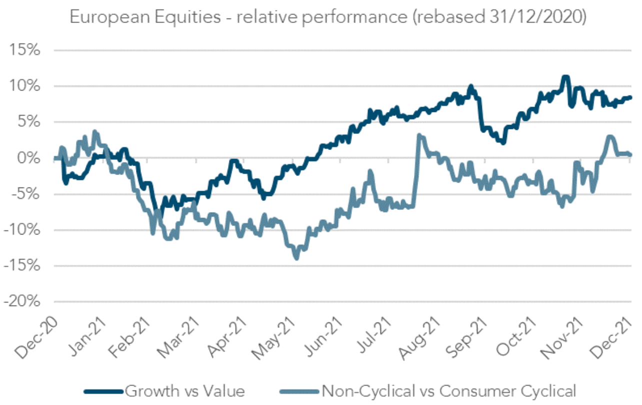
EQUITY

Investors were not disappointed in 2021 as developed market equities rallied. The feel good factor that dominated sentiment following the Pfizer announcement in November 2020 continued for most of 2021, with global equities (MSCI World Index) generating a total return +17.3% in $ terms (+31.4% in € terms). The total return generated in 2021 was slightly ahead of the +16.5% (+7.0% in € terms) generated in 2020. The positive return generated in 2020 despite the COVID-19 shock is explained by the high exposure to US stocks (c. 70% of the index is made up of US stocks) found in the MSCI World Index.

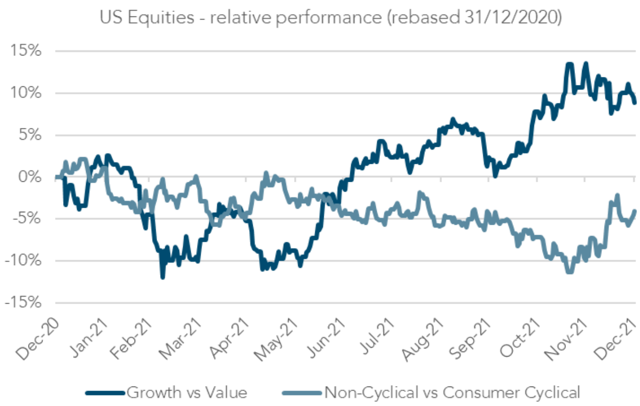
At the start of 2021 the expectation was for a year of strong synchronized economic growth coupled with loose fiscal and monetary policy and rising inflation. This provided the perfect backdrop for Europe, due to its higher tilt to value stocks as opposed to growth. Despite this, US stocks (S&P 500) generated a total return of +38.2% in € terms (+28.7% in $ terms) compared +24.9% for their European counterparts (STOXX 600). The UK outperformed the EU slightly in € terms with a total return of +26.0% (+18.4% in £ terms), which is attributable to the strength in the sterling as currency traders priced-in a rate hike in the UK (this was also visible in the US but to a lesser extent).

The virus developments along the year were much less straightforward than initially expected. The base case expectation going into 2021 was that the vaccine would be the start of the end for the virus. The threat of a new variant was well known but the likelihood of this materialising could not be specified. The vaccine rollout programme started strongly in the UK and US, with Europe lagging behind. As summer approached, reports started to emerge that the vaccine protection against infection was starting to wane. This was first observed in Israel, then in the UK and Europe. Until then, the returns on local currency terms for the US and Europe were largely equal (1Q2021: +6.2% for the US vs +8.2% for the EU; 2Q2021: +8.5% vs +6.4%; 3Q2021: +0.6% vs +0.8%).

Growth and inflation concerns were the main drivers of performance during 4Q2021. European equities underperformed during October and November as concerns over growth and inflation weighed on sentiment. In October, the news-flow was mainly on vaccine efficacy as well as concerns that the growth in vaccination rates had stalled in many major developed economies and remained too low in emerging economies. This led to a preference for stocks that were less correlated to the



Source: Bloomberg



Source: Bloomberg

prospects of the global economy (as highlighted by the Nasdaq outperforming the other developed market indices we follow). This was followed by the discovery of the Omicron variant in November, which again weighed on the economic growth outlook. For the second consecutive month (first time this happened in 2021), the Nasdaq (growth) was the best performer as investors again preferred to buy into stocks that are less impacted by the macro outlook. In December, focus shifted to inflation and interest rate trajectory in the US, resulting in the outperformance of Europe (+5.4% vs +4.5% for the S&P 500) with the Nasdaq (+0.7%) the worst performer.

Omicron news flow has been positive on balance. Despite record daily cases being recorded across the globe, the news flow around the Omicron variant has been positive, on balance. The conclusion so far is that this variant is highly transmissible but less lethal when compared to the Delta variant. In theory, the fast spread of a less lethal virus could signal the start of a less worrying phase of the pandemic. An immunologist at the University of California, San Francisco said that even though the virus will most likely remain with us, the hope is that this variant causes so much immunity that it will quell the pandemic. Whilst this is naturally good news, we caution that a lot of the good news has been priced-in by investors at an index level. The re-opening trade has lagged in the recovery, but a number of other sectors have rallied strongly for most of the year.

In our opinion, 2022 will be another good year for equities with returns in the 10%-15% range across most geographies we follow. The key known unknown risk remains COVID-19, mainly how the situation will develop over the upcoming months. A new variant that is highly transmissible and more lethal could derail the recovery, which would lead to negative revisions. On the other hand, equities could perform better if Omicron leads to a faster route towards normalisation. In addition we believe that inflation and Fed action will also have a significant impact on performance. The price moves seen early in 2022 as a result of higher inflation expectations have been quite large within growth sector, with the Nasdaq down 5.8% in the first six trading days of the year. The risk now is whether inflation will disappoint going forward.

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, will terminate in March 2022.
Investment Grade Corporate Bonds	Neutral to Negative	O/W	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 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 continued to rally through 2021. 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 for most of 2021. 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 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. We have moderated our value tilt given the increased uncertainty on the economic outlook which weighing on cyclicals and value stocks.
Emerging Market Equities	Positive	N	A year that had promised so much ended in disappointment as challenges in China and rising political risk in LATAM weighed on sentiment. EM Equities significant underperformance relative to developed market equities in a year which was characterized by strong synchronized economic growth and loose monetary and fiscal policy. 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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