Investment Strategy Update

March 2022

Curmi & Partners Research

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- Global equity and bond markets came under pressure since the start of the year given the upside surprises in inflation data releases and increasing expectations of faster rate hikes by key central banks.
- Before the Russian invasion in Ukraine on 24th February, European and US bond markets were down between 3.5% and 6.5%, with European bond markets outperforming, while European equities declined by 6.9% and US equities by 11.3%.
- Post-Invasion, risk sentiment deteriorated further resulting in equity markets marking a year-to-date drawdown of 14.7% in Europe and 12.5% in the US.
- Equity markets seem to have found support on 8th March recovering to –6.4% since the start of the year in both Europe and the US (as at 18th March 2022).
- Commodities have rallied substantially with crude oil prices surging by 39.2% and agricultural and livestock prices increasing by 18.4% (as at 18th March 2022) given the increased concerns on global supply chains and the actions taken to limit Russian exports.
- The war in Ukraine and the sanctions imposed on Russia is expected to impact the global economy primarily through lower commodity supply from the region as more nations and private entities are actively seeking to reduce imports of Russian goods.
- Inflation expectations continue to soar following the development in Ukraine given the higher energy and food prices.
- Economic growth forecasts are being revised downwards, most notably in Europe, as a result of the slowdown in activity expected in the first half of the year.
- Unemployment rates continue to decline in advanced regions showing greater progress in absorbing economic slack brought about by the pandemic.
- With the assumption that the Ukraine conflict will remain localised, we assess the economic fallout in Europe to be manageable, with low risk of a recession, given the substantial improvement in underlying conditions.
- In our view, the key market determinants going forward will be (1) inflation, (2) the war in Ukraine, (3) COVID-19 trends, (4) monetary policy and (5) stagflation risks.
- We have reduced duration further following the pullback in benchmark yields in anticipation of a move higher in rates as markets shift focus back to economic fundamentals in advanced regions.
- After scaling back some equity risk in our investment strategy in January, we still maintain a pro-risk approach with the view of gradually increasing our allocation to equity and high yield credit further as the situation in Ukraine de-escalates.

The year started on a weak footing with both bonds and equity markets falling in value on the back of the upside surprises in inflation data and increasing expectations of rate hike announcements by major central banks. Before the Russian invasion in Ukraine on the 24th of February, we viewed the repricing in yields to be excessive despite the clear guidance by central banks that they will wind down their QE programmes and increase rates.

Despite our preference to seek to shorten duration in the opportune time, given the extent of the movement in yield curves, we maintained a neutral duration position versus the benchmark with the view of reducing duration following a corrective movement in benchmark bond yields. We also held onto a neutral duration position to counterbalance the pro-risk positioning in corporate bonds and equities.

The pro-risk positioning in corporate bonds was maintained through our tilt towards lower-rated securities and subordinated bank bonds within the investment-grade space and the overweight allocation to high yield bonds. We reduced our exposure to selected value positions in developed market equities in January to lighten up the equity risk of the portfolio following the rally in equity markets in the previous quarters and to reduce the sensitivity of the portfolio during periods of market vulnerability brought about by central bank expectations and some concerns around stagflation risks. With these sales, we reduced the tilt in our portfolio strategies to value stocks to have a more even balance between value and growth stocks but maintained an elevated equity beta profile.

Despite toning down the overall level risk in our investment strategy, we still maintained a pro-risk approach given the substantial improvement in underlying economic fundamentals, particularly the very low levels in unemployment rates in advanced economies, growth forecasts pointing towards above trend expansion in output which supports the outlook on earnings growth and credit trends.

The invasion on the 24th of February was highly unexpected which led to markets opening sharply lower on the day. Our initial reaction is that the event would lead to a sharp deterioration in risk sentiment but the implications on advanced economies was highly uncertain. On the one hand, the progress in underlying economic fundamentals has been robust pointing towards strong growth rates this year and the next. On the other hand, the risk of a full-blown confrontation between the West/NATO and Russia could not be ruled out. Moreover, the sanctions that ensued, although targeted towards Russia, have direct, indirect, intended and unintended consequences on Western economies and financial markets. The extent of these consequences is still difficult to ascertain.

Given the increased risks to the downside and the wide range of potential outcomes, the market has been pricing-in higher risk premia. In our opinion, reacting to sharp intraday movements and wide bid-ask spreads when the implications on the medium-term outlook are unclear, is a costly and inadequate course of action which leads to the high possibility of taking unfavourable positions in an untimely manner.

Our focus from the day of the invasion onwards has shifted to stress testing our medium-term economic outlook and contextualising the implications of sanctions on Russia. The war will impact the global economy through four key channels: (1) the direct hit to the economic output in Russia and Ukraine, (2) lower exports to the region, (3) lower commodity supply from the region, and (4) the risk of tighter financial conditions.

Here we note that the share of Russia in the global economy is fairly low, equivalent to 1.8% of global GDP, 1.9% of global exports and 1.3% of global imports. Moreover, Euro Area trade flows to Russia are less than 1% across both exports and imports. The key trading partners of Russia are Belarus, Kazakhstan, the Netherlands, Finland, Turkey and Poland.

On the other hand, Russia has a comparatively significant contribution in the production of key commodities. Russia produces 17% of global gas production, 11% of global oil production, 11% of precious metals and 11% of wheat. The impact on commodities has already been felt with the sharp surges in commodity prices as Western economies are making plans to reduce or halt all-together trade with Russia. Europe is particularly vulnerable since it purchases 48% of the Russian supply of oil and 72% of the Russian supply of natural gas, which conversely equates to just under 20% of EU gas supply sources.

Whilst the situation is developing on an ongoing basis, our current assessment of the most likely outcome is one where the military conflict remains isolated within Ukraine, that direct confrontation by NATO is highly unlikely, the flow of energy supply from Russia would remain uninterrupted until major importers (European nations) switch to alternative sources and that the economic implications on Western Economies (particularly Europe) would be limited to the extent that the situation would not derail the economic recovery post-pandemic. We expect to see slower growth in the first half of 2022 which would reaccelerate in the second half of 2022. As a result, we view the market drawdown to be an opportunity to increase risk in our portfolios and re-establish a pro-risk asset allocation to outperform during the market recovery.

These expectations have so far been reinforced by the statements issued by NATO highlighting that the alliance will fall short of sending troops in Ukraine, and, more recently, the positive headlines that negotiations between Ukraine and Russia are heading in the right direction.

In the meantime, economic data releases and central bank communication have reinforced our assessment that underlying economic conditions are strong and that the extent of impact from the Ukraine war should be manageable. Having said that, the situation remains very fluid, particularly in Ukraine, and there are multiple factors that can materially affect the medium-term outlook. In the current environment of heightened uncertainty, the risk of tail events should not be underestimated.

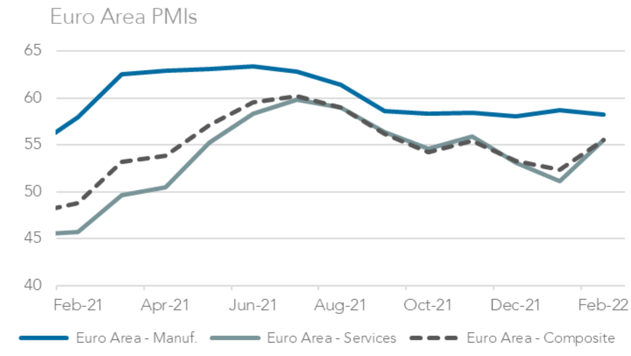
MACRECONOMIC

Euro Area

The third estimate of the 2021 fourth quarter GDP growth rate came in at 0.3% quarter-on-quarter, in line with the second estimate and following a 2.3% quarter-on-quarter growth in Q3. This is the slowest growth in three quarters, as Omicron spread across Europe later in the year and restrictions hurt the services sector while labour shortages persisted due to illness or quarantine rules. Considering full year 2021, the Euro Area economy advanced 5.3%, following a 6.4% contraction in 2020.

The economic recovery was expected to resume during the first quarter of this year as restrictions were lifted in numerous countries as the peak of the Omicron cases was reached and the spread slowed down, and booster jabs were being administered at a decent pace. However, the Russian/Ukraine war in February-March will likely have a disrupting effect on the economic recovery. Apart from the sanctions in place, companies are voluntarily cutting ties with Russia, impacting mostly the trade channel. Despite energy trade remains uninterrupted so far, global commodity prices continue to surge, leading to increasing risks of lower consumer spend in the face of higher inflation. Europe's dependence on Russian energy means it is bound to suffer more than most regions from the economic fallout of the war in Ukraine, leaving the European Central Bank ("ECB") torn between fighting record inflation and cushioning the expected hit to growth. Additionally, difficulty sourcing inputs from Russia and Ukraine at a time when supply shortages were already problematic could also weigh on Euro Area output.

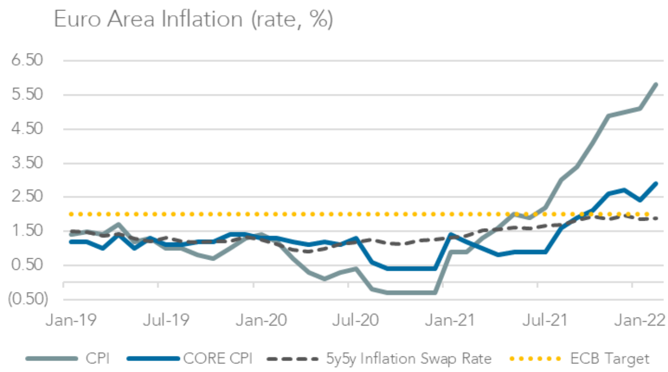
Economists are now estimating Q1 and Q2 GDP to be c. 0.2% and 0.3% quarter-on-quarter respectively, as the invasion is expected to drag on, and further sanctions are implemented. Further ahead, the outlook is even more uncertain, probably slowing down the recovery pace of 2022 significantly compared to prior expectations as firms source alternative materials and governments reduce dependency on Russian energy. Moreove inflation is expected to remain higher than expected by Q4, further impacting cost-of-living. In fact, ECB projections show 3.7% as their forecast for real GDP growth in 2022 compared to consensus forecasts of 4% and down from the December forecast 4.2% for 2022. However, there will probably be a partial catch-up in activity in 2023 and inflation will be less of a drag on spending and, while sanctions are likely to stay in place, firms will have learned to adjust for such restrictions, at least partly. The ECB projected real GDP to be 2.8% in 2023 during the March meeting, compared to the 2.9% projected in the December meeting, showing the ECB expect 2023 real GDP growth to be fairly in line and not impacted by the war.



Source: Bloomberg

The February final Composite PMI stood at 55.5, compared to the prior 52.3 and the flash estimate of 55.8. The expansion was weaker than the highs seen in the second half of last year as business capacity was constrained by supply shortages and poor staff availability. Expansions were of equal strength across both manufacturing and services, with a more substantial rebound from January in the latter driving the resurgence in growth at the composite level. However, the accelerated expansion in new orders and business activity was accompanied by a record increase in prices charged for goods and services.

The flash headline inflation rate for February surged to 5.8%, compared to the prior 5.1% and the market expected 5.4%, as energy continues to record the biggest increase (Feb: 31.7%; Jan: 28.8%) due to rising global energy prices, while food inflation rose (Feb: 4.1%; Jan: 3.5%). This means that the increase in food inflation is also expected to run further as the war drags on, together with further energy inflation. Similarly, the flash core inflation rate surged to 2.7%, compared to the prior 2.3% and the market expected 2.5%. The fact that the core rate reached a record high suggests that the increase was due to more than just these one-off effects.



Source: Bloomberg

Inflation is now very likely to rise above 6% in the coming months and looks set to remain well above the EC-

B's target for a long time. Goldman Sachs forecast core inflation in the Euro Area to peak at 3.0% in April and the headline rate to peak at 6.5% in July.

In view of the upside surprises in inflation in recent prints, the ECB has likewise indicated that inflation should be at 5.2% in 2022 but that it will come down to just under its 2% target by 2024. This is seen as a fairly dovish assessment and it is based on the fact that inflation is high because of high energy prices as well as food prices and other goods' prices but given the limited pass-through on wages so far reduces the scope of a sustainable rise in inflation. Furthermore, the increasing inflation seen makes it more likely that workers will soon push for much higher wages, further putting pressure on inflation.

The unemployment rate for January came in at 6.8%, down from the prior 7% and the market expected 6.9% as the recovery in the labour market gains steam while countries started to ease Omicron related restrictions.

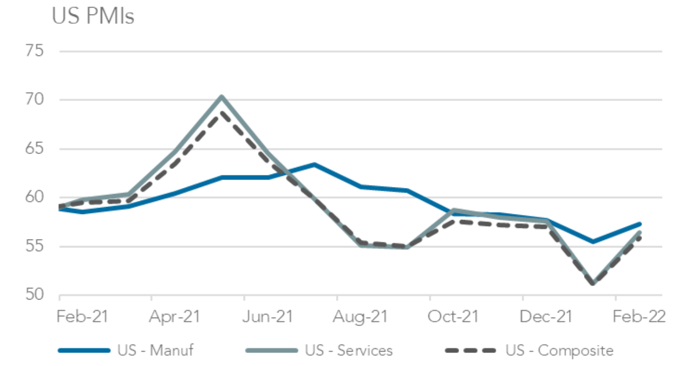
At its March meeting, the ECB highlighted the near-term uncertainties brought about by the war in Ukraine but did not materially downgrade its growth forecasts for the Euro Area in 2022 suggesting that the ECB's evaluation is that the economic impact from the Ukraine conflict is expected to be manageable and, more importantly, will unlikely deter the central bank from its projected course of action.

Despite the downward revisions to GDP growth forecasts, large upward revisions to inflation forecasts have prompted the Governing Council to signal this acceleration of the exit timeline, and net APP purchases are now expected to average €30bn in the second quarter versus €40bn previously, and end "in the third quarter" rather than continue until at least October 2022. This will pave the way for the first rate hike soon after, as long as inflation dynamics do not weaken.

United States

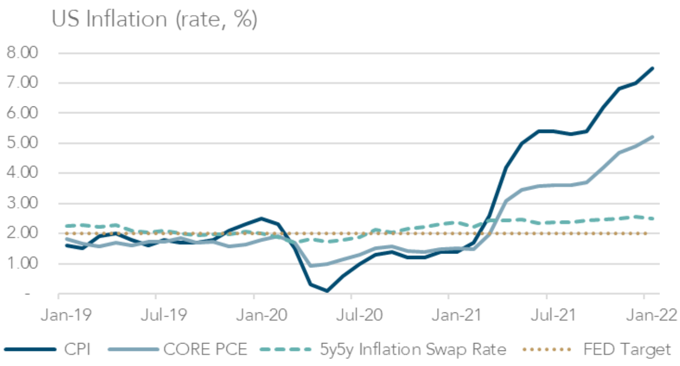
The US economy expanded at an annualised 7% quarter-on-quarter in 4Q2021 according to the second estimate, slightly higher than the advanced estimate of 6.9%. This remains the strongest expansion since the record growth in 3Q2020 of 33.8%. Considering full year 2021, the second estimate shows that the economy advanced by 5.7%.

The impact of the Russia/Ukraine war is likely to be negligible on the US economy. According to Capital Economics, goods exports to Russia and Ukraine combined were worth just $9bn last year, and US banks have little direct exposure to either country. The conflict may however drive renewed disruptions to some global supply chains. However, the geographical distance means the US is far less exposed than Europe. Instead, the main impact will come via the rise in global commodity prices.



Source: Bloomberg

The February final Composite PMI stood at 55.9, compared to the prior 51.1 and the flash estimate of 56.0. Growth regained momentum in both manufacturing and services activities following the Omicron surge in the month of January. Stronger demand conditions led to the fastest upturn in new business since July 2021. Furthermore, higher new sales levels were supported by increased foreign client demand, as new export orders rose solidly. Inflationary pressures remained elevated, despite manufacturers recording a slight slowdown in hikes in supplier costs, with these inflation charges leading to a sharp rise in service sector output prices. Further expansions in backlogs of work (slowest pace in a year given easing of material shortages) led to greater motivation to hire new staff, with firms able to increase workforce numbers at the steepest pace since May 2021, despite ongoing reports of labour shortages.



Source: Bloomberg

The inflation rate for February continued to surge to 7.9%, compared to the prior 7.5% and the market expected 7.9%. Headline inflation continued to soar as a result of surging energy costs, continued labour shortages due to Omicron and supply disruptions, coupled with strong demand. Energy remained the main contributor, contributing 27% in January (Dec: 29.3%), with gasoline prices surging 40% (Dec: 49.6%). With gasoline futures continuing to rally in line with oil prices, energy prices will rise more sharply this month. There were some encouraging signs that the recent upward pressure from goods shortages is fading. New vehicle production and sales rebounded strongly, and should in turn raise the supply of used vehicles too. This suggests the upward pressure on vehicle prices will soon fade and potentially go into reverse.

Similarly, the core inflation rate for January saw an upward move to 6.4%, compared to the prior 6.0% and the market expected 6.4%. With core CPI inflation, the acceleration in "rent of shelter inflation" and in "food away from home" prices supports the view that a cyclical acceleration in inflation is underway and, with labour market conditions exceptionally tight, it is unlikely to abate any time soon.

The Ukraine/Russia war will prevent inflation from falling as much as it otherwise would have in the coming months. The rise in global commodity prices (particularly oil) means headline inflation will remain worryingly elevated over the next couple of months, potentially declining towards year-end, however at a slower pace than originally anticipated.

The unemployment rate for February edged down to 3.8% from the prior 4%, coming in below the market expected 3.9%. The number of unemployed persons edged down by 243,000 to 6.27m. In February 2020, the unemployment rate was 3.5% and the number of unemployed persons was 5.7m. The labour force participation rate edged up to 62.3% from the prior 62.2% (highest since March 2020).

In February, 678,000 jobs were added, compared to the prior 481,000 and the market expected 400,000. This is another sign that the real economy has considerable momentum, with the Omicron wave having had surprisingly little impact. The strength in job additions was widespread, leaving jobs at 2.1m below pre-pandemic levels. Many economists believe the job market could recover all the pandemic losses this year. This strength will give the Fed greater confidence to push ahead with its planned policy tightening.

In his congressional testimony, Powell made it clear that a rapidly healing US economy no longer needs such an accommodative monetary policy and that the Fed in fact began raising interest rates at its March meeting to restrain surging inflation. Powell said he is inclined to support a 25 bps increase with the median dot plot representing committee member expectations showing seven total consecutive increases of 25bps each in the course of 2022.

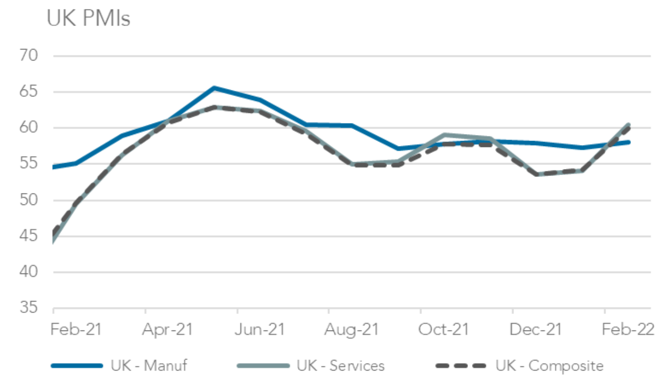
Powell said he expects a "series" of interest rate increases this year, and also hinted that he could support raising rates by larger increments later on if inflation fails to moderate sufficiently. Powell also pointed out that the outbreak of war in Ukraine brought a significant degree of uncertainty for monetary policy.

Alongside plans to raise rates, the Fed will also begin scaling back its $9tn balance sheet. While no details have yet been provided about when that process may begin and at what pace, Powell suggested a roughly three-year timeline to shrink it to levels where "it needs to be".

United Kingdom

GDP shrank 0.2% month-on-month in December, less than the expected contraction of 0.6% and following the November expansion of 0.7%, suggesting Omicron was less severe than initially anticipated. It is possible that GDP fell in January as that is when Omicron cases peaked, and many couldn't work. However, with the easing of restrictions by mid-month, it is likely that economic recovery restarted.

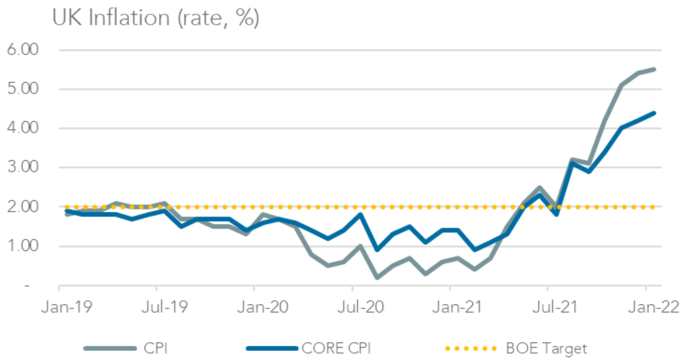
Similar to the US, as the Ukraine invasion has escalated, the upside risks to inflation and the downside risks to activity have increased. Essentially, the higher inflation itself will be an extra drag on real GDP by reducing real household incomes. On top of that, the reduced business revenues from firms that are not able or willing to do business with Russian companies will also impact GDP growth over the coming months, although this impact will likely be small when compared to the impact of growing inflation.



Source: Bloomberg

The February final Composite PMI stood at 59.9, compared to the prior 54.2 and the flash estimate of 60.2. The latest reading pointed to the fastest rate of expansion for eight months, as the easing of Omicron restrictions unleashed faster growth across both the manufacturing and services sectors. The rebound was particularly sharp in the service sector, with growth outpacing that seen in manufacturing. However, domestic demand from looser COVID restrictions, fewer raw material shortages, and easing global supply chain issues allowed for production to rise at the highest pace in seven months. Accelerated increases in both new orders and employment were also recorded. Inflationary pressures remained acute, however, with both input costs and output charges increasing at sharper rates than in January.

The February headline inflation rate rose to 6.2%, compared to the market expected 5.9% and prior figure of 5.5%. This was mainly due to the rising cost of energy and food prices. Similarly, the February core inflation rate increased to 5.2%, compared to the prior 4.4% and the market expected 5.0%.



Source: Bloomberg

As a result of the war and the subsequent surge in energy prices, together with the already expected tax hike and utility hike in April, economists are now expecting CPI inflation to peak at 8% in that month, and to only fall back to about 5% by the end of 2022. Goldman Sachs expects inflation in the UK to peak at 9.5% in October (versus April previously).

The unemployment rate for the three months to January came in at 3.9%, below expectations of 4.0% and the prior figure of 4.2%. The unemployment rate has fallen to pre-COVID levels. That was partly due to a rise in inactivity in the three months to January driven again by more people saying they cannot work as they are long-term sick. But in January alone, the inactivity fell. That shows that some of the rise in inactivity since the pandemic began is cyclical. That said, we are becoming more concerned that some of the rise in inactivity due to long-term sickness means that labour supply will not snap back as quickly as originally thought.

The continued improvement in underlying economic conditions and the surge in inflation gave the Monetary Policy Committee ("MPC") of the Bank of England ("BOE") the confidence to raise its key Bank Rate by 25 bps to 0.75% during its March 2022 meeting, in line with expectations. This back-to-back increase pushed short term borrowing costs to the highest level in two years. The MPC also voted to continue to reduce the stock of government bond purchases, financed by the issuance of central bank reserves, by ceasing to reinvest maturing assets.

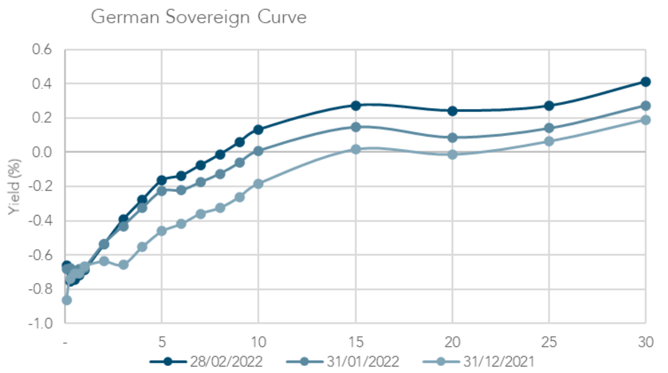
Due to the war and with CPI expected to increase over the coming months as a result (higher global energy inflation and also wage inflation), the MPC will probably be sensitive to any further signs that higher inflation is leading to higher price expectations and/or faster wage growth. Economists are expecting the BOE to raise rates further in the course of 2022 due to rising inflation expectations.

RATES

Euro Rates

Ongoing improvements in underlying economic fundamentals will push core rates in EUR higher. The Composite PMI rose to 55.5 in February following the recent low printed in January. This shows encouraging evidence of growing momentum as cases fell back down following the surge of the Omicron variant. Moreover, the unemployment rate dropped to a record low of 6.8% in January, reinforcing the argument that economic slack is being absorbed fairly quickly underpinning the relatively high growth forecasts. Inflation data, on the other hand, continued to surprise to the upside with in February.

While the generally robust macro drop would support a move higher in EUR core rates on the back of both rate hike expectations and a term premium, the heightening uncertainty brought about by the conflict in Ukraine increased probability of tail events. Particularly, at the forefront is Europe's vulnerability to gas supply disruptions which, apart from increasing pressure on prices, is impacting the growth outlook.



Source: Bloomberg

As a result, the path forward for the ECB is less clear given the presence of material tail risks which has generally kept bund yields low during this phase of the conflict in Ukraine. Going forward, as long as the war in Ukraine remains a localized conflict, the primary impact on the European economy would be an inflation shock, while the impact on economic output should be limited.

The robust macro backdrop in the Euro area, combined with increased fiscal spending (post-COVID and also in response to the Ukraine situation) allows the ECB greater comfort to scale back stimulus and focus on bringing down inflation. Therefore, in the absence of a material deterioration of the situation of Ukraine and diminishing tail risks, we expect to see a gradual grind higher in Euro Area yields and prefer to maintain a short duration position.

Having said that, the situation currently remains very fluid as the conflict continues to evolve. The impact of current sanctions and further measures, particularly the unintended consequences on the Euro Area financial system and economic activity remains uncertain at this stage.

Widening of sovereign spreads resumed around the ECB meeting in March where it communicated a revised (lower) schedule of asset purchases as well as the planned termination of the open-ended QE programme in the third quarter to pave the way for the first rate hike.

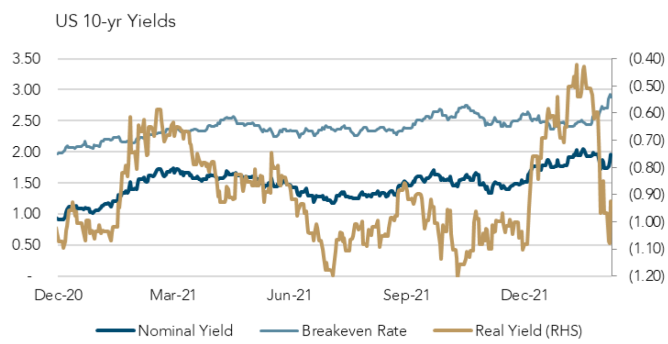
Moreover, the prospect of increased net supply of government bonds, which is increasingly tilted to the upside, underscores the greater degree of absorption required by the private sector of issuance flows compared to the recent past. Increased net supply is reflective of greater initiatives of European sovereigns to protect households from higher energy expenses as well as structure shifts, such as the commitment by Germany regarding defence spending.

On this basis, we see scope for sovereign spreads to continue to widen. Widening of sovereign spreads will also be supported by either growth downgrades as well as renewed hawkish messaging by the ECB.

US Rates

The main determinants of pricing in the US treasury market has been another shock to supply, primarily manifested by a surge in commodity prices and, simultaneously, safe haven flows on the back of increased geopolitical uncertainty following the invasion of Russia in Ukraine.

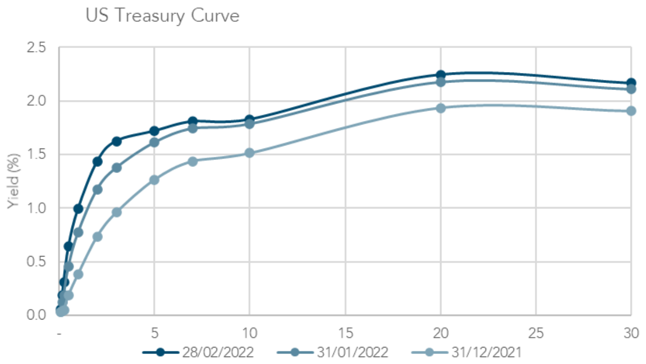
Breakeven inflation rates soared, with the 10-year rate on inflation-protected securities ("TIPS") rising towards 2.90% (after dipping to 2.40% area in January), while nominal yields declined resulting in a sharp move lower in real rates.



Source: Bloomberg

The belly and long-end of the US Treasury curve outperformed given the stickiness at the front-end, with relatively limited softening seen in terms of rate hike pricing.

This has been consistent with a hawkish Fed, with officials reiterating that the central bank will remain on course despite the increased uncertainty to the growth outlook brought about by the Ukraine invasion. As a result of these movements we have seen a rapid flattening of the yield curve with the 2s10s dropping to just 24 bps away from inversion.



Source: Bloomberg

As we have highlighted in our previous update, as short-end rates continued to grind higher, market pricing has converged closer to consensus forecasts with implied forwards now peaking at just above the 2.2%.

Moderate worsening of the Ukraine conflict can result in a continued flattening of the curve as a result of continued pressure on prices, which strengthens the scope for the Fed to hike rates, as long-end yields continue to be weighed down by safe haven buying or foreign demand. In this case, an inversion of the US treasury curve would be consistent with the worsening outlook on the growth-inflation dynamics and increased stagflation concerns.

In the severe scenario where the situation in Ukraine continues to escalate, for instance to the point that NATO would be involved in a direct confrontation with Russia, there would be a basis for the Fed to hold off from further rate hikes.

Our baseline scenario is that we will continue to see the gradual de-escalation of the conflict in Ukraine which should see diminishing tail risks on the geopolitical front. These conditions would provide a strong basis for market focus to shift back to domestic economic developments, primarily the absorption of economic slack in the US and high inflation, which will likely lead to a sharp sell-off in long-end yields and a re-steepening of the curve. In the meantime, abating uncertainty will strenghten the motivation short positioning.

UK Rates

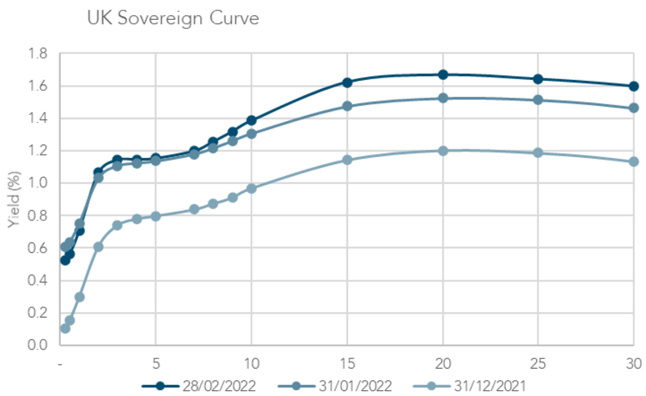
The UK should weather the impact from the Ukraine conflict better than most European nations given its diverse sources of energy supply which should shield it, to an extent, from the sharp surges in energy prices. Having said that, it will still be impacted through second round effects, primarily the impact on global commodity prices.

The BOE's communication has been somewhat cautious going into the March meeting, and while a degree of caution will remain as a result of heightened uncertainty from the Ukraine war, it is unlikely to deter the BOE from progressing with further rate increases in upcoming meeting, but could lead to a delayed response to allow for improved clarity on the outlook.

Markets are still pricing-in 125 bps of tightening by November however, the expectations of the 25 bps hike in the March MPC meeting has been scaled back going into the meeting in line with the broader softness we have seen in front-end pricing. The situation in Ukraine has made the path expected from the BOE less clear as hawkish committee members may now be more cautious from tightening monetary policy swiftly given the heightened uncertainty. Dovish members continue to cite the risks of a policy-induced recession while a higher shift in inflation could hinder economic growth given the negative impact on disposable income and loss of consumer confidence.

Combined with the current high degree of uncertainty, we could see further softening of front-end pricing as members push back against market pricing.

The recent flattening of the UK gilt curve, similar to what we have seen in the US, has been the combination of forces effecting the front-end (expectations of further rate increases by the BOE in response to persistently high levels of inflation), and flight-to-safety which has weighed on longer-dated gilt yields. In fact the 2s10s has now dipped to as low as 11bps.



Source: Bloomberg

We maintain our bearish medium-term outlook on UK rates, particularly at the long-end, which should underperform as the curve re-steepens with the de-escalation of the war in Ukraine. The increased issuances expected going forward and the balance sheet run-off by the BOE should reinforce the move higher in gilt yields.

CREDIT

Euro Credit

Corporate bonds sold off significantly in February as expectations of tighter monetary policy conditions due to the high and persistent levels of inflation continued during the month. However, the sell-off was further compounded towards the latter stages of the month upon the announcement that Russia had begun its invasion of Ukraine on the 24th of February, even though corporate bond spreads continued to widen in the days leading up to the invasion due to the build up of Russian troops along the Ukrainian border.

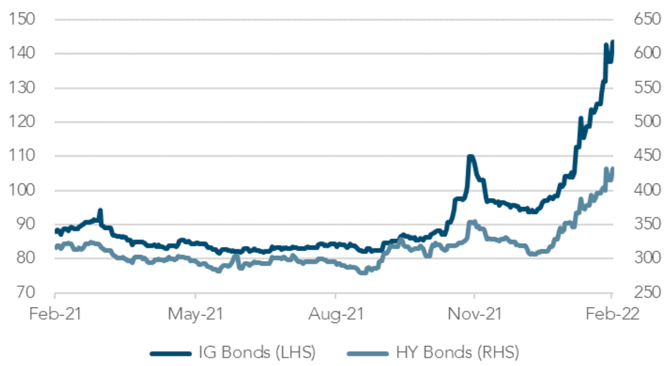
The European corporate bond market experienced the greatest spread widening during the month when compared to its US and UK counterparts. In fact, investment grade ("IG") spreads widened by c. 39bps during the month, with high yield ("HY") spreads widening by c. 79bps. While the spread widening that occurred was initially led by market sentiment surrounding the rise in inflation and the possibility of tighter monetary policy conditions, the Russian invasion of Ukraine towards the last week of February contributed to further spread widening as a flight to safety ensued given the elevated levels of uncertainty that the conflict brought with it. The widening of corporate spreads occurred despite the rise in the bund yield which rose from -5bps at the start of the month to +5bps by the end of the month following the ECB's communication in the February meeting.

While the situation and ultimate ramifications of the Russia/Ukraine conflict remain highly fluid in our view, the risk-reward trade-off in spreads has improved following the short and sharp widening experienced in February. With that being said, we now find ourselves in a position whereby we must also weigh recent spread widening against the ECB's hawkish message at the March meeting, which signalled an earlier-than-expected end of net APP purchases than previously indicated.

Whilst the sharp move in spreads since the start of the year implies that we can take some comfort in increasing spread duration for additional portfolio carry, the hawkish messaging leaves us incrementally more cautious on pushing exposure too far out of the curve. Similarly, we also view CSPP eligible securities - that trade at a premium to non-eligible names - as particularly sensitive given the premium these names still trade at.

We view the recent underperformance in Financials spreads as an opportunity to add risk, whilst also acknowledging that the sector may face some additional headwinds related to geopolitical uncertainty. In that vein, we remain selective and look for names with minimal (preferably none) exposure to Russia. At this juncture, given the shifting tone from the ECB, we would have a preference for increasing exposure to USD versus EUR on the IG side. Whilst in HY, USD has clearly outperformed EUR on a year-to-date basis. The c.100bp premium currently on offer for EUR HY spreads relative to USD is an attractive premium for portfolios.

Whilst the conflict has increased the pace of negative rating actions, the majority relates to names that are directly linked with the region, and until we begin to see a material uptick in defaults, we continue to remain comfortable with the current quality of corporate balance sheets.



Source: Bloomberg

US Credit

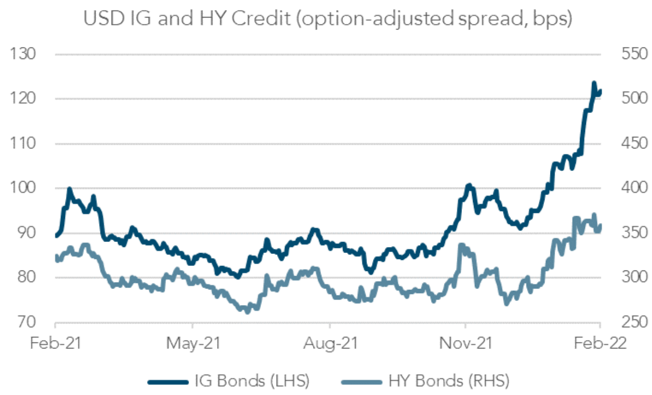
US corporate bond markets outperformed their UK and European counterparts during February on both a spread and total return basis as despite the sell-off, spreads within both US IG and non-IG segments of the market widened by c. 16bps each. While US corporate bond yields did rise during the three weeks leading up to the Russian invasion, spreads within the IG segment widened by a lesser degree when compared to European and UK peers as spreads within the US HY market contracted, despite the Fed's hawkishness and Russia's invasion of Ukraine.

During the month, the yield on the US treasury remained stable as it practically ended the month at similar levels seen at the beginning of the month, despite touching an intra-month high of c. 2.00% following the publication of January's FOMC meeting minutes and US consumer prices climbing by 7.5% in January.

In both the EUR and USD IG markets, spreads have met and marginally exceeded year-end targets. While the outcome of the Ukraine/Russia conflict remains highly uncertain, especially as it pertains to potential additional disruptions to supply chains and industrial production, the spread widening of the past few weeks and the continued emphasis from central bank officials on data dependency has improved the risk-reward trade-off in our view. This is not to say that a further repricing of risk premium is unlikely, though the asymmetry is now much less skewed to the downside relative to only a few weeks ago.

Whilst we have seen progress with respect to fears that the conflict will escalate beyond Ukraine, a full stabilization of the region is still not in sight. Nevertheless, we would recommend adding risk in high-quality pockets of the markets that have been caught in the crossfire of the market moves. This includes financials in both the EUR and USD IG markets.

Within the HY space, the USD double-B bucket appears to have underperformed single-B counterparts during the sell-off, however the resilience of the Bloomberg US Corporate High Yield Bond Index as a whole may challenge near-term returns, notably amidst a substantial uptick in volatility and only a 17bp spread widening. We would generally prefer to see some normalisation of spreads here before gaining comfort relative to the EUR HY space. Month-end option-adjusted spread for the Bloomberg US Corporate High Yield Bond Index is 75bps tighter than current model-implied levels for year-end 2022. In terms of drivers, moderate treasury market volatility and an expected deceleration in business activity have among the largest effects, though a forecast higher two-year treasury yield and lower leverage tend to temper any widening in forecasts. The key undefinable is the war in Ukraine which, should the situation persist, may lead to further fracturing in global trade and a widening in USD HY spreads (in line with EUR).



Source: Bloomberg

UK Credit

Initially, UK corporate credit spreads widened in February following the BOE's decision to hike rates by 25bps to 50bps during its February meeting. However, in a similar pattern to Eurozone corporates, spreads widened further following Russia's invasion of Ukraine.

January was a difficult start for the sterling IG, with a 3.27% local-currency total-return loss, and still a 2.8% loss when swapped to euros. February was marginally better for returns, with a 2.55% total-return local-currency loss (2.73% swapped to euros), but still one of the worst months for sterling returns since the onset of the pandemic. The losses in Sterling IG credit were largely on par with those in EUR IG during the month, in both excess and total-return terms. Sterling high grade excess returns posted a 1.86% loss – also the worst of the COVID era – driven by a nearly 30bp spread widening in the index. As spreads are being driven predominantly by invasion headlines and the consequent energy -price volatility, it is hard to say when we will see a turn in spreads.

Whilst the shifting hawkish tone from the ECB has now created a more balanced dynamic with respect to relative central bank messaging and the earlier hawkish tilt from the BOE, we continue to favour EUR paper despite the (albeit marginal) spread pickup available on GBP paper. The expectations remain that the BOE will still raise rates further this year to rising inflation expectations. Additionally, the BOE has already allowed £27.9bn of gilts to mature without backfilling that supply, and a further £70bn is expected to come due over the remainder of 2022 and 2023. As the economic recovery is likely to slow down over the coming months, there may be scope for spreads to marginally underperform their EUR counterparts and as such, we prefer maintaining GBP exposure for portfolios mandated specifically to do so at this juncture.

Defaults and Rating Backdrop

The global corporate default tally has risen to 10 over the last few weeks to 2 March, remaining comfortably below the 18 defaults registered during the same period in 2021. The US region leads the default tally so far this year with 6, followed by emerging markets with 4. European quarterly defaults have been declining since the first quarter of 2021 and were last lower in the first quarter of 2016. Emerging markets is the only region where defaults so far in 2022 have been higher than the previous year (YTD 2021: 2 defaults) as risks in the region are increasing. The Russia/Ukraine conflict threatens to keep energy prices high, reinforcing price pressures from food, logistic charges and persistent supply disruptions.

As of the most recent update of S&P default rate forecasts in mid-February, the baseline expectations were for the US and European speculative-grade default rates to rise to 3% and 2.5% respectively as of December 2022. The pessimistic scenario on the European side was for default rates to spike to 5% in a situation where the Russia/Ukraine situation devolved and energy prices spiked, adding to inflationary pressures that could weigh on sentiment and cause a drop in consumer spending and sharply tighter financing conditions for speculative grade-issuers as risk appetite dried up.

On the ratings front so far, there have been 37 financial and nonfinancial corporate, sovereigns and international public finance rating actions in which S&P cited the Russia/Ukraine conflict, energy prices, or both as factors driving the decision. The majority of these moves have related to banking and financial institutions domiciled in Russia, Ukraine and Cyprus.

EQUITY

There had been some concern around the deteriorating relationship of Russia and Ukraine for most of the year but markets were still giving the benefit of the doubt, in the hope that full blown conflict could somehow be avoided. Regrettably, such hopes were put to bed on 24 February, when Russia's leader Putin authorized a special military operation in Ukraine's eastern Donbas region. The escalation of events in Russia/Ukraine led to a sharp sell-off in risky assets.

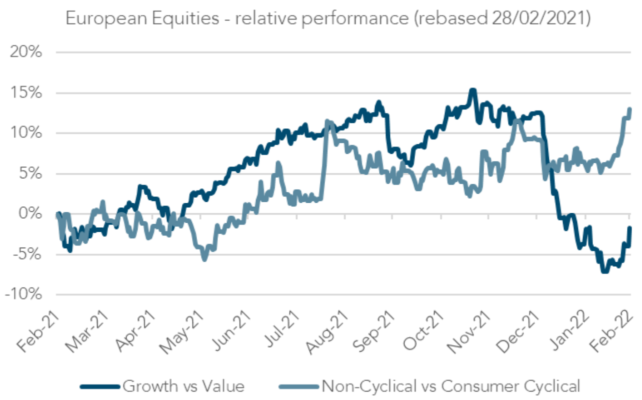
Since the start of the year there has been a lot of uncertainty around the global growth/inflation mix. The concerns during January were mainly on the inflation end of the spectrum, with interest-sensitive sectors outperforming growth during the month. The outbreak of the war in Ukraine exacerbated such concerns as a conflict would put more pressure of prices, namely energy. The key area of uncertainty here was how would the developments in Ukraine impact central bank policy. The surge in energy prices would put pressure on inflation, yet there were questions as to how consumer sentiment would be impacted not how much this would weigh on global economic growth. As we have mentioned in our earlier reports, tightening of monetary policy against a backdrop of weakening growth is rarely good for investor sentiment. How long the conflict will persist for is another key concern, as the longer the uncertainty persists for, the more damaging it is for the global economy.

The Ukraine conflict could impact equity market from several sources. The key sources of risk for equities, in our opinion, are: (1) Energy cost; (2) Financial conditions; and (3) Trade and consumer confidence. So far we have seen investors price-in events that are yet to transpire, such as a disruption in gas supply (hence the rally in gas prices) as well as a significant slowdown for the European economy (despite no signs that impact will be meaningful, at least for now). The risk of a further geopolitical escalation paired with close to historically low gas storage levels could lead to production shutdowns, either because of the lack of natural gas or because production is unprofitable given high spot prices.

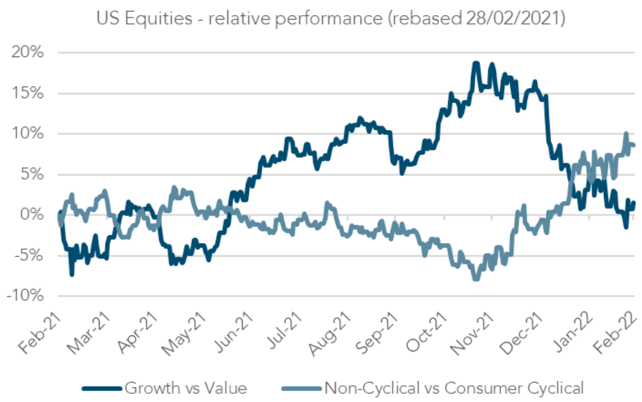
The VIX spiked to 36.6 on the first day of the Ukraine invasion. The intra-day swings were quite extreme and have only been seen on the onset of one-off events like the outbreak of COVID-19, the Global Financial Crisis, the European debt crisis and the US/China trade war. Goldman Sachs say that the uncertainty brought about by the conflict led to low top of book depth, which points towards a deterioration in liquidity conditions in equity futures.

Looking at the moves seen in different asset classes, equities saw high single-digit negative moves from peak to trough (intra-day high on 23 February to intra-day low on 24 February), with the Dax recording a -7.5% move. The biggest intra-day reversal was recorded by the Nasdaq 100 at +7.4% (calculated as the move from the intra-day low to the intra-day high on 24 February).

US has been preferred by investors since the onset of



Source: Bloomberg



Source: Bloomberg

the Ukraine conflict. The STOXX 600 and S&P 500 total return during February was fairly close at -3.0%. Yet, it seems that investor preference post the invasion has changed significantly. Calculating total return during February before the invasion (1 February to 23 February), the S&P 500 loss was double that reported by the STOXX 600 (-6.3% versus -3.1%). In the final three trading days (24 February to 28 February), the S&P 500 total return of +3.5% was well ahead of the -0.1% for the STOXX 600. This is in-line with the view that tensions with Russia could have more implications for Europe than the US.

Uncertainty also brought value outperformance to an abrupt end. Global value stocks performed strongly relative to their growth counterparts in January, with a total return of -1.2% versus -9.3%. The outperformance was more clear in Europe at +2.7% versus -8.9%, as interest rate expectations were continuously being revised higher. This continued in February, with global value stocks delivering a -2.5% total return versus -7.3% for growth, but this outperformance reversed sharply in the final three trading days (24 February to 28 February), as global value stocks delivered a total return of +0.9% versus +4.1% for growth stocks. The main driver of this reversal was the possibility that the war could force central bankers to delay the tightening cycle, despite the impact on inflation. Additionally, the war threatens to derail the global economic growth as uncertainty should weigh on consumer sentiment and spending. Moreover, high inflation due to higher energy prices raises the stagflation risk, adding to central bankers' dilemma.

Geopolitical events are generally tough to call but overreaction to headlines is not recommended. Historically, geopolitical driven market sell-offs have been steep, but are typically short-lived. Absent of a positive catalyst, we expect investors would want to have more clarity on how the war has impacted the growth/inflation mix before sentiment recovers.

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. This has been confirmed in the March meetings of key central banks despite the increased uncertainty on the growth outlook as a result of the war in Ukraine. We continue to favour an underweight allocation to sovereign bonds 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 shifts in the benchmark curve. The outlook for periphery credits in Europe has deteriorated at this stage as PEPP, a significant contributing factor to tighter peripheral spreads, will terminate in March 2022.
Investment Grade Corporate Bonds	Neutral	O/W	Investment grade returns will continue to depend largely on movements in benchmark rates, further stimulus and sporadic covid outbreaks remaining under control. The war in Ukraine has led to substantial spread widening given the increased downside risks which, in our view, provides an opportunity to add names on a selective basis. The default and rating environment for global credit has continued remained stable, if not improving, 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. This provides an element of comfort around the overall tighter spreads vs historical whilst noting that the recent spread widening offers a better cushion against adverse movements in benchmark bond yields. Whilst our medium term outlook is that benchmark yields are biased to move higher, we are taking opportunity of the recent spread widening post-Ukraine-invasion to increase our exposure to IG corporate bonds.
High Yield Corporate Bonds	Positive	O/W	The elevated uncertainty on the growth outlook and higher inflationary forces as a result of the war in Ukraine as led to a substantial widening in credit spreads. Having said that, the improved underlying economic conditions and positive credit rating trends provide a solid underpinning 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. We continue to screen for business profiles that should see limited drag on operational performance as finance costs and input costs increase.
Developed Markets Equities	Positive	N	The correction in the equity market started in February, as persisting inflationary pressures led to a re-pricing of interest rate expectations. In the summer of 2021, the market was pricing no interest rate hikes for 2022 in the US, but by February this had moved to 7 rate hikes. The invasion of Ukraine on 24th February has changed the landscape, with a surge in energy prices leading to downward revisions in growth outlooks. We have moved away from the reflationary concerns to stagflation concerns. Yet, our stance on the asset class remains unchanged, but the situation remains uncertain. A key risk is a prolonged conflict leading to high energy prices persisting for longer than expected and supply-side concerns to weigh on margins and corporate profitability.
Emerging Market Equities	Positive	N	The backdrop for EM equities was favourable during 2021, with strong synchronized global economic growth, higher commodity prices and positive investor sentiment. However, country specific concerns (like regulation and property concerns in China) weighed on performance. In 2022, we continue to expect the asset class to deliver a strong performance, especially in certain regions within EM. The invasion of Ukraine and the impact this had on inflation has presented a challenge for certain EM countries, but our larger exposure to commodity exporting countries should boost performance.

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

DISCLAIMER