Investment Strategy Update

April 2022

Curmi & Partners Research

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- Global growth expectations have moderated given the effects of the Ukraine war on commodity prices and supply chains, as well as the slowdown in China following the surge in COVID-19 cases which led to lockdowns in major cities.
- The economic impact is expected to be deeper for the Euro Area and other commodity-importing countries given the sharp increase in energy and commodity prices.
- The strong initial conditions, particularly the medical improvements to combat the virus spread and the absorption of economic slack with tighter labour market conditions, suggests that the economic impact should be manageable given that the economic impact is mostly a supply shock, rather than a demand shock.
- The risks of a recession in the US remains low, despite the negative fiscal impulse and the tighter financial conditions, while a continued increase in energy prices and/or the disruption of gas supply to Europe may lead to a contraction in the region.
- Given the acute price pressures in energy and commodities, headline inflation rates have risen further. However, the pass-through to higher core inflation rates, mainly in Europe, is less obvious given the subdued wage growth.
- Major central banks have turned decisively more hawkish in March given the clear upside risks to inflation guiding towards a faster reduction (or reversal) of quantitative easing measures and higher interest rates.
- As the situation in Ukraine has seemingly de-escalated, risky assets found support early in March supported by the reduced pessimism and increased risk appetite.
- March saw some recompression in credit spreads across investment grade and high yield bond markets while benchmark bond yields soared on the back of higher inflation premia and expectations of a faster pace of reduction in monetary stimulus.
- Major equity indices rebounded from the 8th March lows, with growth and defensive stocks outperforming value and cyclical stocks.
- We have increased our short-duration bias in early March and increased our exposure to credit spreads across both IG and HY corporate credit.
- We have increased our allocation to developed market equities to benefit from the rebound in equity markets whilst maintaining a balanced position across growth and value stocks with an overweight in US equities given the current environment.

Inflation concerns have been compounded with the Russian invasion of Ukraine. Russia is a key producer of energy and critical commodities. Given the escalation of tensions and the introduction of sanctions, energy and commodity prices rallied to extreme levels leading to acute inflationary pressures. Risky assets continued to sell-off in the first few days of March given the heightened geopolitical uncertainty and risks to growth. However, equity markets seem to have found support early in March given signs of de-escalation in Ukraine with improving headlines on negotiation talks between Russia and Ukraine, as well as the re-affirmative statements by NATO that they will fall short of a direct military involvement in Ukraine.

The impact to growth so far seems to be manageable primarily because of the very strong initial conditions in advanced regions as well as the increasing probability that the war will remain contained within Ukraine. Most economists have revised global growth expectations lower with consensus estimates pointing towards a more trend-like growth of 3.5% in 2022 mainly as the drag from the war in Ukraine, increased supply disruptions and tighter financial conditions will partly offset the improvements achieved in combatting COVID and the strong return in consumption from increased levels of household incomes. On this basis, the economic risks are being mostly characterised as those of a supply shock, rather than a demand shock, which is inflationary but not necessarily demand destructive.

US economic growth expectations have been revised slightly lower to 3.2% in 2022 given the negative fiscal impulse as well as the tighter financial conditions. The Federal Reserve indicated that it will raise rates by another 1.5% bringing its policy rate to 1.9% by the end of the year. Market pricing is implying a more aggressive path implying a policy rate of 2.4% by year-end and has more recently lifted the expected terminal rate of this rate hiking cycle to the 3% area. Core inflation came in at 6.5% in March 2022 and is expected to come down towards 4% by the end of the year given that the increase in good prices should moderate while monetary policy will be tightened substantially.

Growth in the Euro Area is expected to be impacted more directly from the war in Ukraine given its proximity to the conflict as well as the critical trade channels of several member states with Russia, more notably for the supply of energy. Consensus estimates forecasts Euro Area real GDP growth to be at 2.9% with increased recession risks if the supply of gas from Russia is halted or the price of energy surges much further. So far there has been little evidence of disruption in gas flow limiting the risks of spillover effects from the gas market. The inflation prints have seen a sharp uptick in March with core inflation reaching 3%. Analysts do not expect core inflation to rise much further from here, leading to market expectations that the monetary policy path will be less hawkish than is currently being guided by the European Central Bank ("ECB"), particularly given the downside risks to the growth outlook. Specifically, the ECB has indicated that it expects to end its quantitative easing ("QE") programmes in the third quarter and to raise rates some time after. We see scope of a more aggressive monetary tightening path by the ECB if we see clearer signs of second round effects on inflation expectations particularly if labour market conditions tighten further leading to an increase in wage growth. However, this remains unlikely for the time being given the risks to economic conditions and consumer confidence which could force the Euro Area into contraction.

Therefore, our baseline view is that the impact from the Ukraine war will be sizeable, but likely manageable, with the Euro Area seeing the largest hit as well as other commodity-importing countries. China will be equally important to watch given the recent decline in activity as a result of the continued spread of COVID and the ensuing lockdowns in major cities. Public policy has turned more accommodative which should provide some cover but not fully-absorb the impact of a prolonged period of lockdowns given the country's dynamic zero-COVID policy.

We have maintained a short-duration bias during the recent sell-off in bonds and we expect a continued grind higher in benchmark bond yields as the rate hiking cycle in several advanced regions is underway. With that said, our view on rates is becoming more balanced as we reach higher yield levels. The current elevated inflation premia built in nominal yield curves and the firmer pricing-in of the rate hike trajectory will make bonds look relatively cheap on cross-asset basis.

With the stabilization of credit spreads and a rebound in equity markets, we have increased our overweight to credit by adding exposures on a selective basis to corporates across both investment grade and high yield markets. We took advantage of the wider dispersion in the market by switching into names that have traded wider while the underlying credit fundamentals are on a favourable trend.

We have also increased our allocation to developed market equities in the beginning of March given the marked drawdown across major equity markets and our constructive economic outlook and corporate earnings. More recently, we have reduced our overweight allocation to Latin America, which has been outperforming other emerging markets, and reduced the underweight to China following the sell-off in Chinese equities.

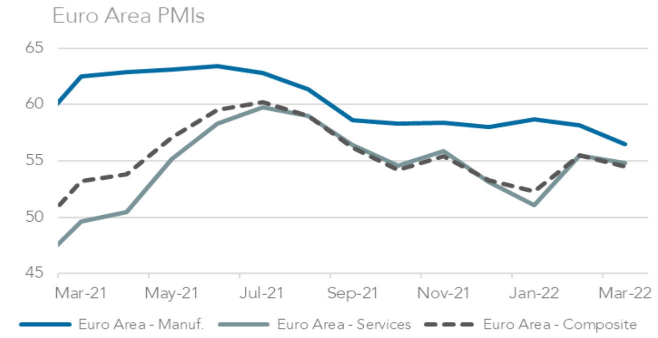
MACROECONOMIC

Euro Area

Just as the supply problems showed signs of easing, the war in Ukraine created new headwinds to growth primarily in industrial production. It would not be surprising if industrial output fell in the coming months. Industrial production in January stalled month-on-month, compared to the prior growth of 1.3% and the market expected growth of 0.1%, as a surge in omicron cases weighed on the economy in the beginning of the year and as supply constraints persisted.

The war in Ukraine has created three new headwinds to the manufacturing growth: (1) weaker export demand as countries will unlikely export goods to Russia at the same levels as before (in 2018, which is the latest published data, exports to Russia accounted for 2.1% of the Euro Area's value-added in the manufacturing sector); (2) new supply chain disruptions are expected in the sourcing of raw materials previously bought from Russia/Ukraine; and (3) higher energy prices will increase firms' costs and reduce consumer demand. These headwinds have already affect the forward-looking subcomponents of the manufacturing PMI data for March.

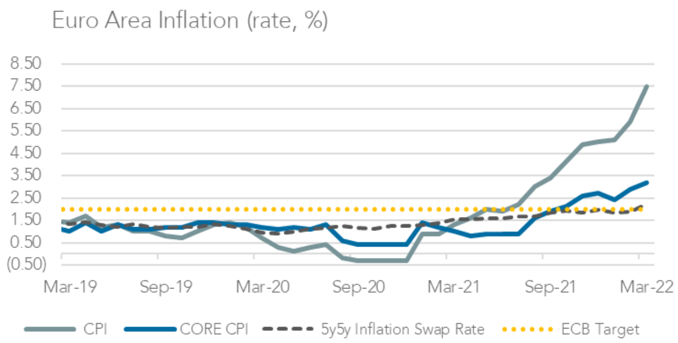
But rising services demand following the removal of restrictions across countries, allowing socialising and tourism to regain pace, should mean that the economy as a whole should avoid a recession, unless the rising COVID cases causes consumers to be more cautious once again with regards to socialising. Furthermore, rising inflation costs could result in less consumer spending.



Source: Bloomberg

The March final Composite PMI stood at 54.9, down from the prior 55.5 and the flash 54.5. Growth was driven by the services sector, where production rose faster than in February. The easing of virus-induced restrictions helped the tourism and recreation sectors, and new orders also increased solidly, although new business from export markets deteriorated. Manufacturing expanded the least in 21-months, impacted by supply bottlenecks due to the invasion and due to rising COVID cases in China, a drop in export demand, and a surge in costs for parts and raw materials on the heels of the war in Ukraine. Finally, business confidence plunged to a 17-month low, clouded by rising geopolitical tensions and worsened inflation.

The March flash headline inflation rate stood at 7.5%, well above that seen in the prior month of 5.9% and the market expected 6.6%. Inflation broke a new record high for the fourth consecutive month as the war in Ukraine and sanctions on Russia pushed fuel and natural gas prices to record high levels. Energy inflation is estimated to be 44.7% (Feb: 32%), but prices of other items also accelerated, including food, alcohol and tobacco (Mar: 5%; Feb: 4.2%). The rise in wholesale gas prices since the war began will not have yet fully fed through to consumer prices, so energy inflation looks set to remain very high.



Source: Bloomberg

On the other hand, the March flash core inflation rate stood at 3% compared to the market expected 3.1% and the prior 2.7%. With raw material costs increasing, inflationary pressures are likely to be passed at higher levels onto clients, therefore resulting in higher wage growth to keep up with the higher cost of living. Therefore, there is a good chance that core inflation will keep rising.

The unemployment rate declined during February to 6.8% compared to the prior 6.9%, however remained above the market expected 6.7%. The number of people classified as unemployed dropped by 181,000, and the fall was broad-based, with almost all euro-zone countries recording a decline. Labour market conditions are set to remain very tight despite the war in Ukraine and, alongside high inflation, point to wage growth picking up. The war may lead to some job losses, but it will not be on a large scale.

The European Central Bank ("ECB") sped up the asset purchase programme ("APP") during its March meeting and said that the APP could end in Q3 if the medium-term inflation outlook will not weaken. Monthly net purchases will now amount to €40bn in April, €30bn in May and €20bn in June. During the press conference however, Lagarde noted that such a move does not mean an acceleration or tightening, but a normalisation process due to high inflation. Lagarde also said the ECB now sees inflation at 5.1% in 2022, higher than 3.2% early projected while GDP growth for this year is now seen slightly lower at 3.7% compared to 4.2%.

Regarding the war in Ukraine, Lagarde said it *"will have a material impact on economic activity and inflation through higher energy and commodity prices, the disruption of international commerce and weaker confidence*". With the Ukraine war and pandemic-related prices pressures still much stronger than anticipated, it is possible that the ECB will not want to wait much longer before beginning to raise interest rates, as signalled already by some ECB policymakers who are suggesting a rate hike before year-end, after the APP is wound down, or even before.

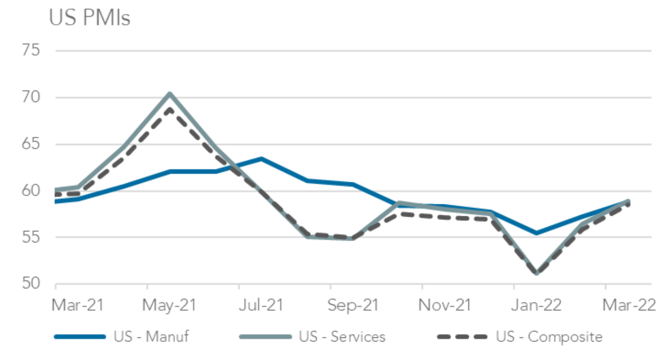
United States

The final annualised Q4 GDP growth showed that the US expanded 6.9% quarter-on-quarter in the last three months of 2021, below the second estimate of 7.1% quarter-on-quarter growth. Still it remains the strongest expansion since the 3Q2020 33.8% quarter-on-quarter growth. Concerns are mounting in the market that front-loading so much monetary tightening this year could weaken real GDP growth, and possibly even tip the economy into a recession.

February retail sales edged up 0.3% month-on-month, below the prior month's gain of 4.9% and the market expected 0.4% increase. This came about as rising inflation limited purchasing power, with a price-related 5.3% month-on-month rise in gasoline station sales, and following the decline in omicron infections, which saw a 2.5% month-on-month rebound in food and drink services sales. The muted increase in February was largely offset by January's significant gain which, overall, suggests that real consumption growth remained solid.

The further unwinding of the earlier omicron-related disruption suggests that broader services spending should see a decent rebound as from March. That said, with real disposable incomes in decline since mid-2021, as earlier fiscal support was withdrawn and the more general surge in prices took its toll, real consumption growth still looks likely to slow over the coming months. Furthermore, should COVID cases surge once again as in the EU, there is a possibility of renewed, albeit minor, consumer absenteeism in retail markets.

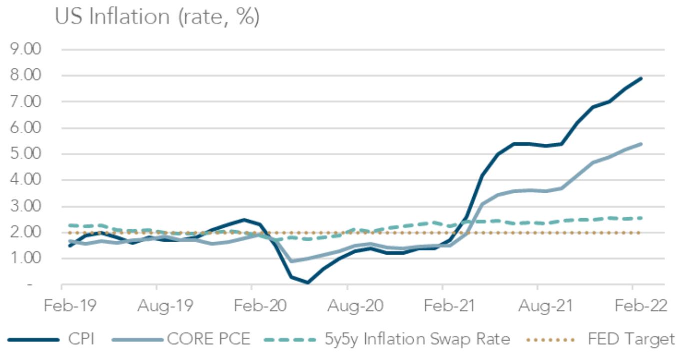
February industrial production grew in line with expectations at 0.5% month-on-month, below the prior month's growth of 1.4%. The jump in manufacturing output last month of 1.2% in part reflects the easing of widespread absenteeism as COVID cases fell back sharply. Something worth noting is that the one weak spot was motor vehicle output which fell by 3.5%, which appears to reflect a renewed worsening in the semiconductor shortage holding back production. Mining output edged up only 0.1% indicating that despite the backdrop of higher prices, producers are responding with only modest production increases.



Source: Bloomberg

US manufacturers have little supply chain exposure to Russia compared to European producers, though the renewed COVID lockdowns in China are a much larger threat, potentially resulting in raw material shortages. This suggests that output will rise more modestly in the months ahead. There is also a renewed, albeit minor (when compared to prior months), risk of labour absenteeism should COVID cases surge once again, although this has not been seen in the US so far.

The March final Composite PMI stood at 57.7 compared to the prior 55.9 and the flash 58.5, to signal a sharp expansion in business activity. The rate of growth was the fastest since last July, as manufacturers and service providers recorded steeper upturns in output. Supporting the sharper uptick in activity was the quickest rise in new business since June 2021. Domestic and foreign client demand strengthened as easing COVID restrictions continued to boost new sales. Meanwhile, inflationary pressures intensified as supplier costs soared, with costs being passed through to customers. Although employment grew at a steep pace, pressure on capacity mounted amid severe raw material shortages (albeit eased), with backlogs of work expanding at a series record rate.



Source: Bloomberg

The headline February inflation rate was in line with expectations at 7.9% compared to the prior 7.5%. Similarly, the February core inflation rate stood was in line with expectations at 6.4% compared with the prior 6%.

The main contributor to annual inflation remained energy (Feb: 25.6%; Jan: 57%), however this was due to strong demand, with the data print on inflation before the Russia/Ukraine war, and therefore the surge in energy costs due to the war is still to come. Another key contributor was food prices (Fed: 7.9%; Jan: 7%) given the extreme drought seen across the west and south, leading to increased prices in fruit and veg. The invasion is causing a surge in agricultural crop prices, meaning that food prices are headed even higher in the near term. Furthermore, ongoing supply constraints (albeit eased), strong demand and labour shortages will likely keep inflation elevated for longer.

During March, 431,000 jobs were added, below the market expected 490,000 and the prior 750,000, which points to a tightening of the labour market. The gain in payroll was helped by the fading effects of omicron, with employment in the leisure and hospitality sector rising by 112,000 jobs (biggest contributor), followed by the professional and business services sector which added 102,000 jobs. Something worth noting is that manufacturing employment rose by 38,000, 6,400 of which came from motor vehicle manufacturing employment, suggesting that semiconductor shortages are easing. There were no signs that the war in Ukraine or the resulting surge in oil prices in the first half of March had weighed on hiring in any parts of the economy.

The March unemployment rate stood at 3.6% compared to the prior 3.8% and the market expect 3.7%, suggesting the labour market has improved. The number of unemployed people declined by 318,000 to 5.95 million, while employment levels rose by 736,000 to 158.46 million, suggesting that more individuals are entering the market to fill the vast vacancies present. Meanwhile, the labour force participation rate edged up to 62.4% in March (Feb: 62.3%), the highest level since March 2020.

Employment is now 1% below from its pre-pandemic level in February 2020, with nearly all that shortfall concentrated in leisure and hospitality. But the complete recovery could happen in the next several months if the current pace of jobs growth is maintained.

March average hourly earnings for all employees increased by 0.4% month-on-month to $31.73, in line with expectations and after rising by 0.1% month-on-month in the prior month. This is smaller than the average 0.5% -0.6% monthly gains seen for most of the past year. While annual wage growth rose to 5.6% this month (Feb: 5.2%), favourable base effects mean wage growth will fall from here onwards, with evidence on pay growth and broader measures of slack, like job openings and quits, suggesting that labour market shortages and pay pressures have levelled off. That in turn should feed through to weaker underlying inflation, easing pressure on the Federal Reserve ("Fed") to deliver a series of aggressive rate hikes.

Following the March meeting rate hike by 25bps, the Fed is set to continue tightening monetary policy through a series of interest rate hikes and will start reducing its $9tn balance sheet at a rapid pace as soon as next month and is prepared to take 'stronger' action on raising interest rates in order to bring down inflation.

Fed policymaker Brainard expects the combined effect of rate increases and balance sheet reduction to bring the stance of policy to a more neutral position later this year. "*It is of paramount importance to get inflation down*" according to Brainard. "*Accordingly, the committee will continue tightening monetary policy methodically through a series of interest rate increases and by starting to reduce the balance sheet at a rapid pace as soon as our May meeting*". Brainard suggested tactic support for more aggressive moves including doubling the pace at which the Federal Funds Rate ("FFR") is raised and delivering 50bps rises at forthcoming meetings. The Fed now sees rate hikes at each of the remaining meetings this year, with the FFR reaching 1.9% by year end.

Wall Street is increasingly anticipating at least two such adjustments in 2022, as a growing number of Fed officials have signalled their willingness to swiftly get to a more "neutral" policy level that neither aids nor constrains growth by the end of the year. Estimates of neutral range from 2.3-2.5%. Stronger action could also mean an even faster contraction in the Fed's holdings of treasuries and agency mortgage-backed securities, which swelled during the pandemic.

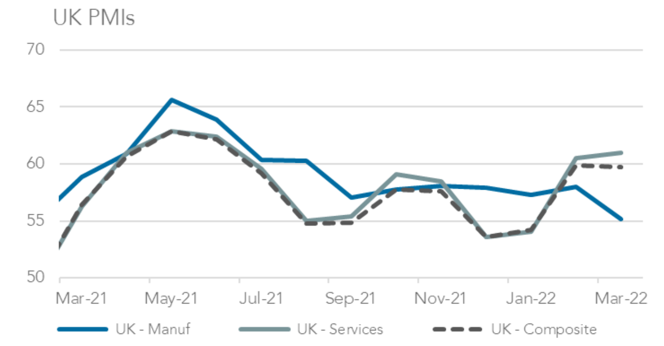
Brainard warned Russia's invasion of Ukraine would put upward pressure on inflation and probably raise already elevated gasoline and food prices. Supply chain bottlenecks could become further extended, especially given new lockdowns that have been announced in China to contain the spread of COVID, developments that further underscore the need for the Fed to move in an "*expeditious*" way to tighten monetary policy.

United Kingdom

The final Q4 GDP growth rate stood at 1.3% quarter-on-quarter, compared to the preliminary estimated 1% quarter-on-quarter. This leaves GDP at 0.1% below where it was pre-pandemic at 4Q2019. Considering full 2021, the economy advanced 7.4%, slightly less than initial estimates of 7.5%, and rebounding from a 9.3% contraction in 2020. This year, the cost of living crisis will likely slowdown GDP growth, however a recession will likely be avoided as households seem willing to eat into their savings to meet the rising costs to return to "normal" life. The squeeze on real household disposable incomes will hit harder from 1 April, and it is uncertain how households will respond. We believe that consumers will be willing to dip into the stock of excess savings built up during the pandemic even during this time.

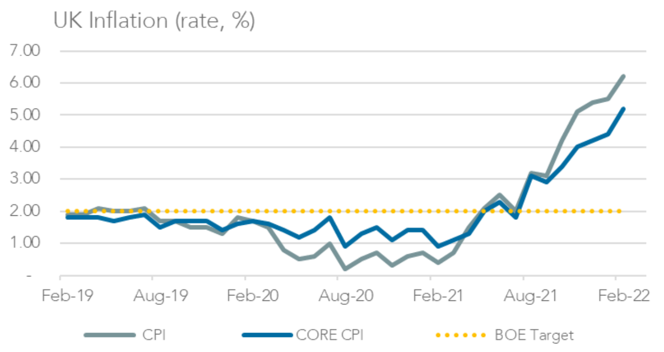
January industrial production grew 0.7% month-on-month, above the expected 0.1% growth and the prior growth of 0.3%. This was led by an increase of 0.8% in manufacturing, mainly of rubber and plastic products, and of basic metals and metal products.

February retail sales declined 0.3% month-on-month, compared to the expected growth of 0.6% and the prior month's growth of 1.9%. The fall had more to do with the shift back towards non-retail spending following the lifting of "Plan B" restrictions and the impact of Storm Eunice on footfall, than it did the cost of living crisis. But, with further rises in inflation and interest rates looking likely, the outlook for overall spending this year seems to be more downbeat. We suspect the coming months are only likely to get more difficult for retailers as the cost of living crisis begins to have a bigger impact, and households are in a prolonged period of negative real wage growth.



Source: Bloomberg

The March final Composite PMI came in at 60.9, higher than the prior 59.9 and the flash 59.7, to signal the fastest rise since June 2021. Stronger economic growth following the removal of pandemic restrictions reflected a sharp and accelerated upturn in service sector output. In contrast, manufacturing production increased at the slowest pace since October 2021. Manufacturers indicated that ongoing supply shortages, greater caution among clients, escalating inflationary pressures and geopolitical tensions had all hampered the upturn. March data pointed to faster rates of input cost inflation in both the manufacturing and service sectors.



Source: Bloomberg

The February headline inflation rate came in at 6.2%, well above the prior 5.5% and the market expected 5.9%, as rising costs of energy and food continue to squeeze the living standards. Similarly, the February core inflation rate came in at 5.2%, well above the prior 4.4% and the expected 5% and also the Bank of England ("BOE") target, pushing the BOE to reassess its dovish tone adopted in the March meeting.

As with the US and Euro Area, the Ukraine war is to bring about an even higher surge in inflation from energy and food. What's more is that as of 1 April, a 54% leap in utilities prices as well as rises in taxes will be felt, including a 1.25% increase in national insurance tax for employees. As a result, wage inflation will grow so that household earnings will be able to meet the rising costs. Therefore, a further surge in inflation is likely have a more meaningful impact.

The unemployment rate in the three months to January fell to 3.9%, below the expected 4% and the prior 4.1%, as the labour market continued to recover. Average weekly earnings (inc. bonuses) increased 4.8% year-on-year in the three months to January, compared to the prior and market expected 4.6%. However, it can be suggested that wage growth is a sign of firms increasing earnings to tame the cost of living crisis (especially as of 1 April) and not solely to fill vacancies.

The mix of decent demand for workers and a diminished supply of workers pushed up the number of job vacancies to a new record high of 1.3 million in February and maintained the upward pressure on wage growth.

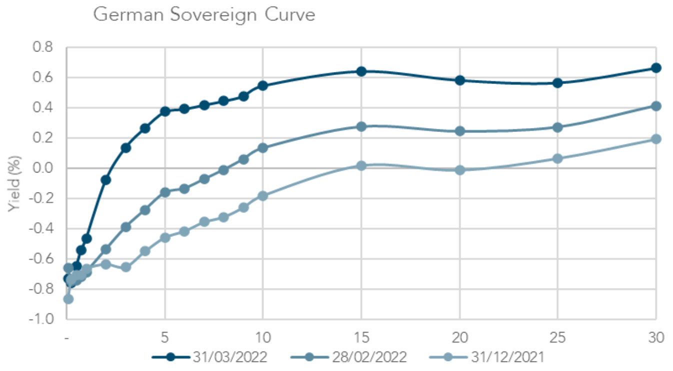
The BOE raised its key Bank Rate by 25bps to 0.75% during its March meeting, in line with expectations, taking interest rates back to pre-COVID levels. Developments since the February report, in particular the invasion of Ukraine by Russia, are likely to accentuate both the peak in inflation and the adverse impact on activity by intensifying the squeeze on household incomes, with the BOE expecting inflation to reach c. 8% in Q2.

According to Governor Bailey, Britons face a "*historic shock*" to their incomes. The BOE governor sounded the alarm on so-called stagflation, suggesting slowing economic growth and soaring inflation posed the biggest challenge to the Monetary Policy Committee ("MPC") since its creation in 1997. Based on its current assessment of the economic situation, the MPC judges that some further modest tightening in monetary policy may be appropriate in the coming months, but there are risks on both sides of that judgement depending on how medium-term prospects for inflation evolve.

RATES

Euro Rates

EUR rates traded higher across the curve during March with the largest impact seen in the 5-year area of the curve. The extent of flattening in the EUR curve has been much more modest than in other regions particularly since the Ukraine invasion.



Source: Bloomberg

The movement of the curve is somewhat uncharacteristic given the nature of the shock. The invasion and subsequent commodity price increases is primarily a shock to supply (inflationary) and not demand (disinflationary) which means that the growth and inflation outlook has worsened for the region. This has been met with increased fiscal spending, when economic conditions and productive capacity have recovered substantially (inflationary) while the ECB pivoted to a relatively hawkish policy response. These conditions would generally induce a more pronounced flattening of the curve.

A possible explanation could be that the market is less convinced that the ECB will be able to follow through with the planned tightening and is therefore pricing in a more dovish central bank response. This may not be unreasonable given the more severe downside risks for Europe given its proximity to the war and dependence on Russian energy. In fact, when decomposing the movement in the 10-year bund yield, the move higher in the nominal rate by 69bps since the start of the year is being explained primarily by a higher inflation premium. Conversely, the proxy from expected short-term rates have drifted lower, given lack of traction of central bank pricing, while the term premium increased.

If the situation in Ukraine continues to de-escalate, the fundamental macro picture and spill-overs of hawkish front-end pricing in other G10 curves, and increased scope for an accelerated timeline for ECB policy normalization should point to higher yields and a flatter curve, or "bear flattening".

The ECB's emphasis on being data dependent following the higher inflation prints and increased volatility in rates should provide solid ground for a more hawkish outcome. On the flipside, an escalation of the war in Ukraine will intensify tail risks for the growth and inflation outlook in Europe. In such an environment, the central bank policy response is less obvious and could result in softer front-end pricing and the curve could remain steeper for longer.

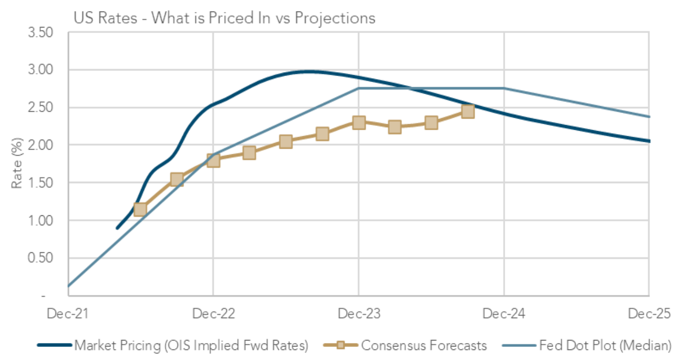
Euro Area sovereign spreads saw some respite following the widening at the start of February, which was in line with increasing expectations that the ECB will tighten monetary policy faster. The pullback in sovereign spreads came as the market softened the pricing at the front-end of rate expectations. Spreads are expected to remain under pressure given the expectations of a continued rise in Euro Area inflation which increases the scope for the ECB to tighten conditions faster. In the meantime, spreads have remained in check given that the quantitative easing programmes are still active.

Increased risks to the growth outlook should also put pressure on spreads given the asymmetric impact on member states. Moreover, spreads remain vulnerable to the higher government funding requirements following the announcements on increasing spending. With regards to the latter, the possibility of European fiscal risk sharing could be a net positive for spreads.

US Rates

The Fed has turned decisively more hawkish at the March meeting following signs that price pressures are broadening, with the last headline inflation print in the US for February reaching 7.9%.

The FOMC dot plot shows a median rate implying 7 25bps hikes this year (and another 4 hikes in 2023) taking the Fed Funds Rate ("FFR") to 1.875% by year-end, with participants indicating willingness to hike in 50bp increments. Market analysts and economists have brought forward the rate hike trajectory, with current market pricing implying a year-end rate of c. 2.5%, that is 9-10 hikes this year. Therefore, the market is implying a faster rate hike trajectory this year. Implied forward rates top-out at



Source: Bloomberg

close to 3% in 2023. This terminal level is in-line with FOMC median projections showing that the FFR will reach 2.875% by end-2023, which by implication suggests the market is implying a slower rate hike trajectory next year.

Goldman Sachs revised up its yield forecasts for YE2022 and YE2023, with the 2-year yield forecasts now at 2.9% and 3.15%, 5-year yield forecasts at 2.75% and 3% and 10-year yield forecasts at 2.70% and 2.80%. This means that from current levels, Goldman Sachs expects the 2-year yield to move higher by 40bps, the 5-year yield by 30bps and the 10-year yield by 35bps (compared to end-March levels). The expected repricing higher at the short-end is expected to be more pronounced on the basis that Goldman Sachs economists expect the terminal rate to be around 3.25% (versus current market pricing of just under 3%).

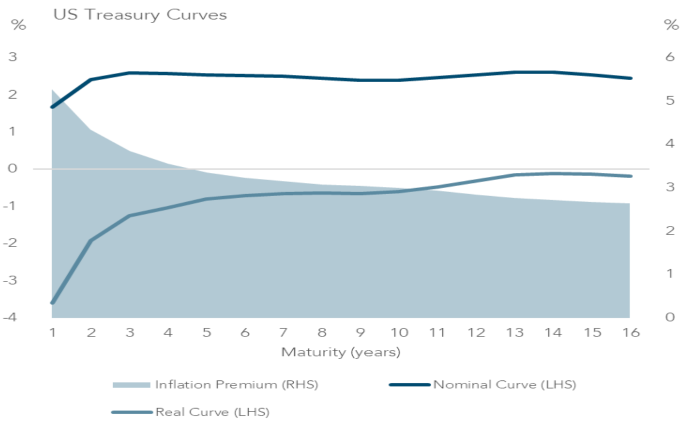
Expectations for the neutral or long-run rate have remained around 2.25% and 2.50%. The typical proxy for the long run rate is the 5y5y OIS forward rate which came up substantially. However, the adjustment here has been much more gradual as we have indicated in previous updates. As rates have moved close to estimates of the long-run rates (that is, markets have fully priced-in current rate hike expectations), markets will be more focused now on the upside/downside risks from here which have become more symmetric.

On the left tail, we have the possibility that the hawkish Fed stance in the economy may be facing headwinds given the fiscal drag and external growth risks (such as the war in Ukraine), which could result in softer front-end pricing and/or deeper inversion.

On the right tail, we have the possibility that inflation continues to drift higher and will take longer to normalise. This would likely mean that the nominal neutral rate should be higher than current baseline assumptions, translating into greater odds of a repricing higher, and the curve to steepen. A de-escalation in Ukraine and fading downside growth risks will allow risk premia to be rebuilt in bonds globally implying less flattening than is currently expected.

Current uncertainty on the eventual outcome will persist at least some way into the hiking cycle, allowing the market, economists and policymakers the time to assess the effects of Ukraine and the impact of rate hikes. Therefore, a re-steepening of the yield curve is not particularly likely at this stage. In fact, a repricing higher will be primarily driven by higher short-end rates with expectations of some modest inversion in the 2s10s at least by year-end.

The inversion in the US treasury is primarily explained by higher inflation premia at shorter tenors and a deeply inverted inflation swap curve. The real rate curve has flattened materially but remains upward sloping.



Source: Bloomberg

The inversion of the treasury curve has historically been synonymous with increased recession risks. In the current environment, recession risks have increased given the risks to the growth outlook (coming from fiscal drag and geopolitical uncertainty) and the expectations of an aggressive rate hiking cycle which will impact demand and investment and can induce a sharp economic slowdown. Having said that, given the very strong initial conditions, the possibility of a recession remains unlikely with economic forecasts generally pointing towards above-average growth rates.

The inversion of the curve may be telling a different story, which is that inflation is expected to come down materially from current levels, as seen in the deeply inverted inflation swap curve.

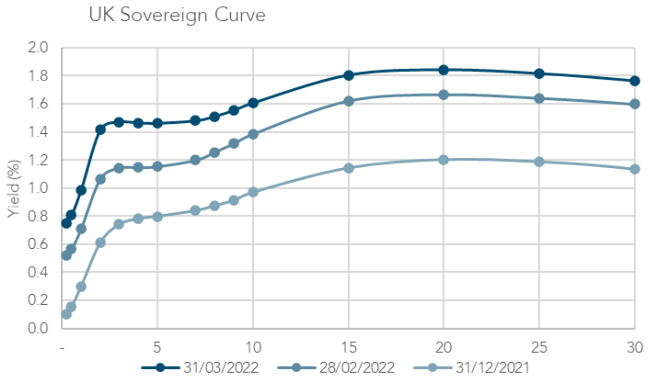
An inversion in the real curve is a more reliable indicator of a recession given that in a high inflation environment, some modest inversion in the nominal curve would imply smaller odds of a recession compared to previous hiking cycles.

UK Rates

The UK Gilt curve has similarly moved higher and flattened during March as a result of (a) higher inflation risks resulting in higher inflation premia across the curve and (b) increased anticipation of further rate hikes by the Bank of England ("BoE").

As can be observed when decomposing the movement of the UK 10-year gilt yield, the expected trajectory for policy rates softened shortly after the Ukraine invasion as a result of greater policy uncertainty and increased downside risks to the growth outlook. However, the market pricing of short-term rates got firmer shortly after, ahead of the March Monetary Policy Committee meeting.

The developments in Ukraine have accentuated the ex-



Source: Bloomberg

pected peak levels in UK inflation as well as the adverse impact of higher energy prices on disposable income, which has also worsened the growth outlook of the net-energy-importing nation.

Despite the increased risk to growth, the BOE has reiterated its focus on the inflation target resulting in stronger expectations of a front-loaded rate hiking cycle.

In the Spring statement, the UK Chancellor presented a supportive budget for fiscal year 2022-23 involving the deployment of some fiscal headroom accumulated in recent months, where the intended deficit is just under £100bn. This came c. £30bn lower than expected. Moreover, the net issuance needs for the fiscal year are of just £17.6bn resulting in expected gross issuance of £124.7bn and redemptions of £107.1bn, suggesting a relatively benign issuance calendar.

Given the likelihood of further sharp increases in inflation and the tight labour markets, expectations are pointing to the BOE raising rates to 1% in May which would likely bring about the start of active Gilt sales to start shortly after. Current forecasts estimate a reduction of about £150bn of QE holdings through both redemptions and sales over the next three years.

Goldman Sachs rose their year-end 10-year gilt yield forecasts from 1.7% to 1.95%, that is 35bps higher from end-March levels. Indeed, expectations of further rate increases combined with quantitative tightening and increased fiscal spend should continue to push UK yields higher.

CREDIT

Euro Credit

Eurozone corporate bond spreads tightened against the sovereign benchmark yields as spreads in the investment grade ("IG") and the high yield ("HY") space compressed by 15bps and 38bps respectively during the month of March. The movements in spreads were primarily driven by the de-escalation of the Russian invasion of Ukraine, a more hawkish ECB and economic indicators showing that inflation has remained at elevated levels.

Spreads have tightened back to levels prevailing before the invasion of Ukraine, reflecting reduced monetary policy uncertainty and still-negative real yields. We have seen more tangible developments that point to an easing of the crisis in Ukraine-Russia and, even if a ceasefire may not be imminent, markets have also been trading strongly as a consequence. Nevertheless, the invasion has brought more concerns over inflation and downside risks to growth, potentially to the point of recession. However, there are some aspects that may justify the tightening in spreads, even if the backdrop has, on balance, worsened.

The considerable uncertainty in January and most of February surrounding potential central bank action over persistently high inflation has reduced, with the ECB having signalled its intention to end quantitative easing by Q3. Despite ongoing uncertainty on when hikes will occur, there is broad acceptance that the path of hikes will be very slow.

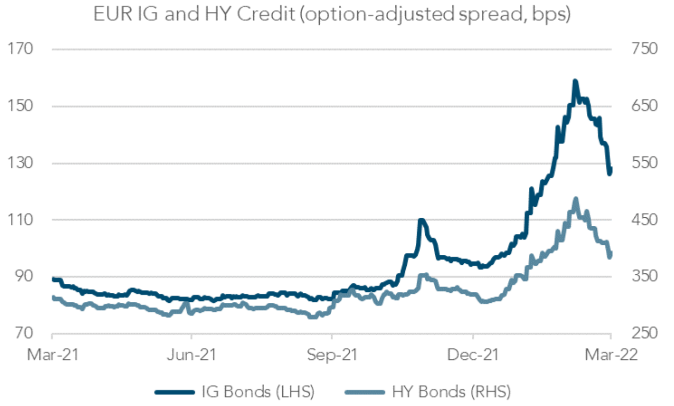
Following such a sharp move in rates and spreads on a year-to-date basis, all-in yields are more attractive today, providing some additional resilience in breakevens at this stage. With inflation higher still, real yields are still very low relative to history and as such, we believe demand for credit (more so high yield) will remain strong, and generally speaking do not expect further sharp decompression in high-beta credit spreads.

The lingering concern for corporate credit investors remains the unknown of economic downside, even despite forecasts of positive year-on-year growth in both 2022 and 2023. Of particular concern is the potential for a consumer-led slowdown amidst a squeeze on disposable income from high energy prices. As such, we tend to prefer focusing on areas of the market where the ability to pass on costs to consumers is high and/or products are viewed as core requirements rather than luxury indulgences.

In IG, breakevens have risen from record lows to record highs in the post-COVID era. Such record breakeven highs provide ample (33bps) cushion against future rate or spread widening before negative total returns and persuade us that high grade is the most protected it has been in years. In terms of curve positioning, we saw some relative flattening of the curve in February as the invasion sparked default fears due to evolving sanctions. This curve has flattened further during March as the credit rally in the latter part of the month benefitted the longer end of the curve to a greater degree. As the 10+ year bucket currently pays on average just 29bps more than the 3-5 year bucket, we tend to continue favouring the front-mid end of the curve as a better trade-off between yield and rate risk.

In high yield ("HY"), yields have also spiked during the conflict and the inflation-led selloff, up over 200bps to c.5.05% yield-to-worst. After this major move, HY breakevens are now roughly 147bps, implying a significant cushion against rising rates before negative total returns. This is nearly double the cushion we saw at the lows in 3Q2021.

Despite very low issuance during March, mainly as a result of ongoing geopolitical conflicts, April tends to be much smaller in net supply for HY than March, with additions since 2011 averaging just €1.9bn. The expectation is for this April to be no different given still wider yields and the ongoing conflict. Such modest new supply should be well digested by the market, as defaults are absent (at least within names not directly linked with the conflict) and many bond investors continue to seek HY as a shelter from rising bund yields.



Source: Bloomberg

US Credit

Similar to their European counterparts, corporate bond spreads in the US also compressed during March as IG and HY corporate bond spreads tightened by 6bps and 34bps respectively. While the conflict in Russia and Ukraine seems to have had less of an effect on the US corporate bond market due to its geographical distance from the war, the US corporate bond market seemed to have been driven by the ever increasing hawkishness of the Fed and economic data which continued to show elevated levels of inflation and a tight labour market.

The primary narratives that have hampered 1Q returns for US credit are elevated inflation and tightening monetary policy, amongst ongoing geopolitical risks and the lingering pandemic concerns. However, a key question asked by investors more recently is: what does a flat/ inverted 2y10y treasury curve mean for corporate credit?

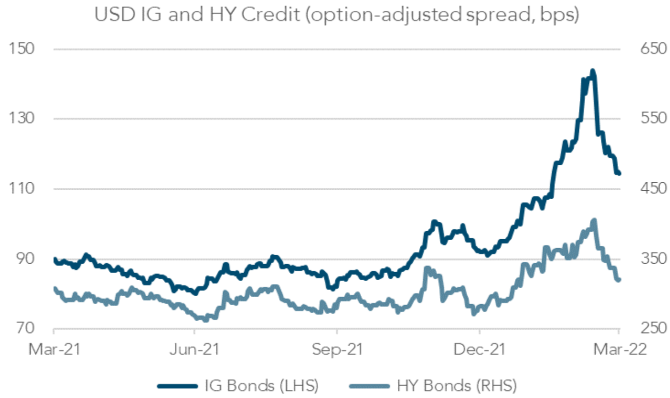
Historically, an inversion of the 2y10y curve have been one of the surest leading recessionary indicators, with the economy, on average, entering into recession c. 20 months from the inversion of the 2y10y curve. The Fed believes that the 3m10y spread is a far better signal for a recession, likely because this better captures the monetary policy stance.

Whilst the 2y10y has come under pressure and flirted with inversion, the 3m10y remains fairly steep and implies a lower probability for the US to enter a recession in the short-term. Nevertheless, according to Barclays rates strategists, the rates market is implying that the 3m10y curve could invert sometime in 1Q2023, which in turn would infer a higher probability for a 2023 recession if confirmed. Naturally, the more likely a recession, the wider we can expect corporate credit spreads to drift.

On aggregate, given the lower risk of recession in the short-term, we see spreads as likely remaining range-bound, due in part to the tailwind from likely lower April primary market activity, and no Fed meeting until the 4 May. However, the macro picture remains challenging for spreads to materially outperform in the medium-term, and given the more attractive spreads on offer for EUR credit, we prefer deploying capital in that space for the time being.

Bloomberg intelligence see option adjusted spreads for USD IG credit as potentially testing the 160bps area, having already topped out at 145bps in mid-March before closing the month at 116bps. This view comes both as monetary policy constricts, inflation lifts and the spread curve re-steepens to accommodate these impacts, with the tail risk of a renewed risk-off sentiment, a Fed remaining far behind the inflation curve, or a lower growth narrative also driving their less constructive view on the space.

Benchmark duration within USD HY has been grinding higher in recent weeks as bonds previously trading at a premium and by extension, call-constrained, are now trading lower and priced to maturity. As a result, the improvement in USD HY breakevens, whilst welcome, has been somewhat more muted than the same meas-



Source: Bloomberg

ure for EUR paper, and the space does not screen as attractively as EUR. On balance, and similar to IG credit, we prefer EUR spreads within the HY space given more attractive spreads on offer. The distance from year end spread forecasts also imply somewhat more material negative excess returns expected until the end of the year, however, we continue to maintain a short duration stance to take advantage of flat treasury curves.

UK Credit

The UK corporate bond market followed a similar pattern to the movements seen in the US and the Eurozone, however spread compression was more muted. In fact, spreads within the IG space tightened by less than 1bp and spreads within the HY space tightened by c. 23bps. The yield on the gilt climbed by c. 19bps during the month as it closed at the 1.61% level. The higher gilt yields were driven the BOE's decision to raise rates by 25bps at it March meeting, together with inflation data showing that the price of goods and services rose by 6.2% in February and could rise to about 8% according to the BoE.

The BoE has raised interest rates at each of its last three meetings, and started passively unwinding its balance sheet during March. But there were signs in the minutes of the March meeting that the BoE is becoming increasingly concerned about demand and, reflecting that concern, the central bank softened its rate hiking guidance.

Nevertheless, the market is almost fully pricing in another 25bps rate hike at the upcoming meeting on 5 May to bring rates to 1.00%. This level of rates could potentially also usher in the beginning of active gilt sales, piling further pressure on bond pricing in the near term. As the backdrop on both the economic recovery and monetary and fiscal policy support remains unchanged, we continue to favour EUR credit over GBP as the expectation remains for UK yields to continue drifting higher.

Defaults and Ratings Backdrop

After 14 months of largely positive ratings actions, and global corporate defaults at their lowest level since 2014, the momentum seems to have stalled. Downgrades have surpassed upgrades for the past four weeks, and the number of weakest links, that is borrowers rated B- or lower with a negative outlook or currently creditwatch negative, has risen for the first time since June 2020. The conflict is clearly a significant factor, with 129 recent ratings actions attributed directly or indirectly to the conflict, and the increase in weakest links largely driven by Europe and EEMEA. As weakest link default rates are on average higher than overall HY defaults, it is likely that global defaults will increase this year, perhaps beyond the initial baseline forecasts of 3% in the US and 2.5% in Europe by year end.

Whilst downgrades are outpacing upgrades, ratings overall remain resilient outside of the countries directly affected by the conflict and the sanctions and entities highly exposed to the surge in commodities prices. As we have highlighted previously, many corporates started the year with stronger balance sheets, having taken advantage of two years of cheap funding to extend their maturity schedules, and still managed to gain some benefit from solid economic growth for most of the first quarter. Banks, including those in Europe, have also proved resilient, having significantly reduced their exposure to Russia following its annexation of Crimea in 2014. Thus far, negative ratings actions on financial institutions have mainly been focused in Russia, Ukraine and Belarus, with many of them linked to downgrades of the sovereigns and the view of a deteriorated operating environment.

EQUITY

The Ukraine invasion was a gamechanger in terms of macro-economic expectations. The surge in energy prices since the invasion, as well as the impact from sanctions and supply-side constraints has led to several negative revisions for global growth forecasts, with inflation expectations moving the other way. Investors found this deterioration in the growth/inflation mix hard to digest, primarily as this was already a concern at the start of the year when growth expectations were higher and inflation expectations were lower.

The Ukraine conflict has led to a shift in narrative, away from reflation to stagflation. A reflationary environment, that is a backdrop of strong growth and rising inflation, is generally more supportive for equity market performance. At the start of the year investors were cautious as growth was slowing down (but still above-trend), whilst at the same time interest rate expectations rose from 0 in the summer of 2021 to 7 by February. The impact on the asset class was relatively mild pre-invasion, with long duration equities hit the hardest. The invasion of Ukraine has fuelled stagflationary fears, which is generally much tougher to navigate.

Stagflation tends to be bad for most financial assets, often leading to negative real returns. Since the global financial crisis in 2007, central banks have been fighting against deflation, slashing interest rates to zero and implementing quantitative easing. This low inflation led to strong real returns across financial assets. The best performing asset classes were long duration assets that benefited from ultra-low interest rates like the Nasdaq. During the stagflationary period of the 70s and early 80s, the total return performance was almost a mirror image. Inflation in the real economy was very high, most assets fell in real terms and the assets with the highest returns were gold and commodities. Value stocks materially outperformed growth stocks as interest rates increased.

Equities started March on a weak note, with European equities suffering a weekly loss of -7.0%. Yet, by the end of the month, these losses had all but reversed as risk sentiment recovered. March was the first month of positive performance for both the S&P 500 and STOXX 600 since December 2021, despite the uncertainty brought about by the war. On a year to date basis, all domestic market indices we follow are still in the red, except for the FTSE 100 which has a bigger tilt to energy and basic resources. Emerging markets outperformed developed markets during the first two months of the year, when the narrative was reflation, partly due to the number of commodity exporters within the index. However, the Ukraine war has weighed on performance in March as the index registered a -2.3% loss during the month.

The strong recovery in equity markets cannot mask the high risk. The US has been under the microscope for some time due to the high inflation prints. However, most countries are reporting high inflation, even in Germany, a country that has been fighting deflation for over two decades, headline inflation surged +7.6% year-on-year in March. We acknowledge that the risk of the conflict spiralling into a world war now seem less obvious, but uncertainty remains very high.

We think that equity market performance has been in parts aided by a number of factors:

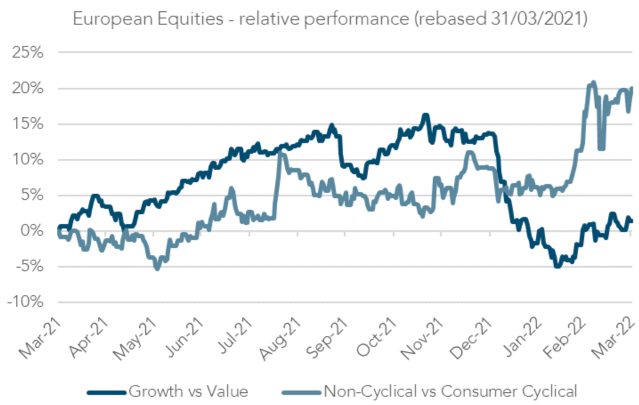
(1) Gap between dividend yields and nominal or real yields remain above the average since 1990.

(2) Equities are a real asset. As long as economies grow, revenues and dividends should also grow. The higher deflation risk that followed the financial crisis in 2007 led to an increase in equity risk premium and reduced the bond term premium. This is now starting to reverse but still remain higher than pre-financial crisis.

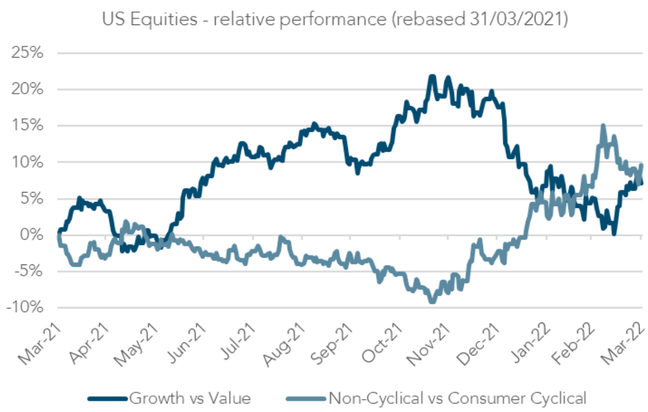
(3) High household savings rate, which implies healthy household balance sheets which should support consumer spending over the near term.

(4) Credit markets have been relatively stable, reducing systematic risks. The cash to asset ratio remains high.

(5) Valuations are still below long-run averages.



Source: Bloomberg



Source: Bloomberg

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 quantitative easing programmes, a significant contributing factor to tighter peripheral spreads, will terminate in 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 to remain stable for issuers and regions not directly impacted from developments in Ukraine, though cracks are beginning to form for more exposed entities. Recent spread widening offers a significantly better cushion against adverse movements in benchmark bond yields than we have seen for a number of years. 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, though maintain a preference for a low-to-neutral duration stance vs the broader corporate market.
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 has led to a substantial widening in credit spreads. Having said that, the improved underlying economic conditions and still stable credit rating environment provides 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 the growth outlook. 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 has boosted performance.

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

DISCLAIMER