Investment Strategy Update

August 2022

Curmi & Partners Research

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- August flash Purchasing Manager's Indices show that activity is weakening substantially and suggest that both the US and the Euro Area are contracting.
- We expect global growth to decelerate to below-trend in the second half of the year given the drag from the Russia-Ukraine conflict and tighter financing conditions.
- The Euro Area will likely enter a recession in the second half of the year given the gas supply disruption and the ongoing war in Ukraine, with the risk of a more severe downturn in the event of a complete shutdown in gas supplies.
- The US will likely avoid a recession but the growth outlook remains weak given the contraction in residential investment, fiscal drag and slowdown in consumption growth and trade.
- Despite the uncertainty from COVID, housing and export demand, China is expected to report continued growth in 2022 supported by the policy stimulus.
- Inflation is expected to moderate given the slowdown in demand for goods, improvement in goods and labour supply as well as the efforts of central banks to tighten monetary policy.
- Central bankers will unlikely be deterred from progressing with their tightening plans given that inflation levels are still very high and that underlying sources of inflation remain intact.
- Any rally in front-end rates is expected to be limited given the firm pricing of central bank policy, while long-end rates have further room to soften given the still high long-run neutral rates and wide inflation premia.
- We have moderated our view on duration given that the risks around medium to long-end yields is more balanced today which gives us comfort to restore a neutral exposure possibly introducing a marginally long duration position.
- Downgrade risk has increased especially for issuers rated B-, particularly names in consumer products and capital goods, many of which are facing inflationary cost pressures that continue to weigh on margins.
- We continue to favour defensive credit positioning by moving up in quality, as we expect spreads to re-widen by year-end, with lower rated securities having less stable balance sheets likely to underperform.
- Our view is that equity rallies cannot persist until we get some additional clarity on inflation dynamics and the impact on economic growth from the aggressive tightening cycle.
- We remain underweight equities over the short term with a defensive skew in our positioning to protect against episodes of poor market sentiment.
- Commodity-exporting emerging economies have outperformed for most of 2022, however we expect momentum to fade given the global growth concerns and uncertainty around China, particularly COVID risks and the recent tensions with Taiwan.
- We are looking to reduce our allocation to EM equity and establish an underweight position.

Economic data is showing signs of weakening activity following a period of strong recovery from the pandemic. The drop in output in Russia and Ukraine, the high inflationary pressures and tighter financial conditions are starting to impact demand for goods and services in other regions. Soft indicators have been showing a decline in business and consumer confidence. More recently, the Purchasing Managers' Indices (PMIs) released in August have marked a drop in business activity across major economies (see Exhibit 1), with most indices printing below 50 indicating contraction. UK was the exception with the composite PMI still holding in expansionary territory at 50.9 primarily supported by some resilience seen in service sector activity.

The decline in PMI data to such levels is generally consistent with outright falls in economic output. What's more is that forward-looking sub-indices, mainly new orders and new export orders, have shown a continued decline indicating that more weakness is yet to come.

The silver lining is that supply chain disruptions seem to be easing in advanced economies. This is evidenced by the decline in supplier's delivery times and input prices. Separately, commodity prices and shipping costs have also come down adding to signs that global inflation may be at a turning point.

The US CPI print for July was received well by market participants given that headline inflation fell more than expected. The decline in energy and commodity prices means that global headline inflation should start to moderate in the coming quarters (see Exhibit 2). However this will not be even across regions. Particularly in Europe, the higher gas prices mean that headline inflation is expected to remain high for longer compared to the US, with the possibility that it rises further. Similarly, the removal of utility price caps in the UK means that headline inflation is also expected to rise sharply in October.

Despite several regions showing that the rate of increase in price levels is starting to decelerate, we remain very far from central bank target levels. Moreover, with more broad-based increases in non-energy goods and service prices, it is unlikely that we will see core measures of inflation coming back down at the same rate as the headline measures. With that said, we do not expect central banks to reduce their efforts in fighting inflation for the time being. Central bank expectations have increased further in recent weeks with markets now pricing in a peak rate of 3.8% in the US around March 2023 and 2.2% in the Euro Area in June 2023. These imply further increases in policy rates of circa 150bps and 220bps across the two regions respectively (see Exhibit 3). Fed Chair Jerome Powell's reiterated at the Jackson Hole Symposium in August that there is still a long way to go bring inflation down towards acceptable levels.

At the same time, the increased downside risks to the growth outlook cannot be overlooked by policymakers, particularly in Europe, since the impending slowdown in demand should, in itself, be a disinflationary force. Therefore, we are seeing a growing scope for a slower pace of rate hikes going forward and for central bankers to wait and assess the effect of the first rate increases before progressing further. We may possibly see a "stop-and-go" type of approach being adopted by central banks in this rate hiking cycle. However, while labour markets remain on a very strong footing, central bankers will unlikely pivot away from a hiking path.

Market movements are underpinned by the inter-relationship between inflation dynamics, growth outlook and central bank policy.

Yields climbed back in August following lost hopes that central banks would review their course of action on the back of the gloomy economic outlook. We are viewing this drop in bond prices as a good opportunity to square our short duration bias in our fixed income strategy and to explore the scope for a modest long duration position. Our view is that risks are more balanced around the direction of yields. The short-end of benchmark yield curves remain propped up by expectations around the central banks' rate hike trajectory. On the other hand, the current implied long-run neutral rates are high when considering the current macro backdrop. The US 5y5y forward nominal and real rates are trading well above pre-pandemic levels, which look cheap in the context of a slowing economic growth path (see Exhibit 4). We therefore see scope for the sell-off in bonds to lose momentum and for the belly and long-end of benchmark curves to outperform going forward.

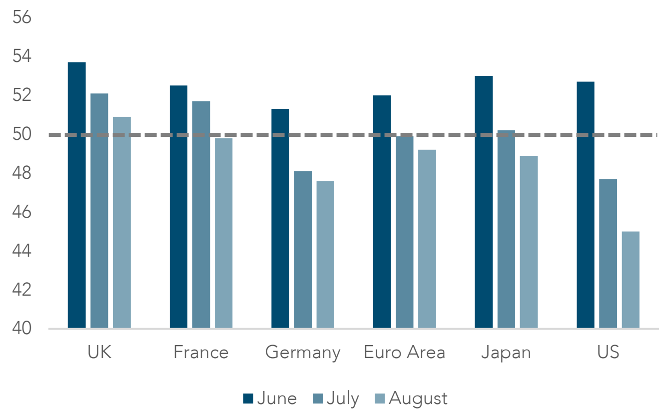
As recession risks mount, the outlook for credit spreads looks weaker, particularly off the back of what turned out to be a very strong rebound since mid-June. Higher interest rates, rising costs, lower consumer and business confidence, volatile financial markets and cost of living pressures are likely to continue weighing on spreads. Although, the corporate sector enters this downturn relatively well prepared, with cash balances and liquidity levels still relatively bolstered as a result of the pandemic stimulus. We continue to favour defensive positioning by moving up in credit quality, and see the recent rally as an opportunity to do so. We believe this relief rally is temporary and think that spreads will likely widen by year-end, with lower rated securities having less stable balance sheets likely underperforming.

Year to date, Euro investment grade ("IG") credit has faced many catalysts for underperformance (war in Ukraine, gas crisis, Italian politics) which has culminated in spreads peaking at around 220bp. The strong rally in Euro IG credit since end-June relative to both USD and GBP has opened up some potential in cross currency relative value terms over a multi-year horizon, though we continue to prefer holding Euro IG credit for the time being. Within HY, the Euro-Sterling spread is beginning to look attractive again, whilst at current levels, USD spreads continue to appear very rich overall (see Exhibit 5).

Looking at developed market equities, we believe that rallies cannot persist until we get more certainty on inflation, particularly an inflection in inflation data, and the impact on economic growth from the aggressive tightening cycle. For the first time since 2020, analysts are starting to revise margins down. Compared to other downturns the margin revision has been relatively modest so far. EPS revisions generally track PMIs, but so far remain elevated compared with the recent sharp fall in the survey data, which could point to further downgrades in consensus EPS. The relative underperformance between cyclical and defensive stocks is in line with the subdued PMI levels, but this also shows that current pricing is vulnerable to further weakness in activity (see Exhibit 6). Moreover, we believe that European earnings estimates need to fall to reflect the weakness in the macro environment. On this basis, we continue to prefer maintaining an underweight allocation to equities with a selection of stocks that is tilted towards defensive names.

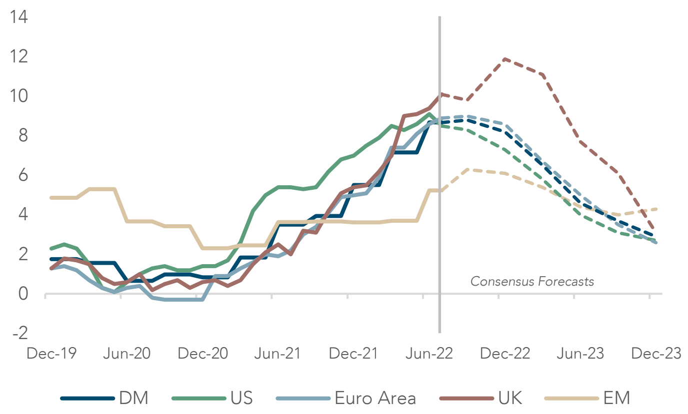
In emerging markets, commodity-exporting countries have outperformed for most of 2022, but the rally is expected to abate if global growth concerns rise. We have some concerns around China's economic health, especially the risk from COVID given the zero-tolerance policy, and the recent tensions with Taiwan. We therefore prefer introducing an underweight allocation to EM equities as a tactical short-term position.

Exhibit 1: Composite Purchasing Managers' Indices



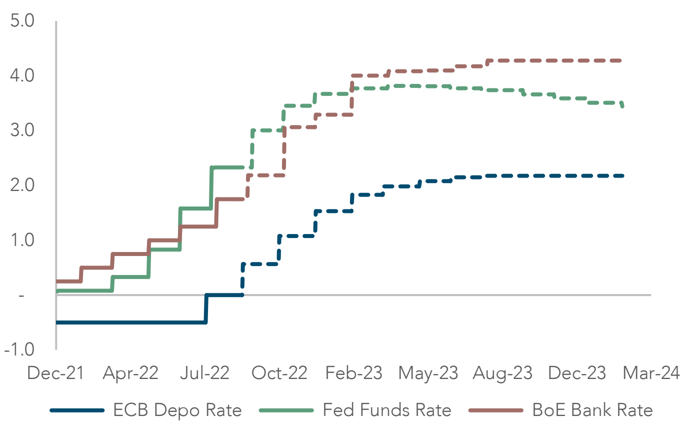
Source: Bloomberg, Curmi & Partners

Exhibit 2: Headline CPI Inflation (%)



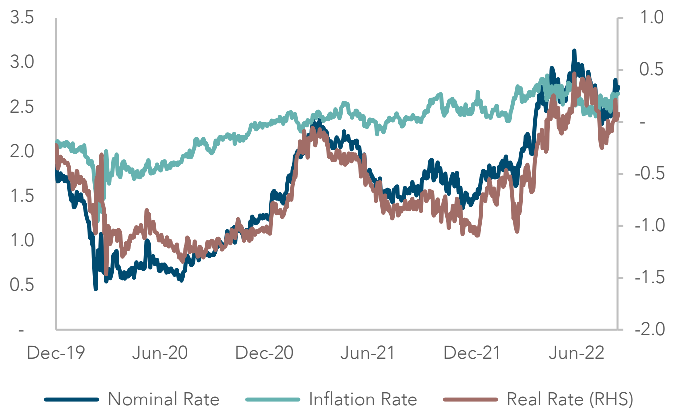
Source: Bloomberg, Curmi & Partners

Exhibit 3: Implied Market Pricing of Policy Rate Trajectory (%)



Source: Bloomberg, Curmi & Partners

Exhibit 4: US 5y5y Forward Rates (%)

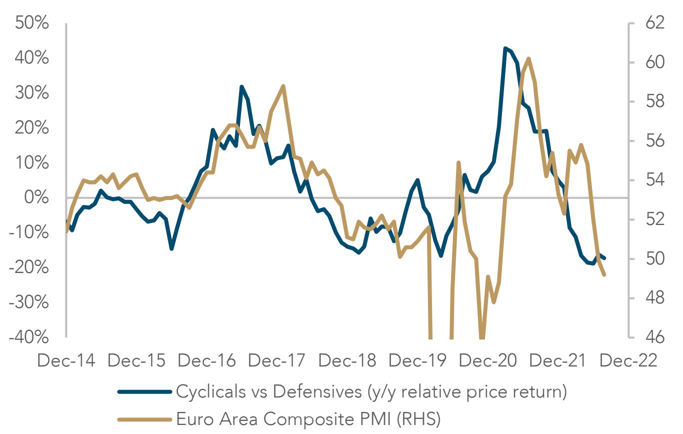


Source: Bloomberg, Curmi & Partners

Exhibit 5: High Yield Relative Credit Spread Movements (bps)

Source: Bloomberg, Curmi & Partners

Exhibit 6: Europe Cyclicals vs Defensives and Composite PMI



Source: Bloomberg, Curmi & Partners

ASSET CLASS VIEW AND POSITIONING

Asset Class	View	Allocation	Positioning
Developed Market Sovereign Bonds	Negative / Neutral	U/W	In the short term, growing recessionary fears may act as a tailwind for the asset class, though 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. Given the recent sharp movements upwards in benchmark bond yields, the scope for further negative curve returns has diminished, particularly in light of the growing signs of an impending economic slowdown. On this basis, we have added some sovereign exposure and reduce the overall short duration bias in our portfolios. Following the decompression in peripheral spreads with the planned reductions in QE purchases, the ECB has launched its new anti-fragmentation tool intended minimize debt sustainability risks while it raises policy rate, and is expected to cap further substantial widening in spreads. On this basis, we are comparatively more constructive of selected peripheral positions.
Investment Grade Corporate Bonds	Neutral	O/W	Investment grade returns will continue to depend on movements in benchmark rates and corporate spreads, though following the material widening since the onset of the Ukraine conflict, the asset class has begun providing reasonable opportunities to add risk 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 we acknowledge the risks for benchmark rates to move higher, we are taking the 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 versus the broader corporate market.
High Yield Corporate Bonds	Neutral	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. A stable credit rating environment provides a solid underpinning to seek opportunities on a selected basis, though with underlying economic conditions beginning to show some signs of weakness, we place additional focus on names and sectors less exposed to a potential slowdown. We remain selective in holding high yield positions as we focus on identifying new positions on a name-by-name basis, screening for names based on resilience of cash flow and strength of balance sheets that should see limited drag on operational performance as finance costs and input costs increase.
Developed Markets Equities	Negative	U/W	Our short-term view for developed market equities remains largely unchanged. In our opinion, rallies cannot persist until we get some additional clarity on inflation (peaking) and impact on economic growth from the aggressive tightening cycle. Fed Chair Powell recently highlighted that we are yet to see the full impact of the rate hikes, and consequentially, the full impact on the economy. The upcoming inflation releases could provide some relief assuming we see inflation peak, but then attention will turn on activity data. In Europe, there is the added uncertainty coming from the Russian gas threat and the rising political risk in Italy. Given this, we remain underweight the asset class over the short term. We are also maintaining our defensive skew relative to the benchmark which should offer protection during periods of uncertainty. The prospects for the equity market over the medium/long term remain positive, in our view.
Emerging Market Equities	Neutral / Negative	N	The dovish tone from the Fed has supported EM equities in recent weeks. Commodity exporting countries have outperformed for most of 2022, but the rally could abate if global growth concerns rise. We have some concerns around China's economic health, especially the risk from COVID and recent tensions with Taiwan. On the COVID front, we think that the only way forward for the country is to abandon the zero tolerance policy, yet this would lead to a large wave of infections in the country. (China is the only country to have experienced only one wave). On the latter, the supply-side issues in the event that China invades Taiwan could be very significant, especially for Europe. Given this, we are looking to reduce exposure to the asset class over the short term and establish an underweight position.

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

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