MONTHLY HOUSE VIEWS

February 2021

Crosscurrents, but a favourable wind

This year was supposed to herald a new dawn, but successive waves of COVID-19 infections and the emergence of new, more virulent strains has put renewed pressure on healthcare systems, forcing governments to tighten and extend lockdown restrictions. In turn, this has pushed economic activity back, particularly in services businesses dependent on people interacting in close quarters or in activities not deemed "essential". The UK provides an apt example: services Purchasing Managers' Index (PMI) surveys for January registered at 39.5, plunging from 49.4 in December (50.0 marks the dividing line between expansion and contraction in activity). This is the sharpest contraction in the sector since May 2020, obviously reflecting the latest national lockdown. Manufacturers, while better off, are not immune, particularly as the first post-Brexit disruptions begin to bite. Indeed, the UK manufacturing PMI for January was recorded at 54.1, below 57.5 in December, driven lower not only on pandemic-related factors, but also by Brexit-linked delays at ports.

Nonetheless, considering the disastrous economic picture which unfolded following last year's lockdowns, this time is materially different. Once again, the UK is a case in point. Despite the painful strictures on economic activity and the horrific human toll of the virus which continues, PMI data also shows the third consecutive month of **improved business optimism – the strongest since May of 2014 – as the UK's vaccine rollout so far in 2021 has been a success, fuelling hope of a strong economic rebound later this year**.

The US has taken a much less stringent approach, leaving individual state governors to decide on restrictions. As a result, mobility data for retail and recreation activities show a relatively modest 25% decline from pre-pandemic levels whereas the falls in Europe range from 45% to 65%. Unsurprisingly therefore, **business confidence in the US has remained buoyant in both manufacturing and services according to January's PMI**.

While optimism in the face of a still virulent pandemic is well-grounded, much will depend on the speed with which countries can ramp up their inoculation programmes. **The first movers in vaccination – notably the UK and the US – have made great strides, with about 19% and 12% of their respective populations already inoculated**[1] (only Israel and the UAE are ahead, both with much smaller populations). Vaccine approval came much later in the EU partially due to slow EU-internal procurement coordination – the UK just evaded this by Brexiting. This meant Continental programmes only really got underway in late December, three weeks after the UK. Provided that supply delays can be reversed quickly, one can reasonably surmise that countries will be able to begin to lift restrictions by the spring, with the UK and the US leading the EU by a month or so.

Recovery in Asia is much less dependent on vaccines. China – a critical source of global aggregate demand – actually saw its economy grow 2.3% last year and will likely see growth accelerate to over 8% in 2021, a level that hasn't been seen since 2011. Moreover, China has not had to resort to the type of monetary easing employed by the US Federal Reserve and the European Central Bank (ECB) – while key 3-month rates were cut by 160 basis points to their lows in March last year, they then rose steadily to their 2020 high in late November. Nor has fiscal stimulus been necessary for China's recovery at the scale seen in the West. According to the Institute for International Finance, Beijing's government debt to GDP ratio rose by 10.1 percentage points (pp) to 63.0% between Q3 2019 and Q3 2020 whereas the US piled on 25.5pp over the same period, taking its ratio to 127.2%, the highest level ever recorded in peacetime.

More is to come in Washington. President Trump signed a $900 billion support bill in late December and his successor has proposed a supplementary $1,900 billion package, together representing some 13.4% of GDP. **Some worry about the potential market distortions caused by all this stimulus, but it has prevented the world's**

[1] As of 9-February-2021 (https://ourworldindata.org/covid-vaccinations). Counted as a single dose and may not equal the total number of people vaccinated, depending on the specific dose regime (e.g. people receive multiple doses).

largest economy from falling into a deep abyss, having regained roughly three-quarters of the output lost during the first half of last year, and over half of the jobs.

While there are worries about the inflationary impact of all this stimulus, we don't consider sustained, structural inflation a serious risk at present for a variety of reasons, including large output gaps and low money velocity. This is not to say headline inflation may not jump in the short term given rising food and fuel prices – but it is probably wise to look through such transitory factors.

Bottom line

On balance, we believe risk assets – particularly equities – remain compelling, supported by strong momentum and a recovering global economy.

As always, we are guided by the four pillars of our investment process:

- **Economic regime:** Our Leading Economic Macro Indicator (LEMI) suggests **the global economy is in expansion, which is clearly favourable for risk-taking.**
- **Valuations:** Valuations for equities – the largest source of risk and return in most strategies – remain challenging in absolute terms. However, with global interest rates near zero, **there is a case for a higher than usual tolerance to valuations** (i.e. future cash flows are discounted by less). **Moreover, companies are reporting stronger than expected earnings, which should help lower rich valuations, all else being equal.** For example, over halfway through earnings seasons, the US equity market (i.e. S&P 500) is reporting year-over-year growth in earnings of 1.7% for the fourth quarter, compared to expectations of a 9.3% decline on 31 December 2020. Should the final figure be positive, as expected now, it will be the first time the index has reported annual growth since Q4 2019.
- **Momentum: Global equities remain in positive momentum** on the ten-month moving average metric that we favour. This is clearly supportive of increasing exposure to the asset class.
- **Sentiment:** There are numerous recent anecdotes of heady sentiment: an army of retail investors infamously fueled speculative excesses in GameStop to thwart hedge funds which had bet heavily against it; Tesla is up about 20% thus far in 2021 on top of the near 700% return last year; Bitcoin is up about 60% this year following on from its 300% gains in 2020. Other anecdotes suggest increased pessimism, such as record high cash balances in the US (i.e. $4.4 trillion) or a near-record household savings rate in the UK (i.e. 16.9%). Of the indictors we follow, **the market in the aggregate does not appear to be overbought**.

On balance, we remain comfortable with our risk-on stance given a strengthening economic backdrop, strong momentum and tolerable valuations, especially given stronger than expected earnings. However, we are cognisant of downside catalysts. These include vaccine-resistant coronavirus mutations, logistical setbacks in mass inoculations or a less supportive monetary and fiscal policy backdrop than expected – higher inflation, should it come, may cause rates to rise faster than expected, challenging risk assets. Therefore, **we continue to hold significant safety assets as a form of risk mitigation** including gold and low-volatility, defensive alternatives (e.g. hedge funds).

As ever, we are constantly monitoring markets. Should conditions change, particularly with the economic regime, or signals from our valuation, momentum or sentiment framework, we will adjust our asset allocation accordingly.

In accordance with the applicable regulation, we inform the reader that this material is qualified as a marketing document.
CA159/H2/20

OUR ASSET ALLOCATION

The table below presents the latest conclusions of the KH Investment Committee:

			Summary house views				
		Strong UW	UW	N	OW	Strong OW	Change since last KHIC
EQUITY	**GLOBAL EQUITY**				X		
	United States			X			
	Eurozone				X		
	United Kingdom			X			
	Japan				X		
	Emerging			X			
FIXED INCOME – SOVEREIGN	**GLOBAL RATES**		X				
	U.S. Treasuries		X				
	German Bunds		X				
	UK Gilts		X				
	EM Government Bonds ($)	X					
	Duration USD*				X		
	Duration EUR*				X		
	Duration GBP*				X		
FIXED INCOME – CORPORATE	**US Investment Grade**		X				
	Eurozone Investment Grade		X				
	UK Investment Grade		X				
	High Yield	X					
FOREX	**EURUSD**				X		
	JPYUSD			X			
	GBPUSD				X		
	EM FX (vs. USD)			X			
ALTERNATIVE	**COMMODITIES**				X		
	Brent		X				
	Gold					X	
	ALT. STRATEGIES			X			
	L/S Equity				X		
	Event-Driven				X		
	FI Arbitrage		X				
	Global Macro		X				
	CTAs				X		

	Positioning	*Duration
O/W	Overweight	Long – 7-10 years
N	Neutral	Intermediate – 5-7 years
U/W	Underweight	Short – 3-5 years

Source: Kleinwort Hambros 8-February-2021

*Duration: short = Up to 5 years, medium = 5-7 years, long = 7+ years. HY = High Yield bonds (higher return but greater risks), IG = Investment Grade bonds (higher quality but lower return)

EQUITIES	
United States	We remain Neutral on US equities, which reached new all-time highs in early February as investors welcomed fiscal support proposals from newly inaugurated President Biden.
Eurozone	We continue to be Overweight the region in our allocations given its sensitivity to a cyclical upturn in activity.
UK	We remain Neutral given stringent lockdown restrictions and Brexit disruptions, which will have a strong impact on the UK economy.
Japan	The Japanese equity market is attractively valued, and momentum is positive. Furthermore, the safe-haven characteristics of the Yen provide some buffer against market volatility. We are Overweight.
Emerging (EM)	Emerging Market equities are well positioned to take advantage of a global Cyclical recovery. We remain Neutral.

FIXED INCOME	
Sovereigns	Government bonds remain unattractive, offering negligible or negative yields to investors.
Duration*	We retain a medium-to-long duration position across most portfolios as a bulwark against wide volatility in risk assets.
Investment Grade**	Spreads have tightened further towards historic lows and we remain Underweight.
High Yield**	With yields hitting new all-time lows in late January, HY offers insufficient compensation for default risk and we remain Underweight.
Emerging debt (in $)	While the yield on offer is compelling, we do not feel it warrants the credit risk that EM issuers carry. We are Underweight.

CURRENCIES	
EUR/USD	The upward move has temporarily stalled due to Italian debt concerns and the slow vaccination program.
GBP/USD	Negative rates have become a discussion point once again, however the pound is pricing in vaccination progress.
EUR/GBP	The 0.8000 level recently gave way, opening the downside. Overall, we expect the pound to come out on top in the short term.
USD/JPY	We expect a pause in the USD/JPY rally, triggered by US Stimulus and/or a breather in the equity markets.
Emerging	We expect the renminbi to consolidate in coming months before heading higher again.

ALTERNATIVES	
Hedge funds	We prefer strategies which can hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short.
Gold	Gold remains a critical risk hedge with few good alternatives at present, and fundamentals remain solid. We are Overweight.
Oil	We expect oil prices to trade sideways in coming months at best and have no direct exposure.
Income producing Alts.	Attractive opportunities exist in infrastructure, selected real estate and specialist lenders for Target Return and income-focused strategies.

Source: Kleinwort Hambros 8-February-2021
*Duration: short = Up to 5 years, medium = 5-7 years, long = 7+ years.

**HY = High Yield bonds (higher return but greater risks); IG = Investment Grade bonds (higher quality but lower return)

FIXED INCOME

Little value left

Many fixed-income markets saw record high prices and record low yields in January on sustained central bank purchases. With little value left, our allocations to sovereign bonds and "credit" – i.e., investment grade (IG) and high yield (HY) corporate bonds – exposure remains Underweight.

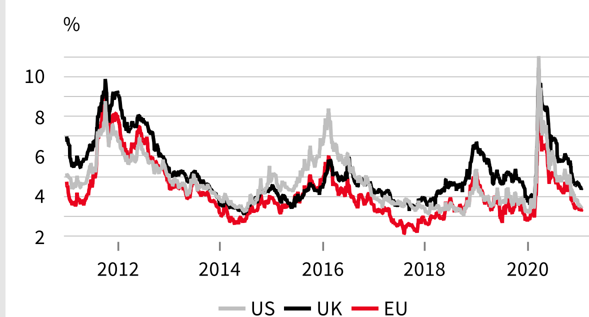
Sovereigns

US. In the aftermath of the Democrats' "blue wave" victory in Georgia leading to control of both chambers in Congress, investors cut back their Treasury positions on hopes of massive fiscal stimulus – which were promptly confirmed when the senate endorsed a $1.9 trillion relief package in early February - pushing 10-year yields up to a 10-month high at 1.17%. Nonetheless, regular massive buying of Treasuries by the Fed has taken its holdings to new record highs, helping keep a cap on upside in yields.

UK. 10-year sovereign ("gilt") yields have traded mostly between 0.2% and 0.3% before breaking through the 0.5% threshold for the first time since March 2020. Stringent lockdown restrictions have pushed the composite PMI survey into recession territory while exporters are struggling to cope with the new customs checks and non-tariff barriers with the EU. Although the rapid pace of vaccination should enable the government to ease lockdown ahead of EU neighbours, the Bank of England is unlikely to tighten policy for the foreseeable future.

Eurozone. Upside in core sovereign bond yields in the Eurozone has been extremely modest, with 10-year German Bund yields at -0.42%, slightly above the three-month average. The tightening of lockdown restrictions across Europe and the resulting double-dip recession have bolstered investor-demand for safe havens while the pace of ECB buying has accelerated since the central bank added €500bn to its bond purchase programmes in December. Despite the recent bounce and with cyclical recovery looming in H2, there is little scope for core bond yields to fall much lower.

High Yield spreads have narrowed



Source: SGPB, Macrobond, 26/01/2021

Credit

US. As highlighted last month, yields on IG bonds hit all-time lows at the end of last year and "spreads" (i.e., yield differentials) over Treasuries have only risen modestly since. At these levels, IG credit has largely priced in the expected cyclical recovery and offers little value. Speculative-grade HY bond yields hit new lows in late-January, offering little compensation for default risk. We remain Underweight.

UK. There is little more value in sterling-denominated credit. Spreads over gilts have only widened 2bp after hitting record lows earlier in January and GBP HY yields hit new all-time lows in late January. The economy has started 2021 with a sharp slump in PMI business confidence which does not augur well for credit quality. We remain Underweight.

Eurozone. Yields on euro IG bonds are barely positive at only 0.24% and still very close to December's all-time lows. Spreads over Bunds are at 93 basis points (bp), not much more than Spanish government bonds at 62bp and again close to record lows. Yields on HY bonds are little changed in recent weeks and still only just above the 2017 all-time lows. The economic environment is likely to worsen under the weight of lockdown restrictions, which is likely to place weak balance sheets under great pressure. In all, we remain Underweight euro-denominated credit.

Emerging Market (EM) debt

Looking around the global sovereign bond markets, EM issuers stand out with spreads over US Treasuries of 300bp. The global economy will begin to reaccelerate as vaccinations progress, helping improve credit quality. However, prices have rallied hard from the Spring 2020 lows taking yields to all-time lows. For this reason, we remain Underweight

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EQUITIES

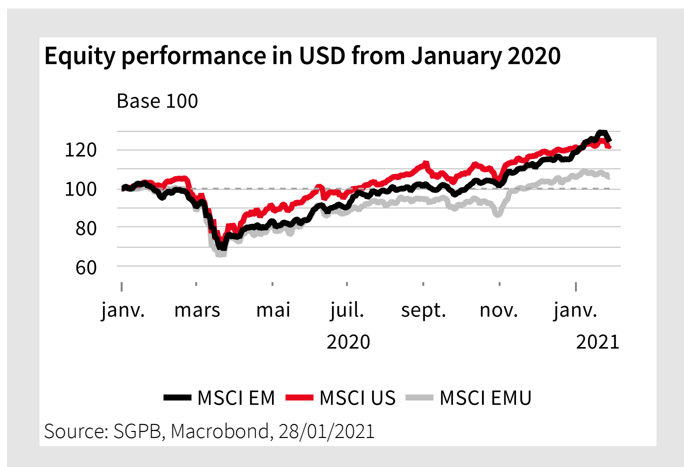
Can't stop, won't stop, Game Stop

We maintain an Overweight allocation to global equities, with a regional focus on Japan and the Eurozone. In addition, we carry sizeable exposure to Global Environmental Opportunities.

US. Despite a brief market frenzy induced by surging retail investor activity and ongoing economic uncertainty, US equities reached new all-time highs in late January as investors welcomed a massive $1.9 trillion relief package passed under the newly inaugurated President Biden. In addition, rapid progress in vaccination deployment has raised hopes that the pandemic could be brought under control sooner than anticipated. Nonetheless, the rapid spread of new virus mutations could slow the attainment of collective immunity and keep households on the defensive. Despite the strength in PMI surveys, the job market has weakened since October with a steady rise in new claims for unemployment benefits.

The continued strength in US equities has taken valuations to 23 times forward earnings, just shy of the 25x record reached in early 2000 during the dotcom mania. This time round, the market has again been led higher by Technology where valuations stand at a 77% premium to the 10-year average. We remain Neutral US equities but have recently reduced our position in favour of a globally diversified allocation to Environmental Opportunities.

UK. January's PMI surveys told a tale of sharp slowdown in the UK economy, given stringent lockdown restrictions – set to be extended until early March at least – and the post-Brexit slowdown in cross-Channel trade. However, the UK's vaccination programme remains unparalleled among western economies, raising hopes of early easing of lockdown restrictions. UK equities are cheap, trading at a modest 10% premium to the 10-year average and should benefit from a cyclical pickup in activity. All in all, we remain Neutral.



Source: SGPB, Macrobond, 28/01/2021

Eurozone. After strong outperformance over US equities in November and December as investors reacted to excellent results of vaccine trials, Eurozone equities have given up some of their advance in January. Vaccination programmes were slower to start in the EU while new virus strains have prompted governments to tighten lockdown restrictions, pushing the economy back into contraction territory. Nonetheless, we remain confident that fiscal and monetary support will throw a safety net for businesses and households and that inoculations will continue to accelerate, paving the way for strong cyclical recovery from H2 onwards, enabling investors to look beyond near-term problems. We remain Overweight.

Japan. Japan steadily underperformed the global average throughout the 2010s but has managed to keep pace since the start of last year. The impact of the pandemic has been less severe than in the west and Japan is well placed to benefit from China's strong recovery. Moreover, valuations are relatively reasonable at 18.3 times forward earnings with a 2% dividend yield. The consensus expects a 37% increase in this year's earnings and we remain Overweight.

Emerging Markets. Overall, emerging market earnings are expected to have declined by a modest 4% in 2020. This masks sharp regional divergences however – earnings tumbled 43% in eastern Europe and -55% in Latin America while they actually rose 9% in emerging Asia, thanks to solid growth in China, Taiwan and South Korea. Earnings should recover strongly while valuations at 16x forecasts are rather attractive. Moreover, global cyclical recovery should translate into further growth in global trade flows, a boon for EM exporters.

Global Opportunities. We see increasing value in Environmentally-focussed equities across the globe. This allocation seeks to take advantage of what we consider irreversible trends in environmentally-linked policymaking, legislation and consumer behaviour. As a result, we will be investing in companies at the forefront of natural resource efficiency (e.g. renewable energy, energy efficiency, sustainable agriculture and forestry) and the protection of ecological integrity (e.g. water support and technologies, waste management and recycling, as well as pollution control).

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CURRENCIES

Pound setting the pace

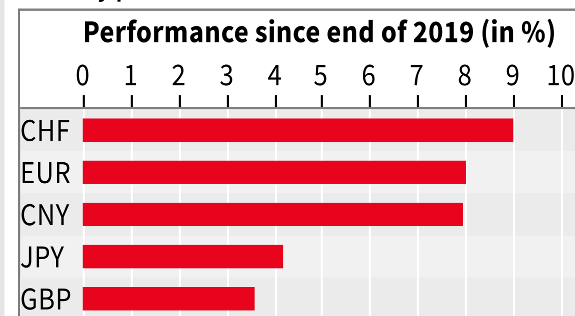
We expect the US dollar to resume its downward trend against both advanced economy and emerging market currencies. Nonetheless, the US dollar remains an important safe haven, which adds a source of protection in portfolios. Sterling has traded higher on relief that "no-deal" Brexit has been averted and on the rapid vaccination rollout

Dollar Index. The Dollar Index (DXY) reached oversold levels in early January, hitting its lowest point since April 2018 before regaining some lost ground. In part, this reflected some safe haven buying after mobs entered the US Capitol and, in part, the impact of a modest rise in US Treasury yields on hopes of reflation. Looking ahead, we expect the dollar to resume its decline. With key rates on hold for many quarters to come and asset purchases continuing apace, there is likely to be little dollar support from higher rates or yields. Nonetheless, the US dollar remains an important safe haven, which adds a source of protection in portfolios.

EUR/USD. The biggest drop in equity markets in three months has left its mark on the single currency. Currently, the euro is facing some challenges including an Italian debt crisis and a slow vaccine deployment. The US dollar has been a little stronger of late, but the main problems have been specific to the Eurozone. Recently, the 1.2000 level gave way to the downside, and we have revised down the 3-month forecast to 1.2200 from 1.2400 to reflect the current challenges.

GBP/USD. Negative rates have been the main topic of conversation and at times the pound has showed its nerves. However, the UK vaccination rollout is going very well and there is a sense of optimism for an economic recovery in the months ahead. Furthermore, US fiscal easing should keep the dollar on the backfoot. In the near term, significant resistance persists around our Q2 2021 forecast of 1.3750 but once this is broken, we anticipate a steady grind higher.

Currency performance versus the dollar



Source: SGPB, Macrobond, OECD, 27/01/2021

EUR/GBP. EUR/GBP has fallen 3.3% since the start of the year, clearly showing the divergence between the pound and euro. The 0.8800 support level is protecting further GBP gains for the time being, but this might not hold for long. According to momentum indicators the cross is teetering on oversold territory, however we do not expect EUR/GBP to shoot back up to 0.9000. We have therefore adjusted the near term forecast to 0.8873 from 0.9073.

USD/JPY. This cross has halted its downtrend and is currently tackling the 106.00 level on the topside. USD/JPY moves are largely dependent on US real yields and with the recent move higher in yields the dollar has benefitted. Stronger equity markets have also played their part by hurting the safe-haven Yen. However, the move higher seems stretched; Japan has coped much better with the pandemic than other advanced economies and continuing structural reforms may encourage inward investment flows.

EM currencies. JP Morgan's index of emerging currencies had gained over 11% against the dollar since last April's record lows before shedding some ground in January. Despite last year's strength, the long-term downward trend in EM currencies remains intact. However, we think they may break out higher this year. Zero short-term rates in the US could encourage "carry trades" where investors buy EM currencies for their higher rates. Moreover, cyclical recovery should favour the whole EM complex.

USD/CNY. China's pandemic management during 2020 enabled the country to reopen much earlier than advanced economies, avoiding the need for the massive fiscal support doled out by western governments. As a result, China's debt ratios have suffered less during the pandemic than in the US or EU. Moreover, 10-year CNY government bonds yield 3.19%, making it one of the most attractive sovereign bond markets. We expect the new Biden administration to maintain a hard line on China but to shift its focus away from punitive tariffs, a switch that may be facilitated by recent currency strength. All in all, we expect the renminbi to consolidate in coming months before heading higher again.

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ALTERNATIVES

We continue to hold safe-haven alternatives such as gold

We expect oil prices to trade sideways in coming months until demand makes a meaningful recovery. Fundamental drivers for gold should cushion any volatility in 2021. We prefer hedge fund strategies which hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short.

Commodities

Oil

Crude oil prices continued their rally in early January as OPEC and its allies, including Russia, held their first monthly meeting of the year. Saudi Arabia stunned traders with a voluntary cut in output of 1 million barrels per day (mb/d) in February and March – this enables Russia and Kazakhstan to increase production by 75,000 mb/d each but still leaves total supply from the allies below market expectations. Riyadh's fear is likely to be that demand will continue to be crimped by travel restrictions and lockdowns across much of the northern hemisphere.

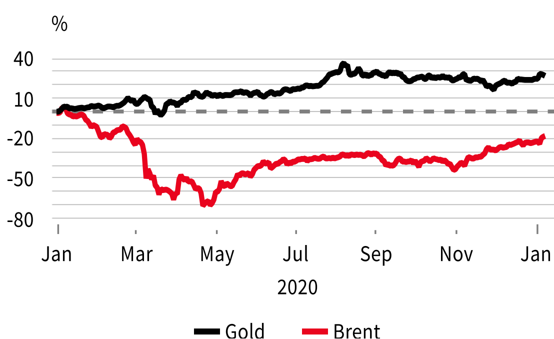
However, higher prices may encourage US producers to ramp up output – they already reached 11.0 mb/d in December, up from 9.7 mb/d at their 2020 lows, as average Brent prices rose from $43 in November to $50. This in turn could prompt the Saudis to change tack given their reluctance to yield too much ground to US producers, whose successful exploitation of shale oil reserves saw them replace Saudi Arabia and Russia as the world's leading supplier in 2018-2019.

All in all, we expect Brent prices to trade sideways in the coming months and do not have any direct exposure to it.

Gold

Gold ETF flows tend to be somewhat momentum-driven – as prices declined -5.4% over the course of November, ETFs saw the first outflows in twelve months, which drove gold sales of 107 tonnes (t). Moreover, in Q3, central banks registered the first quarter of net sales of gold since Q4 2010. The selling was dominated by two countries – Turkey and Uzbekistan – both of which resumed buying in October which saw a return to net purchases of 23t.

Crude oil recovery from April crisis



Source: SGPB, Macrobond, 07/01/2021

As a non-yielding asset, gold prices tend to be sensitive to changes in the yields available in other safe-haven assets like US Treasuries. Despite the recent rise in 10-year yields, those on inflation-linked securities – which reflect expected inflation – recently reached record lows at -1.11%. At such levels, the opportunity cost of holding gold becomes negligible, which tends to support gold prices as we saw with December's 6.8% rally.

We also continue to remain Overweight gold for two other reasons. One is diversification: While vaccine news where a huge boon to markets, it is prudent to remember that risks have dissipated, though they have not disappeared. In an environment where traditional diversifiers (e.g. Government Bonds) are less effective, gold remains one of the few assets with little to negative correlation to equities.

In addition, there is momentum, which remains an important consideration for any volatile asset class. Should momentum turn negative, and that signal is confirmed, we will consider trimming or selling our position. However, at present, momentum remains positive.

Alternative investment strategies

Preference for Merger Arbitrage type strategies

Hedge funds can help in unstable market conditions, but selectivity is key. We prefer strategies which hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short. These strategies provide relatively safe, uncorrelated sources of returns from equities, our most significant allocation across balanced and growth multi-asset strategies and provided positive contributions to returns – and lowered risk – especially during periods of volatility. In the market volatility in 2020, our hedge fund selections all held their own and performed well.

Income Producing

In Target Return strategies, we are exploiting several niche investment opportunities in selected real estate (e.g. medical centres, student accommodation), infrastructure and specialist lending (e.g. pharmaceutical royalties, economic infrastructure).

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