MONTHLY HOUSE VIEWS

August 2021

Peaky Blinders

With global equities up +12.5%[1] in GBP terms, the story of the year continues to be the stock market. Policy – for now – continues to be exceptionally supportive. The US Federal Reserve (Fed), the Bank of England (BoE), the European Central Bank (ECB) and the Bank of Japan (BoJ) continue to collectively pump hundreds of billions of dollars of liquidity into the financial system every month. This has cut short every equity market wobble thus far in 2021: as markets falter they are met with a surge of cash looking to be deployed, taking us back to all-time highs. On a related note, government spending remains extremely robust globally, with the US on the verge of approving a gigantic infrastructure bill with bipartisan support amidst ongoing pandemic-driven fiscal largesse in the G7.

In addition, genuine economic growth momentum has been helped on more recently by pent-up consumer spending. July nonfarm payrolls in the US showed an increase of 943,000, the largest monthly increase since August 2020. Of that, 380,000 jobs were in the leisure and hospitality sector (253,000 in restaurants and bars). In Europe, Manufacturing Purchasing Managers' Indices remain buoyant (i.e. in the 60+ range). UK consumer spending last month was up 11.6% compared with July 2019. Notably, the first growth in the entertainment sector since prior to the pandemic was registered[2]. This is all underpinned by rising vaccination rates with over 30% of the world population having received at least one COVID-19 jab. In the five biggest world economies, vaccination rates are significantly higher: US (59%); China (64%[3]); Japan (47%); Germany (62%); and the UK (69%).

This is translating into earnings. With 90% of S&P 500 companies having reported Q2 results, earnings growth is at an astounding 89%, up from expectations of c. 52% at the start of the quarter. Revenue growth is equally spectacular at just under 25%.

However, the bond market has been telling a different story, with a huge sell-off in the winter (implying investors are bullish on risk assets) having moderated into the spring, before partially reversing over the summer (implying bearishness). Ten-year US government bonds saw a peak above 1.7%, but now trade closer to 1.3%; UK gilts hit a high near 0.9% but are now yielding 0.6%; German bunds came as high as -0.1%, but have slumped closer to -0.5% now. This tells a darker tale of peak growth, peak profit, peak policy.

This concept of "peak" is worth visiting. Effectively, it means that the rates of economic growth, earnings growth and policy support – monetary in particularly – has hit a high point and will now start to decelerate, which is supposedly undesirable. We do not deny that we have reached peak growth purely from a "rate of acceleration" perspective. The IMF expects global growth in 2021 to be 6% with advanced economies growing about 5%. According to their forecast this will slow next year to 4.4% and 3.6%, respectively. However, this year's stellar figures are a result of a base effect, as they follow a massive global and advanced economy contraction last year of -3.3% and -4.7%, respectively. Next year's growth, which *builds* on the gains of this year, is understandably slower, but it is reflective of an economy which is getting ever larger.

Ultimately, growth is good, even if it is slower. Extensive in-house analysis shows that equity risk premium is positive and compelling when economies are in any of "recovery", "expansion", or "slowdown" regimes, which can last for years. The regime to avoid is "contraction", which thankfully appears nowhere on the horizon. The same dynamic applies for earnings.

Most market observers generally accept that liquidity – meant originally to rehabilitate economic growth – has been a huge support for risk assets. How will those assets fare without it?

No one knows for sure. But to begin to answer the question, we must refresh ourselves on how liquidity works. In a normal world, central banks conduct open market operations (OMO) routinely. This involves both buying and selling government bonds. Buying bonds from the market increases liquidity as it replaces them with newly created cash, which then often gets recycled into financial assets such as equities. The mirror operation is selling bonds, which removes liquidity from the

[1] MSCI AC World to 10 August 2021

[2] Reuters. 9 August 2021. *Sporty summer lifts post-lockdown UK consumer spending.* (https://www.reuters.com/business/retail-consumer/sporty-summer-lifts-post-lockdown-uk-consumer-spending-2021-08-09/)

[3] Mainland China has administered at least 1,782,525,000 doses of COVID vaccines as of 10 August 2021. Assuming every person needs 2 doses, that's enough to have vaccinated about 63.8% of the country's population. (https://graphics.reuters.com/world-coronavirus-tracker-and-maps/countries-and-territories/china/)

system. This is conducted to keep money supply growth at an ideal balance where it is contributing to loan growth, the lifeblood of an economy, without letting inflation get out of hand. In an abnormal market environment, such as now, this is effectively a one-way operation where central banks only buy bonds, which is more commonly known as "quantitative easing" (QE).

QE cannot go on forever. For one, it raises the risks of inflation – the theoretical result of liquidity being created out of thin air and added to the economy without commensurate goods or services being created. For another, it has caused huge demand for financial assets, which now has resulted in high valuations for almost everything. Therefore, it would be ideal for QE to be stopped before it fundamentally breaks something in the system. However, ending QE itself is tricky. History suggests it can be done benignly or disruptively:

- **The benign outcome:** Central banks buy bonds at a decreasing pace (tapering) and then stop buying them altogether. The Fed did this with aplomb from 2014 onwards (see chart below), at first simply stopping to buy new bonds and held the bonds they owned until maturity, thereby "running off" the balance sheet at a slow pace over time (i.e. flat Fed line from 2014 to 2016 in particular). When the economy was ready, they even resumed "normal" OMO with a bias to reducing the overall size of the balance sheet, actively selling more bonds back to the market than they buy (i.e. downward trend of Fed line from 2017 to 2019). As it was done in an environment of sufficient economic growth, the result was a "healthy deleveraging" which did not destabilise markets.
- **The disruptive outcome:** Central banks can go too fast from "run off" to "sell off", as the ECB did in 2013 and 2014. This scuttled growth and deflation suddenly became the chief worry. The ECB is the cautionary tale which gives policymakers pause in being too quick to taper.

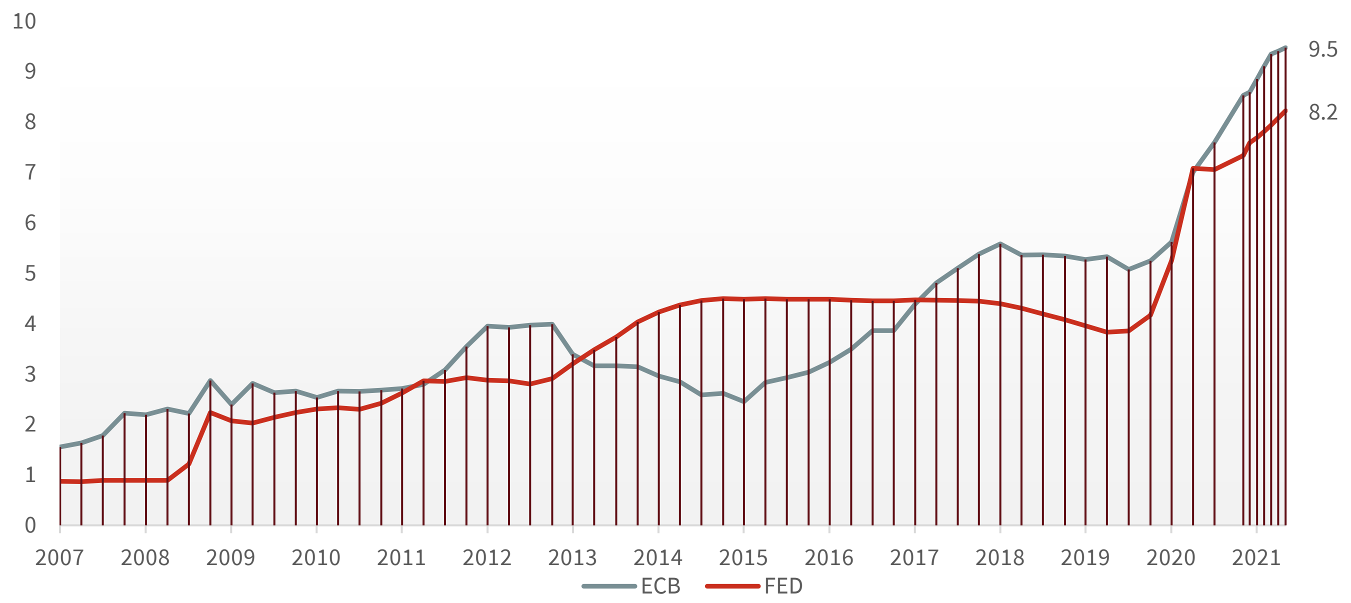
We believe that policymakers have been excellent at balancing the various risks and rewards of policy support thus far. Nonetheless, policy errors are possible.

Bottom line

We believe the case for risk-taking is well supported given a strengthening economic backdrop and strong momentum. Therefore, our portfolios are risk-on.

Nonetheless, we continue to hold a stable of safe-haven assets to offset risks, particularly those from equities – which are expensive and supported somewhat by heady sentiment. These include cash, government bonds, gold, and defensive alternatives (e.g. low-volatility hedge funds, Tail Risk Protection Note).

Major Central Banks: Total Assets, Trillions of Dollars
2007 - 2021



Source: Kleinwort Hambros, Bloomberg Data as at 31 July 2021
Fed denotes US Federal Reserve, ECB denotes European Central Bank and BoJ denotes Bank of Japan

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**				■		
		United States		■				
		Eurozone				■		
		United Kingdom				■		
		Japan				■		
		Emerging			■			
FIXED INCOME	SOVEREIGN	**GLOBAL RATES**		■				-
		U.S. Treasuries		■				-
		German Bunds		■				-
		UK Gilts		■				-
		EM Government Bonds ($)	■					
		Duration USD*				■		
		Duration EUR*				■		
		Duration GBP*				■		
	CORPORATE	**US Investment Grade**		■				
		Eurozone Investment Grade		■				
		UK Investment Grade		■				
		High Yield	■					
FOREX		**EURUSD**			■			
		JPYUSD			■			
		GBPUSD				■		
		EM FX (vs. USD)			■			
ALTERNATIVE		**COMMODITIES**				■		
		Brent		■				
		Gold				■		
		ALT. STRATEGIES			■			
		L/S Equity				■		
		Event-Driven				■		
		FI Arbitrage		■				
		Global Macro		■				
		CTAs				■		

	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 9-August-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	p6
United States	US Equities reached new all-time highs despite growing concerns around the impact of the Delta variant on the ongoing recovery. We are wary of the region's valuations and remain Underweight to seek opportunities elsewhere.
Eurozone	The bloc ramped up its inoculation program and the NGEU fund started pouring out stimulus, supporting the medium-term case for the region. We continue to be Overweight with a preference for more cyclically sensitive sectors.
UK	The UK all but removed its last remaining pandemic restrictions in July, and monetary policy remains accommodative. Valuations remain attractive and we remain Overweight.
Japan	The Olympic games concluded with mixed accolades and the country is struggling with a rise in Covid cases. An extremely efficient vaccination campaign paired with expected fiscal stimulus underpin our positive outlook. We are Overweight.
Emerging (EM)	Emerging Markets struggled with unexpected regulatory intervention by the Chinese government, as well as continuing surges of the Coronavirus. However, valuations remain reasonable and we are Neutral.

FIXED INCOME	p5
Sovereigns	As growth worries outweighed inflationary worries yields on government bonds were again pushed lower. We took some profits but retain a protective allocation in multi-asset portfolios. We are Underweight.
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. We remain Underweight.
High Yield	HY yields and spreads remain close to historic lows and we've stuck to an Underweight stance.
Emerging debt (in € and $)	Credit risks of most issuers remain elevated and the backdrop of increases in US 10-year Treasury yields ahead will cap upside for EM debt. We are Underweight.

CURRENCIES	p7
EUR/USD	The euro is vulnerable with the ECB sitting behind the Fed and BoE in terms of tightening monetary policy.
GBP/USD	Sterling stands strong despite the recent appreciation in the US dollar due to a more hawkish Fed.
EUR/GBP	The one-way moves to the downside continue; however significant support is on the horizon.
USD/JPY	Japanese economic growth remains anemic, but overall, we anticipate trading close to 110.00
Emerging	A stronger dollar is a threat to EM currencies, and capital flows to EM remain challenging.

ALTERNATIVES	p8
Hedge funds	We prefer strategies which can hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short.
Gold	We recently trimmed our position in favour of other safe-haven assets such as our Tail Risk Protection Note. We are Overweight.
Oil	The UN is focusing more of its attention on the effects of climate change, which again has brought closer attention the long-run reliance on fossil fuels.
Income producing Alts.	Attractive opportunities exist in infrastructure, selected real estate and specialist lenders for Target Return and income-focused strategies.
Tail Risk Protection	We believe the Tail Risk Protection Note (TRPN) offers our portfolios yet another critical source of safety and complements the existing diversifiers.

Source: Kleinwort Hambros 9-August-2021

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FIXED INCOME

Tug of War

The inflationary risk of an overheating economy was outweighed by worries about the effect of a Delta-fuelled rise in Covid infections, pushing yields lower. We are taking some profits from our Government Bond exposure and remain Underweight.

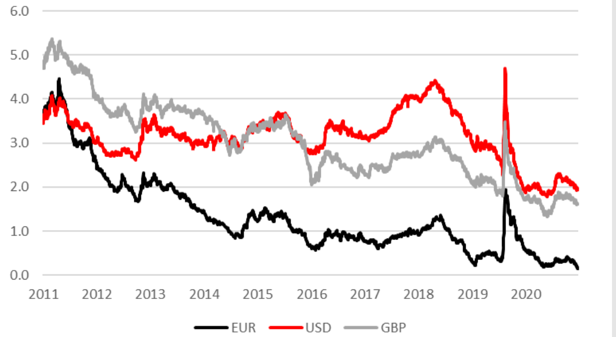
Sovereigns

US. Bond investors found themselves amidst a tug of war between the inflationary risk of an overheating economy and the disinflationary risk of the Delta variant threatening economic recovery. As of late, the latter seems to win. Despite an impressive addition of 943,000 jobs to employers' payrolls in July - and an accompanying decline in jobless rate to 5.4% from 5.9% - unemployment is nowhere near pre-pandemic levels of around 3.5%. In the context of rising Covid case numbers across the country, investors seem to err on the side of the Fed, rejecting lingering inflationary pressures as transitory and dropping expectations tapering in the short term. With yields on 10-year Treasuries as low as 1.18%, the only way is likely up. We take some profits on our positions and remain Underweight.

UK. Much like the brief period of summer and sun, July in the UK saw "Freedom Day" come and go without prolonged frolicking, and the economic reopening is well underway. While not making changes to monetary policy, the Bank of England recently turned more hawkish in its narrative, retaining additional flexibility should inflationary pressures prove long-lived after all. On the other hand, 1.9 million workers remain on the government's payroll under the country's furlough scheme for the time being, providing little evidence of a tight labour market or indeed any reason to revise interest rates in the short term. As yields on 10-year Gilts dropped as low as 51 basis points (bps) in July we took some profits and remain Underweight.

Eurozone. Despite a significant ramp-up in inoculations, the number of Covid cases in the Eurozone is soaring again. Keen on sending strong messages of support during the struggling economic recovery, European Central Bank (ECB) President Christine Lagarde promised the expansive monetary policy to remain in place until "at least March 2022". Yields dropped to their lowest levels since February and we are Underweight.

Yields on IG Credit are again nearing all-time lows



Source: KH, Bloomberg, 30/07/2021

Credit

US. Issuance of high-grade debt ramped up in July as companies scrambled to take advantage of low-cost funding before the beginning of the summer lull in August. Spreads rose marginally from their 2021 lows, reflecting the increased threat of the Delta variant to businesses. High Yield spreads also rebounded from their decade lows of 302bps in July to up to 340bps in early August. Given the ongoing uncertainty around the economic recovery, the spreads for neither asset class sufficiently reward for their inherent risks and we are Underweight.

UK. IG spreads in the UK remained unchanged, just above 100bps, amidst the country's ongoing reopening. Hence, these do not compensate for the risk of any upside in gilt yields as bond prices normalise. Sterling HY spreads – also at 2014 lows – are tighter still than those in euros or dollars, resulting in an unfavourable risk/reward ratio. We are Underweight.

Eurozone. As EUR IG spreads remained largely flat throughout July - at around 85 bps – the drop in government bond yields resulted in new all-time lows in yields for the asset class: 0.13%. While Bund yields will likely remain locked at ultra-low levels on the short term, the only way for them is up, and we remain Underweight IG credit. HY spreads recovered somewhat from their 2021 lows – rising to 313bps in July from 287bps in June – there is little appeal here either. We are Underweight.

Emerging Market (EM) debt

EM debt spreads continued to climb throughout July as governments struggled to contain new outbreaks of the Delta variant and wide-spread lockdowns and other restrictions became again more likely. Credit risks of most issuers remain elevated and the backdrop of potential increases in 10-year Treasury yields ahead will prove challenging for EM debt. We remain Underweight.

EQUITIES

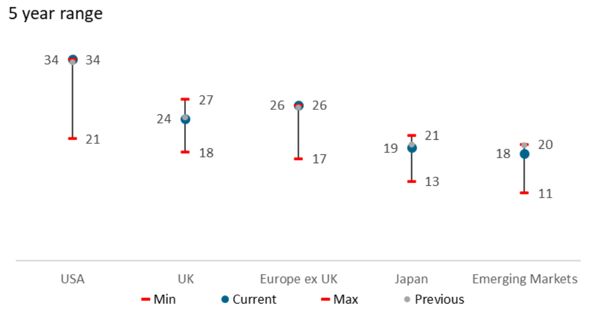
In Spite of Everything

Equity markets reached new highs despite growing worries about the economic implications of the Covid Delta variant. We continue to prefer exposure to the Eurozone, Japan and the UK, who are well positioned to take advantage of a cyclical recovery.

US. Undeterred by the economic dilemma faced by bond investors - weighting the inflationary risks of an overheating economy against the deflationary risk posed by the Delta variant - equity investors soldiered on, propelling the US flagship index S&P500 to new all-time highs. Most of the performance was driven again by Growth stocks: The Russel 1000 Growth Index outperformed its Value counterpart by 2.5% over the month of July alone. Thus, despite a jaw-dropping year-on-year earnings growth rate 89%, the US still remains the most expensive of developed markets we follow measured by P/E ratio. As a result, we are Underweight to allocate to better opportunities elsewhere.

UK. The UK flagship equity index FTSE100 largely lagged the global average throughout July as investors focussed on more growth-focussed markets amidst resurging worries about the implications of rising Covid cases. The country's once world-leading inoculation campaign has stagnated to a shadow of its former self as remaining restrictions were all but lifted, leaving private organisations to impose their own mask mandates instead. Year-on-year inflation rose to 2.5% throughout the reopening process, but investors and the BoE seem to agree on its transitory nature, pointing at large swathes of economic resource that continue to be underutilised: Unemployment remains at 4.8% (compared to 3.8% before Covid), even considering those 1.9m workers remaining on the government's furlough payroll, and office attendance is still 40% below its pre-pandemic level. Valuations remain comparatively cheap despite the undeterred economic recovery and promising growth potential. We are Overweight.

The US remains the most expensive developed market



Source: KH, Bloomberg, 30/07/2021

Eurozone. Following a sluggish start, the EU ramped up its vaccination campaign to administer about three times as many shots as the US per day (56 for every 10,000 residents vs 20 in the US), and twice as many as the UK (27 per 10,000) at the end of July. Having overtaken America in terms of proportion of population inoculated, the bloc remains behind on the road to economic recovery. However, its NextGenerationEU recovery fund has begun to pour out stimulus payments and the ECB reiterated its promise of loose monetary policy for the foreseeable future. Much value remains to be unlocked and we are Overweight.

Japan. Statistics show that, in normal times, Japanese equities tend to rally during any Olympics where Japanese athletes won more than ten gold medals. They achieved 27 in the end, but these are no normal times, and these were no ordinary Olympics, and the TOPIX closed down 2.1% over the month of July. A surge in Covid cases complicated the picture, although a belated but extremely efficient vaccination campaign (185 shots per 10,000 residents per day) promises to curb the infection rate in due course, and the government is expected to pass a sizeable stimulus package ahead of the election in September. We are Overweight.

Emerging Markets. The Chinese Communist party flexed its regulatory muscles in July, raising worries of autocratic economic intervention reminiscent of Soviet practices, and spooking foreign investors. Elsewhere, EM governments' struggles to contain flaring surges of Covid infections continue to hamper a sustained economic recovery. However, valuations remain reasonable amidst positive long-term outlooks and we are Neutral.

Global Opportunities. Environmentally focused equities have huge impetus behind them, and we have taken a meaningful position in most strategies. We aim to capture the upside in irreversible trends in environmentally linked policymaking, legislation and consumer behavior. As a result, we have invested 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).

CURRENCIES

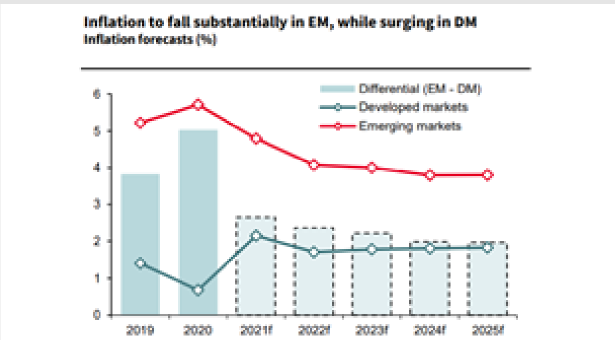
Early Talks on Tapering

The EU is catching up on the vaccine race, however a dovish ECB is hampering the euro's spirits. Is the US dollar's fortune about to change or are we perhaps just seeing exaggerated summer moves?

Dollar Index. The greenback continues to perform well versus its counterparts due to the expectation that the Federal Reserve's interest rate hiking cycle is nearer than previously thought. A divergence is forming between the Fed and the ECB, which has been reflected in the recent breakdown in EUR/USD. That said, it is still two years before the first-rate hike is expected in the US, and a whole lot can happen (or not happen!) between now and then. The medium outlook for the USD could be more positive but we will re-evaluate our stance on the dollar at the end of the summer once more normal trading resumes. FX volatility is expected to rise in the meantime; however, we haven't seen any material pick up so far in G10 or EM FX so far.

GBP/USD. The Bank of England kept rates and bond purchases unchanged last week, at 0.1% and £896 billion respectively. Inflation is moving up and could hit 4% later this year although this is expected to be temporary. Despite the recent rally in the USD dollar, the pound has held it together. The UK took a very heavy hit during the pandemic; however, the re-opening of the UK economy is proving to be a boon for the pound. For the 4th quarter of this year, we are sticking with our 1.4000 forecast.

EUR/USD. The most recent ECB meeting delivered a dovish outcome as expected. The ECB doesn't have runaway inflation to deal with, and asset purchases are unlikely to be reviewed until after the summer. It is also clear that interest rates won't be increased for the foreseeable future. None of this is ground-breaking, however since the ECB meeting EUR/USD has fallen 1.5% to below 1.1750 and is threatening a deeper correction to 1.1700. Vaccine rates in Europe have picked up markedly since the spring, however this has not flowed through to a stronger euro. To factor in this independent weakness, we have revised down out EUR/USD forecast from 1.2100 to 1.1900 for the end of this year.



Source: SG Cross Asset Research / EM Strategy

EUR/GBP. EUR/GBP is trading at the lowest level since March 2020. The euro is independently weak, despite the dramatic turnaround in vaccine rates in large parts of Western Europe. After the 0.8500 support level was broken the cross weakened further but will likely run into some strong support soon. UK growth forecasts have been revised higher, and the cross continues to shrug of post-Brexit woes over the Northern Ireland Protocol and fishing rights. Our 4th quarter view has been shifted down slightly to 0.8500.

USD/JPY. The recent rally in the US dollar has sent USD/JPY above 110.00. However, it hasn't been a one-way street, with the cross challenging the 108.75 area of support over the last couple of weeks. Volatility is on the rise, and the Yen remains a pawn, with US yields and rate expectations dictating play. Furthermore, there isn't much to get excited about in Japan, with economic growth expectations recently being revised lower. Japan is struggling to bat off the pandemic, and the BoJ is nowhere near being able to increase rates, with inflation still being just a pipe dream. Overall, we would expect the cross to remain in the 110.00-112.00 trading range for the month ahead.

EM currencies. EM FX has had a modest positive performance this year, however local bonds have performed poorly. Currency volatility has declined across all EM regions, which may have helped support a number of EM currencies. Inflation has fallen significantly in most regions, contrary to the surge in inflation in developed markets. However, The road ahead is likely to be rocky for EM in general, especially if the US dollar continues its run and the Federal Reserve starts tapering asset purchases sooner than expected.

USD/CNY. The Yuan is still holding onto its appreciation since the start of the pandemic. An unexpected rise in the global demand for Chinese goods, some linked to treating or dealing with Covid-19, have boosted exports. Chinese assets have seen increased flows, in both equities and bonds. China has deployed much less monetary easing than the rest of the world, which has been positive for the CNY. Chinese policy makers have rolled out a range of measures to weaken their currency since June, including PBoC verbal intervention and hikes on foreign currency deposits. A drop below the 6.40 level could cause some concern to policy markers, potentially prompting further measures.

ALTERNATIVES

Diversifying Diversifiers

We recently trimmed some of our Gold position in favour of other safe-haven assets such as our Tail Risk Protection Note (TRPN), which offers our portfolios yet another critical source of safety and complements existing diversifiers.

Gold

Gold was up in the month of July and ended on par with its 200-day moving average at $1,840 per troy ounce. Since the start of August however, it has fallen -4.6%. This was partly due to better than expected jobs number out of the US, as employers added the most jobs in nearly a year and the unemployment rate declined more than forecasted. This is a sign that the US economy is becoming stronger and continues well on its way to recovery. This sets the scene for tapering by the Federal Reserve, closing the tap on the quantitative easing that helped send gold to record prices during the pandemic.

Other headwinds include a strengthening dollar and expectations of transitory inflation. The Jackson Hole conference later this month should shed some light on the next steps for tapering that the Federal Reservice might take.

While we have recently sold some of our position in Gold in favour of other safe-haven assets such as our Tail Risk Protection Note, we do continue to hold an allocation across most strategies primarily as a safe-haven asset – it has performed well during most crises including during a highly volatile, pandemic-ravaged 2020. We believe gold remains an effective diversifier with a low correlation to equities. Indeed, it tends to be negatively correlated when equities are under heightened selling pressure. This is an important consideration for why we continue to hold it instead of exiting the entire position.

Oil

The words of United Nations Secretary General Antonio Guterres about the dire consequences of fossil fuels have put the future of oil into question in the long-term: “This report must sound a death knell for coal and fossil fuels before they destroy our planet.” The UN will meet in Glasgow in November to discuss potential next steps to be taken by all nations.

Despite OPEC+ settling its dispute and returning more supply to the market, the Delta variant has affected the short-term demand outlook and interrupted the rally in oil. In the US virus cases surged to the highest weekly level since early February. In China airline seats being offered dropped the most since early in the pandemic, as the nation implements fresh restrictions to contain the latest wave. WTI trades at around $67 per barrel, down -7.8% since the end of July.

Hedge funds: Prefer 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 continue to find attractive sources of income across a broad range of alternative asset classes; specialist real estate (medical centres and student accommodation), infrastructure (social, digital) and specialist lending (property, pharmaceutical royalties, economic infrastructure).

Tail Risk Protection Note

Tail risks are typically understood as unlikely but severe crisis events which shock markets and dramatically impact the value of risk assets negatively. The Dot.com bust at the turn of the century and the Great Financial Crisis in 2008 and 2009 are examples of such events.

It is important to note that we do not have a heightened sense of any tail risks materialising. Nonetheless, we are cognisant that current valuations for most assets are high, and this exacerbates the potential drawdowns in the event of a risk event. We believe the TRPN offers our portfolios yet another critical source of safety and complements the existing diversifiers.

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