HOUSE VIEWS

DECEMBER 2021

Recovery To Continue into New Year

Strong recovery to continue in advanced economies. Growth will probably be lower after this year's rebound but should remain dynamic. Company and household finances look strong and built-up savings should keep consumption ticking over. Monetary and financial conditions are also helpful, with real interest rates still clearly negative. Prices remain under upward pressure from base effects, supply chain tensions and labour supply inelasticity, but these all should gradually decline allowing inflation to ease back in the New Year; though it is likely to exceed central bank targets for some months yet. Another COVID wave could pose a threat to mobility, but greater vaccine take-up and new treatments should limit its reach.

A higher-growth environment will bring higher inflation – albeit mostly short-lived – prompting central banks in several countries to shift to a restrictive monetary policy stance. The Federal Reserve (Fed) will likely continue tapering its asset purchase programme and will start hiking rates in 2022, despite this, compared to its long-term history the monetary policy in context remains exceptionally loose. The European Central Bank (ECB), meanwhile, will likely stick to its highly accommodative policy as Eurozone inflation remains more modest. Although rate hike expectations at the next meeting have reduced for the Bank of England, we are still likely to see interest rates increasing at some point in the next few months to regain credibility following confusing policy messages.

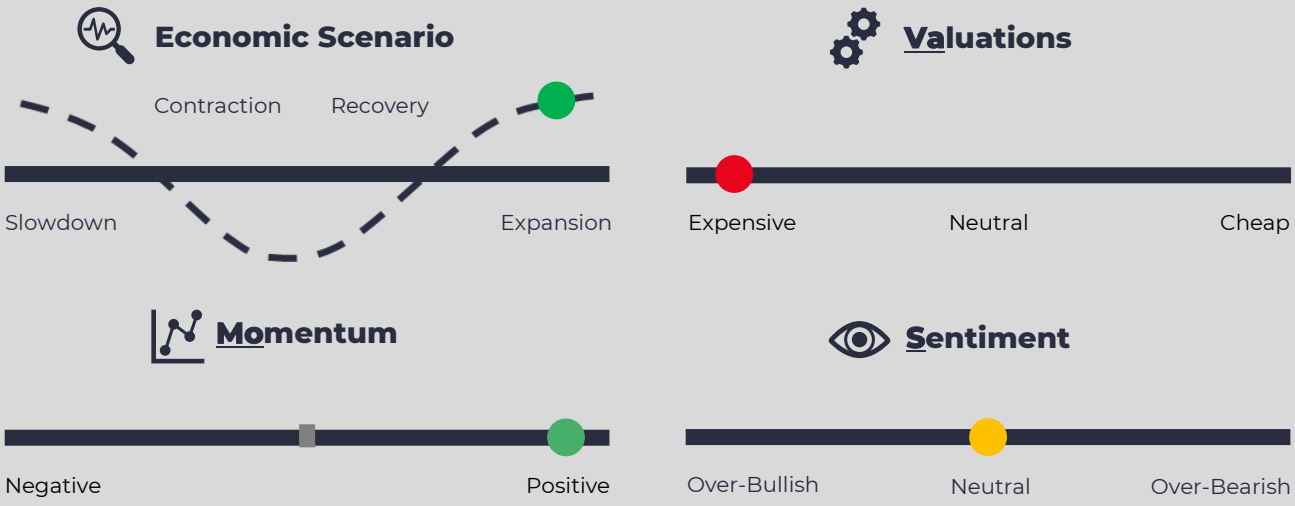
We are moderately risk-on with a continued preference for equities in most strategies. We believe the case for risk-taking is well supported given a robust strong economic backdrop and continued positive momentum for risk assets. Nonetheless, we are wary of expensive valuations and risks from factors such as the Omicron variant, stubbornly high inflation, the potential for central bank policy errors and Chinese real estate contagion. Therefore, we continue to hold a stable of safe-haven assets including cash, government bonds, gold, and defensive alternatives (e.g. low-volatility hedge funds, Tail Risk Protection Note).

KLEINWORT HAMBROS

Unless otherwise specified, all statistics and figures in this report were taken from Bloomberg and Datastream on 26/11/2021

PROCESS AND CONVICTIONS

Our **VaMoS™ framework** puts our investment philosophy into practice



We are **moderately risk-on** and have a **bias towards equities**, which is well supported by a **strengthening economic backdrop** and **strong price momentum**.

We favour **regions that are likely to benefit from a cyclical recovery**. Equity exposure is tilted towards the **Eurozone, Japan and the UK**.

Environmentally-linked policymaking, legislation and consumer behaviour are irreversible. We favour companies that are contributing positively to these themes.

Expensive valuations give us some cause for concern. As such, we hold a **stable of diversifiers** (**government bonds, gold, hedge funds** and **a Tail Risk Protection Note**) in order to help offset downside risk.

OUR ASSET ALLOCATION

The table below presents the latest conclusions of the Kleinwort Hambros 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			■			
		USDJPY				■		
		GBPUSD			■			
		EM FX (vs. USD)			■			
ALTERNATIVE		COMMODITIES				■		
		Brent		■				
		Gold				■		
		ALT. STRATEGIES			■			
		L/S Equity				■		
		Event-Driven				■		
		FI Arbitrage		■				
		Global Macro		■				
		CTAs				■		

Source: Kleinwort Hambros 6-December-2021

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

FIXED INCOME

Between a Rock and a Hard Place

The advent of the new Covid variant upended plans for what could have been a coordinated, gradual tightening of monetary policy. Central bankers find themselves in an uncomfortable position between stubborn inflation and rising uncertainty, but we expect yields to continue rising in the medium term.

Sovereigns

US. The yield of the 10-year treasury note trended upwards throughout most of November to 1.65%, reflecting strong stubborn inflation and expectations that the Federal Reserve (Fed) will start hiking rates by summer 2022. The Fed had already announced its plans for tapering, cutting net securities purchases by USD 15 billion a month, however the advent of the Omicron variant, the resulting bout of uncertainty, and stubbornly high inflation data caused Fed Chair Jay Powell to suggest a more accelerated plan of action. Investors struggled to make sense of the action and a volatile November saw yields dipping to 1.35% before recovering again to 1.46%. We expect the Fed to begin a gradual cycle of funds rate hikes in H2 2022 as 10-year yields continue to rise and remain Underweight.

UK. As in the US, Omicron derailed the Bank of England's latest rhetoric suggesting a sooner-rather-than-later reversal of the historically low interest rate policy. Yields on 10-year gilts dropped accordingly from their highs of 120bps in October to 72bps in early December, erasing much of the summer's upward trend. Nonetheless, we do not see much additional downside potential and expect yields to return to positive momentum as the latest wave of Covid uncertainty subsides. We are Underweight.

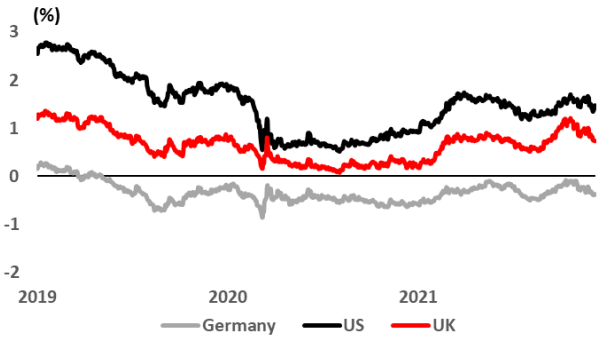
Eurozone. Sovereign yields dipped last month as the health picture took a turn for the worse. Yields on the 10-year German Bund slid back below -0.3%. The European Central Bank (ECB) is likely to sustain security purchases in 2022 with inflation set to drop back towards 2% and economic recovery easing back in some member states. We remain Underweight Eurozone sovereign bonds.

Credit

Developed markets. Spreads widened somewhat in response to fears for renewed economic restrictions following the rise of Omicron as US Credit spreads over government bonds exceeded 100bps for the first time since March. Nonetheless, spreads remain exceptionally tight by historical standards and offer limited protection against further rate hikes. We are Underweight.

Emerging markets. EM debt markets remained relatively calm all things considered. Alarming inflation in Turkey and a looming real estate crisis in China did not translate into a broader EM sell-off and even the possibility of a new global wave of Covid cases fueled by the new variant was taken in stride by investors. Spreads rose marginally but do not sufficiently compensate for inherent risks in our view. We are Underweight.

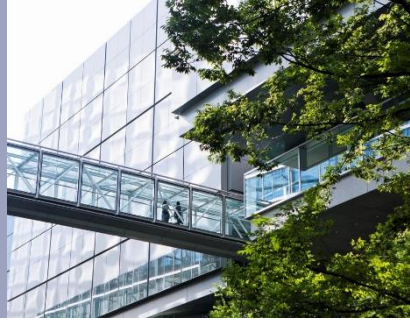
Sovereign bonds yields (%)



Sources: KH, Bloomberg, 07/12/2021

EQUITIES

Not the First Rodeo



Even if the uncertainties concerning COVID and economic recovery could generate some volatility, the context for risk assets will remain globally favorable. We continue to favour cyclically sensitive markets with attractive valuations such as the Eurozone, Japan, and the UK.

United States. On 24th November, the day before South African scientists announced a new variant of the novel Coronavirus, the US flagship equity index S&P 500 stood at just above 4,700 points, an all-time high. Chaos ensued over the next few days as investors assessed the development, and the index lost -4% in value. 1.5 weeks later the S&P stands just below 4,700 points, testing all-time highs. US stocks are exceptionally resilient, drawing support from further earnings growth in 2022 in a still dynamic economy. Financial conditions remain generally helpful despite Jay Powell's changing rhetoric on accelerated tightening. Nonetheless, exceptionally high valuations cause us some concern and we remain Underweight the US to seek more attractively valued opportunities elsewhere.

United Kingdom. Over the two-week period following the November 24th announcement, the UK's flagship FTSE 100 index was the only one amongst its peers posting a positive return; +0.87%. High vaccination rates and a sophisticated track-and-trace system should all but prevent new, strict Covid restrictions and the latest uncertainty may sway the Bank of England to extend its loose interest rate policy a while longer despite high inflation readings. We appreciate the attractive valuations and remain Overweight.

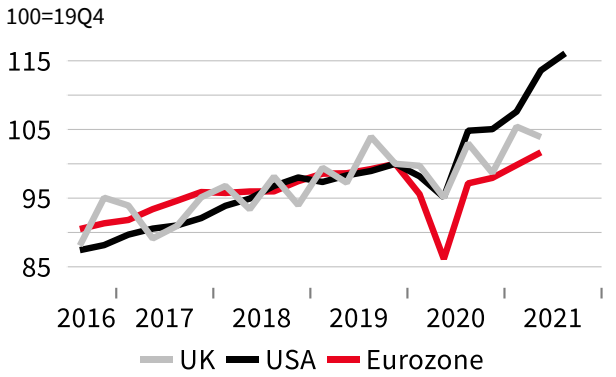
Eurozone. Attractively priced and with some of the best earnings outlooks of the main developed markets, Eurozone equities continue to offer interesting upside. The latest wave of COVID cases has led some states to clamp down in the run-up to Christmas, but higher vaccination rates and new treatments should limit the wave's reach. We remain at Overweight.

Japan. Despite an exceptionally high vaccination rate and low case numbers Japan chose to impose strict restrictions to counter the latest Omicron variant. In the medium term however, corporate earnings growth should be helped by the stronger economic recovery that finally seems to be taking hold and Japanese equities remain attractively priced for the time being. We are Overweight.

Emerging markets. While China's economy will likely continue its slowdown in 2022, the authorities look to have the fire-power to avoid any brutal crash. On this reading, stocks look attractive given the still healthy medium-term growth outlook for China and wider Asia. 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 behaviour. 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).

Gross operating surplus



Sources: SGPB, Macrobond, Eurostat, BEA, ONS, 10/2021

CURRENCIES

Forward Looking

It is unclear if the Bank of England (BoE) believes in forward guidance or not. Either way markets are trying to analyse every comment and will scrutinise the next BoE rate announcement. The US dollar is still leading the way as markets price in a hike for the end of next summer.

Dollar index (DXY). The dollar strengthened 3.5% against a basket of G10 currencies in November as the Federal Reserve is still expected to win the race in monetary tightening compared with most of the developed world. The greenback has followed US yields higher, and it is not far away from overbought territory according to momentum indicators. The Omicron Covid variant caused panic in the markets temporarily, but the disruption seems to have been contained so far.

GBP/USD. Currently the futures market is pricing in a 23% chance of rate hike on 16th of December. The likelihood of a rate hike has receded significantly, but the recent comments from the BoE have been somewhat confusing. Labour data in November showed an improvement, and the next data release will be announced two days before the rate decision. The UK workforce is still missing over 500,000 employees compared to the beginning of the pandemic, and a close eye will be kept on wage inflation in the coming months. Overall, we remain Neutral on the GBP as the BoE looks likely to keep pace with the Fed's monetary tightening. We have adjusted our forecast down from 1.3700 to 1.3500 to factor in the recent move to the downside.

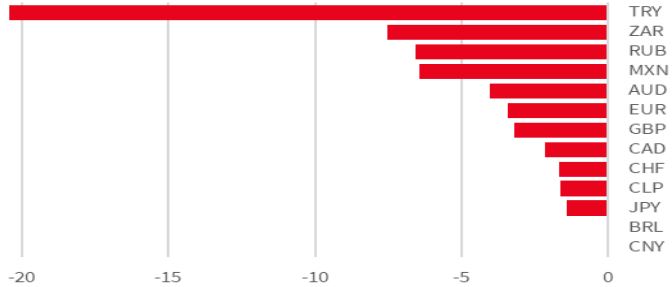
EUR/USD. The euro lost over 4% versus the dollar and traded down to the 1.1200 level last month as the worsening public health situation in Europe and prospects of a relatively more hawkish Fed have kept the euro contained. Longer term, we believe the US' more advanced phase of policy tightening and growth gap compared to the Eurozone should tip the scales toward a strengthening dollar. That said, in the near term there is space for the single currency to challenge the 1.1400 level. Overall, we remain underweight the euro and have revised down our forecast to 1.1600 for the first quarter of next year.

EUR/GBP. This currency cross is currently trying to break the 0.8600 level (GBP/EUR 1.1628). Brexit challenges still appear to be having a limited affect on EUR/GBP. In our view the euro is still likely to make up some lost ground as the pound has given up some of its 2021 gains. Considering this, our forecasts for next year have been shifted upwards.

USD/JPY. The JPY ended the month at 115, down 1.5% on the month and 11% since the start of the year. This weakness in the yen reflects the country's weak economic growth, hampered by health measures and various economic uncertainties. That said, we remain Neutral on the JPY. The yen is still a safe-haven currency and inflationary pressures remain low (0.1% underlying inflation in October).

Emerging Market FX against USD. Emerging market currencies weakened sharply against the dollar, the hardest hit being the Turkish lira, which shed 20% during the month as the Central Bank of Turnkey cut policy rates despite inflation running at over 20%. Globally, the prospect of Fed monetary tightening, a slowing Chinese economy and rising political risks look like a bad combination for emerging market currencies.

Currencies variation over 1 month against USD (%)



Sources: SGPB, Macrobond, 25/11/2021

ALTERNATIVES

Diversification is still key

We remain Overweight on gold due to its safe-haven properties in the event of a market downturn. Hedge funds offer another protection against turbulence. Elsewhere, pressure on commodities should ease back to normal in 2022. Our Tail Risk Protection Note performed well over the recent market volatility spike.

Commodities

Oil. The recent rise in the dollar, up 7% versus its currency basket year to date and 2% over the quarter, has halted the spike in the oil price. Moreover, the US and China have agreed a coordinated release of strategic oil reserves to try and drive prices down as well as OPEC+ – led by Saudi Arabia – sticking to their production increase targets.

Gold. The price of gold is 6% lower year-to-date. However, in a year in which equities rallied strongly, it makes sense for safe-havens to have sold off - the Japanese yen suffered a similar fate, losing nearly 10% versus the US dollar. Nonetheless, we continue to hold gold as valuations remain high for equities and real yields are well into negative territory. Furthermore, we believe it provides important safety and diversification in multi-asset portfolios, especially in the event of a sell-off in risk assets.

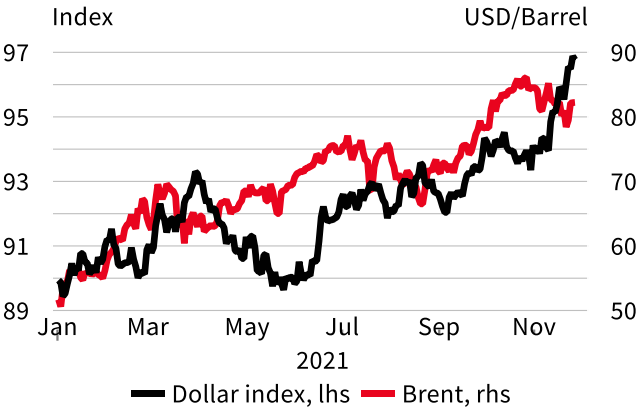
Hedge Funds. In unstable market conditions hedge funds can help a portfolio, but selectivity is key. We prefer strategies which hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short. These strategies provide relatively safe, uncorrelated sources of returns from 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.

Income Producing. In Target Return strategies, we continue to hold 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 Tail Risk Protection Note offers our portfolios yet another critical source of safety and complements the existing diversifiers.

The recent rise in the dollar has slowed the rise in oil prices



Sources: SGPB, Macrobond, ICE, 2021

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- The investment management methodology implies a degree of risk linked, among other factors, to the use of derivatives, leverage and short selling; and

- The terms and conditions applicable to redemption may continue to expose you to risk during the period between the redemption request and execution (usually prior notice of 45 calendar days before the last business day of the end of each quarter is required but can be longer for some investments).

Some funds are subject to extended redemption periods or a restriction is placed on the amount of withdrawals from the fund during a redemption period. This is known as gating. The implementation of a gate on a hedge fund is up to the hedge fund manager. The purpose of the provision is to prevent a run on the fund, which would impact on its operations. Investors should consider a hedge fund with a gate as illiquid, as withdrawals from these funds are restricted.

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Channel Islands

SG Kleinwort Hambros Bank (CI) Limited is regulated by the Jersey Financial Services Commission ("JFSC") for banking, investment, money services and fund services business. The company is incorporated in Jersey under number 2693 and its registered address is PO Box 78, SG Hambros House, 18 Esplanade, St Helier, Jersey JE4 8PR.

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In relation to investment services compensation will be payable, however, only in circumstances where we have been in default to you of our obligations. It will not be available merely because your investments have not performed as well as you had expected unless we are somehow at fault.

For further information about the schemes (including the amounts covered and eligibility to claim) please contact your Private Banker or refer to the FSCS website: www.fscs.org.uk.

IMPORTANT INFORMATION – PLEASE READ

Channel Islands

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