MONTHLY HOUSE VIEWS

July 2021

In Transitory

The success of the vaccine rollout in many countries has allowed for the unlocking of economies and a gradual return to normalcy, particularly for the services sector, which had been battered by strictures on movement. The restart has, however, led to a spike in inflation – the headline consumer price inflation (CPI) in the US hit 5.4% in July, above the 4.9% market consensus. This has weighed on sentiment, with some fearing overheating conditions, and a potential hawkish turn in central banks' monetary policies, particularly the Federal Reserve (Fed), which plays such a pivotal role in global capital markets.

Such fears are likely premature. The surge in inflation readings is largely driven by year-on-year base effects as prices fell dramatically for many goods and services in the throes of the pandemic. These effects will dissipate in the months ahead. Moreover, while macroeconomic fundamentals are robust, there is a slowdown in some leading indicators (e.g. manufacturing PMIs in the US and UK), which suggests global growth momentum has peaked or is close to doing so. In addition, while reopening is the dominant theme, new COVID variants and renewed localised lockdowns remain part of the economic landscape.

As a result, recent central bank meetings have continued to stress that monetary policy will remain accommodative in the short term, with most policymakers convinced the overshoot to 2% inflation targets will prove transitory. Longer term, structural inflation is usually predicated on tight labour markets, but employment remains far from pre-crisis levels. Over 7 million people who had jobs in 2019 in the US are still unemployed; in the UK, it's over 1 million. There are other notable pockets of slack too. Roughly one in five offices in the US will be empty in 2022, according to Moody's Analytics, with rents across the country projected to fall by 7.5% this year.

With crosscurrents between high but likely transitory inflation, the Fed delivered a masterful hawkish turn, indicating two rate hikes in 2023. This has pushed up front-end yields while long-term interest rates eased somewhat in a "flattening" of the US yield curve. This suggests the Fed successfully managed to assuage the market's concerns about long-term inflation while keeping monetary support at record levels for the time being.

Other central banks have remained expansive. The Bank of England has downplayed concerns over a pick-up in inflation at its June meeting with near unanimity, kept interest rates at their historic low of 0.1% and maintained its bond-buying target at £895 billion. The European Central Bank maintained its dovish tone as well.

The combination of the above has helped global equities to another strong quarter. Although equity valuations look rich in absolute terms versus their own history, they are not relative to government bonds. Indeed, from a total returns perspective there is little alternative to equities over the medium term, as government bonds are all but guaranteed to deliver losses over time once inflation is factored in. Corporate bonds are not much different – the difference in yield between corporate bonds and sovereigns (known as "credit spreads") is narrow, offering little value.

Bottom line

We believe the case for risk-taking is well supported given a strengthening economic backdrop and strong momentum. Nonetheless, we are wary of expensive valuations. **On balance, we are moderately risk-on with a continued preference for equities** but have been tilting more towards less expensive, value-oriented regions. We also continue to hold a stable of safe-haven assets, including gold, low-volatility, defensive alternatives (e.g. hedge funds) and government bonds.

- **Economic regime:** Our Leading Economic Macro Indicator (LEMI) suggests the global economy is in a state of 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. We believe central banks have little appetite to raise rates at present and inflation is likely to remain subdued over time, albeit a transitory rise is occurring. We remain tolerant of higher global equity valuations at the headline level but have been tilting our exposure towards less expensive regions and away from Growth to Value.
- **Momentum:** Global equities are in positive momentum versus their ten-month moving average. This is supportive of increased exposure to the asset class.
- **Sentiment:** Sentiment is displaying signs of exuberance in some areas (e.g. rising S&P 500 net speculative positioning) but defensiveness in others (e.g. trade-weighted US Dollar strength).

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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**				■		
		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 12-July-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	After a longer period of Value-outperformance, Growth took the lead again in June amidst the Fed's announcement of earlier-than-expected monetary tightening. We do not expect inflationary pressures to cause this in the short-term but valuations remain expensive and we are Underweight.
Eurozone	The NGEU plan has been approved which confirms our positive view on the region. We continue to be Overweight with a preference for more cyclically sensitive sectors.
UK	The UK is set to remove its last remaining pandemic restrictions in July, and monetary policy remains accommodative. We remain Overweight.
Japan	Japan has been struggling with a rise in infection rates, but equity valuations and outlook remain attractive. We are Overweight.
Emerging (EM)	Emerging Markets are stuck between an upswing in commodity prices and rising cost of borrowing as US yields rise. We are Neutral.

FIXED INCOME	p5
Sovereigns	Government bonds are not particularly attractive, but we continue to hold protective positions across our core strategies. Overall, we remain 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 further increases in US 10-year Treasury yields ahead will cap upside for EM debt. We are Underweight.

CURRENCIES	p7
EUR/USD	We expect the euro and dollar yields to rise in parallel, which argues for sideways trading in coming months.
GBP/USD	A technical correction is likely to put a pause on sterling's rally in the near term.
EUR/GBP	We anticipate sideways trading in the coming months in absence of a fresh catalyst.
USD/JPY	We expect a strong cyclical recovery in Japan in H2, which should help the yen stabilise against the dollar.
Emerging	With US rates set to grind gradually higher, we expect EM currencies to trade sideways for now.

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	With inflation set to rise faster than bond yields for the remainder of the year we expect gold prices to continue their recovery. We are Overweight.
Oil	Rising oil demand as economies reopen will be met by increased output, leaving prices in a range.
Income producing Alts.	Attractive opportunities exist in infrastructure, selected real estate and specialist lenders for Target Return and income-focused strategies.

Source: Kleinwort Hambros 12-July-2021

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

FIXED INCOME

Not Quite Fed Up

The Federal Reserve's (Fed's) surprise change in tack heralded the beginning of the end of a decade-long ultra-loose monetary policy. Our convictions are unchanged – Underweight in both sovereigns and "credit" (i.e., IG and HY corporate bonds).

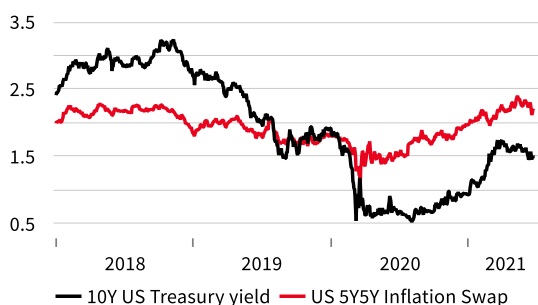
Sovereigns

US. The Fed delivered a hawkish surprise at their June meeting, acknowledging for the first-time potential intervention to counteract runaway inflation if required, and hinting at two rate-hikes in 2023. The market's appeared to welcome a more pro-active stance to policymaking in a time of increasing inflationary pressures. Yields on 10-year US Treasury bonds rallied briefly to 158 basis points (bps) before retreating to under 130 bps in early July, the lowest level since February. The Fed's view of transitory inflation seems to gain more wide-spread support; however, we see limited room for further yield compression on the short term and remain Underweight.

UK. The Bank of England (BoE) voted to keep monetary policy unchanged at their meeting in mid-June, anchoring the benchmark interest rate at 0.1% for the foreseeable future. The board's chief economist Andy Haldane cast the sole dissenting vote, warning of rising consumer prices and recommending a reduction to the ongoing asset purchased programme by £50bn to £845bn. Even more so than in the US, there remains sufficient slack in the economy for any inflationary pressures to prove transitory, which should keep monetary policy accommodative in the short term. We are Underweight.

Eurozone. Last, but not least, the European Central Bank (ECB) avoided "taper talk" as it voted to keep its stimulus programme unchanged as well, signalling a rift between US/Eurozone policymaking. After a brief rally, the yield on 10-year German Bunds retreated to -32bps, markedly below its May high of -10bps.

The pickup in inflation expectations has levelled out



Source: SGPB, Macrobond, U.S. Department of Treasury, 30/06/2021

Credit

US. IG spreads dropped to 116bps from 130bps throughout June as investors took up more credit debt amidst falling sovereign yields and positive economic sentiment. At these levels close to all-time lows, spreads offer little protection against further rises in sovereign yields. Yields on HY bonds also reached new all-time lows in June on continuing optimism about reopening driving a cyclical recovery. Again, HY spreads of only 300 bps offer little protection against default risk and we remain Underweight US corporate bonds.

UK. Reopening optimism driven by vaccination success and abundant liquidity have kept IG spreads over gilts close to historical lows. However, these do not compensate for the risk of further upside in gilt yields as bond prices normalise. Sterling HY spreads – back at 2014 lows – are tighter still than those in euros or dollars, resulting in an unfavourable risk/reward ratio.

Eurozone. While yields on euro IG bonds have risen from mid-December's all-time lows at -0.02%, at only 0.25% they remain deeply unattractive as headline inflation further increased to 2.0%. With further upside in inflation possible in coming months likely driving Bund yields higher we remain Underweight IG credit. HY in euros offers little more appeal – yields remain close to April's all-time lows and spreads are back at only 300 bps.

Emerging Market (EM) debt

EM debt spreads appreciated significantly throughout June, rising from 305bps to 320bps in early July as investors reacted to the Fed's hawkish announcement of two likely rate hikes before the end of 2023. However, credit risks of most issuers remain elevated and the backdrop of further increases in 10-year Treasury yields ahead will prove challenging for EM debt. We remain Underweight.

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EQUITIES

Moving Swiftly On

Equity investors chewed on the Fed's announcement of earlier-than-expected monetary tightening and valuations remain elevated. We have been reducing our Growth exposure in the US, towards the Eurozone, Japan and the UK.

US. Despite missing President Biden's self-declared vaccination target of inoculating 70% of American adults by 4th July, there was some reason to celebrate: The continuing reopening of the economy is likely to translate into an expected 60% year-on-year earnings growth within the S&P500 in the second quarter of the year, propelling the flagship index to new all-time highs on Independence Day. Growth stocks made up some ground against their Value counterparts as investors gained clarity on the Fed's monetary policy plans, however the government's bipartisan $1.2tr infrastructure deal is set to provide support for sectors like construction and manufacturing over the coming months.

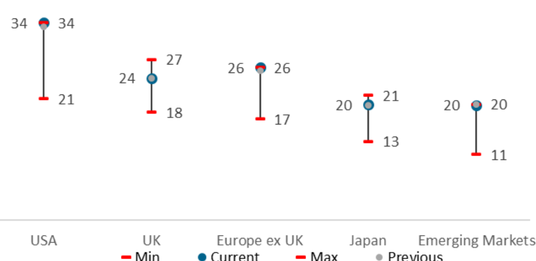
Stacked with elevated valuation in mega-cap stocks, US indices continue to top the ranking of most expensive regions in the developed world and we are Underweight to allocate to better opportunities elsewhere.

UK. Aided by a world-leading vaccination campaign and the ongoing cyclical recovery, the UK flagship equity index FTSE100 has been largely mirroring its US counterpart until mid-June, when the Fed's announcement provided additional tailwinds to American Growth sectors. With lower inflationary pressures and significant slack left in the economy ahead of "freedom day" on July 19th – when the UK is set to shed its last remaining Covid restrictions – the BoE's monetary policy will remain accommodative for the foreseeable future, which should continue to add fuel to the fire of the cyclical recovery. Nonetheless, for the time being, the market continues to trade at discount to its historical valuation ratios of price-to-earnings, P/CF and P/B. We are Overweight.

The US remains the most expensive developed market

Price to 5y average earnings

5 year range



Source: KH, Bloomberg, 30/06/2021

Eurozone. After initial struggles with vaccination rollout, the current rate of inoculations suggests the region will overtake the US in terms of jabs administered per person in the near future. As a result of this delay in economic reopening, the ECB is facing less pressure of the economy running hot and can keep the foot on the pedal of quantitative easing, helping to unlock additional value in regional equity markets. In addition, the approval of the €800bn "NextGenerationEU" plan provides a positive backdrop for Eurozone economy and should strengthen the outlook for the forthcoming two years. We are Overweight.

Japan. Japanese equities struggled in June with the further depreciation of the Yen to its lowest since February 2020 – and 7.9% off its peak in January this year – as generally positive market sentiment drove investors to shed their need for safe-haven assets. The government further struggled to contain rising Covid infection rates, threatening the much-anticipated Summer Olympics in August. However, Japan's vaccination campaign is ramping up and we expect some upside for Japanese equities over the remainder of the year as infections fade and businesses take advantage of a cyclical recovery. We are Overweight.

Emerging Markets. Emerging Market equities have largely been trading sideways for the past quarter, stuck between rising commodity prices on one hand, and the financial burden of rising US yields – which pressure EM currency-denominated securities – and the continuing struggle to contain the Covid pandemic on the other. The now Centenarian Chinese Communist Party, presiding over the largest of EM forces, will take care to use all monetary tools at its disposal to keep alive the economic resiliency that supported many economies in the region, but many idiosyncratic risks remain for the time being. 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).

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CURRENCIES

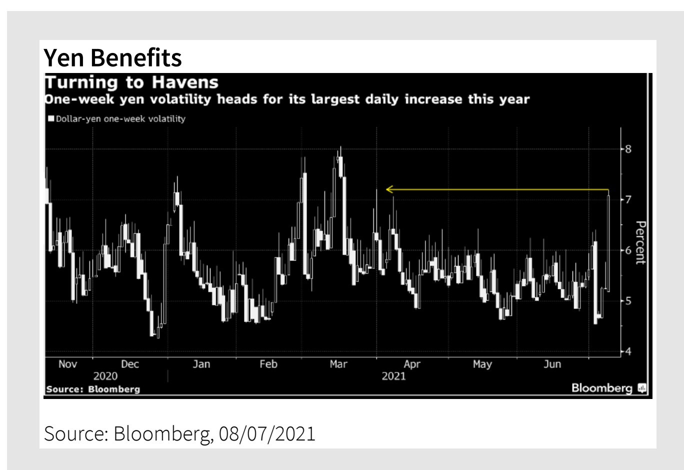
Managing Inflation

Inflation remains at the top of the agenda, but more concerning to markets are the disjointed economic recoveries around the world. Equity markets continue to rally; however, inflation and new COVID variant concerns could well put the brakes on.

Dollar Index. The dollar has been resurgent in June as the Dollar index hit its highest levels since the start of April. The Federal Reserve has been cautious, however the expected date of a reduction in quantitative easing has been brought forward. The US Treasury bond market yield has fallen significantly from 1.50% in June to 1.25% at the start of the July, however the positive correlation with the US dollar has temporarily broken down. Inflation remains on everyone's minds, but for the time being central bankers are talking it down as transitory.

GBP/USD. The 1.3750 level has been tested as profits are taken off the table. GBP/USD has underperformed in recent weeks mainly due to a resurgence in the dollar and concerns around the Delta variant. That said, GBP/USD looked rich near 1.4200, and was due a technical correction. If the 1.3660 region breaks, we could see further downside move. However, we need a significant catalyst for this to happen in our view. Looking ahead, we expect this correction to be short-term in nature, and still expect GBP/USD to trend higher to 1.4000 over the next couple of months, once the UK economy has been fully re-opened.

EUR/USD. The European Central Bank is expecting inflation to remain above the 2% level in the near term before stabilising later in the year. Monetary policy needs to remain expansionary for an extended period of time to get European economies back on their feet. Just like GBP/USD, EUR/USD has struggled in recent weeks and the cross is currently testing the 1.1800 level, which hasn't been broken through since the start of April. The stronger US dollar is mainly responsible for this drop in the near term, however we don't expect it to be long-lasting and see EUR/USD moving back above 1.2000 later in the summer.



Source: Bloomberg, 08/07/2021

EUR/GBP. Trade disagreements between the EU and UK continue to linger, however the cross is becoming numb to these headlines. The pound has held onto its gains since the start of the year, and surprisingly hasn't let up even for a short period of time. With the UK set to fully ease restrictions on 19th July it is difficult to imagine a sustained bout of sterling weakness ahead even considering the Delta variant. Therefore, our forecast is very close to current levels at 0.8642 for the third quarter, and our view remains firmly neutral.

USD/JPY. Volatility is on the rise and the yen benefits due to its safe-haven characteristics, as the Delta variant spreads around the world. The currency has finally caught a breath after a disappointing past few months. The surge in US 10-year yields weakened the rate-sensitive yen significantly at the start of the year. However, over the last few weeks US treasury yields have corrected lower, and now that USD/JPY has broken below 110.00, 109.00 could be within reach.

EM currencies. The currencies of oil and commodity-based countries such as Brazil and Russia outperformed the US dollar in the month of June. However, the vast majority of EM currencies are down versus the dollar as low vaccine rates and Covid-19 outbreaks continue to weigh on their economies. US monetary policy is unlikely to shift soon, however the Federal Reserve's interest rate path has been brought forward, which could keep many EM currencies supressed.

USD/CNY. China signalled they may soon release more support for their economy, which suggests the pandemic recovery is far from over. The Chinese 10-year bond has dropped below 3%, and USD/CNY has sold off to the 6.50 level. This year USD/CNY has been fairly stable, trading mainly between 6.35 and 6.55 after the dramatic fall witnessed last year. If the dollar continues to appreciate, 6.60 could well be tested in the months ahead. However, there is a lot to factor in, including global market risk sentiment and inflation risk around the world.

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ALTERNATIVES

Gold and hedge funds continue to be part of our stable of safe havens

Falling real rates should continue to support Gold prices. We prefer hedge fund strategies which hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short.

Gold

As we have argued in recent months, one major factor behind the slump in gold prices between last August and March was the inexorable rise in real yields, i.e. the difference between 10-year Treasury yields and headline CPI in the US. Since March however, yields have fallen back precipitously to the 1.35% level and CPI has shot up from 1.3% in August to 5% in May (most recent reading), taking real yields well into negative territory and creating support for gold prices.

While we reduced our gold positions earlier in the year, we have continued to hold a meaningful 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.

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).

Oil

Saudi Arabia and the United Arab Emirates and still deadlocked in a dispute regarding output levels. This means that OPEC+ is set to keep output levels unchanged next month. Global fuel consumption is rebounding strongly from pandemic lows, causing the market to be significantly tight. Unless a deal can be made where OPEC+ increase supply, oil prices are likely to continue to rise in the short-term and continue its upward price move which is currently at a two-year high at $75 a barrel (Brent Crude. Even if OPEC+ manages to agree a deal, the IEA report shows that the 400,000 barrel-a-day output hike under consideration will still fall far short of consumer's needs. The 23-nation group pumped 40.9 million barrels a day in June, the IEA estimate that consumers will need 43.45 million a day from OPEC+.

More saliently, while short-term increases in the price of oil may be expected if no deal between the Saudis and the Emiratis is struck, it may well lead to a collapse in oil prices as time goes on. This is because no deal may well cause the Emiratis to opt out of OPEC+ production strictures altogether, and thereby incentivise others to do so as well.

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