MONTHLY HOUSE VIEWS

June 2021

The Price Is Right

In markets, there is from time to time a single data point that garners intense, widespread scrutiny and reflects the zeitgeist of the moment. In the immediate aftermath of the Great Financial Crisis, it was US house prices. During the Eurozone crisis, it was credit default swaps – a tool to hedge default risk – on periphery borrowers and banks. A year ago, it was the daily number of new confirmed COVID-19 cases. Today, it is inflation, in particular in the US.

This topic has emerged as a key concern for several reasons. Money supply growth has reached historical highs at over 20% year-on-year (YoY) ever since May 2020; growth in hourly earnings has averaged 4.6% YoY since January 2020; commodity prices have surged 62% over the past twelve months; supply bottlenecks (for example, in semi-conductors) have fuelled fears of overheating; and fiscal spending plans announced since last December amount to over 30% of US GDP.

Rapid progress in vaccinations has fuelled hopes that the pandemic will soon be over – over 50% of the US population has received at least one dose of a vaccine and mobility measures show that traffic related to retail and recreation are almost back to normal. This has bolstered business confidence. The IHS Markit US Composite Purchasing Managers Index (PMI) hit an all-time high of 68.7 in May 2021 as it registered the steepest upturn in business activity since data collection began in October 2009. Rates of new business growth were the fastest on record in both the manufacturing and service sectors.

Therefore, unsurprisingly, some market participants have begun to fret about rising prices, as witnessed by market expectations for US inflation. Swap contracts for five-year expected inflation in five years time (5Y5Y) have risen from lows of 1.22% in March 2020 to 2.52% today, while 10-year breakevens (another measure of the market's expectations for inflation) touched a recent peak of 2.53% over the same period.

This matters because inflation expectations have enormous influence over monetary policy, bond yields and equity market valuations. Bond prices have tumbled as ten-year Treasury yields rose from 0.51% last August to 1.64% and the iShares 20+ ETF of long-duration bonds has fallen 20.5% over the period. For equity investors, short-dated Treasury yields are often used as the risk-free rate when discounting the net present value of future cash flows – this means that Growth stocks (where high valuations rely on earnings growth many years into the future) are particularly vulnerable to rising rates.

However, we should note that these inflationary worries are largely a US phenomenon. Market expectations for inflation have risen in the Eurozone, but not to the same extent – 5Y5Y swaps have risen from the March 2020 crisis low of 0.72% to 1.64% but remain well below the European Central Bank's (ECB) 2% target. And the Bloomberg consensus of private forecasts sees Eurozone headline inflation peaking at 1.7% in 2021 before easing back to 1.3% next year. In China, both headline and core inflation are below 1% - and the country is much further ahead in its recovery from the pandemic than its Western counterparts.

Bottom line

As we noted last month, this year should see higher prices as economies reopen and pent-up consumer demand is unleashed, but this should prove transitory. Gaps between actual and potential output still gape wide and there is enormous slack in the labour market, as well as huge underutilised capacity in commercial real estate. In addition, ageing populations, supply-chain efficiency and technology-driven productivity gains will exert lasting disinflationary pressures. We believe that these factors will push inflation lower again in 2022.

We remain sanguine and believe it unlikely that base interest rates will rise for many months to come, if not years. Moreover, **we remain risk-on.** 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 a state of expansion, which is clearly favourable for risk-taking.** Eight of the ten underlying forward indicators of economic growth remain positive which is reflective of a broad and powerful economic backdrop.

- **Valuations:** Valuations for equities – the largest source of risk and return in most strategies – remain challenging in absolute terms. Heightened valuations have been further challenged by increased inflation expectations, which raises the spectre of rates rising. However, as discussed above, **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 may well occur**. 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 remains neutral**.

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.

OUR ASSET ALLOCATION

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

Summary house views

Asset class	Sub-class		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		
	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-June-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 equity valuations have become extended and a change in leadership is underway from Growth stocks, which are heavily represented in US indices, towards Value stocks. We remain Underweight.
Eurozone	Eurozone equities have outperformed global indices year-to-date on forecasts of a strong recovery. We continue to be Overweight the region.
UK	The UK is continuing to ease lockdown restrictions and Brexit uncertainty is largely behind us, which should boost cyclical recovery and bolster investor sentiment. We remain Overweight.
Japan	Japan equities valuations remain relatively attractive. We keep our Overweight.
Emerging (EM)	Despite lingering struggles with Coronavirus outbreaks in some countries, our long-term view on EM equities generally remains largely bullish and 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 euro and dollar yields to rise in parallel, which argues for sideways trading in coming months.
GBP/USD	Sterling has rallied steadily against the dollar thanks to the UK's world-beating roll-out of vaccinations and general dollar weakness.
EUR/GBP	We expect the euro to trade sideways against sterling in coming months and remain Neutral.
USD/JPY	We forecast that USD/JPY will consolidate just below current levels but expect increased volatility as risk sentiment waxes and wanes.
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 8-June-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

Uphill battle

Today's environment of reflating economies and spiralling debt issuance to finance fiscal largesse presents a challenging backdrop. Our convictions are unchanged – Underweight in both sovereigns and "credit" (i.e., IG and HY corporate bonds).

Sovereigns

US. 10-year US Treasury bonds were oversold at end March after yields had surged 123 basis points (bps) from their August 2020 lows (yields move inversely to prices). Yields have remained range-bound ever since, moving between 1.55% and 1.75% as investors continued to assess the recent surge in inflation. As outlined in this month's opening piece, there are many good reasons to expect higher inflation for the remainder of this year before disinflationary forces return in 2022. Nonetheless, the improving cyclical backdrop argues for less risk aversion and higher yields and we expect to see 2-2.25% over the next 12 months.

UK. Like US Treasuries, yields on 10-year sovereign bonds ("gilts") have tracked sideways since late-February, temporarily reaching new 2-year highs in mid-May at 0.90%. This move has been driven by a vaccine-driven recovery but also by a rally in 10-year breakeven rates (inflation expectations calculated by subtracting yields on inflation-linked bonds from those on fixed-coupon gilts) which have reached 3.59%, the highest since 2008. We remain Underweight but continue to hold protective positions of medium-to-long duration across strategies.

Eurozone. While US Treasuries have been trading sideways, 10-year German Bund yields recently retracted from their 2-year highs of -0.10% in May to -0.20% at present. Nonetheless, confidence remains elevated that the surge in vaccinations will ensure lighter restrictions to support a cyclical recovery and that crisis-level negative yields may become a thing of the past in due course. Moreover, the ECB is likely to slow the pace of its asset purchases in the third quarter (Q3) after a burst of accelerated buying in Q2 to stem any tightening in financial conditions. Looking ahead, we expect Bund yields to again track higher in line with Treasuries.

Credit

US. IG spreads have tightened towards early 2018's all-time lows and offer little protection against further rises in sovereign yields. Yields on HY bonds reached new all-time lows in early May on optimism about reopening driving a cyclical recovery. This has encouraged a surge in borrowing with HY issuance up 64% YoY. However, HY spreads of only 300 bps offer little protection against default risk. We remain Underweight US corporate bonds.

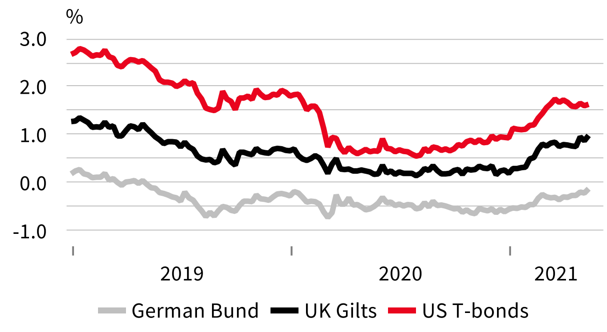
UK. Reopening optimism driven by vaccination success and abundant liquidity have kept IG spreads over gilts close to historical lows. However, these do not compensate for the risk of further upside in gilt yields as bond prices normalise. Sterling HY spreads – back at 2014 lows – are tighter still than 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 compared with April's headline inflation at 1.6%. 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 sovereign bonds in USD still look attractive. Yields have fallen since early April but at around 4.4%, still offer a positive real return. Chinese government bonds in CNY pay 3.1% yield, an attractive premium to headline inflation at 0.9% YoY in April. 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.

Sovereign bond yields have paused for now



Source: SGPB, Macrobond, U.S. Department of Treasury, 20/05/2021

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EQUITIES

Tilting Towards Value

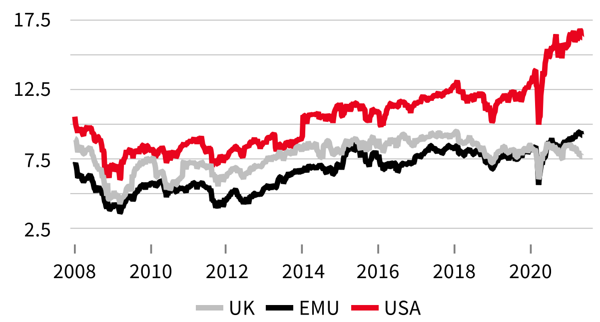
A synchronised global recovery and rising rates should favour cyclically-sensitive Value stocks and markets. As a result, we have tilted allocations away from Growth stocks in the US and towards the Eurozone, Japan and the UK.

US. US equities have been in a steady upward channel ever since the first announcement of successful vaccine trials sparked hopes that the pandemic could be brought under control. There have been minor pullbacks in prices – for example, as Treasury yields spiked higher – but the uptrend has resumed, aided by 48% YoY growth in Q1 earnings, 23% above analysts' forecasts.

However, valuations have become extended – the price-to-cash flow ratio (P/CF) has reached 16.2x, well above the Eurozone and the UK at 9.2x and 7.7x respectively, while the cyclically-adjusted price-to-earnings ratio (CAPE) has only ever been higher during the dot-com bubble. Moreover, a change in leadership is underway with Growth stocks, which are heavily represented in US indices, and are beginning to underperform Value. This is hardly surprising – Value companies tend to be more cyclically sensitive and less vulnerable to derating as long-term yields move higher. We believe there are better opportunities elsewhere and remain Underweight.

UK. UK equities have outperformed the global index handily since early November thanks to a world-leading vaccination campaign and a favourable base-effect resulting from the Brexit-induced uncertainties of years prior. Nonetheless, the UK continues to trade at a discount to its ten-year average on ratios of price-to-earnings, P/CF and P/B, making it the cheapest major market we follow. At the same time, expected 2021 earnings growth of 59% - the highest in our universe. Moreover, international investors have begun to increase allocations as Brexit uncertainties faded, helping push sterling higher against the dollar. We keep our Overweight.

The US price-to-cash flow ratio has become extended



Source: SGPB, Macrobond, MSCI, 18/05/2021

Eurozone. Eurozone equities have outperformed global indices year-to-date (YTD) as investors have begun to realise just how strong the coming cyclical recovery will be. EU member states are now vaccinating a higher proportion of the population each week than the US and the UK. As a result. analysts have revised earnings forecasts higher and now expect faster growth than in the US both this year and next.

The Eurozone also fits the bill for our tilt towards Value – the price-to-book ratio (P/B) is at 1.7x versus 4.2x in the US and dividends yield twice as much. Cyclically sensitive areas like materials, industrials, financials, consumer discretionary and energy represent 58% of the MSCI EMU index and 37% of the MSCI USA while IT – the archetypal Growth sector – is twice as large in the US. We expect further outperformance and remain Overweight.

Japan. Japanese equities have retreated from somewhat overbought levels in mid-March as investors have fretted about pandemic emergency measures' impact on growth. However, Japan continues to rank towards the bottom of the global table for numbers of infections and analysts have begun to factor in a cyclical pick-up in activity later this year, revising 2021-2022 earnings 5.8% higher over the past three months. Valuations remain relatively attractive – especially the CAPE ratio – and we remain Overweight.

Emerging Markets. On one hand, China – the heavyweight in emerging indices – has begun to reduce policy support for the economy and its index breakdown is heavily skewed towards Growth stocks. On the other, rising US yields are often a headwind for emerging companies which have borrowed in dollars. For the longer term however, valuations are reasonable and earnings growth should continue strong in years ahead, justifying our optimistic view. We are Neutral.

Global Opportunities. We see increasing value in Environmentally-focused 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

Ranges remain in play

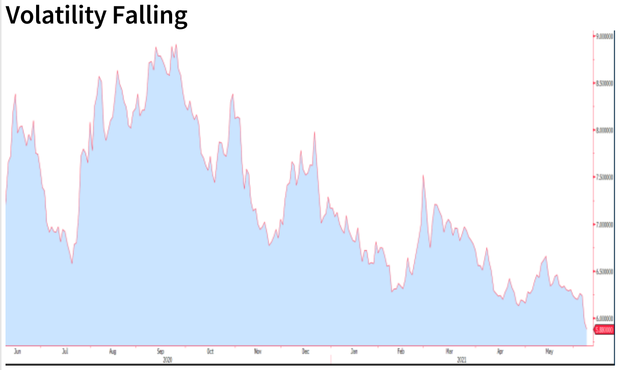
In the coming months global sovereign bond yields should move higher in parallel, meaning more sideways trading in most currencies. In the longer term we would expect undervalued currencies with strong fundamentals, such as the euro, to attract inflows.

Dollar Index. The dollar index has fallen back towards early January levels, reversing the 3.7% rally seen in the first quarter of this year. One of the major drivers has been the Treasury bond market yield, which rose sharply over Q1, up 0.83%, but has since fallen back. With inflation set to continue its recent acceleration for the remainder of the year we expect bond yields to move higher again and the dollar index to trade sideways in coming months.

GBP/USD. Cable recently reached a new high for the year, 1.4248. The pound is still benefiting from the pace of the vaccination rollout, however a full economic opening on June 21st is still in question; and with the heavy restrictions on international travel the UK is clearly not out of the woods yet. GBP/USD is teetering on oversold territory and does look too rich around 1.4200. The US dollar has been stable, although inflation risks and Federal Reserve commentary will continue to dictate the direction in the months ahead. In the near term we expect GBP/USD to pull back to the 1.4000 region before strengthening further into next year, where we have revised our forecast up from 1.4200 to 1.4300.

EUR/USD. The euro has bounced strongly from the undervalued levels seen at the end of March. The cross is up approximately 5% but seems to be slowing down near 1.2200. Important technical resistance comes in at the 1.2000 level, which is protecting the downside for the time being. The European Central Bank is concerned about inflation, which jumped 2% in May versus 1.6% in April, passing its ECB target. However, overall, we maintain our neutral stance.

Volatility Falling



Source: Bloomberg, 08/06/2021

EUR/GBP. Some lingering post-Brexit challenges continue to play out, although until now largely missing the headlines. The City of London's challenge to retain jobs is just one of the financial dilemmas the UK will continue to face. All told, EUR/GBP has been trading in a choppy range either side of the 0.8600 level. The cross is trading close to our forecasts, however in the short term the cross does look undervalued.

USD/JPY. USD/JPY has been stuck in a narrow trading range in recent months after gaining 7.2% over Q1. Growth differentials favour the greenback, as does the differential in rates – the Bank of Japan's yield curve control (it targets 10-year Japanese Government Bond yields close to zero) has been successful while Treasury yields have risen sharply this year. Looking ahead, we expect strong cyclical recovery in Japan in H2, which should help the yen stabilise against the dollar.

EM currencies. After a sharp fall in March, JP Morgan's index of emerging currencies has moved steadily higher against the dollar, aided by the stabilisation in US Treasury yields. These rates are key for many emerging countries borrowing in dollars – when rates move higher, the dollar often follows, imperilling their ability to service their debt obligations. Moreover, many EM countries have limited access to vaccines and new case growth remains worryingly high. The silver lining of the pandemic for many emerging markets has been a rapid improvement in their current account balances and we expect EM currencies to trade sideways for now.

USD/CNY. China has completed its recovery from the collapse in activity in January/February 2020 and the authorities have begun to roll back some of last year's policy easing measures. M2 growth – a measure of the broad money supply supporting the economy – is back at 8.1% YoY, down from last year's peak at over 11% and in line with the 2018-2019 average. US economic policy is much looser and Washington's twin budget and current account deficits continue to worsen – a mismatch in fundamentals which is likely to favour further CNY strength.

ALTERNATIVES

Gold Rallies on Lower Real Yields

As economies reopen, expanding oil demand will be met by increased output, leaving prices in a range. Gold prices should continue to recover on falling real rates. We prefer hedge fund strategies which hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short.

Commodities

Oil

US oil production has remained remarkably stable so far this year at around 10.8 million barrels per day (mb/d), despite last year's sharp fall in the crude oil rig count from 680 to 170 at August's lows. Since then, the rally in oil prices – from an average of $43.3 per barrel (/b) in Q3 2020 to $66.4/b so far this quarter – has encouraged new investment and the rig count has recovered steadily to reach 350. The US remains the single largest contributor to global oil supply (see chart) and we expect output to rise steadily as demand picks up.

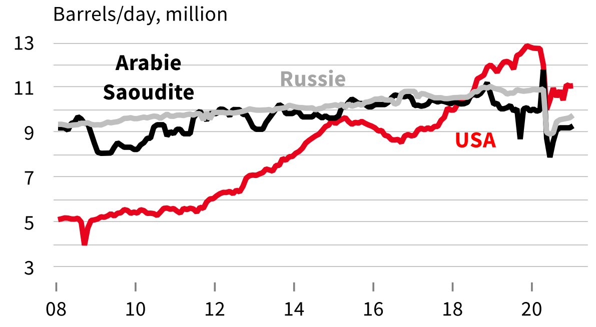
The OPEC cartel of oil producers and its allies led by Russia have committed to a gradual increase in output over the next three months in order to meet post-pandemic demand. As vaccination programmes have progressed rapidly across advanced economies, governments have been emboldened to ease curfews and lockdown restrictions, enabling mobility measures to recover. Already, traffic related to retail and leisure in the US is back close to pre-pandemic levels and the summer "driving season" should further boost demand for gasoline.

All in all, Brent prices should continue to trade between $60 and $70/b in coming months.

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 seem to have stalled in the 1.60-1.75% range and CPI has shot up from 1.3% in August to 4.2%, taking real yields deep into negative territory, creating support for gold prices.

Oil output has started to increase



Source: SGPB, Macrobond, EIA, 04/2021

Despite the recovery in gold prices (+9.5% since end March), ETFs saw outflows of -18.3 tonnes (t) in April on top of the -178t sold in Q1. Nonetheless, the outlook is brightening for gold demand – Chinese imports increased by 32t in March to the highest level since early 2020 while in India official imports in March were the highest in a decade despite the pandemic delay to the wedding season.

We expect these factors to help gold prices continue their recovery and continue to hold a meaningful position as an effective diversifier with a low correlation to equities.

Alternative investment strategies

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).

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