MONTHLY HOUSE VIEWS

OCTOBER 2021

Not every Buck is a Stag

The end of September and beginning of October witnessed the steepest sell off in risk assets this year. Global equities, which had rallied to record highs just weeks earlier, reversed notably and witnessed a 5% drawdown (peak-to-trough loss). Safe-haven assets such as government bonds offered no harbour in the storm – ironically, they may well be the cause of it. Yields surged dramatically as central banks signalled a "tapering" of quantitative easing programs, and rising rates too.

While risk asset gains remain robust over the year thus far, fears have bubbled up centred on slowing economic growth and rising prices.

China has been a principal factor. A furious regulatory crackdown on some parts of the digital economy, worth 40% of GDP by some estimates, had been underway for most of the summer. This was compounded by the collapse of Evergrande, a Chinese real estate behemoth, in early September. Evergrande is likely to cause a sharp slowdown in the broader Chinese real estate market, a major driver of domestic activity. In addition, a recent energy shortage in China has further hit sentiment. Some expect Chinese growth to halve next year from 8% this year.

This energy shortage is far from a Chinese phenomenon, and global oil prices have surged above $80 per barrel for the first time in 2018. Other commodities are at record highs. This has coincided with other shortages on all manner of goods as ports clog up with ships, disrupting "just-in-time" supply chains. Moreover, labour is widely

reported to be scarce by those companies currently reporting their periodic earnings. Local idiosyncrasies exist too, such as Brexit in the UK, which has contributed to a painful lack of lorry drivers. This has all stoked inflation worries.

This combination of slowing growth and rising inflation has led to a rather cavalier usage of the word "stagflation". Stagflation refers to a period of rising prices but slower growth. While that is technically true today, the word is meant to imply a long period of structurally weak growth and high inflation, combined with the misery of painfully high unemployment. The 1970s are a case in point. Just as not every buck is a stag, not every minor slowdown in growth and rise in price pressures is stagflation. We are nowhere near such conditions.

Demand remains buoyant

Indeed, at the root of most of today's supply shortages is a voracious demand for goods and services. This is unequivocally good for businesses. Manufacturing Purchasing Managers' Indices (PMIs) for the US, UK and Eurozone ended the quarter buoyant at 60.7, 57.1 and 58.6, respectively (anything over 50 implies growth). While China's factory activity just dipped under 50, services returned to expansion despite all the domestic turmoil.

Consumers appear well anchored globally too. European consumer activity is at pre-pandemic levels in a sign of returning consumer confidence across the eurozone. US air travel, restaurant visits and hotel stays are robust. Moreover, US households have accumulated $3 trillion in cash during the pandemic, which provides plenty of dry powder for ongoing consumption.

The UK is suffering from a more acute supply chain crisis than many other advanced countries, partly due to an exodus of European workers in the wake of Brexit. However, in the UK too, payrolls have exceeded the pre-pandemic record. The housing market also remains strong: the average house price on Nationwide's measure is about 13% higher than before the pandemic began. The household savings ratio of 11.7% remains well above historic levels, indicating further room for growth.

Supply chains should normalise in time

Given the "shut-down / restart" nature of the recovery, a voracious demand has been unleashed simultaneously across much of the globe. This has led directly to difficulties for some sectors and production chains. However, many of these issues – and the upward pressure on prices – are likely to be temporary. For example, shortages of microchips appear to be easing as used car prices appear to have peaked (microchips are a key component of new cars). Used cars were the single biggest driver of the elevated inflation readings in the US earlier this year.

The more important single indicator of sticky, structural, and worrying inflation is spiralling wage growth, which leads companies to raise prices, which then leads workers to demand higher wages (the negative vortex witnessed in the 1970s). Some will point to rising pay for longshoremen in the US, or of lorry drivers in the UK. However, the wider data would suggest plenty of slack in the system. Unemployment rates are still higher in advanced economies than before the pandemic. Wage pressures seem under control too: Atlanta Fed's Wage Growth Tracker shows US nominal wage growth at 3.9%, about in line with pre-pandemic levels; average weekly earnings in the UK increased 6.8%, but that is due to a flattering base effect.

More importantly, perhaps, is the Labour Force Participation Rate in the US, which is at 61.7%, well below the 63.4% at the beginning of 2020. A similar measure in the UK, the economic inactivity rate, remains at 21.1%, well above pre-pandemic levels. Clearly, potential workers are still staying home for reasons which likely include ongoing crisis-era benefits, Covid-fears and school closures. Those factors all are ending or abating, and the supply of labour will likely expand meaningfully in the weeks and months ahead.

Shipping – and container – shortages may admittedly be stickier. Demand for shipping has soared for current consumption and to beef up inventories prior to Christmas. Furthermore, carriers have opted against carrying heavier products such as wheat, which increase vessel fuel costs. As a result, American farm exports bound for China end up languishing as shippers prefer to rush them back to Asia empty to capitalize on the more lucrative, lighter China-to-US-bound route. This has led to the port in Los Angeles – a major US hub – to export three times as many empty containers as full ones. Experts think this anomaly may take six months or more to revert.

Despite shipping issues and some tightness in parts of the labour market, expected forward revenues, earnings and margins for S&P 500 companies are all at record highs, a feat difficult to achieve if cost pressures were a major headwind. Policymakers, too, have been excellent at balancing the various risks and rewards of policy support thus far. We expect tapering and subsequent rate rises will be done slowly and gradually enough to be tolerable.

Bottom line

We expect economic activity to remain strong over the next few quarters, particularly in the developed world, with labour markets getting back on track and still supportive financial and fiscal conditions. We also expect inflation to return to pre-pandemic levels in 2022 in most countries. This slowdown in growth and rise in inflation simply cannot be characterised as stagflation.

We believe the case for risk-taking is well supported given a robust economic backdrop and still positive momentum for risk assets (despite September's sell off). Nonetheless, we are wary of expensive valuations. **On balance, we are moderately risk-on with a continued preference for equities in most strategies**. We do, however, also 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).

As always, our decisions remain rooted in our investment process, the four pillars of which currently indicate the following:

- **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. However, as we believe central banks have little appetite to raise rates at present, we remain tolerant of higher global equity valuations.
- **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 has fallen back into neutral territory.

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

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**				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 7-October-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	Jay Powell's reassuring comments at Jackson Hole seemed all but forgotten as flaring inflationary fears pushed yields higher and spooked equity markets. Valuations dipped slightly as a result, but we remain Underweight.
Eurozone	Inflation figures are nearing central bank targets as well, although from the bottom and without seriously threatening the ECB's loose monetary policy. Valuations and cyclicality remain attractive and we are Overweight.
UK	Reports of Brexit-induced supply shortages weighed on UK equities in September but should be resolved in the medium term. Valuations are attractive and we are Overweight.
Japan	Japanese markets remained relatively robust throughout the global equity sell-off in September, though gave up much of the outperformance in October. Valuations remain attractive and we are Overweight.
Emerging (EM)	The double whammy of USD yield spikes and a local Evergrande crisis shook EM markets but the medium- and long-term outlooks remain robust. We are Neutral.

FIXED INCOME	p5
Sovereigns	The return of inflationary fears caused yields to soar across the board. We are Underweight but retain a protective allocation in multi-asset portfolios.
Duration*	We retain a medium-to-long duration position across most portfolios as a bulwark against wider volatility in risk assets.
Investment Grade	Spreads remain at historic lows. We remain Underweight.
High Yield	HY yields and spreads remain close to historic lows and we maintain 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 single currency remains under pressure, but the cross is likely to find some support below the 1.1600 level.
GBP/USD	Soaring energy prices and Inflation have hampered the pound, however downside moves seem to have stretched too far.
EUR/GBP	The lows for the year are currently being tested, and the downside momentum is expected to continue.
USD/JPY	Increasing US yields have driven USD/JPY higher, and the 112.00 resistance has been breached.
Emerging	Performance in emerging currencies continues to be erratic, as the Federal Reserve takes gradual steps towards normalising monetary policy in the US.

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	Although Gold trades below its 200-day moving average, it does appear to be a good hedge in case of disruptions in risky markets. We remain Overweight.
Oil	Oil continues to rally as the global power shortages have increased the demand for oil. This could hamper global economic growth if it continues.
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 7-October-2021

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FIXED INCOME

Pressures Mounting

The current environment with its ongoing recovery, mounting inflationary pressures and rising expectations for monetary tightening is tough for bonds. We are sticking with our Underweight on sovereign debt and credit.

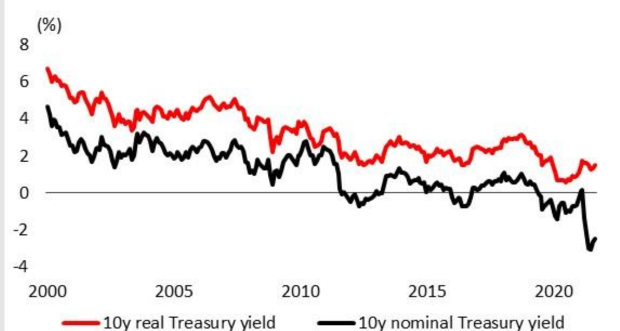
Sovereigns

US. Following a summer marked by pandemic fears which saw yields on 10-year Treasuries tighten to levels as low as 1.17%, inflation expectations returned with a bang in late September, forcing yields up to 1.53%. Our scenario for coming months sees a continuation of the economic recovery, with the labour market getting back to normal and a fall-off in inflation to nearer the Fed's target levels. This should be accompanied by an upward drift in Treasury bond yields over the next twelve months and we remain Underweight.

UK. Inflation expectations have been risen to the next level as a combination of Covid- and Brexit-related supply chain disruptions resulted in reported shortages from gas pumps to produce aisles. Investors' swift re-evaluation of inflationary pressures was accompanied by a significant change in market expectations for monetary tightening, which was hitherto anticipated for early next year. 10-year Gilt yields broke through the 1% level for the first time since mid-2019, rallying steadily from 0.52% in August to 1.08% in early October. We do not anticipate any further significant moves in the short term and remain Underweight

Eurozone. 10-year German Bund yields have followed a similar path to UK Gilts, recently getting back to around -0.2%. The ECB is still running a major asset purchase programme, helping keep yields low and limiting inter-country spreads between single currency states. However, the last quarter has confirmed both the ongoing recovery as well as its accompanying supply chain shortages and Bund yields could track Gilt yields going forward. We remain Underweight.

10-year real US Treasury yield dropped to all-time lows



Source: KH, Bloomberg, 30/09/2021

Credit

US. September's rising Treasury yields did not leave investment grade debt unscathed as spreads – remaining at just below 90 bps, close to their all-time lows of 2018 – offered little protection. While Credit yields rose to 2.15% as a result, up from their lows of 1.78% at the end of 2020, we do not consider this attractive enough to amend our positioning. Spreads on High Yield debt remained steady around 329 bps and thus of little interest also. We are Underweight on both.

UK. IG spreads over Gilts bounced from all-time lows in September, albeit only by 5 bps to 107 bps, in early October. Credit indices contracted sharply throughout September, returning -3.9% since their mid-year highs in August. Spreads for IG and HY credit continue to offer little protection against further rises in inflation – or Gilt yields – and we remain Underweight.

Eurozone. At just 0.35%, yields on euro IG bonds remain deeply unattractive as inflation continued to pick up over the summer, reaching 1.9% in September. Price declines may be cushioned by a pick-up in the ECB's purchases, but those low yields have limited prospects for capital gains. We are keeping our Underweight. HY in euro offers little more appeal – yields remain close to April's all-time lows and spreads are back at only 300 bps. We are keeping our Underweight.

Emerging debt

EM Government Debt spreads recovered from their slump in August, and at 233 bps are now challenging the heights reached earlier this summer, reflecting the rising risks of Fed action in response to inflationary pressures. From an economic perspective, even if EM regions are likely to continue suffering the effects of the pandemic, they would benefit overall if the recovery in developed countries continued. However, 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.

Past performance should not be seen as an indication of future performance. Investments may be subject to market fluctuations, and the price and value of investments and the income derived from them can go down as well as up. Your capital may be at risk and you may not get back the amount you invest.

EQUITIES

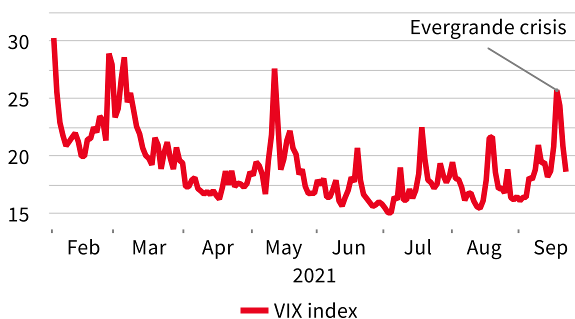
Pouring Fuel on the Fire

Global equities had a rocky start to autumn as supply chain disruptions fuelled inflationary fears and Chinese growth – or the lack thereof - spooked markets. Nonetheless, we continue to assume inflation to be transitory, and remain overweight risk assets with a tilt towards cyclically sensitive markets with attractive valuations such as the Eurozone, Japan, and the UK.

US. September is legendary as the worst month for US equities. This year's culprit for poor performance was Evergrande. The teetering Chinese real estate giant, which owes more than $300 billion, raised fears of contagion. As a result, on 20 September the S&P 500 recorded its worst trading day in 4 months, shedding 1.7%. The VIX - an indicator of S&P 500 volatility - shot up intraday to levels not seen since May. Meanwhile, Jerome Powell's reassuring tone at the Jackson Hole symposium for central bankers earlier in the month seemed all but forgotten as reports of supply chain disruptions and shortages for anything from consumer goods to capital goods rocked investors' expectations for further Fed action and sent treasury yields soaring. US Equity markets dipped further on the development – at -2.04% eclipsing the previous worst trading day - with the one benefit being some much-needed breathing room for valuations. Nonetheless, we remain Underweight in favour of more attractively priced opportunities elsewhere.

UK. If you followed British media in September, you would have hardly expected the FTSE100 to handily outperform its US counterpart S&P500 by 2.4% over the month. Amongst pictures of empty supermarket shelves, long queues at gas pumps and charts of soaring energy prices parallels to the Winter of Discontent abounded, complete with a dramatic spike in inflation expectations and, as a result, Gilt yields. We expect these pressures to ease over the next few months as supply chains adjust to a new normal and the UK's last remaining 1.9m furloughed workers return to the labour market. The UK is still the most attractively valued market in our coverage, trading on a near 10% P/E discount to its 10-year average and paying a dividend yield of over 4%. We are Overweight.

Volatility spikes after a relatively calm summer



Source: SGPB, Macrobond, 24/09/2021

Eurozone. The ECB tweaked its pandemic emergency purchase programme, launched to bankroll the leap in public spending by Eurozone governments, by cutting monthly volumes from nearly €80 billion to around €60-70 billion. This reduction is clearly not a turning point for monetary policy: purchases are still enough to mop up future excess public debt and the ECB has kept enough flexibility to trim volumes up or down in coming months. Also, the ECB is well aware the Eurozone is on the mend, with faster-than-expected recovery in the summer and a strong outlook partly due to high rates of Covid jabs. We remain Overweight this market, preferring cyclically sensitive sectors like materials, industrials, financials, consumer discretionary and energy.

Japan. Japanese equities amply outperformed other regional markets since mid-August before giving up some gains in early October. The rally was driven by the resignation of Prime Minister Suga who is widely blamed for poor management of the pandemic. Infection rates, though still high in the capital, have dropped sharply since then and half the population is now fully vaccinated (vs. 3% at end-May). Some prefectures are now mulling easing restrictions for the fully jabbed this autumn. Nonetheless, Japanese equities remain attractively priced and we are Overweight.

Emerging Markets. Worries about fallout from the zero-Covid policy, Evergrande and data indicating a slowdown in China combined to drive down emerging market equities in September. However, analysts continue to expect strong economic and earnings growth over the medium and long term and valuations remain relatively cheap 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 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).

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CURRENCIES

Normalising Times?

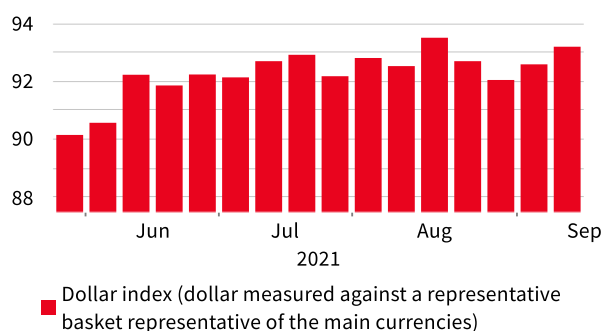
Tapering is starting, inflation is raging, but is it really time for central banks to start raising rates? Central bankers are in a quandary, as developed economies battle sluggish growth, as we slowly exit the biggest pandemic since the Spanish Flu. The dollar is powering ahead; however, we are surprised by the speed of the ascent.

Dollar Index. The US dollar continues to trade on a very strong footing against its G10 counterparts. The Federal Reserve is expected to announce a shift in its asset purchasing policy before the end of the year if significant growth is seen in the labour market. The US jobs report released last week was a blip in the road, and overall, the US appears to be leading the way. If all goes as planned the Federal Reserve will begin its hiking cycle as soon as 2022. These developments are broadly priced in by the market, helping explain the recent rally in the US dollar. Overall, this shift favours the US dollar looking ahead and we have adjusted our forecasts in the currency's favour accordingly.

GBP/USD. Rising inflation and surging energy prices combined with awareness of the Bank of England's struggles are presenting the pound with some problems. In September the pound fell to almost 1.3400 - the lowest level since December last year. The outperformance in the US dollar also aided this move. In our view the downside break did seem overdone and the cross has since rebounded to the 1.3650 region. However, the Bank of England has many challenges ahead, which could keep the lid on upside moves. The central bank kept rates and bond purchases unchanged at its most recent meeting, but despite the observed increase in inflation they did open the door to quicker monetary policy tightening. Taking all of this into account and factoring in the obvious challenges for sterling we have lowered our Q4 forecast to 1.3900 from 1.4000.

EUR/USD. The euro remains almost 20% below its purchasing power parity value against the US dollar. The Eurozone should benefit from a more solid recovery considering its high vaccination rates; however, it is unlikely to be that simple.

US Dollar in Control



Source: SGPB, Macrobond, ICE, 24/09/2021

Even though the ECB have started tapering its asset purchases, the US, due to its faster growth, is widely expected to normalise policy sooner. Furthermore, the global equity market has been rocked by the looming Chinese property crisis, and October is historically a bad month for equities. Therefore, we expect the euro to face an uphill battle over the coming months. The 1.1600 level has already been broken on the downside, which has taken EUR/USD to oversold levels. The cross could bounce a little from here, but we anticipate the downward pressure to continue and have reduced the forecast for this quarter to 1.1700 from 1.1900.

EUR/GBP. EUR/GBP has seen increased volatility over recent weeks; the cross has traded up to 0.8660 but has since retraced and broken below key support at 0.8500. The cross is currently challenging the 0.8450 low for the year. It is difficult to pick a winner though with both currencies facing many of the same problems, including slow economic growth, accelerating inflation and higher energy prices. However, in the near term the downward momentum is likely to push the cross below the lows of the year, which could take out stop losses in the market and trigger a deeper move.

USD/JPY. The dollar has snapped higher versus the Yen as the 112.00 level was broken over the past couple of days, leading to a sharp move higher as limit orders and options got triggered. Rising US yields were the main driver for USD/JPY, and now that the 109.00-112.00 trading range has been broken, more upward momentum is likely. Despite this, the outlook for Japan may finally be looking a little rosier, with an exit from the pandemic on the horizon and a new government coming to power. However, the Bank of Japan will still be unable to increase interest rates with deflation still persisting and therefore we have shifted our view from neutral to bullish on this cross.

EM currencies.

The JPMorgan EM currency index has had a rocky summer, falling over 4% since June. This is primarily due to China and the dramatic contraction in the wake of a regulatory crackdown by Beijing followed by the instability caused by Evergrande. The road ahead is likely to continue to be rocky for EM in general, especially if the US dollar strengthens due to earlier than expected tapering of asset purchases by the Federal Reserve.

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ALTERNATIVES

Offsetting downside risk

Oil continues to rally as global power shortages have increased the demand for the commodity. Expensive valuations and bullish sentiment 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.

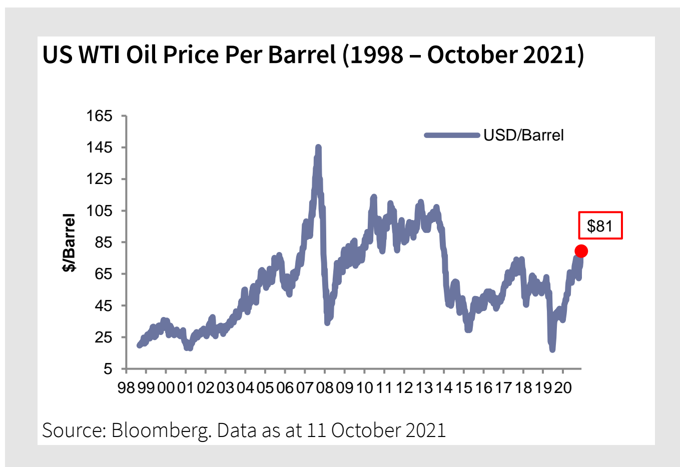
Gold

Gold prices were down -3.1% over September and trading around $1,750 per troy ounce and the metal continues to trade below its 200-day moving average. Despite the weak US jobs report last Friday (non-farm payrolls coming in below expectations at 194,000 vs. forecast of 500,000) gold did not have a strong rally – markets still expect the Fed to begin tapering next month despite the poor report. We remain Overweight to balance our overall positive position on risky assets.

Oil

Oil prices rose over the month with WTI at $81 a barrel, the highest level since October 2014. Concerns about global power shortages have increased the demand for oil ahead of the winter months. Stockpiles in Europe and Asia are running low causing prices of fuels such as coal and natural gas to soar, prompting a switch to oil. Saudi Aramco estimates that the gas shortage has increased oil supply by around 500,000 barrels a day - some Economists even believe that this estimate is too conservative.

There is a possibility that rising energy prices could have a knock-on effect, causing global growth to slow. Some banks have already cut their forecasts for expansion this year and next for the US.



Source: Bloomberg. Data as at 11 October 2021

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 (TRPN)

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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