MONTHLY HOUSE VIEWS

September 2021

Can't live with it, can't live without it

During the summer, Delta's dominance and issues getting people vaccinated generated uncertainties over how long the economic recovery which started earlier in the year could last. Indeed, going into autumn, there is little doubt the public health crisis will be around for a while and continued economic activity may well hinge on how citizens and policymakers decide to "live with Covid".

The International Monetary Fund (IMF) has confirmed its growth forecasts for the global economy (+6.0% in 2021 and +4.9% in 2022), with advanced economies seeing upward revisions, supported by a recovery in consumption, especially of services. The headline figure, however, belies substantial regional disparity. In countries where vaccinations are reaching relatively high rates – such as the United States, the UK and much of Europe – social distancing rules that had been hampering activity have been significantly relaxed – commutes, school runs and holidays abroad have all resurfaced. Even as Covid stays virulent and pervasive, a "new normalcy" is taking root.

However, it's not brighter everywhere. Some advanced countries remain behind the curve given lower vaccination rates and strict public restriction, such as Japan and Australia, where "Zero Covid" policies remain in force. New Zealand has had to reimpose sanctions, a useful reminder against complacency. The outlook for emerging markets and developing economies has been scaled back for 2021. Emerging economies will broadly suffer from reduced access to the vaccines as well as less support from fiscal and monetary policies.

China, as often is the case, is a special category of its own. The country is facing a deceleration in growth because of weakness in both external demand (slowdown in exports) and domestic demand (decline in consumption due to lockdowns). Compounding this is a regulatory crackdown on domestic technology companies, especially the Golden Dragons (US listed Chinese companies). This partly explains why Chinese equities have had a roller coaster ride this year, spilling over to emerging market assets at large. While a recovery appears underway from deeply oversold conditions, the consequences for investment in China over the long-term remains a matter of intense debate. We continue to hold a position in emerging market equities in many strategies, with the investment case underpinned primarily by attractive valuations. We accept those valuations also come with higher volatility, but for their continued inclusion they must also be justified by an expectation of commensurate return.

Undoubtedly, the public health crisis also continues to cause difficulties for some sectors and production chains. These difficulties are putting pressure on the costs of inputs, which may threaten business margins. Nonetheless, the majority of these recent price pressures reflect temporary factors and we expect inflation to return to trend next year. Our belief is underpinned by the fact labour markets still exhibit significant slack, particularly when viewed through the lens of labour force participation rates, which are well below pre-pandemic levels. Sidelined workers will likely seek work again as income support schemes and school closures end. Moreover, margins for S&P 500 companies in aggregate are at a record-high 14.1% (Q2), indicative that most are managing cost pressures with ease, even if the rhetoric from the CEOs may indicate otherwise.

As economies continue to heal and redefine a new paradigm of how to manage "living with Covid", central banks – led by the US Federal Reserve – will maintain an accommodating stance, even if they do begin to taper their sovereign bond purchases. The European Central Bank (ECB) has been the first to do so, announcing on 9 September a reduction in asset purchases via its Pandemic Emergency Purchase Program (PEPP). However, at this stage, the reduction is more symbolic than substantive, with the ECB committing to continue pumping tens of billions of euros of liquidity into market each month. That will be the case for others too as we see out this year.

Bottom line

We believe the case for risk-taking is well supported given a robust economic backdrop and positive momentum for risk assets. Nonetheless, we are wary of expensive valuations. **On balance, we are moderately risk-on with a continued preference for equities**. Nonetheless, we continue to hold a stable of safe-haven assets to offset risks, particularly those from equities – which are expensive and supported somewhat by heady sentiment. These include cash, government bonds, gold, and defensive alternatives (e.g. low-volatility hedge funds, Tail Risk Protection Note).

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, led by less bullish condition in S&P 500 net speculative positions.

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 KH Investment Committee:

			Summary house views					
			Strong UW	UW	N	OW	Strong OW	Change since last KHIC
EQUITY		GLOBAL EQUITY				X		
EQUITY		United States		X				
EQUITY		Eurozone				X		
EQUITY		United Kingdom				X		
EQUITY		Japan				X		
EQUITY		Emerging			X			
FIXED INCOME	SOVEREIGN	GLOBAL RATES		X				
FIXED INCOME	SOVEREIGN	U.S. Treasuries		X				
FIXED INCOME	SOVEREIGN	German Bunds		X				
FIXED INCOME	SOVEREIGN	UK Gilts		X				
FIXED INCOME	SOVEREIGN	EM Government Bonds ($)	X					
FIXED INCOME	SOVEREIGN	Duration USD*				X		
FIXED INCOME	SOVEREIGN	Duration EUR*				X		
FIXED INCOME	SOVEREIGN	Duration GBP*				X		
FIXED INCOME	CORPORATE	US Investment Grade		X				
FIXED INCOME	CORPORATE	Eurozone Investment Grade		X				
FIXED INCOME	CORPORATE	UK Investment Grade		X				
FIXED INCOME	CORPORATE	High Yield	X					
FOREX		EURUSD			X			
FOREX		JPYUSD			X			
FOREX		GBPUSD				X		
FOREX		EM FX (vs. USD)			X			
ALTERNATIVE		COMMODITIES				X		
ALTERNATIVE		Brent		X				
ALTERNATIVE		Gold				X		
ALTERNATIVE		ALT. STRATEGIES			X			
ALTERNATIVE		L/S Equity				X		
ALTERNATIVE		Event-Driven				X		
ALTERNATIVE		FI Arbitrage		X				
ALTERNATIVE		Global Macro		X				
ALTERNATIVE		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-September-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	The S&P 500 reached new heights in August following Jay Powell's carefully calibrated speech reassuring markets of favourable conditions for the remainder of the year. However, valuations are stretched. We are Underweight.
Eurozone	Collectively, the bloc has now inoculated 70% of its residents which, paired with continually loose monetary and fiscal policies, fosters the ongoing economic recovery. We are Overweight.
UK	Reports of faltering economic growth and Brexit-induced supply shortages weighed on UK equities in August but should be resolved in the medium term. Valuations are attractive. We are Overweight.
Japan	Markets cheered the de facto resignation of Prime Minister Suga, hoping for a more coordinated response to the pandemic going forward. Valuations remain attractive and we are Overweight.
Emerging (EM)	Market reactions to China's regulatory crackdown seemed overblown and the asset class has partly recouped its losses throughout August. Medium and long-term outlooks remain unchanged. We are Neutral.

FIXED INCOME	p5
Sovereigns	Government bonds remain unattractive, offering negligible or negative yields to investors. 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 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 maintain 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	While the potential for activity seems higher in the Eurozone, interest rates remain more attractive in the United States.
GBP/USD	No fundamental trend is anticipated in favour of either of these currencies.
EUR/GBP	Range bound trading is likely to remain in place, with post-Brexit challenges going largely unnoticed.
USD/JPY	The US dollar is expected to dictate future moves, and overall, we remain neutral.
Emerging	Emerging currencies could be penalised by the Federal Reserve's asset purchase policy changes. These uncertainties lead us to remain neutral in the long term.

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	Gold appears to be a good hedge in case of disruptions in risky markets. We remain Overweight.
Oil	The price of oil has been strongly impacted by Hurricane Ida and the evolution of the pandemic. The UN is focusing more of its attention on the effects of climate change, specifically the long-run reliance on fossil fuels.
Income producing Alts.	Attractive opportunities exist in infrastructure, selected real estate and specialist lenders for Target Return and income-focused strategies.
Tail Risk Protection	We believe the Tail Risk Protection Note (TRPN) offers our portfolios yet another critical source of safety and complements the existing diversifiers.

Source: Kleinwort Hambros 8-September-2021

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FIXED INCOME

Oh, the Clean Mountain Air

No pow but all Powell at the annual picturesque Jackson Hole symposium for central bankers, as the Fed chief successfully provided additional colour on monetary tightening without rocking the boat. We expect yields to steadily gain in the medium term and remain Underweight Sovereign Bonds and Credit.

Sovereigns

US. Yields on 10-year Treasuries rebounded from their early-August lows of 1.17% throughout the month as investors eagerly awaited central banker talk from this year's Jackson Hole summit. Chairman Jerome Powell sent the strongest signals yet indicating that the Federal Reserve (Fed) may start tapering earlier rather than later, though mixed economic data complicated matters. On balance, investors expect further announcements towards the end of this year, and yields began to pick up towards 1.36% in early September. Our view – as is the Fed's – assumes the current inflationary spike to be transitory, however yields will likely continue trending upwards over the medium term. We are Underweight.

UK. Persistently high inflation may force the Bank of England (BoE) to tighten monetary policy earlier than expected, and yields on 10-year sovereign bonds ("gilts") rose markedly to 0.70% on the last day of August after recovering from its low of 0.51% earlier that month. Markets expect tightening starting next year at the earliest, which is supported by economic data and the continuing progress on the country's vaccination programme. We remain Underweight.

Eurozone. Ten-year German Bund yields followed a trajectory similar to US Treasury yields and recently returned to -0.33%. The movement was more modest than in the United States, following the more modest economic recovery in the Eurozone. In addition, contrasting the other major central banks, the ECB is maintaining its large-scale asset purchase programme, which helps keep rates low and spreads contained between Eurozone countries. However, with a recovery confirmed in the last quarter, Bund yields should follow Treasury yields upward. We are keeping our Underweight.

Source: KH, Bloomberg, 07/09/2021

Credit

US. Credit's recovery stalled in August as tight spreads offered only limited protection against an increase in Treasury yields. In the short term, spreads for investment grade tightened further to 87 bps, close to 2018's all-time lows, and we do not see any reason to adjust our position. HY spreads at 326 bps are close to the low points prior to the 2007 collapse and are of little interest. We are Underweight.

UK. IG spreads over gilts are back to historical lows, as are those of speculative bonds, proving unattractive for investors looking for income. The macro environment is attractive, but spreads are too tight to offer any kind of protection should conditions worsen – for example if inflation rose sharply. We remain Underweight.

Eurozone. At just 0.35%, yields on euro IG bonds remain deeply unattractive given the 1.6% core inflation in August. Price declines will 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 Market (EM) debt: After a marked rise throughout July, hitting an intermediate peak at just above 235 bps, EM Government Bond spreads trended downwards again, retreating to 211 bps in the beginning of September. Even if those economies 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.

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EQUITIES

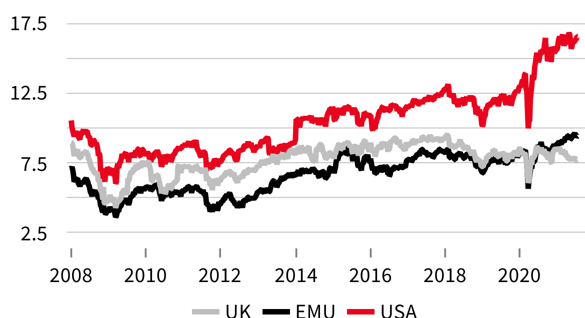
No Summer Slump

Equity markets in developed economies broke records over the summer despite lingering uncertainties inherent to the pandemic. We remain Overweight on equities and continue to prefer exposure to cyclically sensitive markets where valuations are more attractive such as the Eurozone, Japan, and the UK.

US. US equities closed out August at an all-time high following the Federal Reserve Chair's remarks at Jackson Hole which added more colour to the Fed's tapering path while at the same time maintaining an accommodating tone. Jerome Powell reiterated his view that current inflationary forces are transitory and went on to confirm that the Fed would not adjust its asset purchases before the end of the year. Thus, the market could continue to benefit from the ongoing economic recovery paired with abundant liquidity. However, valuations remain extremely high with a price-to-cash flow ratio of 16.5x, while the cyclically adjusted price-to-earnings ratio has only ever been higher during the Dot.com bubble. On balance, we remain Underweight on this market in favour of more attractively priced opportunities.

UK. In late August, reports of the economic outfall of the pandemic mixed with emerging Brexit-induced supply shortages weighed on the country's flagship FTSE 100 index, which underperformed its US counterpart, the S&P 500, by 2.08% in sterling terms. However, the UK remains the most attractively priced developed market of those we follow, with a 9% discount to its ten-year average price-to-cash flow ratio and continuing to pay a dividend yield of 4%. Earnings growth this year is likely to exceed most other developed markets, with a consensus of +76.8% year-on-year. In addition, restrictions have largely ceased, which should boost both the cyclical recovery and investor sentiment. We are Overweight.

More attractiveness for European markets according to price-to-cash flow ratio



Source: SGPB, Macrobond, MSCI, 03/09/2021

Eurozone. Eurozone equities have also profited from the influx of cash but continue to show attractive growth potential. This market should benefit from the continued strong economic recovery, mainly due to very high vaccination rates in EU member countries and upgraded earnings guidance from analysts who are still expecting faster growth than in the United States both this year and next. We continue to favour cyclically sensitive sectors such as materials, industrials, financials, consumer discretionary and energy. All in all, we remain Overweight.

Japan. The mismanagement of the Covid pandemic has become apparent in Japan as Yoshihide Suga, who has acted as Prime Minister for just short of a year, announced that he would not run for re-election later this month. Markets cheered the development and the TOPIX saw a rally of more than 10.5% since late August, expecting a more structured response to the crisis, possibly supported by new fiscal stimulus. Nonetheless, Japanese equities remain attractively priced and we are Overweight.

Emerging Markets. Concerns over the impact of Chinese regulations, both locally and globally, along with the data showing a slowdown in growth have driven emerging equities down temporarily. Indeed, markets showed signs of an overreaction as EM indices proceeded to recoup around 9% of the losses in the second half of August. 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 Overweight.

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

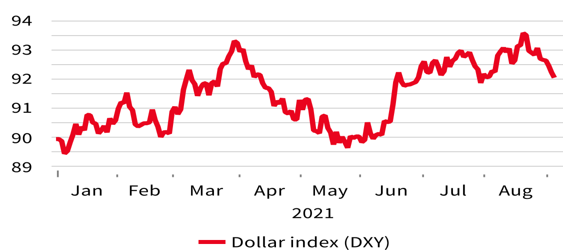
Early Talks on Tapering

It may be too soon to get excited about US rate hikes. At Jackson Hole, Federal Reserve Chairman Jerome Powell made a clear distinction between tapering bond purchases and raising rates. Throughout this, the US dollar has remained steady.

Dollar Index. After making a high for the year, the Dollar Index fell off a cliff, challenging the lows this summer. The Federal Reserve is unlikely to raise rates before 2023. Bond asset tapering could come a lot sooner; however, we wouldn't bet on it. The Fed is focussing on getting the marginalised back into the workforce as a priority. As high inflation numbers are considered transitory, monetary policy is likely to remain on hold and bond yields have slumped over the past few weeks, which has contributed to the USD correction. At the start of the summer the dollar appeared overstretched, however by the end of the August it entered a period of consolidation. Elsewhere, most G10 crosses remain trendless considering the uncertain global economic backdrop and persistently low rates, which are boosting asset prices and depressing bond yields and volatility. It is now very difficult to pick currencies which are dealing better with the pandemic than others.

GBP/USD. Support at the 1.3600 level proved to be too much, and Cable firmly rebounded from this oversold level. The cross has since broken above the 50- and 100-day moving averages near 1.3800 and hasn't looked back. Post-Brexit woes continue to go largely unnoticed, and instead the focus is primarily on the US dollar and the next move from the Federal Reserve. Life appears to have gone back to normal in the UK with the economy recovering, but we might see some shocks this winter, which could keep the pound below 1.4000. Looking further ahead, our forecast for the end of next year remains unchanged at 1.4300.

US dollar stability



Source: SGPB, Macrobond, ICE, 03/09/2021

EUR/USD. The Eurozone exhibits very low levels of inflation; in fact, the real rate of inflation is 10% below where it was in 2010. Widening yield differentials between the euro and the US dollar could damage the euro's prospects over the next couple of years. However, the impact is likely to be very gradual. For the time being, EUR/USD remains in an uptrend, with the next resistance at 1.2000. The cross is currently trading right around 1.1900, and if this area of resistance is broken, we expect further moves to the topside. For the 4th quarter of next year, we expect EUR/USD to be trading close to 1.2100.

EUR/GBP. The cross is trading right around the average price for this summer, 0.8600. It is very difficult to pick a winner from here on out. European vaccination rollout has gained momentum and it won't be long until the EU has caught up with the UK. Considering this, it is difficult to see how the pound can significantly strengthen from current levels. It is going to be more a question of if the pound can hang onto the 2020 gains, which will depend on the next steps from the Bank of England.

USD/JPY. This summer's trading has been choppy either side of the 110.00 level. With risk being on in the equity markets for a large part of the summer, the yen has struggled to strengthen against the US dollar. USD/JPY is trading in a 108.00 to 111.00 range, which has held since early July. Going into autumn we expect more volatility and a gradual ascent with the US dollar benefitting from yield differentials.

EM currencies. Most of the currency volatility seen this summer has been in EM currencies. The JPMorgan EM currency index shows swings of up to 5%. With US tapering talk starting to be priced in by markets, many EM currencies are rightly concerned. In fact, in August only a handful of EM currencies outperformed the dollar.

USD/CNY. Moves in USD/CNY have been light in recent weeks. USD/CNY was unable to break below the 6.35 level, which would have settled nerves at the People's Bank of China. Cues will be taken from the next steps by the US Federal Reserve. However, with interest rate hikes not expected until 2023 at the earliest this could be a long process.

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ALTERNATIVES

Offsetting downside risk

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.

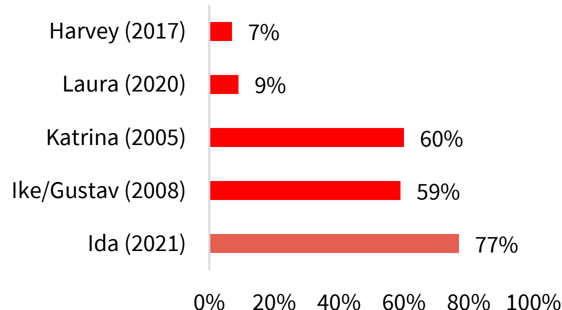
Gold

Gold continues to flirt with its 200-day moving average. The asset class had a volatile month as investors digested the big miss in non-farm payrolls which increased by 235,000, when the median forecast was 733,000. Gold managed to end the month flat. The Fed has emphasised the importance of monthly employment reports as one of the key metrics to remove asset price purchases. This disappointing number makes that story for tapering that much harder. At the same time, there are signs of a resurgent pandemic and big regulatory changes in China that could impede global growth. We believe that gold remains an effective diversifier due to its weak correlation with equities, especially in distressed market environments. We remain Overweight in order to balance our overall positive position in risky assets.

Oil

Oil prices dropped sharply in August – for the first time since March – with West Texas Intermediate (WTI) down -7.4% and Brent down -4.5% in light of concerns over demand in the wake of Hurricane Ida and doubts over the recovery due to the lingering pandemic. Ida hit Louisiana as a Category 4 hurricane, forcing 95% of the oil and gas rigs in the Gulf of Mexico to shut down, hitting output to the tune of over 1.74 million barrels per day (mb/d). Even over a week after it made landfall, 77% of the region's offshore production remains affected, by comparison after Katrina at this time 60% of oil output were offline.

Historic hurricane (% of offshore production affected 10 days after major US hurricanes)



Source: Bureau of Safety and Environmental Enforcement. 08/09/2021

Ida also caused the largest privately owned crude export and import terminal in the United States to shut down, side-lining almost half the country's refining capacity. Added to this natural disaster is the spread of the Delta variant throughout the world, which is triggering new public health restrictions in several countries.

Hedge funds: Prefer Merger Arbitrage type strategies

Hedge funds can help in unstable market conditions, but selectivity is key. We prefer strategies which hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short. These strategies provide relatively safe, uncorrelated sources of returns from equities, our most significant allocation across balanced and growth multi-asset strategies, and provided positive contributions to returns – and lowered risk – especially during periods of volatility. In the market volatility in 2020, our hedge fund selections all held their own and performed well.

Income Producing

In Target Return strategies, we continue to find attractive sources of income across a broad range of alternative asset classes; specialist real estate (medical centres and student accommodation), infrastructure (social, digital) and specialist lending (property, pharmaceutical royalties, economic infrastructure).

Tail Risk Protection Note

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

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

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