HOUSE VIEWS

APRIL 2022

Intercession Good, Recession Bad

When this year began, most forecasters expected inflation to peak in the first quarter before beginning a sharp descent. The war in Ukraine, and the resulting spike in commodities prices, changed that. Latest headline inflation figures in the US, the UK and the Eurozone make for grim reading: 7.9%, 6.2% and 7.5% respectively. They are almost certain to rise further. Moreover, the pandemic, forgotten of late, continues. China in recent weeks has imposed strict lockdowns in parts of the country, including Shanghai, and a new subvariant has led to a surge of cases in Europe. That may well prolong issues for already stretched and disrupted supply chains.

On the plus side, there is little sign so far that rising prices or fear of Covid have slowed consumer appetites. This is particularly true in the US, which leads the global business cycle – demand for everything from cars to furniture to nights out is booming. Household balance sheets in the US are in good shape too as wealth has soared since the start of the pandemic, when wages were largely backstopped by the government while services spending was slashed. US households are currently sitting on $2.3 trillion in savings (10% of GDP) above pre-pandemic levels, which is helping absorb the current inflationary pressures and keep the party going.

In turn, businesses are hiring to meet this robust demand. The US has regained more than 90% of the jobs lost in the pandemic, adding 431,000 positions in March alone. Booming job increases have been seen in sectors such as travel, live entertainment, indoor dining, bars, museums and historical sites. The unemployment rate has fallen to a near record low: 3.6%. The demand for workers is yielding strong wage growth. The latest US Non-Farm's Payroll showed wages rose by 5.6% in the year to March, well above the 2% to 3% range in the years following the Great Financial Crisis. Notably, the biggest gains in US wage growth have occurred at the bottom end of the income distribution – in the leisure and hospitality industry, pay is up 14.9%.

Inflation expectations must remain anchored at all costs

Indeed, while businesses are reporting widespread cost pressures and hiring challenges, forward revenues, earnings, and profits margins continue to be at record levels. However, too much of a good thing can make it a bad thing – are we heading towards a dreaded wage-price spiral?

Essentially, a wage-price spiral is where rising prices cause workers to demand higher wages, which in turn cause businesses to pass on higher wage costs to their customers, which then reinforces higher prices. This vicious cycle must be avoided because it unmoors inflation expectations, which must remain anchored. Should firms and households find themselves unsure about the long-term inflationary outlook, they don't know how much to invest or save, or how to structure long-term contracts, amongst other things. It can result in a deep loss of confidence, which is the lifeblood of an economy. Without confidence – and anchored inflation expectations – we enter a world of painful recession, unemployment, widespread misery and even "lost decades".

Is the Federal Reserve Bank (Fed) going too far, too fast?

Luckily, market indicators of long-term inflation (e.g. 10-year breakeven rates) do not imply that expectations have risen too far beyond most central banks' 2% targets. More plainly put, most economic participants still expect the Federal Reserve to achieve 2% inflation over time. However, for the Fed to maintain its credibility, it has had to radically pivot from a "lower rates for longer" stance at the start of the year. to signalling 50 basis points rate increments for the first time since 2000!

The Fed's sudden, dramatic shift makes perfect sense. One, it will temper red-hot consumer demand. Two, it is critical in the context of the Fed maintaining the credibility of the long-term inflation target. However, it comes with one big risk: is the Fed likely to go too far, too fast, and end up inducing a recession anyway?

Soft landing?

William Dudley, a former president of the Federal Reserve Bank of New York, has called a recession "virtually inevitable", arguing that the Fed had begun raising interest rates too late, therefore it is being forced to "slam the brakes" as opposed to merely tapping them. He is a serious voice, amongst others, and it would be wise to pay heed.

Nonetheless, a recession does not appear on the horizon at present by the factors we follow. Far from it. Corporate profits are strong, households have trillions in savings, and debt loads are (relatively) low. Moreover, the Fed may well hike less than is currently expected by markets, should inflation begin to dissipate faster than forecast. This is more than possible, especially if the geopolitical risk premium on commodities fades.

In addition, the coronavirus-related shutdowns in China may also be short-lived – despite poor local vaccine efficacy – as the country seeks other solutions. For example, Chinese authorities have signed a deal to commercialize Pfizer's Paxlovid, a drug highly effective at preventing hospitalization if taken within five days from the onset of symptoms. China may simply be waiting for sufficient supply before announcing relaxed vaccine rules.

Perhaps most saliently, recent data suggests that many workers who had been kept out of the labour force have been returning as pandemic-related factors ease. More than 400,000 people re-joined the US labour market in March, taking the labour force participation rate (the share of adults who were working or actively looking for work) to 62.4%, the highest since the pandemic. Among people in their prime working years (those ages 25 to 54), the return has been even more impressive. The pressure on wages, and thus inflation, will be blunted should we return closer to the pre-pandemic participation rate of 63.4%, which we expect.

HOUSE VIEWS

APRIL 2022

Bottom Line

There is much moving in markets, some of which is described above. As always, we choose to rely on our investment process to guide our investment decisions. It is currently telling us the following:

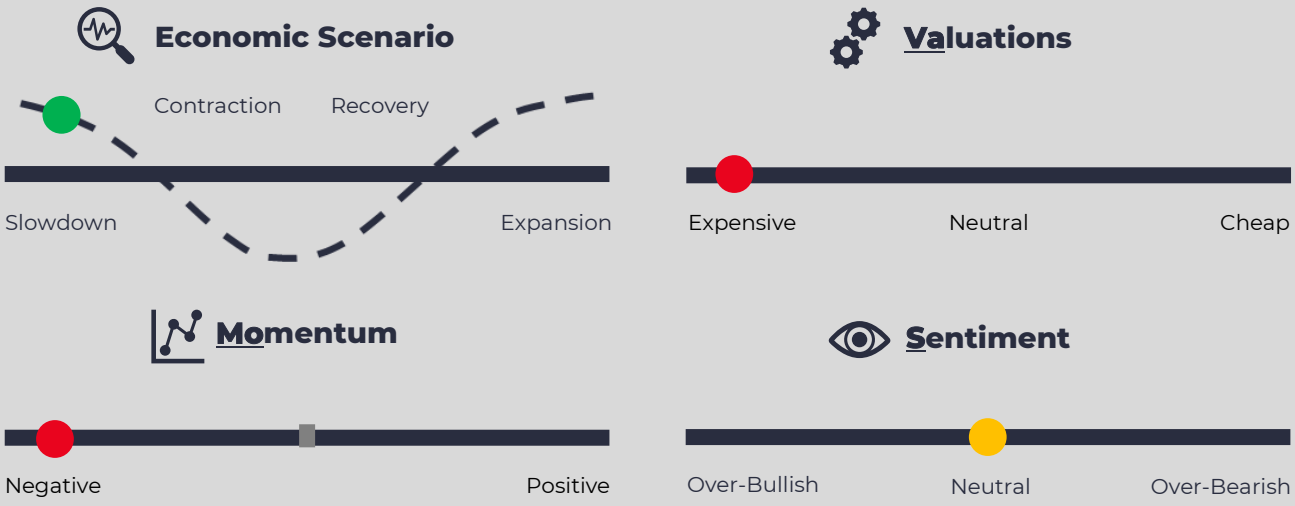
- **The economic outlook remains robust** judging by the forward-looking indicators we measure. Recession does not appear on the horizon, even in Europe, and economies are likely strong enough to absorb higher rates and a gradual "normalisation" of monetary policy. Purchasing Managers' Indices (PMI) for most major global economies are well into expansionary territory. While financial conditions have tightened, it remains relatively easy and cheap for most households and companies to borrow money. Jobs are plentiful. Corporate revenues, earnings and margins are all at (or near) record territory.
- **Valuations had been our biggest source of concern coming into this year but have moderated,** as prices for equities have fallen this year while earnings expectations have remained anchored. Bear markets rarely occur with earnings healthy and rising. Moreover, while equities are still not cheap globally, particularly in the US, they are cheaper than they were. Equities remain more attractive than government bonds, where the real yields remain negative (albeit less so). It is also worth remembering that equities tend to be a better hedge against inflation than bonds, as are commodities.
- **Momentum for equities had turned negative over the first quarter**. This is a signal to cut some risk. It pays to remember that bull markets, such as we have been in until recently, tend to deflate over many months, not "burst", as is commonly perceived.
- **Sentiment in markets is neutral** by the factors we look at. Indeed, global equities are withing spitting distance of their all-time highs despite many of the headwinds.

On the balance of the factors above, we continue to maintain a Neutral stance to risk. We still believe the case for risk-taking is supported given the strong economic backdrop. However, increasing volatility and negative momentum give us cause for concern. We continue to hold a stable of diversifiers (cash, government bonds, gold, hedge funds and a Tail Risk Protection Note) in order to help offset downside risk.

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

PROCESS AND CONVICTIONS

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



We have a **neutral allocation to equities**, which remain supported by a **robust economic backdrop**.

Valuations have softened but **momentum is negative**, giving us some cause for concern. As such, we hold an increased **stable of diversifiers: cash, government bonds, gold, hedge funds, commodities** and **a Tail Risk Protection Note**.

We favour **less expensive regions,** which are **less sensitive to a rising rate environment** such as the **UK** and the **Eurozone**.

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

OUR ASSET ALLOCATION

The table below presents the latest conclusions of the Kleinwort Hambros Investment Committee:

			Summary house views					
			Strong UW	UW	N	OW	Strong OW	Change since last KHIC
EQUITY		GLOBAL EQUITY			■			
		United States		■				
		Eurozone				■		
		United Kingdom				■		
		Japan	■					
		Emerging			■			
FIXED INCOME	SOVEREIGN	GLOBAL RATES		■				
		U.S. Treasuries		■				
		German Bunds		■				
		UK Gilts		■				
		EM Government Bonds ($)	■					
		Duration USD*				■		
		Duration EUR*				■		
		Duration GBP*				■		
	CORPORATE	US Investment Grade		■				
		Eurozone Investment Grade		■				
		UK Investment Grade		■				
		High Yield	■					
FOREX		EURUSD			■			
		USDJPY				■		
		GBPUSD			■			
		EM FX (vs. USD)			■			
ALTERNATIVE		COMMODITIES				■		
		Brent			■			
		Gold				■		
		Diversified Commodities				■		
		ALT. STRATEGIES			■			
		L/S Equity				■		
		Event-Driven				■		
		FI Arbitrage		■				
		Global Macro		■				
		CTAs				■		

Source: Kleinwort Hambros 6-April-2022

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

FIXED INCOME

Surge Pricing

Global bond markets have corrected sharply over the last month amid strong inflationary pressures and a steeper and faster than expected tightening of monetary policies. We remain Underweight on sovereign and corporate debt.

Sovereigns

United States. US sovereign yields have risen substantially in recent weeks. 10-year Treasuries topped 2.6% having started the year at 1.5%. The uptrend is being driven by two factors: levels of inflation are high, starting to spread through the economy (core inflation, which strips out energy and food prices, was 6% in February), and still being boosted by the jump in commodity prices; and the Federal Reserve has embarked on a more substantial rate hike cycle than envisaged at the start of the year. Markets now expect the Fed to raise its funds rate by 225bp in the next 12 months to 2.50-2.75%. Despite this pre-announced tightening, the sovereign yield curve has stayed broadly flat, reflecting fears for global growth in the wake of Russia's invasion of Ukraine. Given all this, we are maintaining our strong Underweight to Treasuries.

United Kingdom. We also remain strongly Underweight on Gilts. The Bank of England continues to tighten policy, raising the base rate to pre-Covid levels and leaving the way open for further rises over coming months. Underlying inflation was running at 5.2% in February and, as in the United States, shows signs of broadening its base. We are Underweight

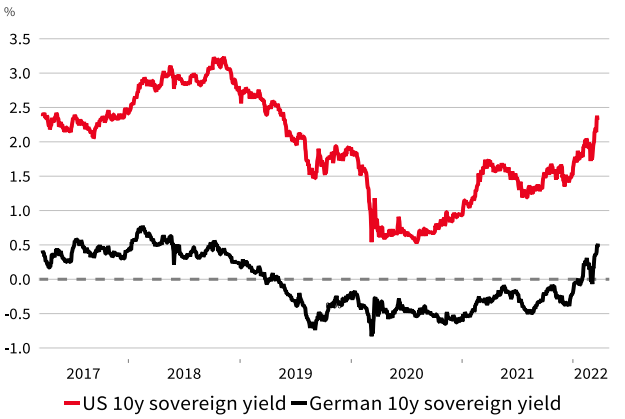
Eurozone. European sovereign yields have, like US yields, risen significantly in March, with the 10-year German Bund paying above 0.6% compared to -0.1% at the turn of the year and the long end of the German sovereign yield curve edging back into positive territory. The European Central Bank (ECB) surprised markets at its March meeting by bringing forward the end of its net asset purchases to Q2-22 and keeping open the possibility of rate hikes in 2022. This sent the message that the ECB would prioritise controlling inflation over growth. Despite the geopolitical crisis and shift in the ECB's tone, sovereign risk premiums in peripheral countries held steady. In general, we are sticking to our Underweight.

Credit

Developed. We remain Underweight on investment grade credits which are closely tracking the trend in sovereign debt. We also remain Underweight on high-yield corporate bonds. Company fundamentals remain sound, however values could well decline in the next few months due to economic and geopolitical uncertainties.

Emerging. We remain strongly Underweight on local currency EM bonds. Developed economies are tightening monetary policy, which is generally bad news for the value of EM assets. While commodity prices are high and some emerging markets are further along the monetary tightening cycle, few governments are well equipped to deal with the economic impact of broadening inflationary pressures.

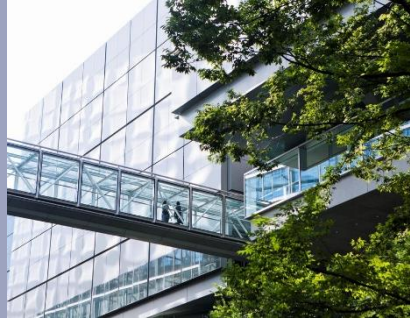
Rise of US and German 10 years sovereign yields



Sources: SGPB, U.S. Department of Treasury, Macrobond 23/03/2022

EQUITIES

Radical Uncertainty



In a global economy shaken by the war in the Ukraine and by the scale of its economic repercussions, we favour a Neutral stance on equities. The general uncertainty about the progress of the war, intense market volatility and the latest surge in input costs strengthen the case for our positioning.

United States. The US equity market has been less affected than the European by the conflict in Ukraine and the resulting rise in commodity prices. The United States is virtually self-sufficient in energy and American companies are not seeing production costs rise or consumer purchasing power fall as much as their European peers. That said, US equities will remain sensitive to geopolitics. They are also still overvalued compared to European stocks and the Federal Reserve has announced a much tighter monetary policy than the ECB from 2022. This new monetary policy stance, coupled with a degree of overvaluation in US assets, could be less favorable for US equity markets. We remain Underweight on US equities.

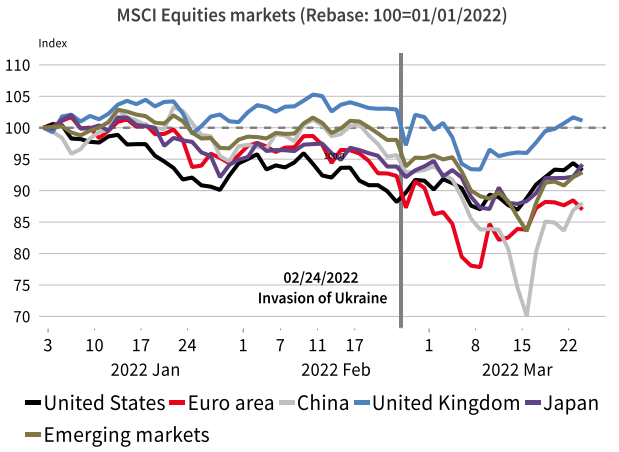
United Kingdom. The UK equity market corrected far less sharply than others at the start of the conflict in Ukraine and is now virtually back to its pre-war levels. The reason for the relative health of the British market lies in its sector composition. It has many commodity-producing companies that are doing well out of current rising prices. Value-wise, it remains attractive, particularly compared to US stocks. We are still Overweight this market, which offers a relatively favourable outlook.

Eurozone. Volatility in European equity markets significantly increased following the Ukrainian invasion and they remain vulnerable to many uncertainties. The risk is that prices could further adjust - for instance, if the conflict worsens or sanctions or countersanctions affecting Russian oil and gas exports are implemented – which could put pressure on companies' production costs and curb household purchasing power by introducing a de facto energy tax burden. That said, new rounds of fiscal support will mitigate the commodity shock following the invasion and monetary policy is likely to remain relatively loose. In addition, valuations remain reasonable and we retain our Overweight position on Eurozone equities.

Japan. While the Japanese equity market rallied on the back of a significant yen devaluation in March, the economy is highly cyclical and the current slowdown in global growth is taking a toll. The nation's dependence on imports such as energy and food are adding to the list of concerns, especially given the yen weakness. We are Underweight.

Emerging markets. While the Chinese market is facing a number of headwinds (property sector, Covid outbreak) and rising commodity prices are hurting some emerging economies, commodity exporting countries are doing well. One such is Brazil, a top performer since the start of the year. Overall, we are Neutral on emerging markets.

Fall of equity markets early in the conflict



Sources: SGPB, Macrobond, MSCI 23/03/2022

FX RATES

Dollar to Remain Strong

Geopolitics and an accelerated normalisation of US Federal Reserve (Fed) policy should buoy the dollar.

Dollar index. Amid major geopolitical risks, the dollar continues to make gains against most major currencies. The Federal Reserve is tightening policy more quickly than other big central banks in developed economies and geopolitical risks should persist for the next few weeks, which should mean continued support for the USD.

EUR/USD. Rising geopolitical risks and the Fed set to tighten policy before the European Central Bank will keep the dollar strong.

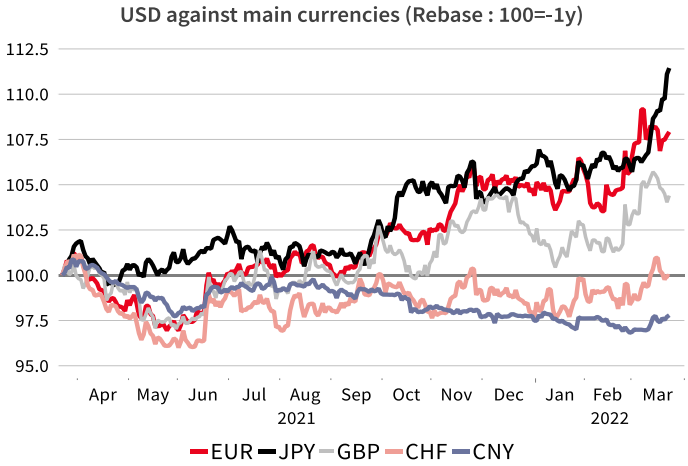
GBP/USD. The currency pair has managed to stay above 1.30 level despite the dollar's strong momentum. The Federal Open Market Committee minutes have indicated that the Fed is considering 50bps hikes as opposed to the usual 25bps moves that have been done recently. This suggests a more aggressive Fed. All eyes will remain on inflation figures to signal how aggressive tightening will be.

EUR/GBP. The pair is currently trading at its lowest level since mid-2017. Worries about the effect on Europe due to the energy crisis and its heavy reliance on Russian gas has increased its vulnerability.

USD/JPY. The yen is a strong currency that has weakened against the dollar this year (down 4%), mainly because of the divergence in monetary policy. The Bank of Japan left monetary policy unchanged, continuing to control the yield curve with underlying inflation still running at a negative -1% in February. The sharp divergence in monetary policies should help the dollar against the yen. But a number of risks (geopolitical, equity markets) and the inflation gap should limit downside pressure on the JPY.

EM FX (vs USD). Despite rising geopolitical risks, emerging market currencies as a whole have strengthened. The RMB continues to make gains versus the dollar against a backdrop of big current account surpluses and less central bank intervention. Meanwhile, Latin American currencies are being boosted by their real rate differential and high commodity prices.

Appreciation of the dollar against the main currencies, except for the Chinese Yuan



Sources: SGPB, Macrobond, Macrobond 23/03/2022

ALTERNATIVES

Diversification is Paying Off

Alternative assets are doing well out of the uncertainty and volatility currently afflicting traditional markets. They are the first choice for hedging risk, at a time when risk appetite is weak. We remain Overweight on gold and Hedge funds, and have recently added to diversified commodities, another good diversifier.

Commodities

Oil. Brent and WTI prices are extremely volatile, fluctuating with every twist and turn of the Ukraine conflict. With no visibility on how the war will go, notably on the scale of international sanctions on Russia and its oil and gas exports, the safe bet is that oil prices will remain volatile.

Gold. Current intense volatility on financial markets is good for safe-haven assets. Also, high inflation and an economic slowdown are further boosting the value of gold. In the last 6 months, the gold price has risen nearly 6% against the dollar. Unless there is a de-escalation of the Ukraine conflict and commodity prices return to normal, gold will remain attractive. We remain Overweight.

Diversified Commodities. While commodities are a volatile asset class, we believe the risks are likely tilted asymmetrically to the upside. Simply put, should the conflict worsen, commodity prices may still increase markedly; should the conflict subside, commodity markets will likely remain tight given years of underinvestment (particularly in oil and gas). Moreover, as the inflation outlook has changed because of the war, the risk / reward equation of holding commodities – a natural inflation hedge – is now more favourable.

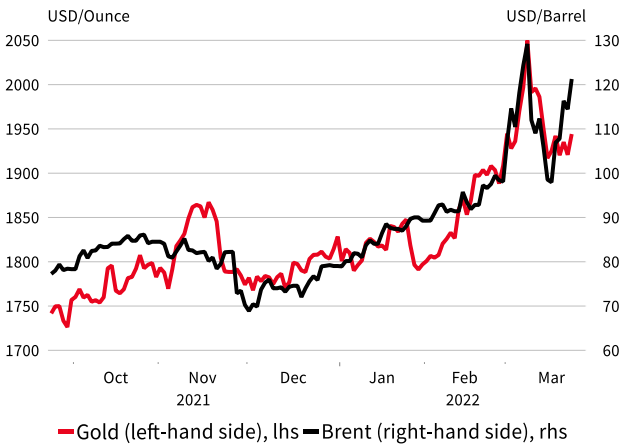
Hedge Funds

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

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.

We believe the Tail Risk Protection Note offers our portfolios yet another critical source of safety and complements the existing diversifiers.

Towards a stabilization at a high level of oil and gold prices



Sources: SGPB, Macrobond, ICE 23/03/2022

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- Shares of this type of fund carry no guaranteed return of capital, which, under certain circumstances, may lead to the loss of your entire investment;

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

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

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

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Channel Islands

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

SG Kleinwort Hambros Bank (CI) Limited – Guernsey Branch is also regulated by the Guernsey Financial Services Commission ("GFSC") for banking, investment and money services business. Its address is PO Box 6, Hambro House, St Julian's Avenue, St Peter Port, Guernsey, GY1 3AE.

The company (including the branch) is also authorised and regulated by the UK Financial Conduct Authority ("FCA") in respect of UK regulated mortgage business and its firm reference number is 310344. This document has not been authorised or reviewed by the JFSC, GFSC or FCA.

Gibraltar

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Compensation Scheme

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

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IMPORTANT INFORMATION – PLEASE READ

Channel Islands

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Gibraltar

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