

HOUSE VIEWS

JULY 2022



ON A THIN LINE

Central banks are increasingly worried by inflation and have yet to fully tame it, creating uncertainty. They continue a challenging balancing act of tightening enough to slow the economy without tipping it into recession – a sweet spot that is shrinking day by day. While worries of stalling economic activity continue to grip markets, they have caused a sell-off in oil markets, pushing prices from \$120 per barrel to around \$100. While this drop might provide relief to consumer sentiment, it is not enough to meaningfully offset inflationary pressures just yet.

A falling equity market makes valuations continue to look more attractive for the time being: multiples have retracted to their long-term averages in the US, something not seen for well over 3 years. However, analysts' earnings forecasts continue to be strong despite a slew of headwinds facing companies – increased input costs, potential fall in demand for products, persistent covid-related bottlenecks in supply chains, to name a few. It is our view that the forecasts are too bullish currently and are likely to tamper slightly to more realistic levels.

While fears of a recession persist, labour markets continue to look robust as recent data out of the US surprised to the upside with US employers creating 372,000 jobs in June – 7,000 more than expected. As a result, the unemployment rate remains well anchored at a five-decade low of 3.6%. This however spells more trouble for the Fed, as a tighter labour market means more potential wage pressures. Digesting the news, the market consensus turned more hawkish, expecting another 75-basis point hike in the US by the end of July. By year-end, the market currently predicts interest rates to hit 3.5% in the US and 2.75% in the UK.

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Bottom Line

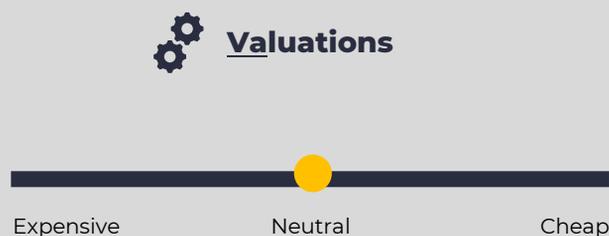
In uncertain times like these it pays to not panic, stay disciplined, and trust the process. It is currently telling us the following:

- **The economic outlook remains in slowdown** judging by the forward-looking indicators we measure. While this is favourable for risk assets for the time being, the index has been trending downwards for several months and some components that have been bolstering its outlook until now, such as interest rate spreads, might be losing steam in the months to come.
- **Valuations are neutral**, as prices for equities have fallen this year but earnings expectations have remained anchored, leading to affordable if not cheap assets compared to their own recent history. However, analysts' expectations appear somewhat overbullish given the number of headwinds arising in the real economy.
- **Momentum for equities remains negative** by the 10-month moving-average metric that we favour. This is cause for caution.
- **Sentiment in markets is overbearish**, driven largely by a strong dollar paired with equity outflows. Usually this would be a buying signal but when paired with negative momentum and a precarious economic climate, it is best to not act just yet on this signal alone.

In order to better reflect the risks of a slowing economy and negative momentum in markets we are reducing our risk by moving from Neutral to slightly Underweight in terms of our equity allocation. The proceeds will be held in cash in most strategies to be deployed should any opportunities present themselves. We continue to hold an increased stable of diversifiers such as: cash, government bonds, gold, hedge funds, commodities and a Tail Risk Protection Note. This provides a resilient positioning in the wake of rising volatility and sufficient flexibility to adjust our views should conditions change.

PROCESS AND CONVICTIONS

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



We have a **slight underweight to equities**, reflecting a **slowdown** in the **economic scenario** and **negative momentum**.



Valuations appear neutral but earnings maybe too optimistic. As such, we hold an increased **stable of diversifiers: cash, government bonds, gold, hedge funds, commodities** and a **Tail Risk Protection Note**.



We favour the **UK** given its **defensiveness, inflation sensitivity** and **attractive valuations**.



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

OUR ASSET ALLOCATION

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

		Summary house views					Change since last KHIC	
		Strong UW	UW	N	OW	Strong OW		
EQUITY	GLOBAL EQUITY		■				-	
	United States		■					
	Eurozone			■			-	
	United Kingdom				■			
	Japan	■						
	Emerging			■				
FIXED INCOME	SOVEREIGN		■					
	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-July-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)



Bond markets were torn in a crossfire of sorts as sentiment fluctuated between concerns about inflationary pressures and growth slowdowns. Given the rising risks to activity and attractive sovereign yields we followed up on last month's increase of Sovereign exposure with a further reduction in Credit risk.

Sovereign

United States. As growth concerns seemed to have moved back into focus of bond investors sovereign yields, which had just rallied as high as 3.10%, retracted back below the 3% threshold in late June. Abandoning what it said at its previous meeting, the Fed hiked its policy rate by 75 bps to 1.75% in June, leaving the door open to further 75 bps rises if it feels inflation is not coming down fast enough. This new trajectory for monetary tightening raised fresh concerns around their impact on growth in the short- and medium term, and the yield curve flattened as markets priced in a sharper economic slowdown. With headline yields around 3%, we think part of the correction is now behind us and the environment continues to favour Treasuries as investors seek safe havens in a world worried by fears of recession. We remain slightly Underweight.

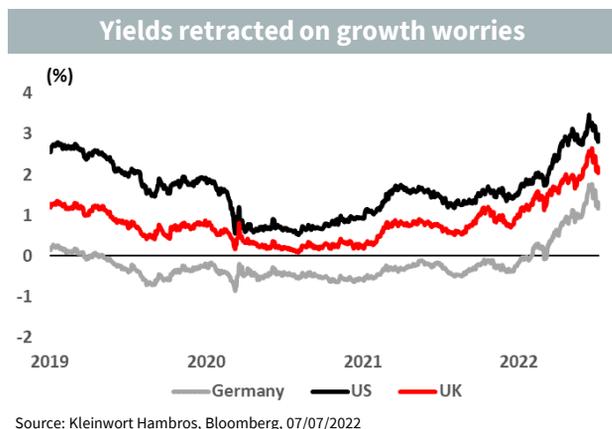
United Kingdom. The Bank of England should continue to tighten rates aggressively as Britain is haunted by particularly severe inflationary pressures with CPI projected to reach double digit figures later this year. For now, inflation touched 9% in April and the monetary authorities are forecasting stagflation for 2022-2023. Money markets are pricing in a base rate of 3% at year-end – brought forward from a similar rate expectation for late 2023 – and yields fell from June highs of 2.6% as investors priced in the growth implications of such aggressive tightening. We are Underweight.

Eurozone. The 10-year Bund and OAT touched 1.70% and 2.26%, respectively, their highest since 2014, before retracting towards the second half of the month. The ECB announced the start of a monetary tightening process, which will involve hiking all rates by 25 bpd in July and a possible 50 bpd rise in September. Meanwhile, fears for growth are mounting as monetary tightening is coming on top of various external shocks (war in Ukraine, China's zero-Covid policy). Risk premiums on sovereign debts have widened substantially, with Italian BTPs reaching 4%. Fading growth prospects and the launch of an “anti-fragmentation” programme are good news for sovereign debt. On Balance, we remain Underweight.

Credit

Developed Markets. We remain Underweight to investment-grade bonds. Yields have shifted over recent weeks, making the carry on these assets more attractive, however specifically for high yield names further spread-widening remains on the cards should the economic environment deteriorate further. We are Underweight.

Emerging markets. We remain Underweight emerging market debt. Monetary tightening in developed economies is generally bad news for emerging market assets and risks to growth remain high.



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Reduction in our position



The ongoing negative momentum in equity markets has made valuations appear more attractive, however persistent economic headwinds are likely to cause earnings prospects to degrade in the short term. While a severe recession is not our base case we are wary of the implications of a slowdown in economic activity and have reduced our equity exposure to a slight Underweight.

United States. Equities markets have been among the hardest hit by the correction this year, particularly tech stocks. The Nasdaq has lost 26% of its value since the turn of the year. The correction reflects the toughening of monetary policy, with rapid rises in real yields undermining the value of US stocks, many of which were in any case overpriced. We think the US economy should continue to grow in coming months due to a labour market that remains vigorous (in terms of both jobs and wages) and ongoing catch-up by the service sector, however, rising risks to growth are affecting companies' revenue estimates and adjustments to expected earnings will likely see valuation multiples widen in the coming months. We are Underweight.

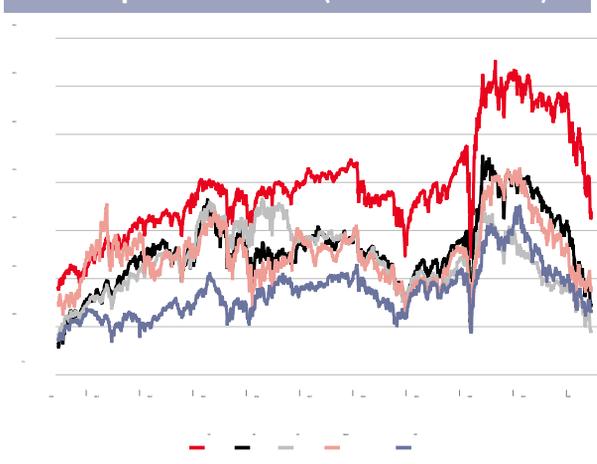
United Kingdom. Prospects for the British economy look grim, with inflation among the highest of any developed economy, falling real household incomes and a serious risk of technical recession. However, the UK equities market should continue to do relatively well thanks to its weak correlation to the national economy and a sector composition that could be tailor-made for the current environment. A weakening Pound is providing additional support for British internationals generating large proportions of their incomes abroad. We remain Overweight.

Eurozone. The Eurozone equities market is still facing a difficult environment. War drags on in Ukraine, energy prices show no signs of returning to normal and the ECB is poised to start tightening policy earlier and more aggressive than expected. This tightening of financing conditions adds to the woes of households, whose incomes are already being squeezed by inflation and remain below pre-Covid levels. While most European economies can count on some support factors, such as still substantial surplus household savings and an accommodative fiscal policy in the shape of the European stimulus plan the war and resulting energy crisis are likely to affect the region worse than others. All things considered we reduced our exposure to Neutral.

Japan. The Japanese equities market has to deal with an economy struggling to recover pre-Covid momentum. Japan's GDP contracted in Q1 2022, and the outlook remains poor with weak business investment, plunging household confidence and international trade still being held back by Chinese lockdowns. We remain Underweight.

Emerging markets. Equities markets in emerging economies suffered serious losses in H1 2022, but could well rebound in H2, assuming lockdowns end in China. The Chinese market can also count on strong political support. Emerging market valuations are therefore looking relatively attractive. We remain Neutral.

Stock price correction (12M forward PER)



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FX RATES

Dollar continues to strengthen



Strong geopolitical tensions and faster normalization by the Federal Reserve will keep the dollar high against major currencies. Sterling continues to weaken given the political leadership turmoil and uncertainty around the Northern Ireland Protocol Bill.

Dollar index (DXY). With risks significantly on the rise, the dollar continues to make gains against most major currencies. The Federal Reserve is tightening policy quicker than other big central banks in developed economies and the relatively robust pace of US economic growth combined with a persistence of geopolitical risks over coming weeks should translate into continued support for the USD.

EUR/USD. Ongoing geopolitical risks, mounting threats to Euro area growth, and the Fed's intensified pace of monetary policy tightening will continue to support the USD for the next few months.

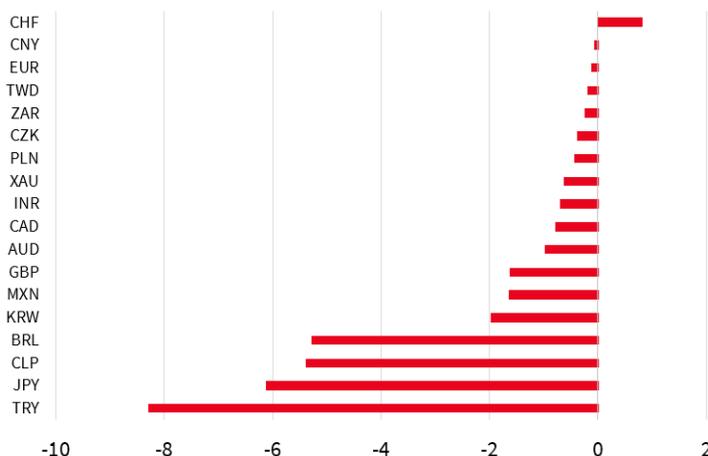
GBP/USD. The currency pair fell to around 1.2. The pound has had some weakness given the earlier than expected departure of Boris Johnson as PM. There is still too much uncertainty around the Northern Ireland Protocol Bill and whether this will trigger a trade war with the EU. Recent employment data from the US signals more aggressive Fed hiking and the safe-haven qualities of the greenback supports the dollar's continued strengthening.

GBP/EUR. Sterling has slipped in value over recent weeks amid revived Brexit tensions. We remain Neutral on the cross, as the gap between nominal rates in the two regions is likely to remain stable.

EM currencies. Emerging currencies remain on a downward trend. On the one hand, the Fed's larger than expected tightening cycle is increasing downward pressure on major emerging floating currencies such as the MXN, CLP or ZAR. On the other hand, rising political and economic risks in Turkey and Colombia also explain the poor performance of emerging currency indices.

Strong appreciation of the US dollar against major currencies

Currency variation vs USD over 1 month



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ALTERNATIVES

A still favorable context for alternative assets



The current climate of persistent inflation, uncertainties surrounding the economy and underperforming stock markets is helpful for alternative assets. We continue to hold a stable of diversifiers to offset the ongoing volatility.

Commodities

Oil. Recession fears continue to cause oil to trade in a volatile nature as a recession would most certainly cause demand to drastically fall. Oil started the year at \$77 and has risen to recent highs of \$120 before selling off to around \$100. The recent higher-than-expected US employment figures suggest that the fears of recession do not seem to be shared by companies yet, inducing further volatility. On the supply side, OPEC announced plans this month to raise production faster than expected. With Saudi Arabia leading the charge, the cartel of exporting countries agreed to increase production by 650,000 barrels per day in July and August 2022. Even so, this should only partly make up for the slump in Russian supplies.

Gold. While central bank rate hikes and a strong dollar are unhelpful for gold prices, the current situation of persistently high inflation, economic uncertainty, and lackluster outlook for equities will continue to foster investors' demand for gold as a safe haven asset. We therefore maintain our Overweight.

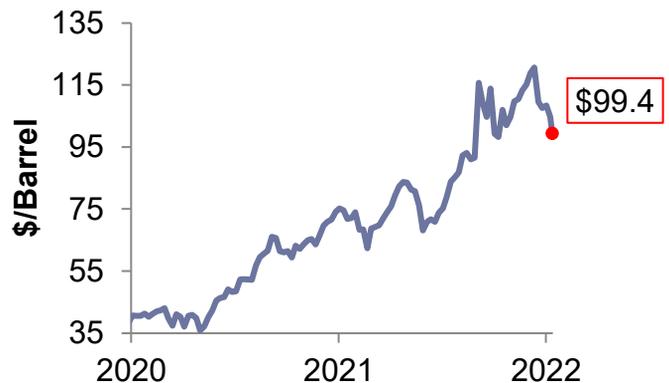
Hedge Funds

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. It is important to remember that our hedge fund allocation is flat this year while the equity market is down, this has been a great diversifier for strategies.

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.

The price of Oil has sold off slightly with recession fears impacting growth



Source: Kleinwort Hambros, Bloomberg, 12/07/2022

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- 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).

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