HOUSE VIEWS

NOVEMBER 2021

THE BUMPY RECOVERY CONTINUES

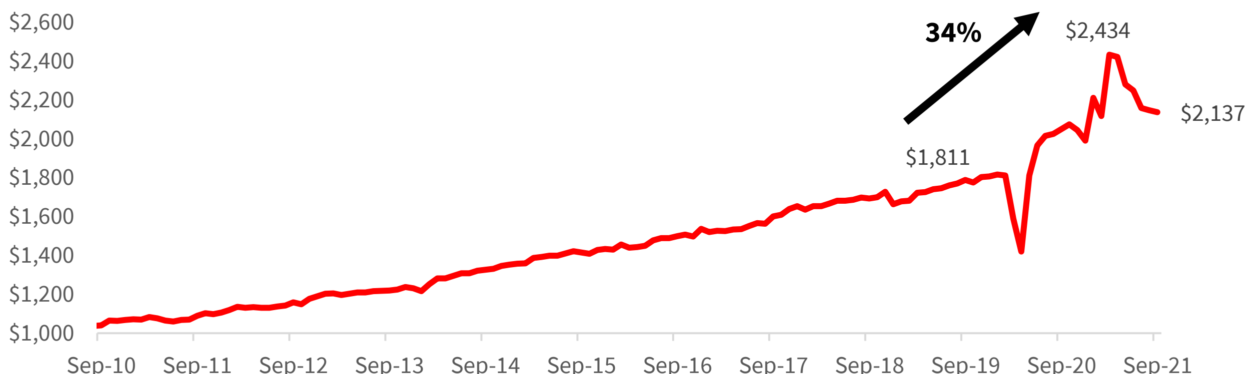
Following a torrid September, global equity markets have resumed an upward trajectory. October saw gains in most regions, and this has carried on thus far in November, led by US indices which are all at or near record highs. Will the good times roll on? There are plenty of reasons for continued optimism, though, as always, risks swirl in the mix as well.

Growth is expected to remain robust in developed economies, particularly due to favourable monetary policy and financial conditions. Indeed, even as the Federal Reserve has begun its “tapering” programme, there is still $400 billion in liquidity to be added to markets before asset purchases finally cease. And at that point, we arrive at a place of historically low interest rates. Indeed, central banks globally are expected to normalise their policies only gradually, as the Bank of England recently displayed, staying its hand on raising interest rates to much surprise. This gentle policy backdrop should continue to support robust aggregate demand, which will be bolstered by the passage of a $1 trillion US infrastructure bill and may well be followed by an even larger one focused on climate and social safety-nets. Manufacturing Purchasing Managers' Indices (PMIs) for the US, UK and Eurozone remain buoyant at 58.4, 57.8 and 58.3 respectively (anything over 50 implies growth), while China's factory activity tipped back into positive territory in October also.

Might this monetary largesse and aggregate demand lead to persistently high inflation? It can, but here too we are sanguine. For the next few months, inflation will no doubt continue to surpass central bank targets: the October figure for US CPI came in at 6.2%. However, such high rates of inflation are likely to ease once temporary factors are behind us. At the root of most of today’s apparent surge is the base effect compared to where prices were at this time last year. For example, in November 2020, the price of a barrel of Brent Crude was in the $40s compared with in the $80s now; that rise is unlikely to be repeated. There were also marked shifts to our consumption patterns, with post-Pandemic consumption of durable goods 34% higher (at its peak) than before in real terms (**see figure 1**). Now, after having gorged on goods in lieu of services, patterns appear to be trending back to normal as Covid restrictions fade.

Figure 1 - Real Personal Consumption Expenditures: Durable Goods

2010 - September 2021 (Billions of Chained 2012 Dollars, Monthly, Seasonally Adjusted Annual Rate)



Source: US Federal Reserve (https://fred.stlouisfed.org/series/PCEDGC96)

KLEINWORT HAMBROS

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Unless otherwise specified, all statistics and figures in this report were taken from Bloomberg and FactSet on 10 November 2021

HOUSE VIEWS

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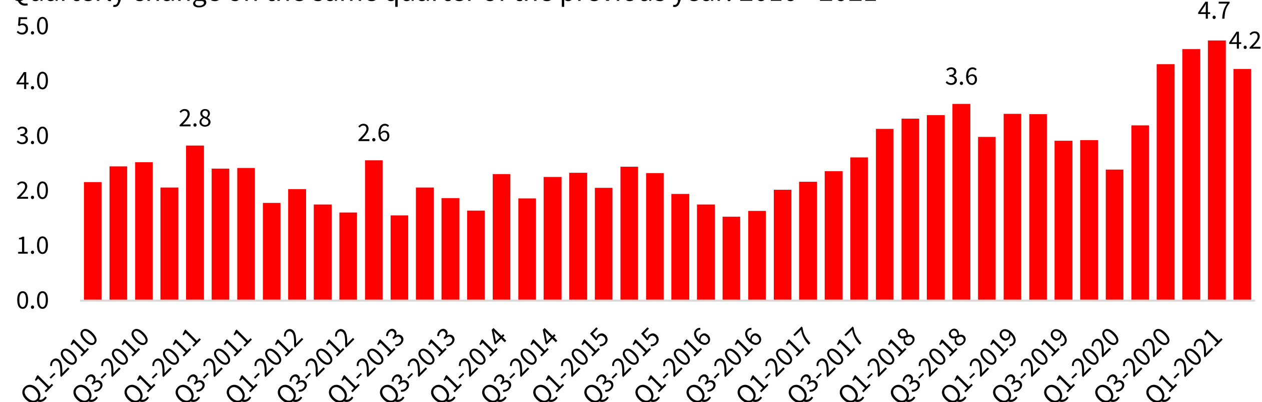
The more important single indicator of sticky, structural, and worrying inflation is spiralling wage growth, which leads companies to raise prices, thus leading workers to demand higher wages. The OECD's Labour Compensation Per Employed Person recently hit 4.7% – very high, historically speaking (**see figure 2**). However, here too, it appears a peak may have been hit, or at the very least, a deceleration. The labour supply is likely to become more elastic than in recent months, as ongoing crisis-era benefits, Covid-fears and school closures are ending or abating.

However, all is far from rosy, and there are risks the market may well be under-pricing. One lurks from China's real estate sector. In September, global markets sold off hard over the possible failure of China Evergrande Group, the world's most indebted property developer with $300 billion of unpaid debts. Markets can have short attention spans and the furore seemed to have passed as Evergrande made payments on its dollar bonds. However, a contagion effect may be occurring and a wave of defaults among other large (and not so large) developers has since occurred. Where does this end? No one can tell. At best, it will lead to some local pain in domestic Chinese balance sheets as assets are written down in value. This is particularly true if, as expected, some form of government intervention occurs. At worst, the Asian debt crisis of the late 1990s comes to mind. This is a matter we continue to watch closely.

Figure 2 - Labour Compensation per employed person

Quarterly change on the same quarter of the previous year: 2010 - 2021



Source: OECD.Stat

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.

We believe the case for risk-taking is well supported given a robust economic backdrop and still positive momentum for risk assets. Nonetheless, we are wary of expensive valuations and other risks. 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).

HOUSE VIEWS

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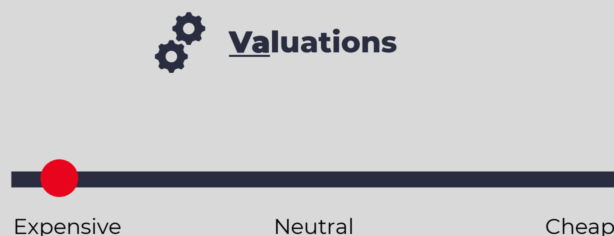
As always, our decisions remain rooted in our investment process, the four pillars of which currently indicate the following:

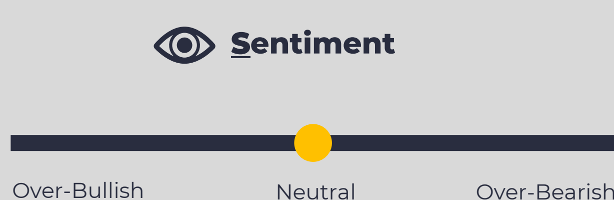
- Economic regime: Our Leading Economic Macro Indicator (LEMI) suggests the global economy is in a state of expansion, which is clearly favourable for risk-taking.
- Valuations: Valuations for equities – the largest source of risk and return in most strategies – remain challenging in absolute terms. 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.

We continue to constantly monitor 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.

PROCESS AND CONVICTIONS

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





We are **moderately risk-on** and have a **bias towards equities**, which is well supported by a **strengthening economic backdrop** and **strong price momentum**.

We favour **regions that are likely to benefit from a cyclical recovery**. Equity exposure is tilted towards the **Eurozone, Japan and the UK**.

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

Expensive valuations 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.

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				■		
EQUITY		United States		■				+
EQUITY		Eurozone				■		
EQUITY		United Kingdom				■		-
EQUITY		Japan				■		
EQUITY		Emerging			■			
FIXED INCOME	SOVEREIGN	GLOBAL RATES		■				
FIXED INCOME	SOVEREIGN	U.S. Treasuries		■				
FIXED INCOME	SOVEREIGN	German Bunds		■				
FIXED INCOME	SOVEREIGN	UK Gilts		■				
FIXED INCOME	SOVEREIGN	EM Government Bonds ($)	■					
FIXED INCOME	SOVEREIGN	Duration USD*				■		
FIXED INCOME	SOVEREIGN	Duration EUR*				■		
FIXED INCOME	SOVEREIGN	Duration GBP*				■		-
FIXED INCOME	CORPORATE	US Investment Grade		■				
FIXED INCOME	CORPORATE	Eurozone Investment Grade		■				
FIXED INCOME	CORPORATE	UK Investment Grade		■				
FIXED INCOME	CORPORATE	High Yield	■					
FOREX		EURUSD			■			
FOREX		JPYUSD				■		
FOREX		GBPUSD			■			
FOREX		EM FX (vs. USD)			■			
ALTERNATIVE		COMMODITIES				■		
ALTERNATIVE		Brent		■				
ALTERNATIVE		Gold				■		
ALTERNATIVE		ALT. STRATEGIES			■			
ALTERNATIVE		L/S Equity				■		
ALTERNATIVE		Event-Driven				■		
ALTERNATIVE		FI Arbitrage		■				
ALTERNATIVE		Global Macro		■				
ALTERNATIVE		CTAs				■		

Source: Kleinwort Hambros 4-November-2021

*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

The beginning of the end

Central banks have abstained from raising interest rates for now, though the Federal Reserve has taken the first steps of tightening monetary policy by tapering their bond-buying programme. We retain some protective government bond exposure but have reduced duration across our sterling strategies.

Sovereigns

US. After hitting 1.7%, yields on 10-year T-Notes dropped below 1.5% in the first week of November, ironically in response to the Fed's long-awaited announcement that it would begin unwinding its stimulus programme to $105bn each month, down from $120bn. Markets easily digested the news, taking solace in Jay Powell's reassuring rhetoric outlining a patient and gradual approach to monetary tightening. This complements our expectations of robust economic growth, underpinned by consumption and business investment over the coming quarters. We are maintaining an Underweight to US government bonds.

UK. Elsewhere, the Bank of England made some waves, announcing at their November meeting that they would indeed not (yet) raise rates amidst rapidly mounting inflationary pressures. This sent yields tumbling to as low as 85bps from their October highs of 120bps. We have considered bonds a defensive allocation and higher duration positions were likely to allow for greater protection in the event of market stress. However, our view on the government bond market has evolved given stronger economic growth, higher inflation and tighter monetary policy. As a result, we consider that the direction of yields over the medium to long term is likely higher. We view this recent fall in yields as a favourable opportunity to bring our duration in line with our benchmark. Nonetheless we continue to remain underweight the asset class.

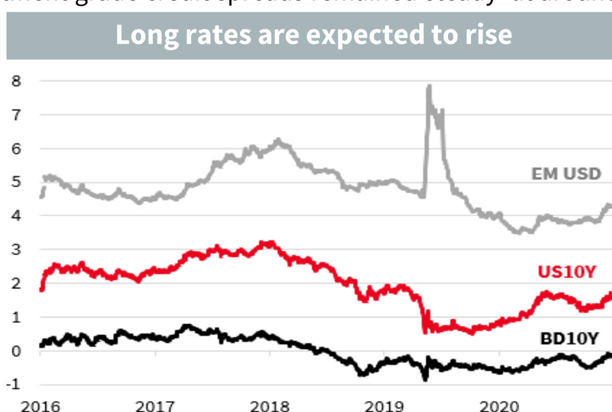
Eurozone. 10-year German Bund yields have followed similar paths to US T-Notes - after peaking at -0.08% in mid-October, the 10-year Bund yield fell to -0.27% in November. Similar to in the US, these declines reflect market expectations that the ECB will raise its key rate as soon as 2022 in light of inflationary pressures, and that growth will slacken. As such, we are maintaining our Underweight to Eurozone sovereign bonds.

Credit

Developed markets. The solid growth outlook and current inflationary environment are positive for corporate balance sheets as they reduce the risk of default and investment grade credit spreads remained steady at around 90bps in the US and just below 110bps in the UK. Credit indices gained throughout October as a result of falling sovereign yields but spreads remain too tight to offer reasonable protection against the gradual rate hikes we are expecting in the medium term. We are Underweight.

Emerging markets. Central banks in Brazil, Russia, Chile, Poland and elsewhere have started major tightening cycles against a backdrop of much greater inflationary pressure. Further, the growth outlook has deteriorated in light of public health restrictions, increased political risk, and the slowdown in China. We are Underweight.

Long rates are expected to rise



Sources: SGPB, Bloomberg, 28/10/2021

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EQUITIES

Resilience pays off

US equities again demonstrated their resilience, shrugging off supply chain disruptions and a historical Fed tapering announcement. We remain Overweight equities and have re-adjusted our US exposure while retaining Overweights to other, more attractively valued regions such as the Eurozone, Japan, and the UK.

United States. After September's correction, US equity markets surged back, topping their summer highs on the back of strong earnings reports. The market can count on further help from still ample liquidity and the strength of the economic recovery. Input price pressures are a clear and obvious risk to companies' earnings, but firms should be able to mitigate the impact on margins. Rates may be on the rise but remain accommodative in real terms. We have adjusted our positioning upward for the recent rally in US equities but remain Underweight overall.

United Kingdom. With a year-to-date return surpassing 13% in early November, all things considered, the UK's flagship FTSE100 equity index has weathered a perfect storm of Covid- and Brexit-related issues better than expected. Indeed, the Bank of England recently brushed aside worries about inflation, labour market trends, supply chain resilience and the trend in COVID-19 and left its base interest rate unchanged. British stocks still look attractively priced. However, we sense increasing headwinds to the region's medium-term upside potential and have taken some gains on our existing positions. Overall, we remain Overweight.

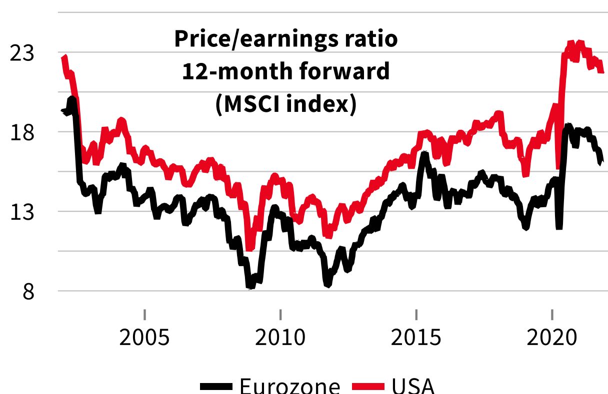
Eurozone. The Eurozone economy continues its recovery against a backdrop of rocketing energy prices and input price pressures. Some sectors are finding it harder to pass on price rises to consumers than in the United States and will feel a squeeze on margins. That said, European stocks remain more attractively valued and still offer substantial upside. We therefore remain at Overweight on this market, preferring cyclicals and companies with the pricing power to offset input pressures.

Japan. Japanese equities have staged a remarkable recovery in October with the NIKKEI returning 8.23% from its lows earlier in the month. The recent elections produced an "absolute stable majority" for the ruling party LDP, and the prospects of a continuing economic reopening, coupled with the potential for further stimulus should push Japanese equities higher in the medium term. We are Overweight.

Emerging markets. Central banks in many emerging markets have hiked rates in the face of severe inflationary pressure. In this environment, risks of a slowdown remain, but stock values and long-term prospects still appeal and we remain 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).

European valuations remain well below those of the US



Sources: SGPB, Macrobond, 28/10/2021

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CURRENCIES

Fed tapering beginning, dollar winning

The more rapid tightening by the Federal Reserve relative to the ECB is likely to suppress the single currency over the coming months. The Bank of England kept rates on hold at the latest meeting and now the focus will be on labour market data and inflation, ahead of the December 16th meeting.

Dollar index (DXY). The USD is holding steady against a basket of leading advanced and emerging market currencies. The Federal Reserve has now started tapering quantitative easing, reducing monthly purchases by $15bn. If it continues at this pace, tapering could be completed by the middle of next year. The Federal Reserve's view is that inflation remains anchored, and the market is currently pricing in a rate hike for October 2022. Over the coming months, the dollar is likely to draw further support from the growth gap between the US economy and the rest of the world and ongoing current account surpluses in Asia and Europe.

GBP/USD. Sterling had been performing well up until a week before the Bank of England announcement. However, as a rate hike was priced out, and indeed the BoE didn't hike, sterling fell below the 1.35 level to almost 1.34. The market will be closely watching labour data between now and the December meeting. Surging inflation and sluggish economic growth are major challenges for the UK, and the next policy call will be a tough one for the central bank. Brexit-related issues could also present some headwinds for the pound. Overall, we remain neutral on sterling, and have updated our forecast to 1.37 for the first quarter of next year.

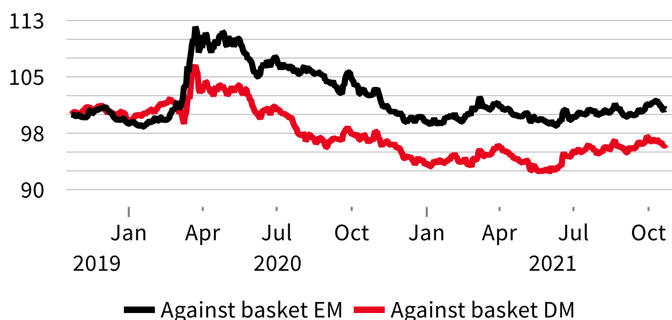
EUR/USD. Europe's economy continues to recover as public health restrictions normalise and domestic demand booms. In France, for instance, economic activity was back at pre-crisis levels by Q3, sooner than analysts' consensus expectations. Meanwhile, inflationary pressure in the Eurozone, mainly reflecting rising energy prices, has markets betting the ECB will start raising rates in 2022 at the earliest. We remain slightly underweight EUR/USD as we believe the US' more advanced phase of policy tightening and its growth gap compared to the Eurozone should tip the scales towards a strengthening USD. The dollar is also a valuable safe-haven currency in the current high-risk environment and its growth gap.

EUR/GBP. The 0.86 level is a key target for this cross to breach in order to see a prolonged upward move. Momentum indicators suggest that the cross is in neutral territory, however we think the picture for the pound is not as positive as it was a few months ago. In our view, receding rate hike expectations in the UK could send EUR/GBP above the 0.86 level in the coming weeks and create a new trading range.

USD/JPY. The yen is still the weakest-performing advanced-economy currency against the US dollar this year. USD/JPY ended the month at 113.70, down 2.39% on the month and 9% since the start of the year. This weakness by the yen reflects worries around the country's struggling economic growth, hampered by strict health measures and various economic uncertainties. That said, we remain Neutral to JPY. The yen is still a safe-haven currency and inflationary pressures remain low (-0.5% underlying inflation in September).

EM currencies. Emerging market currencies ex. Asia suffered severe bouts of volatility last month. The BRL and TRY were hardest-hit, returning -4% and -7% respectively, against a backdrop of double-digit inflation and rising political risks. We are neutral-bearish on EM currencies, as the steep rise in policy rates should provide support. Furthermore, Asian EM currencies are holding steady against the dollar, helped by substantial current account surpluses.

Evolution of the dollar index (100= Nov 2019)



Sources: SGPB, Macrobond, Fed, 22/10/2021

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ALTERNATIVES

Golden shine

Supply shortages continue to drive-up oil prices while gold is buoyed by inflation. 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. Helped by the prospect of higher inflation, the metal climbed to $1,820. It returned to positive momentum and is again trading above its 10-month moving average. Since the latest FOMC meeting in late September, bond markets have raised their 5-year inflationary expectations to 2.9% from around 2.4%. We think gold remains an efficient source of diversification, with little correlation to equities and remain Overweight.

Oil. Oil prices are at their highest since 2014, boosted by a global supply shortage and strong US demand. The OPEC cartel of oil producers and its allies (OPEC+) are only gradually raising production, having cut back considerably in the early months of the pandemic, despite rocketing prices. US President Biden has appealed to OPEC+ to increase production from the current 400,000 barrels a day, but with little success. Biden is set to make an announcement this week and will most likely take a firmer stance on the situation as rising prices could hamper US growth potential. In the meantime, it currently looks as though any hope of Russia increasing their supply of gas to Europe is fading, likely shifting some demand to oil in the region.

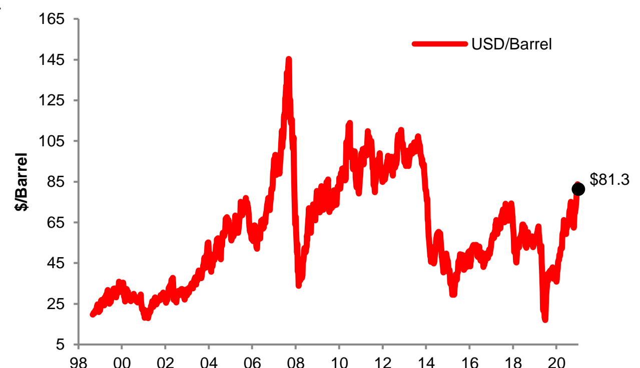
Hedge Funds. In unstable market conditions, hedge funds can help a portfolio, but selectivity is key. We prefer strategies which hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short. These strategies provide relatively safe, uncorrelated sources of returns from 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. 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 hold 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.

US WTI Oil Price Per Barrel (1998 – November 2021)



Sources: Bloomberg, 5 November 2021

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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).

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.

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Gibraltar

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Compensation Scheme

United Kingdom

SG Kleinwort Hambros Bank Limited is covered by the Financial Services Compensation Scheme ("FSCS"). The FSCS can pay compensation to eligible depositors or investors if a bank is unable to meet its financial obligations. Most depositors and investors – including most individuals and businesses – are covered by the scheme.

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.

For further information about the schemes (including the amounts covered and eligibility to claim) please contact your Private Banker or refer to the FSCS website: www.fscs.org.uk.

IMPORTANT INFORMATION – PLEASE READ

Channel Islands

SG Kleinwort Hambros Bank (CI) Limited is a participant in the Jersey Bank Depositors Compensation Scheme (the "JBDC Scheme"). The JBDC Scheme offers protection for eligible deposits of up to £50,000. The maximum total amount of compensation is capped at £100,000,000 in any five year period. Full details of the JBDC Scheme and banking groups covered are available on the States of Jersey website www.gov.je/dcs or on request.

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Gibraltar

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SG Kleinwort Hambros Bank (Gibraltar) Limited is a participant in the Gibraltar Investor Compensation Scheme (the "Investor Scheme"). [Payments under the Investor Scheme are limited to 90% of a client's total eligible investments which qualify for compensation subject to a maximum payment to any one client of €20,000 (or the sterling equivalent).] [Note: include the limit wording if the document is not a Financial Promotion (limits not required for Financial Promotions/Advertisements.)] You may be entitled to compensation from the Investment Scheme if we cannot meet our obligations. Further details of the Investor Scheme are available on request or can be found at www.gics.gi. If you would not normally be classified as a retail client you may not be eligible for this scheme.

General

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