MONTHLY HOUSE VIEWS

March 2021

The Great Rate Debate

The investing world has been aflutter over the first quarter as it digests **the possibility of renewed inflation**. Some consider this a paradigm shift in markets which for years have experienced anaemic levels of price rises. Indeed, for most of the period since the Great Financial Crisis, the spectre of deflation has been the overarching concern for major central banks.

This potential sea change has several supports. **One, while neither quantitative easing (QE) nor deficit spending are novel, the sheer scale of the programs today certainly is.** Most notably, the newly elected Biden administration in the US recently pushed through a $1.9 trillion stimulus package on top of the $900 billion support bill passed in late December – together, a staggering 13.4% of GDP. The Federal Reserve is doing its part, continuing its purchases of $120 billion in bonds each month. The US is hardly alone. In the UK, the budget deficit is on par to be 16.9% of GDP in 2020-21 and 10.3% next year, levels akin to those during World War II. The European Central Bank has clearly stated it is monitoring bond yield increases closely and remains committed to "accommodative" financial conditions.

Two, money supply has shot up dramatically, particularly in the US. In previous editions of QE, nothing on this scale occurred because much of the liquidity stayed on bank balance sheets. Therefore, the money multiplier remained low amid muted demand for loans. Fiscal spending was much smaller too, relatively speaking. Today, a much larger proportion of spending is going straight to households via direct payments: In the immediate wake of the pandemic, $1,200 cheques were sent out as part of a massive relief package. A second stimulus payment of $600 was sent to most US adults late in 2020. Now, $1,400 are being remitted to all but the richest Americans. This is unprecedented.

Three, with a rapid ramp-up in vaccinations in most developed countries, expectations are that a surge of spending will occur once restrictions on mobility are lifted later in the year, particularly in the services sector. Economists fear that unleashed consumer spending will overheat the global economic recovery and stoke the inflationary pressures fomented by huge government spending and monetary excess.

For these (and other) reasons, inflation expectations have surged from the historical lows witnessed in the throes of the pandemic last year. This has market implications. For one, **investors have been tolerant of higher equity valuations given the extremely low or negative base rates set by central banks**. Presumably, if inflation continues to rise, central banks will be forced to tame it by raising those base rates, thereby calling into question historically high prices for stocks when compared to earnings.

Perhaps more importantly, inflation fears have driven yields on government bonds around the world sharply higher (i.e. investors should demand more yield when inflation expectations rise if they want to receive the same inflation-adjusted income). In the US, the yield on 10-year Treasuries has jumped from 91 basis points (bps) at end-2020 to over 1.6% now; UK gilts have gone from 20 bps to 80 bps; and German bunds from -57 bps to -34 bps. This has caused direct losses for holders of these bonds. However, it also makes government bonds more attractive, assuming yields don't keep rising, and partly erodes the relative attractiveness of equities, which has been one of the important pillars supporting risk assets for many years.

However, markets may well have got ahead of themselves regarding inflation expectations. While we recognise the above factors, there are important mitigants, most importantly the existence of gaping output gaps. These include **high levels of unemployment**: US employers now report 10 million fewer jobs than before the pandemic and US unemployment is at 6.3% vs. 3.5% last year. Wide swathes of the public are dependent on cash flows from the government simply to stay afloat; this is where the stimulus is largely targeted. It is also worth bearing in mind that there is much more slack in the system now than in the pre-pandemic period where inflation remained muted even as unemployment was at record lows. In addition, there is **huge underutilised capacity for office and retail real estate**.

Therefore, **a rise in actual inflation would presumably not be rapid** given this huge excess capacity that must be worked through first. Let's not forget that actual inflation remains very muted at present in most of the West; and in China – on track to become the world's single biggest economy – year-on-year core consumer prices rose by 0% in February.

The high level of unemployment at present is important, as sustained and structural inflation is often linked with wage growth, for which there is little current pressure. **Long-term structural trends such as aging and inequality remain entrenched too** – older, richer people tend to save more and spend less. **These factors should keep medium and long-term inflation under control, which will eventually stabilise the bond market**.

We do accept that prices may start to rise in the short-term as a result of pent-up demand once economies go through post-vaccination bonanzas and subsequent increases in money velocity. However, this should be transitory, not structural. Moreover, this spending surge should lead to robust economic growth and earnings, as well as higher employment. This is beneficial to corporates as it increases sales and profits while allowing for maintained margins, which helps support the case for equities and risk assets.

Moreover, **we take central bankers at their word that they have little intention to raise rates until pre-pandemic level of unemployment and economic activity are firmly in hand**. It is much more likely they act to curb the increase in yields – buying long-dated bonds as part of ongoing QE programs for example – than raising rates and endangering a nascent recovery.

It is useful to remember that **market expectations of future inflation have a profoundly chequered history**.

Bottom line

We remain positively postured and are risk-on. As always, we are guided by the four pillars of our investment process:

- **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, particularly in the US, which remains the most expensive global region. Heightened valuations have been further challenged by increased inflation expectations, which raises the spectre of rates rising. However, **we believe central banks have little appetite to raise rates at present and inflation is likely to remain subdued *over time, albeit a transitory rise may well occur*. Moreover, while government bonds yields have moved higher, they still are far less attractive relative to equities.** For these reasons, we remain tolerant of higher global equity valuations at the headline level, **but are tilting our exposure towards cheaper, more cyclical regions**.
- **Momentum: Global equities are in positive momentum** on the ten-month moving average metric that we favour. This is supportive of increasing exposure to the asset class.
- **Sentiment:** Of the indicators we follow, some, such as the trade-weighted US dollar and S&P 500 net speculative positions, imply increased bearishness. Others such as global equity fund flows imply increased bullishness. **On balance, we are in neutral territory**.

We believe the case for increased risk-taking is well supported given a strengthening economic backdrop, tolerable valuations, strong momentum and sentiment that is not overbought. Nonetheless, **we continue to hold a stable of safe-haven assets to offset risks**, particularly those from equities. These include gold, low-volatility, defensive alternatives (e.g. hedge funds) and government bonds.

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

In accordance with the applicable regulation, we inform the reader that this material is qualified as a marketing document.
CA159/H2/20

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				■		
	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*				■		
FIXED INCOME – CORPORATE	US Investment Grade		■				
	Eurozone Investment Grade		■				
	UK Investment Grade		■				
	High Yield	■					
FOREX	EURUSD				■		
	JPYUSD			■			
	GBPUSD				■		
	EM FX (vs. USD)			■			
ALTERNATIVE	COMMODITIES				■		
	Brent		■				
	Gold				■		-
	ALT. STRATEGIES			■			
	L/S Equity				■		
	Event-Driven				■		
	FI Arbitrage		■				
	Global Macro		■				
	CTAs				■		

	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 16-March-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	
United States	We reduced our allocation to US equities to Underweight to diversify into more cyclically-sensitive, undervalued regions.
Eurozone	Eurozone equities resumed the outperformance that begun in November. We continue to be Overweight to the region with a preference for more cyclically-sensitive sectors.
UK	An exceptionally successful vaccination campaign and a clearly defined roadmap raises hopes for the UK to emerge from lockdown faster and stronger than its peers. Valuations remain attractive and we increased our exposure to Overweight.
Japan	Continually buoyant momentum has propelled Japanese equities to their highest levels since 1991. Nonetheless, valuations remain reasonable and we remain Overweight.
Emerging (EM)	Emerging Market equities are well positioned to take advantage of a global Cyclical recovery. We remain Neutral.

FIXED INCOME	
Sovereigns	Government bonds reclaimed some of their core benefits – namely protection and income – following the recent surge in yields. We marginally added to our positions but remain Underweight.
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 slightly recovered from their historic lows in February but we remain Underweight.
High Yield**	With yields only slightly recovering from all-time lows in mid-February, HY offers insufficient compensation for default risk and we remain Underweight.
Emerging debt (in $)	While the yield on offer is compelling, we do not feel it warrants the credit risk that EM issuers carry. We are Underweight.

CURRENCIES	
EUR/USD	We don't have a strong conviction on this pair and it's challenging to pick a favourite. Risk appetite is likely to drive the cross-rate.
GBP/USD	Investors have been bullish on the pound largely due to the speed and success of the vaccination rollout and the diminishing possibility of negative interest rates by the Bank of England. Nonetheless, we do expect GBP/USD upside moves to slow.
EUR/GBP	Hope and optimism about the UK getting back to a new normal have been supporting sterling. However, the UK will be dealing with the complications around Brexit for some time, and the years ahead will be bumpy.
USD/JPY	Optimism has pushed safe havens lower, but USD/JPY is now close to fair value.
Emerging	Recent weakness has been driven by outflows – many investors shy away from EM assets in times of rising dollar rates. However, one side effect of the pandemic has been to improve many countries' current account balance.

ALTERNATIVES	
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 prices have unequivocally entered negative momentum as rising yields eroded its attractiveness as a safe-haven asset. We reduce our allocation but remain Overweight given ongoing diversification benefits.
Oil	We expect oil prices to trade sideways in coming months at best and have no direct exposure.
Income producing Alts.	Attractive opportunities exist in infrastructure, selected real estate and specialist lenders for Target Return and income-focused strategies.

Source: Kleinwort Hambros 16-March-2021
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**HY = High Yield bonds (higher return but greater risks); IG = Investment Grade bonds (higher quality but lower return)

FIXED INCOME

Yields on the Rise

Most fixed-income markets saw a retreat from record high prices and low yields recorded in January as inflation expectations surged. While the impact remains marginal, government bonds have at least somewhat reclaimed their main benefits of offering protection and paying income. We increased our positions but remain overall Underweight.

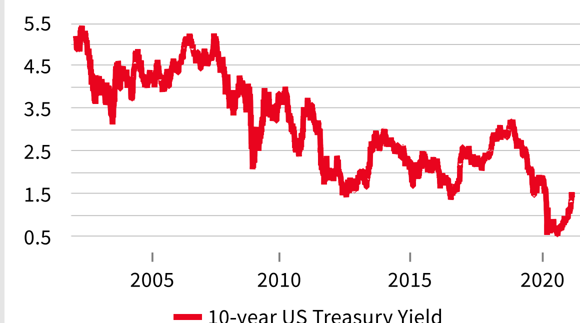
Sovereigns

US. Yields continued to surge in March on worries of an earlier-than-expected return of inflation. Strong progress in vaccination programmes has strengthened conviction that lockdown restrictions will be phased out, paving the way for a strong H2 recovery. In addition, some worry that President Biden's proposed $1.9tr stimulus package is excessive and will result in an overheating of the economy. Nonetheless, significant slack remains, most notably in the job market where the number of Americans in employment is still almost 10 million below pre-crisis levels. This suggests that the Fed is likely to keep policy easy, continuing its massive Treasury purchases which will help keep a cap on yields in the medium-term.

UK. 10-year sovereign ("gilt") yields shot higher in February, gaining almost 50 bps as world-leading progress in vaccinations raised hopes of rapid economic recovery. With core inflation at 1.4% in January, many investors feel yields can only rise further. The Chancellor of the Exchequer's spend-now-pay-later approach, paired with ample monetary support, continues to underpin the recovery. Although the Bank of England has ruled out negative key rates, it is unlikely to tighten monetary policy in the foreseeable future. All said, further upside in gilt yields should be limited for now.

Eurozone. Upside in core sovereign bond yields has been relatively modest with 10-year German Bund yields at -0.30%, only 34 basis points (bps) above November's lows. The European Central bank (ECB) has given every indication that asset purchase programmes are likely to continue at the current rapid pace. Nonetheless, with cyclical recovery looming in H2, there is little scope for core bond yields to fall much lower.

10-year Treasury yield hits highest level in a year



Source: SGPB, Macrobond, U.S. Department of Treasury, 04/03/2021

Credit

US. IG yields have tracked Treasury yields higher since year-end, leaving "spreads" (i.e., yield differentials) very close to 2018's decade lows. Speculative grade HY bond yields hit all-time lows in mid-February and, with spreads close to multi-decade lows, offer little protection against default risk. We see little change in the outlook for USD corporate bonds and – with low yields and tight spreads – we remain Underweight.

UK. Sterling-denominated credit holds little more promise. IG spreads over gilts hit all-time lows in mid-February and have barely widened during the recent sharp rise in sovereign yields. HY spreads at 275 bps are tighter than for comparable credit risk in euros or dollars. In part this may reflect optimism about vaccine-fuelled recovery but such spreads still fail to compensate for default risk. We are Underweight.

Eurozone. After reaching an all-time low in mid-December at 0.0%, yields on euro IG bonds have tracked core sovereign yields modestly higher. However, spreads over Bunds are only 74 bps – just 20 bps more than Spanish government bonds – and offer little value for investors. Yields on HY bonds are little changed in recent weeks and still only just above the 2017 all-time lows. In the short-term, the economic environment may worsen under the weight of lockdown restrictions, which is likely to place weak balance sheets under significant pressure. We remain Underweight.

Emerging Market (EM) debt

EM sovereign bonds surged together with Treasuries in March as spreads recovered from recent lows, increasing to 340bps. EM economies are set to register a sharp acceleration in growth as the global economy recovers from the pandemic – the International Monetary Funds expects +6.3% this year and +5.0% in 2022. Nonetheless, yields remain close to all-time lows and we remain Underweight.

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EQUITIES

Still bullish

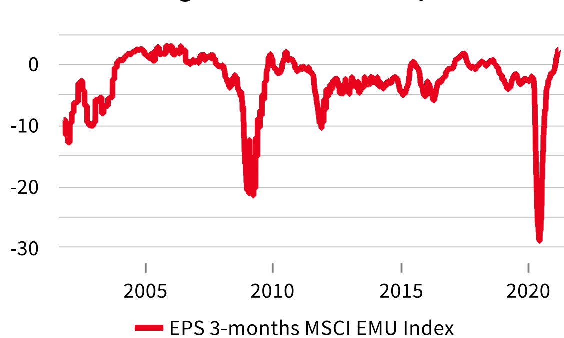
We continue to maintain an Overweight allocation to global equities. In the context of rising bond yields, we expect the recovery in "value" stocks to continue and increased our exposure to UK Equities to join our existing Overweight allocations to Japan and the Eurozone.

US. Recent rises in bond yields have put downward pressure on equity markets, in particular those with the highest valuations. While US stocks have regained all-time highs reached in mid-February, there has been a switch in market leadership – smaller stocks have outperformed large caps (the Russell 2000 index of smaller companies has outstripped the larger stocks in the Russell 1000 by more than 25% since the first vaccine announcements in early November) and cheaper "value" stocks have done better than more pricy "growth" companies (the Russell 3000 Value index has surpassed its Growth equivalent by 18% over the same period).

US equities remain expensive on many measures – the price to forward earnings ratio is currently at 23 times, a level only exceeded during the tech stock bubble in early 2000. With higher rates putting pressure on multiples, we are reducing our growth-biased US exposure in favour of "value" opportunities in other regions and move to Underweight.

UK. Business confidence surveys improved sharply in February, encouraged by world-leading progress on vaccinations, and the government has announced a detailed roadmap to lift all restrictions by late June. In addition, the recently announced budget promises ample fiscal support to a convalescent economy, and attractive tax incentives may foster an uplift in business investment and innovation. Valuations remain very appealing and the market is set to benefit strongly from a cyclical pickup in activity. We are increasing our exposure to Overweight.

Euro zone earnings forecasts revised upwards



Source: SGPB, Macrobond, MSCI, 04/03/2021

Eurozone. In March, Eurozone equities accelerated their outperformance that begun in November, when markets reacted to excellent vaccine trial results and investors began to rotate portfolios towards laggard markets with relatively cheap valuations and high sensitivity to the economic cycle. The initial ramp-up of vaccinations across the EU has disappointed and new virus mutations have kept restrictions and curfews in place, a combination which is likely to keep the region in recession until spring. However, government fiscal support remains generous and the ECB shows no sign of abandoning its commitment to easy monetary policy. We remain Overweight.

Japan. Japanese equities reached multi-decade highs in February, rising to levels not seen since early 1991 in the aftermath of the bursting of Tokyo's stock market bubble. This time however, the rise in has come without any exaggeration in valuations as shown by the price to cyclically-adjusted earnings ratio (a measure of current market levels compared to trend earnings) which remains 6% below its 20-year median. We remain Overweight.

Emerging Markets. Emerging markets lagged global equities in February as investors locked in some profits after several months of strong outperformance. Looking ahead, we expect a stronger recovery in growth than in advanced economies, helped by the pick-up in trade flows and emerging supply bottlenecks which should help improve EM exporters' pricing power. In this context, earnings growth should be solid this year while valuations remain cheaper than in the US and Europe. We expect EM equities to recover from the recent bout of weakness but do expect volatility to increase as US yields rise. We remain Neutral.

Global Opportunities. We see increasing value in Environmentally-focussed equities across the globe. This allocation seeks to take advantage of what we consider irreversible trends in environmentally-linked policymaking, legislation and consumer behaviour. As a result, we will be investing 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

Dollar back in town

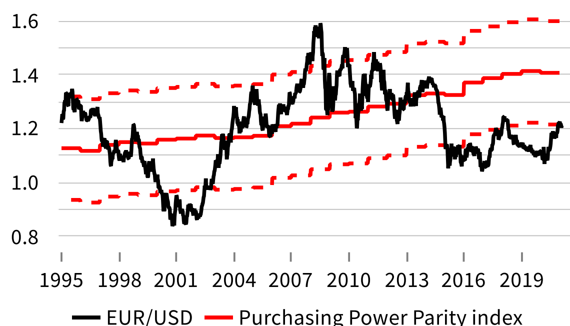
The US dollar has been performing better over recent weeks despite looming US stimulus, mainly driven by rising US Treasury yields. However, the Euro continues to carry an unjustified undervaluation in purchasing power parity terms.

Dollar Index. The global reserve currency, the US dollar, has been performing better over recent weeks despite looming US stimulus, mainly driven by rising US Treasury yields. However, it is prudent to remember that US yields themselves are rising in part due to increased inflation expectations, which will limit US dollar upside. Moreover, the sheer size of fiscal stimulus - current plans represent some 13% of GDP - could raise fears of currency debasement.

EUR/USD. The trading range of 1.1950 – 1.2400 appears to be holding. However, the euro continues to carry an unjustified undervaluation in purchasing power parity terms. Nonetheless, we do not have a strong conviction on this pair and it's challenging to pick a favourite. Risk appetite is likely to drive the cross-rate in the absence of any meaningful economic data points or interest rate expectations.

GBP/USD. Cable rose 1.5% year-to-date and is up over 13% in the last 12 months. Indeed, at one point 1.4200 was breached. However, in our opinion it was overbought and due a correction, which has since occurred. The US dollar has been performing better despite the looming US stimulus, mainly driven by US treasury yields and reflation expectations. Investors have been bullish on the pound largely due to the speed and success of the vaccination rollout and the diminishing possibility of negative interest rates by the Bank of England. Nonetheless, we do expect GBP/USD upside-moves to slow over the next 3 months and keep our near term forecast on hold at 1.3750.

Euro continues to carry an unjustified undervaluation



Source: SGPB, Macrobond, OECD, 04/03/2021

EUR/GBP. EUR/GBP is oversold according to momentum indicators, and the recent pause was overdue. Hope and optimism about the UK getting back to a new normal have been supporting sterling. However, the UK will be dealing with the complications around Brexit for some time, and the years ahead will be bumpy. We expect EUR/GBP to re-group and consolidate over the next couple of months at current levels.

USD/JPY. The US dollar has shot past the 109-mark versus the Japanese yen, its highest level since July 2020. The move – the yen dropped over 5% year-to-date – has been fuelled by the strong pace of US COVID-19 vaccinations and Biden's massive spending plans, which have boosted dollar yields and hopes for a robust economic recovery. This optimism has pushed safe havens like JPY lower but, with USD/JPY now close to fair value, we remain Neutral.

EM currencies. JP Morgan's index of emerging currencies has eased 2% lower since end-2020, having rallied almost 11% from April's lows. Recent weakness has been driven by outflows – many investors shy away from EM assets in times of rising dollar rates. However, one side effect of the pandemic has been to improve many countries' current account balance. Mexico, for example, moved from a modest deficit in 2019 to a 2.4% surplus, the highest since the 1980s. Moreover, global cyclical recovery should favour EM assets, attracting new inflows.

USD/CNY. China's pandemic management during 2020 enabled the country to reopen much earlier than advanced economies, avoiding the need for the massive fiscal support doled out by western governments. As a result, China's debt ratios have suffered less than in the US or EU. Moreover, 10-year CNY government bond yields are well above western counterparts, making it one of the most attractive sovereign bond markets. This has fuelled a 7% CNY rally over the last year or so. However, it appears to be petering out – only 1% of that gain has occurred in 2021 – and the Chinese will be wary of allowing their currency to appreciate much further from here.

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ALTERNATIVES

OPEC+ keeps supply tight

We expect oil prices to consolidate in coming months as supply cuts compensate for sluggish near-term demand. Gold prices should recover once real rates fall again. We prefer hedge fund strategies which hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short.

Commodities

Oil

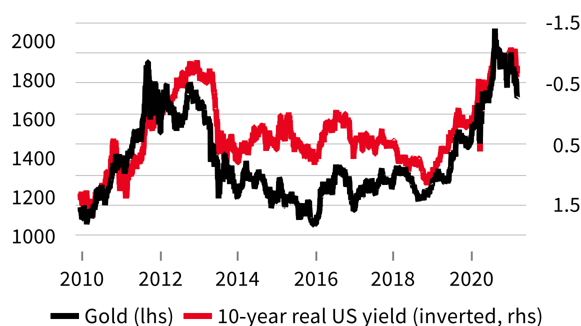
Oil prices have trended steadily higher, gaining over 70% since November's vaccine announcements sparked hopes that a cyclical recovery this year would push oil demand back to pre-crisis levels. These hopes have since been reinforced by massive US fiscal spending plans and rapid progress in vaccinations. Moreover, supply has contracted. US output has tumbled from an average 13.0 million barrels per day (mb/d) last February to 10.4 this year as extreme cold weather disrupted many oilfields in Texas. OPEC and its allies (OPEC+) decided in early March to postpone a planned 500,000 b/d increase in output, with Saudi Arabia maintaining its voluntary 1 mb/d production cuts for another month.

This dynamic should help mop up excess inventories over coming months. However, measures of mobility in the US and Europe suggest that current demand for oil remains well below pre-crisis highs and – with oil prices back at January 2020 levels – US shale producers may soon be able to attract more investment capital to finance increased output.

Oil prices now look set to trade between $60 and 70 per barrel (Brent) in coming months.

Gold

Gold prices have been pushed lower by several factors this year. Fiscal spending and hopes of easing lockdown restrictions have weakened demand for safe havens while propelling global equity prices to all-time highs. Fears of a looming spike in inflation have also driven inflation-adjusted (or "real") 10-year yields higher (see chart).



Source: SGPB, Macrobond, U.S. Dpt of Treasury, BLS, LBMA, 04/03/2021

When real yields are rising, gold prices tend to come under pressure, and lower prices fuel selling in gold ETFs – total ETF gold holdings are down almost 6% from October's highs.

We have held gold across most strategies primarily as a safe-haven asset and it has performed well during most crises, including during a highly volatile, pandemic-ravaged 2020. However, we believe it is prudent to take some profits on our gold positions for two reasons: One, gold is an asset particularly subject to long-term trends. Its price has recently broken through its 10-month moving average, one indicator of long-term momentum, on the downside.

Two, it is difficult to value gold on an intrinsic basis given it has no income stream or expected cash flows. Yet we are cognisant the opportunity cost of holding it in terms of real yields has increased. In this regard, gold has become less attractive as both the nominal and inflation-adjusted yield on most developed market government bonds have risen in 2021.

Nonetheless, gold remains an effective diversifier with a low correlation to equities. Indeed, it tends to be negatively correlated when equities are under heightened selling pressure. This is an important consideration for why we continue to hold it instead of exiting the entire position.

Alternative investment strategies

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 are exploiting several niche investment opportunities in selected real estate (e.g. medical centres, student accommodation), infrastructure and specialist lending (e.g. pharmaceutical royalties, economic infrastructure).

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