

MONTHLY HOUSE VIEWS

January 2021

Glass Half Full

The year 2020 is now behind us, but it is a period indelibly etched into our collective memories. We entered the year cantering towards the eleventh year of a bull market, a long rally seemingly impervious to its own impermanence. Of course, it all came to a shuddering halt as the breadth of the Coronavirus pandemic began to register. The drawdown (peak-to-trough loss) in global equity markets on 23-March – what proved to be the nadir – was about -40%, a stunning collapse that occurred in less than a month. At the time, it appeared that the 50% drawdowns that occurred in 2000 and 2008 would be eclipsed in a matter of weeks. The 1929 drawdown of 80%, the worst of all time, also loomed on the horizon.

What came next was as surprising as the initial plunge. Despite widespread lockdowns, near-total economic stasis, surging unemployment and a terrible toll in illness and death, the second quarter witnessed a powerful rally in risk assets, with global equities rising by 17.7%; by the end of 2020, global equities rallied by 60% from the trough. With the benefit of hindsight, we can synthesise the underpinnings of this rally into two distinct phases.

First, governments and central banks unleashed hitherto unthinkable levels of fiscal spending and monetary stimulus to help stabilise economies and provide liquidity to financial markets, backstopping wages and cashflows across entire economies. Once again, in hindsight, it is clear it was “enough” to underpin the powerful fillip in markets. The long-term consequences remain to be seen – government debt levels are at post-World War II highs and central banks have inadvertently become enormous players in financial markets. Nonetheless, huge government intervention was called for to prevent a Great Depression-style collapse, and governments delivered.

Second, there were critical wins in the battle against the disease. Death rates among Covid-19 patients dropped dramatically (i.e. from 25-30% in the spring to 3-8% in the Autumn) due to lessons learned by doctors during the first wave and the development of better treatment protocols using steroid drugs and non-drug interventions. This allowed economies to tentatively re-open. It was then followed by the real gamechanger of vaccine announcements in November, giving hope of a decisive and definitive end to the nightmare.

Vaccines notwithstanding, we are not out of the woods in terms of human suffering and economic dislocation – a dark winter looms before vaccination efforts begin to bear fruit. As we step into 2021, investors again find themselves facing stunning juxtapositions.

On one hand, we are in the tightest grip thus far of the coronavirus pandemic, with thousands of deaths each day and major economies in various states of lockdown. On the other, human ingenuity and modern technology have never shone brighter, with the fastest ever development of vaccines being followed by the largest mass inoculations ever conducted.

On one hand, last year’s economic slump due to the COVID-19 pandemic is being followed by subdued recovery. Activity in manufacturing has improved markedly from mid-2020 lows, but the services sector – by far more important to advanced economies – remains tepid. On the other, global markets – with equities at all-time highs and rates close to record lows – have chosen to look through the darkness to the light at the end of the tunnel when vaccine-led normality returns.

On one hand, early-January witnessed a mob storm the US Capitol, for many an emblem of the liberal democratic order that has presided over global peace and prosperity since World War II. Clearly, populist distrust of “elites” remains palpable. On the other, major geopolitical tensions appear on the wane – the Biden presidency should bring more predictable policies on trade, and long-standing issues like Brexit are now largely in the rear-view mirror.

Bottom line

On balance, we believe risk assets – particularly equities – remain compelling, supported by strong momentum and a recovering global economy. Valuations are challenging but tolerable given low rates and extreme overvaluation in

fixed income markets. Risks, as always, remain: sentiment is increasingly bullish and we cannot rule out vaccine-resistant virus mutations or similar setbacks, leading to further lockdowns. Nonetheless, we believe the case for increased risk-taking is well supported.

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 recovery, which is favourable for risk-taking; we may even be on the cusp of expansion.** Admittedly, the path of economic activity is highly uncertain and largely dependent on the ongoing fight against the Covid-19 pandemic – **it is possible that renewed lockdowns cause a reversal back into a regime of “contraction”.** Nonetheless, **the risk of this has materially lessened with the mass deployment of viable vaccines**, which scientific advice suggests are equally effective on known variants of the coronavirus.
- **Valuations:** Valuations for equities – the largest source of risk and return in most strategies – remain challenging in absolute terms. However, with global interest rates near zero, **there is a case for a higher than usual tolerance to valuations** (i.e. future cash flows are discounted by less). Moreover, **the emergence of a vaccine – which can lead to normalised economic activity – is likely to be supportive of raised corporate earnings, which will serve to curtail valuations** (all else being equal). Moreover, **valuations for equities when compared with government bonds remain robust** with the latter providing negative returns once adjusted for inflation. The case for government bonds is eroded further given the limited protection they are likely to provide from the current low yields.
- **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, most, such as the trade-weighted US dollar and global equity fund flows, imply increased bullishness. However, they are **not in overbought territory, which would cause us to be more circumspect on risk-taking.** We continue to monitor sentiment closely.

We believe the case for increased risk taking is well supported given a strengthening economic backdrop, strong momentum and still tolerable valuations. However, we are cognisant of downside catalysts. These include vaccine-resistant coronavirus mutations, logistical setbacks in mass inoculations or a less supportive monetary and fiscal policy backdrop. Therefore, **we continue to hold significant safety assets as a form of risk mitigation** – these include gold and low-volatility, defensive alternatives (e.g. hedge funds).

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.

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

	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 12-January-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	The Democratic “clean sweep” is supportive for sentiment but US valuations are elevated. We continue to prefer more cyclically sensitive markets. We reduced our exposure in favour of an allocation to Global Environmental Opportunities.
Eurozone	The liquidity environment is supportive and the EU recovery fund will shortly begin disbursements. We like the pro-cyclical nature of the region and increase our allocation to Overweight.
UK	The UK-EU trade deal removed much of the lingering uncertainties around the future trade environment with the bloc and equities unsurprisingly responded in positive fashion. We remain Neutral.
Japan	The Japanese equity market is attractively valued, and momentum is positive. Furthermore, the safe-haven characteristics of the Yen provide some buffer against market volatility. We are Overweight.
Emerging (EM)	Emerging Market equities are well positioned to take advantage of a global Cyclical recovery. We remain Neutral.

FIXED INCOME

Sovereigns	Given the extremely low (or negative) rate environment on offer from developed market sovereigns, their traditional role as income generators and shock absorbers has been diminished. We have reduced our position further and 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**	Absolute yields remain low, though the asset class offers a reasonably compelling pick-up over government bonds. We remain Underweight.
High Yield**	High Yield bonds remain more vulnerable to economic challenges, especially the weakest issuers. We are Underweight.
Emerging debt (in \$)	Yield spreads have narrowed considerably from their peaks in recent months. 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	Ebbing safe-haven demand, negative real rates and twin deficits have come together to put downward pressure on the USD.
GBP/USD	Finally, we can move on from the Brexit debate and focus on fundamentals which, for now, weigh against the USD.
EUR/GBP	The implementation of the new cross-Channel trade regime may weigh on sterling against the euro in coming months.
USD/JPY	Higher US yields are holding back the yen; however we don't anticipate this to be long lasting.
Emerging	Emerging markets are showing positive signs, but with Covid-19 still wreaking havoc it will be a bumpy road ahead.

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 remains a critical risk hedge with few good alternatives at present, and fundamentals remain solid. We are Overweight.
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 12-January-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

Whatever happened to yield?

Most fixed-income markets ended 2020 with yields and spreads at all-time lows. With global activity set to strengthen in 2021, we suspect that this year will prove more challenging for bonds. Given the limited protection provided by Government Bonds we have further reduced our positions.

Sovereigns

US. Early January’s runoff Senate elections in Georgia finally handed the Democrats a “clean sweep” of the presidency and Congress, reviving market hopes of reflationary fiscal stimulus. However, their majorities in both chambers are razor-thin which might limit the scope of Biden’s stimulus policies. Nonetheless, 10-year Treasury yields have already doubled from the August low of 0.51%, core inflationary pressures remain muted and the Fed an active buyer – all in all, we expect Treasuries to consolidate for now.

UK. With Brexit now complete and the country back in full lockdown, the Bank of England (BoE) is unlikely to change tack and its enhanced asset purchases buying should help keep sovereign (“gilt”) yields close to zero. Real gilt yields – after core inflation of 1.1% - are sharply negative. Gilts’ traditional role as income generators and shock absorbers has been all but evaporated and we reduced our exposure to Underweight.

Eurozone. At its December meeting, the ECB went ahead with the expected increase in asset buying and extended the horizon for its purchases of sovereign and high-grade corporate bonds by 9 months to March 2022. This ensures that Eurozone bond yields will remain at depressed levels for many quarters to come. However, with little room for core bond yields to fall further and with periphery yields already at all-time lows, we find little value in this segment.

Credit

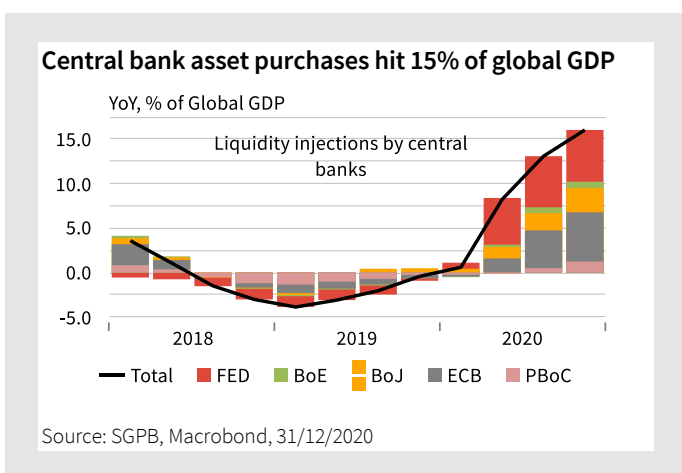
US. Yields on IG corporate bonds hit 1.91% on December 31, the lowest level on record, taking spreads back to late-2019 levels. At such levels, markets have largely priced in 2021’s positive outlook, leaving little room for further spread compression. While the asset class offers a reasonably compelling yield-pickup over government bonds, we continue remain Underweight.

UK. Spreads on sterling IG bonds have also tumbled to all-time lows – at 0.96% – and UK HY yields are at the lowest levels on record. Renewed and strengthened lockdown restrictions are likely to place stress on weaker corporate balance sheets, putting ever more importance into security selection. We continue to prefer higher-quality names and remain Underweight.

Eurozone. In line with their US and UK counterparts, yields on euro IG bonds sit at all-time lows of only 0.23%, with demand bolstered by ECB-buying and pandemic-driven recession conditions. Our scenario of cyclical recovery in the second half of 2021 could put some downside pressure on bond prices and such negligible yields offer little support. We are Underweight.

Emerging Market (EM) debt

Among sovereign issuers in USD, EM bonds stand out. They offer spreads over US Treasuries of 277 basis points and the cyclical upturn in global activity should help improve credit quality. However, yields are close to historic lows and risks continue to outweigh compensation in these regions. We remain Underweight.



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EQUITIES

Vaccines to drive cyclical recovery

With the global economy set to shift into cyclical recovery, we have decided to highlight those markets which should be most sensitive to the upswing, foremost among which should be emerging markets (EM), the Eurozone and Japan. In addition to increasing our overall equity exposure to Overweight, we are introducing an allocation to Global Environmental Opportunities.

US. The US election saga is set to be resolved with a “clean sweep” of the presidency and Congress by the Democrats, bolstering market hopes of reflationary fiscal stimulus. However, the majorities are slim in the House and the Senate which means that the Biden administration may have to stick to centrist policies, scaling back both spending plans and tax hikes. Business confidence surveys point to continued expansion of activity in both manufacturing and services sectors, aided by widespread reluctance to tighten lockdown restrictions despite the rapid spread of COVID-19.

This has provided a supportive backdrop to US equity markets which ended last year at record highs. However, with the MSCI US index up about 20% in 2020 and with profits down just over 11%, valuations stand at a demanding 41% premium to the average of the last decade, led by Technology at an 80% premium. In this context, we decided to somewhat reduce our US Equity position, especially exposure to Growth names, in favour of an allocation to Global Environmental Opportunities. We reduce our overweight to Neutral.

UK. The Christmas Eve conclusion of the trade deal with the European Union somewhat removes the lingering uncertainties about cross-channel trade and, as expected, triggered a re-rating of UK stocks. However, the reintroduction of border checks and regulatory barriers will considerably slow down trade flow over the coming years. We remain Neutral

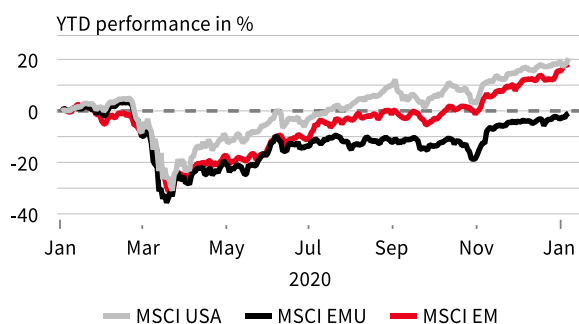
Eurozone. The prolonged restrictions to stem the spread of COVID-19 across the euro zone will weigh on the outlook for corporate profits and recent revisions to the earnings outlook have been downwards. On the other hand, the liquidity backdrop is supportive thanks to the ECB and the long-awaited EU recovery fund will begin disbursements this year. Moreover, valuations are well below those in the US while Eurozone equities are much more cyclically sensitive than their US peers, explaining why investors’ willingness to look beyond the near-term recession. We expect a strong performance given the pro-cyclical nature of the region and increase our exposure to Overweight.

Japan. Japanese equities lagged the global average only slightly last year. Economic reforms continue under the new prime minister and the country has managed to keep a cap on any outbreaks of coronavirus infections. Moreover, Japan is well placed to benefit from the continuing acceleration of growth in China. We continue to hold Overweight positions in Tokyo to benefit from its sensitivity to the cyclical upturn.

Emerging Markets. Last year’s earnings were resilient – particularly in Asia, where China, Taiwan and South Korea all saw an increase in profits – and analysts expect an increase of 34% in 2021. This year should see synchronised global recovery in H2 which should help accelerate global trade flows – emerging markets stand to reap the benefits. Nevertheless, potential concerns surround the impact of sanctions on Chinese technology and telecoms stocks, as well as perennial issues surrounding volatility. We are 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).

Strong performance from emerging markets



Source: SGPB, Macrobond, 07/01/2021

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CURRENCIES

It's all about the dollar

Ebbing safe-haven demand, negative real rates, enormous budget spending and a structural current account deficit have come together to put downward pressure on the US dollar against most major currencies. With the Democratic “clean sweep” of Congress and the White House, we expect these trends to remain in place.

Dollar Index. The Dollar Index (DXY) was down about 7% over 2020. With the benefit of hindsight, the impact of the US election – the event most expected to set off some currency movement – was relatively minor. Instead it has been more a story of steady decline on fundamental factors: safe-haven demand ebbed; the Fed was perceived to be loosening policy faster than its peers; huge deficit spending increased inflation expectations; and the gaping trade imbalance remain unchecked. These factors remain well entrenched, though in the short term the US dollar may be oversold.

EUR/USD. Since the lows seen in March last year, EUR/USD is up 15% closely mirroring the strength in eurozone equities. The EUR was bolstered immeasurably by the agreement between needy member states and former stimulus hawks such as Germany to issue collective debt in the wake of the first wave of coronavirus infections. Investors interpreted this as a clarion call for continental unity and solidarity. As we enter 2021, the eurozone no longer appears moribund, and the euro is again gaining credibility as international payment currency.

GBP/USD. Finally, we can move on from Brexit. Cable hit a high of 1.3700 after the deal became official, before losing some lustre as the latest UK lockdown was announced. The USD side of the cross will matter more in the near term, particularly now the Democrats have regained control of the Senate. This will make it easier to pass fiscal stimulus, which will raise inflation expectations, which will in turn put further pressure on the dollar in months ahead.

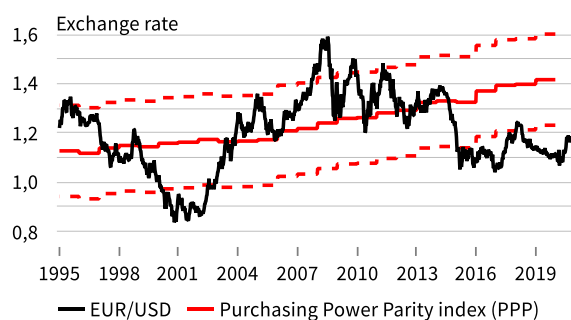
EUR/GBP. EUR/GBP has traded at an average price of 0.8903 over the last year, and currently the spot price is only 1% away from this level. The pound has held firm so far, despite the UK going into its 3rd lockdown. Moves since the Brexit deal passed have been limited, with most of the deal being in the price beforehand. Going forward, we still expect range bound trading, and we don't have a strong conviction on either the euro or the pound.

USD/JPY. This currency cross has trundled along close to the 104.00 level over the past month. Among safe-haven currencies/commodities, we have seen much more price action in gold than in JPY. Japan has coped much better with COVID-19 than many other countries and the fall in US real yields is likely to support JPY going forward. All told we expect USD/JPY to trend slowly lower from current levels in 2021.

EM currencies. JP Morgan's index of emerging currencies has been trending higher against the USD since last April's all-time low. In part this reflects generalised dollar weakness, in part it is driven by burgeoning risk appetite and in part it underlines the attraction of undervalued currencies offering higher interest rates. We expect this trend to continue in 2021 as investors pivot towards regions which should benefit from the upturn in the cycle.

USD/CNY. The renminbi stands out among major currencies with 10-year government bonds yielding 3.15% while the currency has rallied 10.7% against the USD since its late-May lows. China's V-shaped recovery from recession has attracted inflows with manufacturing output growing at pre-coronavirus rates while retail sales are recovering steadily, up 5.0% year-on-year in November. Although we expect the new Biden administration to maintain a hard line on China, policy should be less choppy and erratic and there will likely be less focus on punitive tariffs. All told, we expect the renminbi to consolidate around current levels.

The euro still looks undervalued against the dollar



Source: SGPB, Macrobond, OECD, 30/10/2020

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ALTERNATIVES

We continue to hold safe-haven alternatives such as gold

Oil should trade sideways in the coming months. We continue to remain Overweight gold due to diversification, valuation and momentum reasons. We prefer hedge fund strategies which hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short.

Commodities

Oil

Crude oil prices continued their rally in early January as OPEC and its allies, including Russia, held their first monthly meeting of the year. Saudi Arabia stunned traders with a voluntary cut in output of 1 million barrels per day (mb/d) in February and March – this enables Russia and Kazakhstan to increase production by 75,000 mb/d each but still leaves total supply from the allies below market expectations. Riyadh's fear is likely to be that demand will continue to be crimped by travel restrictions and lockdowns across much of the northern hemisphere.

However, higher prices may encourage US producers to ramp up output – they already reached 11.0 mb/d in December, up from 9.7 mb/d at their 2020 lows, as average Brent prices rose from \$43 in November to \$50. This in turn could prompt the Saudis to change tack, given their reluctance to yield too much ground to US producers, whose successful exploitation of shale oil reserves saw them replace Saudi Arabia and Russia as the world's leading supplier in 2018-2019.

All in all, we expect Brent prices to trade sideways in the coming months and do not have any direct exposure to it.

Gold

Gold ETF flows tend to be somewhat momentum-driven – as prices declined -5.4% over the course of November, ETFs saw the first outflows in twelve months, which drove gold sales of 107 tonnes (t). Moreover, in Q3, central banks registered the first quarter of net sales of gold since Q4 2010. The selling was dominated by two countries – Turkey and Uzbekistan – both of which resumed buying in October which saw net purchases of 23t.

As a non-yielding asset, gold prices tend to be sensitive to changes in the yields available in other safe-haven assets like US Treasuries. Despite the recent rise in 10-year yields, those on inflation-linked securities – which reflect expected inflation – recently reached record lows at -1.11%. At such levels, the opportunity cost of holding gold becomes negligible, which tends to support gold prices as we saw with December's 6.8% rally.

We also continue to remain Overweight gold for two other reasons. One is diversification: While vaccine news where a huge boon to markets, it is prudent to remember that risks have dissipated, though they have not disappeared. In an environment where traditional diversifiers (e.g. Government Bonds) are less effective, gold remains one of the few assets with little to negative correlation to equities.

In addition, there is momentum, which remains an important consideration for any volatile asset class. Should momentum turn negative, and that signal is confirmed, we will consider trimming or selling our position. However, at present, momentum remains positive.

Alternative investment strategies

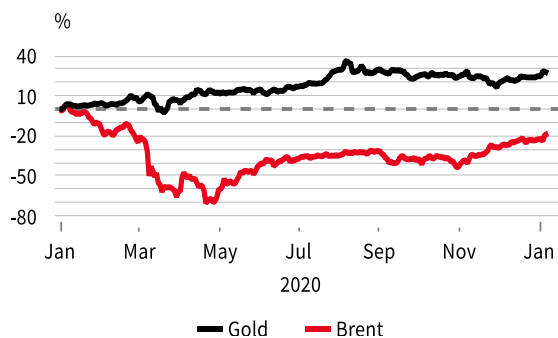
Preference for Merger Arbitrage type strategies

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. These investments have been positive contributors of 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).

Crude oil recovery from April crisis



Source: SGPB, Macrobond, 07/01/2021

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