

MONTHLY HOUSE VIEWS

May 2021

Hanging Loose

The momentum from a buoyant first quarter has carried through into the spring with more robust global economic indicators. While manufacturing already entered a renaissance of sorts last year with global demand for physical goods soaring following the pandemic, demand for services – the bulk of economic activity in advanced economies – also appears to be accelerating now as lockdowns ease and vaccinations proliferate.

In the Eurozone, the Purchasing Managers Index (PMI) for services rose to 50.5 last month (with 50 marking the dividing line between growth and contraction). This is the first expansionary signal since last August. In China, consumer sentiment strengthened to the highest on record amid hopes of a strong post-pandemic recovery, pushing the services PMI up to 56.3. **The recovery in services confidence in the UK and US is even more extraordinary**, with each registering PMI figures above 60 in April. **It is no coincidence that both lead the world's largest countries in terms of vaccinations**, with the UK and the US having administered at least one dose of a coronavirus vaccine to huge swathes of their respective populations (52% and 45%*¹).

The resurgence in services is a critical factor behind what is a spectacular macroeconomic surge. In April, the International Monetary Fund upgraded its global growth projections to 6% for 2021 and 4.4% in 2022. This growth is also translating into strong corporate earnings. For US equities, the earnings growth rate for this year is expected to be about 33%, followed by 13% next year and the 52-week **forward expectations for revenues, profit margins and earnings have all risen to record highs**. The Eurozone and the UK should also have banner years for earnings growth, albeit from deeper troughs.

For now, this **robust macroeconomic backdrop continues to anchor the dazzling momentum in risk assets**. Admittedly, valuations for these assets are elevated by any historical measure, which is a cause of concern. With such a strong economic backdrop, **further rises in rates are possible, which is one of the chief risks for the ongoing bull market and its extended valuations**. Some would argue that it has already begun. In late April, the Bank of Canada (BoC) was the first to move when it announced the tapering of its asset purchases from C\$4bn per week to C\$3bn. It justified this move by pointing to a dramatic upgrade in its forecasts – 2021 growth estimates have jumped to 6.5% from only 4% in January and the BoC now expects that by H2 2022, all economic slack will have been absorbed and inflation will be sustainable around its 2% target.

At its meeting in early May, the Bank of England (BoE) made no headline changes to policy settings, keeping its policy rate at 0.1% and holding the total size of its asset purchase programme steady at £895bn. However, like the BoC, the BoE revised its 2021 growth forecasts higher, to 7.25% versus its previous 5% estimate. This means that GDP will be back to pre-crisis levels by Q4 this year, a quarter earlier than previously thought, thanks to faster consumption of pent-up demand. It also announced it would reduce the weekly pace of its asset purchases, from £4.44bn to £3.44bn.

However, the above must be taken in context. BoE governor Bailey went out of his way to emphasise that this was a mechanical change rather than a signal for policy being tightened. The BoE had fixed a £190bn envelope for asset purchases this year, implying a £3.7bn weekly rate – by reducing the weekly pace, it is simply spreading the remaining purchases out evenly over the rest of the year.

Moreover, the European Central Bank (ECB) and the Federal Reserve (Fed) show no sign of following suit. **The ECB announced that it would accelerate the pace of asset purchases in Q2 given the perceived tightening in monetary conditions** and, indeed, the weekly pace of its Pandemic Emergency Purchase Programme buying has accelerated by 33% since Easter, reaching €25.3bn in mid-April.

¹ Figures from Our World In Data on 10 May, 2021 (<https://ourworldindata.org/covid-vaccinations>).

The US Fed has stuck to its monthly target of \$120bn in purchases despite the recent string of stronger confidence data – for example, the March Institute of Supply Management survey of manufacturers hit a 37-year high, before easing back in April. **Although the economic outlook has brightened, there is still a long way to go before the Fed tightens** – one-fifth of the workforce in lower income categories is still unemployed and **the Fed remains convinced that this year’s spike in inflation will prove transitory**. These views were given some weight by the April payroll data – observers were disappointed to see only 266,000 new jobs added and the unemployment rate edging up to 6.1%.

Bottom line

We remain sanguine and believe it unlikely that rates will rise rapidly for many months to come, if not years. This is primarily guided by our view that inflation expectations should remain anchored at low levels. This year should see higher prices as economies reopen and pent-up consumer demand is unleashed, but this should prove transitory – gaps between actual and potential output still gape wide, there is enormous slack in the labour market and huge underutilised capacity in commercial real estate.

We remain 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**. Each of the ten underlying forward indicators of economic growth are positive – an unusual confluence – which is reflective of a broad and powerful economic backdrop.
- **Valuations:** Valuations for equities – the largest source of risk and return in most strategies – remain challenging in absolute terms. Heightened valuations have been further challenged by increased inflation expectations, which raises the spectre of rates rising. However, as discussed above, **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**. We remain tolerant of higher global equity valuations at the headline level but have been tilting our exposure towards less expensive regions.
- **Momentum: Global equities are in positive momentum** versus their ten-month moving average. This is supportive of increasing exposure to the asset class.
- **Sentiment:** Sentiment remains bullish. Nonetheless, **we remain within our risk tolerances**.

We believe the case for risk-taking is well supported given a strengthening economic backdrop and strong momentum. Nonetheless, we are wary of expensive valuations and bullish sentiment. **On balance, we are moderately risk-on with a continued preference for equities** but have been tilting more towards less expensive, value-oriented regions. We also continue to hold a stable of safe-haven assets, including gold, low-volatility, defensive alternatives (e.g. hedge funds) and government bonds.

OUR ASSET ALLOCATION

The table below presents the latest conclusions of the KH 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						
	GLOBAL RATES						
	U.S. Treasuries						
	German Bunds						
	UK Gilts						
	EM Government Bonds (\$)						
	CORPORATE						
	Duration USD*						
	Duration EUR*						
	Duration GBP*						
FOREX	EURUSD						
	JPYUSD						
	GBPUSD						
	EM FX (vs. USD)						
ALTERNATIVE	COMMODITIES						
	Brent						
	Gold						
	ALT. STRATEGIES						
	L/S Equity						
	Event-Driven						
	FI Arbitrage						
	Global Macro						
CTAs							

O/W Overweight
 N Neutral
 U/W Underweight

*Duration
 Long – 7-10 years
 Intermediate – 5-7 years
 Short – 3-5 years

Source: Kleinwort Hambros 11-May-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 remain Underweight on US equities and stress the importance of diversifying into more cyclically-sensitive, undervalued sectors.
Eurozone	In late April, Eurozone equities reached their highest level since early 2008 on the back of rising optimism about the post-pandemic recovery. We remain Overweight.
UK	The country is gradually easing lockdown restrictions which should boost cyclical recovery and bolster investor sentiment. We remain Overweight.
Japan	Japan is well-positioned to thrive on strong Asia-Pacific trade and growth. We remain Overweight.
Emerging (EM)	After peaking in mid-February, EM equities have given up part of their outperformance over the past twelve months. Nonetheless, outlook and valuations remain attractive and we are Neutral.

FIXED INCOME

Sovereigns	Government bond yields have largely stabilized following their surge throughout Q1. We continue to hold protective positions across our core strategies but remain Underweight overall.
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 tightened further towards historic lows. We remain Underweight.
High Yield**	High Yield spreads remain close to historic lows and we've stuck to an Underweight stance.
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 expect range-bound trading, but the second half of the year should favour the euro zone as it begins to catch up with the US in vaccinations and economic growth.
GBP/USD	Sterling has gained 2% over April and into May as a strong recovery from the coronavirus crisis becomes evident.
EUR/GBP	Post-Brexit disruptions may weigh on sterling against the euro in coming months.
USD/JPY	We forecast that USD/JPY will consolidate just below current levels but expect increased volatility as risk sentiment waxes and wanes.
Emerging	With US rates set to grind gradually higher, we expect EM currencies to trade sideways for now.

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 rebounded strongly from their March-lows, almost cancelling its YTD losses. We 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 11-May-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)

FIXED INCOME

Little Appeal

Today's environment of reflating economies and spiralling debt to finance fiscal largesse presents a challenging backdrop for bonds. Our convictions are unchanged – Underweight in both sovereigns and “credit” (i.e., IG and HY corporate bonds).

Sovereigns

US. After a rapid rise from 0.51% last August to 1.74% at end March, 10-year Treasury yields have paused for breath as bond prices recovered (yields move inversely to prices). These moves have been driven by rising inflation expectations – fiscal spending is massive and raw material prices are rising sharply – and the dissipation of pandemic worries as investors look forward to a steady reduction in lockdown restrictions. Although we expect this year's rise in inflation to be transitory, we see Treasury yields trending higher towards 2.0% over the near future.

UK. The yields on 10-year sovereign bonds (“gilts”) have also risen sharply from last August's all-time lows of 0.08% to 0.85% in April of this year. Investor confidence has been bolstered by the UK's world-leading progress in vaccinations but inflation expectations are also a factor – 10-year breakevens (calculated by subtracting yields on inflation-linked bonds from those on fixed-coupon gilts) has risen to 3.49%, close to the highest level since 2008. Nonetheless, we do not expect the Bank of England to bow to any transitory price pressures, providing breathing room for gilts to largely stabilise at current levels.

Eurozone. Yields on 10-year German Bunds have followed a similar upward trajectory to US Treasuries, recently reaching -0.20%. The size of the move has been more modest than in the US given that deflationary factors are more firmly entrenched in the Eurozone, which remains mired in recession. Moreover, the ECB has stepped up the pace of its €1.85tn asset purchase programme, dispensing €24.9bn per week since Easter, compared to a €18.3bn average in February. Nonetheless, with cyclical recovery looming in the second half of the year, we expect Bund yields to follow Treasuries higher.

Credit

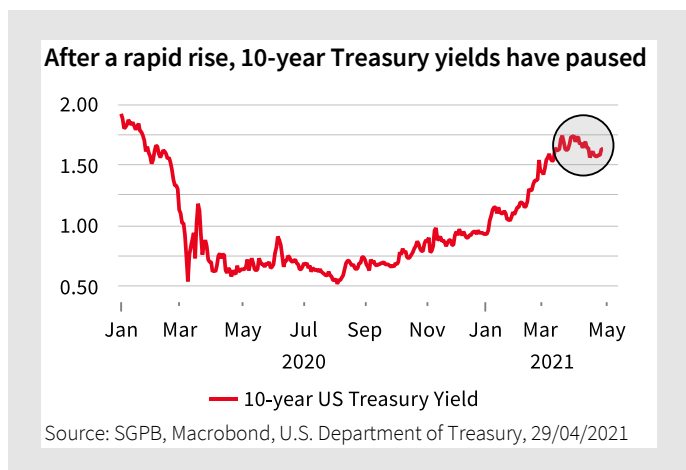
US. Tight yield spreads offered little protection against any rise in Treasury yields and as a result the sector has registered negative performance year-to-date. Subsequently, spreads have tightened further to 196 bps, close to 2018's historical lows, and we see little reason to change stance. HY spreads at 310 bps are close to 2007's pre-crash lows and also offer little appeal.

UK. IG spreads over gilts are back at historical lows as are those on speculative-grade bonds, offering little value for income-seeking investors. The macro backdrop remains supportive but such narrow spreads will provide little protection if conditions deteriorate unexpectedly. We remain Underweight.

Eurozone. Yields on euro IG bonds have risen modestly from -0.02% in mid-December to 0.16% and remain deeply unattractive with headline inflation set to rise further from March's 1.3%. Downside in prices will be cushioned by faster ECB purchases but we remain Underweight. HY bonds in EUR have registered steady performance in recent months on the coattails of the rally in Eurozone equities. However, yields remain close to historic lows and we've stuck to an Underweight stance.

Emerging Market (EM) debt

Despite rising US rates, EM sovereign bonds in USD still look attractive, offering yields of around 4.5%. Selective investment is advised - Asia stands out among its peers, featuring generally higher credit quality and supportive macro backdrop. Nonetheless, we do not feel the spread warrants the credit risk that most EM issuers carry and we remain Underweight.



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EQUITIES

Uptrend Intact

Inflows to global equity markets have been extremely strong since November’s vaccine announcements, pushing many indices to all-time highs. Investors should rotate portfolios towards a balanced mix between Growth and Value.

US. With US Treasury yields easing lower in April, stocks rallied hard to reach new all-time highs. Rising yields are a key risk for equity valuations – a higher discount rate reduces the net present value of future cash flows. Optimism was also bolstered by robust corporate profits for Q1 – with over half of S&P 500 members having reported, earnings are up 52% YoY, 24% higher than consensus forecasts.

Valuations, however, are demanding – the price-to-cash flow ratio is currently 49% above its average over the past decade – and signs of exuberant optimism abound with speculation rife in large and small companies alike. We continue to encourage investors to balance portfolios between Growth – where we find much of the overvaluation – and Value in more cyclically-sensitive sectors and regions. We are Underweight.

UK. We keep our Overweight in UK equities. Earnings growth this year will outstrip most other developed markets – the consensus expects +54.5% YoY – and the UK is the cheapest market we follow. It trades on a 6% discount in price-to-cash flow compared to the last decade’s average and pays a 4% dividend yield. With over half of the population having received at least one vaccine jab, the country is gradually easing lockdown restrictions which should boost cyclical recovery and bolster investor sentiment.

Eurozone. In late April, Eurozone equities reached their highest level since early 2008 on the back of rising optimism about the post-pandemic recovery. Vaccination programmes accelerated last month helping bring new COVID-19 infection rates down and governments have begun to announce roadmaps for easing lockdown restrictions across the continent. As a synchronised global recovery gathers momentum, economies which suffered deep recessions (such as the Eurozone) are set to outperform those where the downturn was milder (for example, the US).

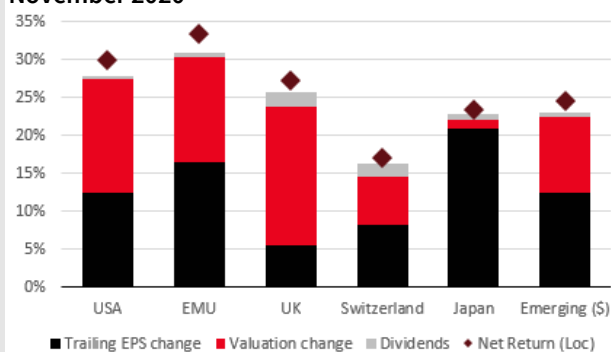
Moreover, the sector breakdown across Eurozone markets is skewed towards more cyclically-sensitive Value stocks. As a result, the analyst consensus expects a sharp acceleration in Eurozone earnings growth this year to 38.4%, outstripping the ~30% growth forecast for US equities. We remain Overweight.

Japan. After tracking global stock markets closely since end 2019, Japanese equities underperformed in April, with no real catalysts other than some modest JPY strength against the dollar and the reintroduction of pandemic restrictions. Analysts have continued to revise earnings forecasts higher – +5.7% over the past three months – while valuations remain relatively attractive. Japan is well-positioned to thrive on strong Asia-Pacific trade and growth and we remain Overweight.

Emerging Markets. After peaking in mid-February, EM equities have given up part of their outperformance over the past twelve months. Nonetheless, we remain constructive: The International Monetary Fund recently upgraded its 2021 GDP growth estimate to 6.7% and analysts continue to revise earnings expectations higher while valuations remain reasonable at 14.7 times 12-month forward earnings. We are Neutral.

Global Opportunities. We see increasing value in Environmentally-focused 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).

Performance breakdown (in local currencies) since November 2020



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CURRENCIES

Growth differentials to give FX direction

The dollar has struggled following the easing of US Treasury yields. We expect the pressure to continue in case of a synchronised cyclical recovery in the second half of the year.

Dollar Index. Following a precipitous fall last year, the trade-weighted US dollar has regained its composure and it is now flat year-to-date. However, the second quarter once again witnessed a sell-off following fears of dollar debasement in the face of enormous US stimulus. Collectively, President Biden's spending plans equate to about 27% of GDP, raising inflation expectations which, in turn, pushed real yields on 10-year US Treasuries back down to about -0.80%.

GBP/USD. Implied volatility is on the rise mainly due to politics, including post-Brexit trade rumbles and Scottish Referendum risks. That said, GBP/USD has been grinding upwards, crossing the key 1.4000 level which had been acting as resistance. We expect the dollar-side of the cross to be more influential with the market focusing closely on the Federal Reserve's economic forecasts and President Biden's stimulus measures. Overall, we remain with a flat view in the short term and expect a slight move up over the next year to 1.4200.

EUR/USD. The single currency has taken on the 1.2000 level, but the real test will be to hold onto this. The European economic recovery is likely to be disjointed, with some countries lagging others in vaccination progress. Looking at EUR/USD over the past ten years, the average price is 1.2100, which is not far from current levels. On the downside, the 1.1700 level remains a key support, and on the topside resistance comes in at 1.2200. In conclusion, we remain neutral on this currency pair and our forecasts are unchanged.

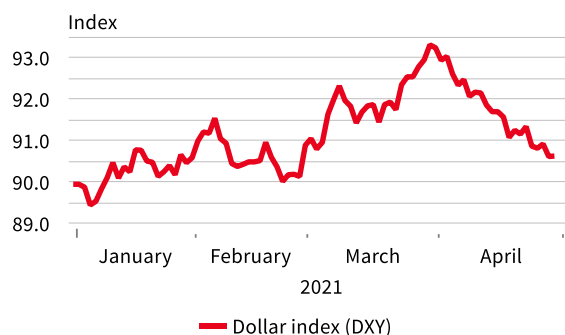
EUR/GBP. EUR/GBP has drifted lower from the 0.8700 level. It is now targeting 0.8600, where the 50-day moving average lies. Technically, following a failed break of 0.8700, the pair remains in neutral territory. We expect EUR/GBP to get comfortable at current levels and trade between 0.8600 and 0.8700 in the weeks ahead.

USD/JPY. USD/JPY has retreated from overbought levels around 111 in late March after a rapid Q1 rally from 103 in early January to settle just under 109 in April. However, expectations of US fiscal spending and reflation have widened Treasury yield differentials versus Japanese Government Bonds, which should keep the US dollar well bid. Looking ahead, we forecast USD/JPY to consolidate just below current levels but expect increased volatility as risk sentiment waxes and wanes.

EM currencies. With US Treasury yields easing lower through April, JP Morgan's index of emerging currencies has regained much of the ground lost from March – as many emerging nations borrow in greenbacks, traders fear periods of rising rates and dollar strength. Fundamentals remain mixed: Turkey's President recently fired the country's central bank governor, who had attempted to raise rates to buttress the currency and cap inflation. Brazil, Mexico, Indonesia and India on the other hand have all seen dramatic improvement in their current account balance during the pandemic. With US rates set to grind gradually higher, we expect EM currencies to trade sideways for now.

USD/CNY. Economic activity in China has snapped back from 2020's draconian lockdown – YoY growth hit 18.3% in Q1 while the trade surplus continues to grow – and the authorities have begun to roll back some of last year's policy-easing measures. This stands in stark contrast with Washington's fiscal profligacy and chronic trade and current account deficits. Chinese government bonds still yield a healthy premium to US Treasuries and it is no surprise that the CNY looks like it will be resuming its upward march against the dollar.

The US dollar has fallen back against major currencies



Source: SGPB, Macrobond, ICE, 29/04/2021

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ALTERNATIVES

Rising Jewellery Demand for Gold

As economies reopen, expanding oil demand will be met by increased output, leaving prices in a range. Gold prices have risen strongly over the last few weeks. We prefer hedge fund strategies which hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short.

Commodities

Oil

At their meeting in late March, OPEC and its allies (OPEC+) decided to commence gradual increases in output, starting with 350,000 barrels per day (b/d) in May, followed by another 350,000 in June and over 440,000 in July. The cartel and Russia believe that demand should continue to recover steadily as the US and UK have made rapid progress in vaccinating their populations and have eased travel restrictions, helping improve mobility measures and thirst for oil.

Despite the recovery in oil prices – up 32% year-to-date – the increase in US oil rigs has been sluggish since last summer’s lows. It takes time and capital to add new rigs and numbers remain around 50% below pre-pandemic levels. As a result, US output remains around 2 mb/d below pre-crisis levels, which has probably emboldened OPEC+ in its increases – major players like Saudi Arabia are reluctant to let prices rise too high for fear of encouraging a new US shale boom.

Nonetheless, we expect US production to rise steadily from here along with additional OPEC+ increases, which will help meet post-pandemic demand. All in all, Brent prices should continue to trade between \$60 and \$70 in coming months.

Gold

Central bank gold purchases continued their recovery in Q1, up 20% to 95 tonnes (t). However, buying remained well below the 250t record highs in Q3 2018. The -10% fall in gold prices in Q1 sparked heavy outflows of -178t from gold-backed ETFs – bullion came under pressure as real rates (i.e., after inflation) rose steadily over the quarter.

On the other hand, demand for gold bars and coins was stimulated by lower prices and investors accumulated an aggregate 340t over the quarter, well above the 5-year quarterly average of 249t. Jewellery demand also continued its recovery from last year’s slump, up 52% YoY to 477t. The improvement was particularly noteworthy in China, where demand reached 191t - the highest quarterly total since 2015 - and India, thanks to a cut in import duties.

These factors have helped push gold well above the \$1800 mark, fighting back from its lows and almost cancelling its year-to-date losses. We continue to hold a reduced position in Gold as an effective diversifier with a low correlation to equities. Indeed, it tends to be negatively correlated when equities are under heightened selling pressure.

Alternative investment strategies

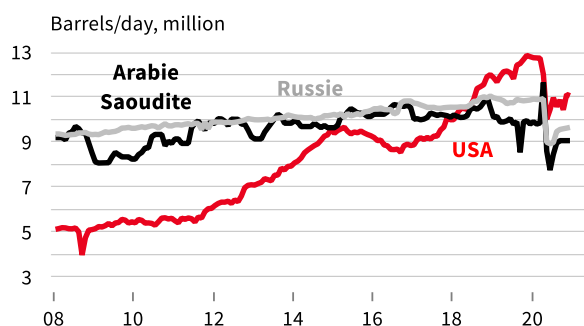
Hedge funds: Prefer Merger Arbitrage type strategies

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).

Oil production has started to increase



Source: SGPB, Macrobond, EIA, 03/2021

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