A delta-shaped backdrop

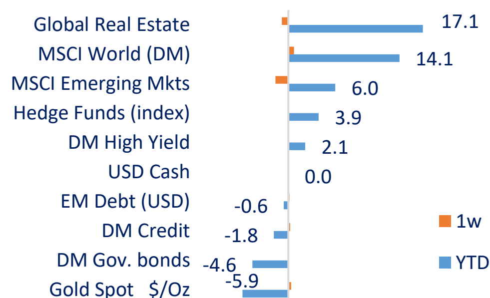
- **H2-2021 starts with a trifecta of questions on the economy, the direction of policy, and the virus**
- **Last week's abundant data draws an encouraging picture on growth and monetary support**
- **But all the ingredients are in place for a potentially turbulent summer**

The currently fast-spreading variant of covid has been designated by the triangle-shaped Greek letter Delta, which in mathematics is used to represent a difference.

The symbol is perfect: the investment landscape is also a triangle between the economy, the direction of policy, and the virus, and the scenario is all about divergences abating between the US and the rest of the world. On the former, last week's deluge of data drew a clearer picture of an already known scenario. US growth is elevated, but not accelerating anymore. The ISM manufacturing came out at 60.6: strong, but below expectations. Job creation in June beat forecasts at 850k, but hours worked stalled and the unemployment rate unexpectedly rose. Bottom-line, data is good enough to justify optimism, but not hot enough to rush the Fed to tapering. These two edges of the triangle look supportive in the US. However, H2 is all about the accelerating economies in regions which had been the most affected by covid. The third edge of the triangle, the virus, is crucial. On that front, news are mixed. On the one hand, the Delta variant is spreading fast – and another mutation can happen anytime. On the other, new cases are trending down in key emerging regions like India, vaccines manufacturers are confident in their effectiveness, and governments are not considering new drastic restrictions.

We remain in the constructive camp, and expect the incoming economic data on services, and the imminent start of the Q2 earnings season to confirm. However, the combination of virus uncertainty, elevated valuations and very bullish positioning could put another triangle-shaped letter in the spotlight: the V of volatility. This is why our overweight equity is associated with significant positions in cash. Stay safe.

ASSET CLASSES USD % TOTAL RETURN, YTD 2021 LAST WEEK



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Cross-asset Update

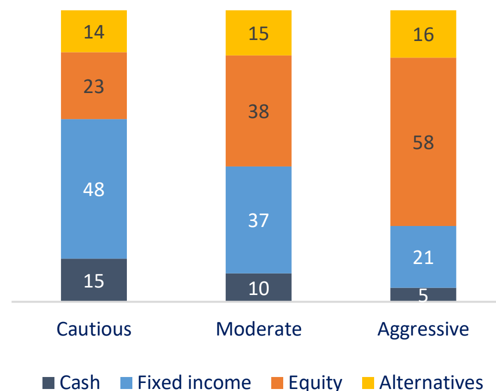
With a few notable exceptions, the major central banks are looking to withdraw liquidity from the system by reducing the purchase of domestic treasuries in order to avoid the risk of the overheating of the economy, or that of financial instability. Everybody remembers the so-called 'taper tantrum' episode, the sell-off across stocks and bonds which took place in 2013 following Ben Bernanke's announcement that the bond-buying program would be gradually reduced. This is the reason why the Fed this time is telegraphing its intentions well in advance, starting to 'talk about talking' about tapering, as per Powell's words, or mentioning that 'people are on notice that these adjustments are coming', as Dallas Fed Kaplan made clear a few days ago. The Bank of Canada and the Bank of England are leading the process, the former already tapering, the latter expected to be done with it by year-end, while the Fed and the Reserve Bank of Australia would be starting next year. The ECB and the Bank of Japan should fall only much later into line.

This, alongside the recent shift in stance on policy rates at the June meeting, when Fed officials raised their median projections for rate hikes in 2023, has important implications for the US dollar. Put it simply, the monetary authorities tapering first should begin the tightening process before others. Also, rising US rates will not bode well for some EM countries, where inflationary pressures will be forcing local central banks to tighten policy, which in turn would pressure growth and add to the pain of the domestic currencies. The dollar started 2021 on the backfoot, with consensus overwhelmingly convinced that QE forever and rate hikes nowhere to be seen on the forecast horizon would warrant a structural bear market in the world reserve currency. Since March this year speculative futures positioning has turned net dollar-long, an occurrence which in the past subsequently coincided with gains for dollar. It now seems that the bear market has once more being delayed and that one should at least be neutral, if not leaning bullish for the second half of the year, which should see rising US yields ahead of the beginning of the tapering implementation.

At the same time, one should wonder whether the tapering story should be taken at face value for the longer term. The Fed has boxed itself in a monetary trap, whereby yields are still at historically low levels and ever larger bond-buying programs have been necessary to achieve some degree of monetary accommodation. How can stimulus be withdrawn without thinking about the consequences in terms of debt-servicing costs as yields rise above tolerable levels? It seems to us that the most probable scenario will see the Fed at some point backtrack on its tapering implementation to continue with some form of easing, with yields capped at levels still in keeping with acceptable costs for the Federal debt. But what if instead of this blue-sky scenario inflation does not come off as much as projected from the currently elevated levels?

It seems that the Fed is finding itself into a tighter and tighter spot, where policy dilemmas one day could be more the norm, than the exception.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

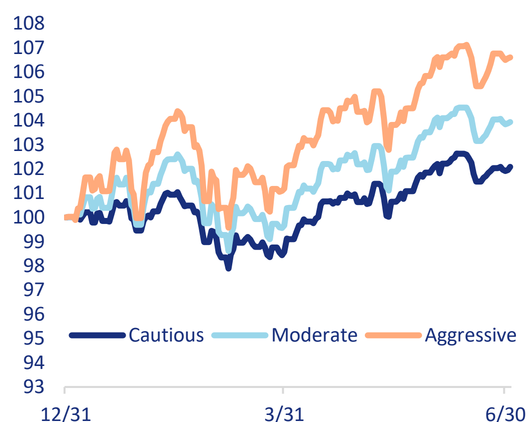


TAA – RELATIVE POSITIONING – MODERATE PROFILE

	UW	N	OW
Cash		=	
DM Gov.	<<<<<<		
EM Debt			>
DM Credit			>
DM H. Yield			>
DM Equity			>>
EM Equity			>
Gold		=	
Real Estate			>
Hedge Funds		=	

UW/N/OW:Underweight/Neutral/Overweight

TAA – 2021 INDICATIVE PERFORMANCE



Source: Bloomberg. CIO Office calculation based on TAA applied to market indices, net total return in USD.

Fixed Income Update

It is that time of the year again. Short-term rates could have a volatile period with the US Debt ceiling back to the fore on 1st Aug, which would throw a spanner into the Federal Govt spending plans. The debt ceiling was suspended for two years in July 2019. The previous such episodes in 2011 and 2013 created heightened periods of volatility in the rates market and led to S&P cutting the US sovereign rating to AA+ from AAA. While there has been a deluge of liquidity due to the Fed's balance sheet expansion and fiscal stimulus, the Treasury has reduced issuance of T-Bills by more than $680bn in the first half of the year, leading to a demand-supply mismatch for short-term funds. This was the main driving factor why FED played around with some short-term rates in its June FOMC.

We are past the halfway mark for this year. It has been "A Tale of Two Quarters." In Q1 2021, we observed growing fear of inflation gripping the markets. 10-year Treasury yields increased from 0.90% to 1.74%. Long-duration and safe-haven assets underperformed while the riskier segments of the asset class performed well. Q2 2021 saw the inflation fears easing up and culminating with the Fed's June FOMC meeting clearly outlining rate hike expectations. Markets came around to be in sync with the Fed. 10-year treasury yields partially reversed their earlier trend to end the quarter below 1.5%. This resulted in a reversal of fortune for the long-duration assets such as EM Sovereign Debt that returned more than 3% in the second quarter.

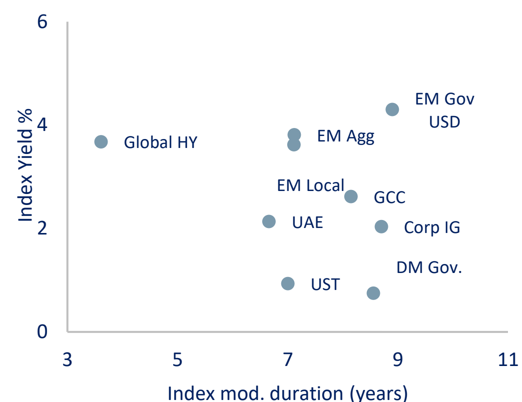
As we move into the second half of the year, the landscape for the credit investors seems calm on the surface, while undercurrents make us more cautious. We expect the 10-year yields to move higher as the current levels look unsustainable to us, with Jobs data remaining the critical indicator for monetary-policy decision making. Credit spreads, already tight, to end the year above previous tights achieved in 2018. Clients are advised to take profits on High-Yield corporates given the above 2% gain in the segment. We prefer to allocate more funds to Emerging Market Debt as the idiosyncratic risks we observed seem to be receding. We expect primary market deals to slow down in the second half as most of the regular issuers have tapped the markets and front-loaded their refinancing requirements. GCC primary markets came into the focus last week as Qatar Petroleum tapped the markets for the first time in a decade to issue the largest EM bonds deal this year by selling $12.5 Bn of multi-tranche securities.

Lastly, the risks to our constructive views simmer under the surface. The upcoming US debt-ceiling, the blow-out of the Covid-19 delta variant, and impending Fed taper announcements muddy the calm waters. Our advice to the clients would be to take some risks off the portfolio as we expect carry to be generating the majority of the future total returns this year.

FIXED INCOME KEY CONVICTIONS

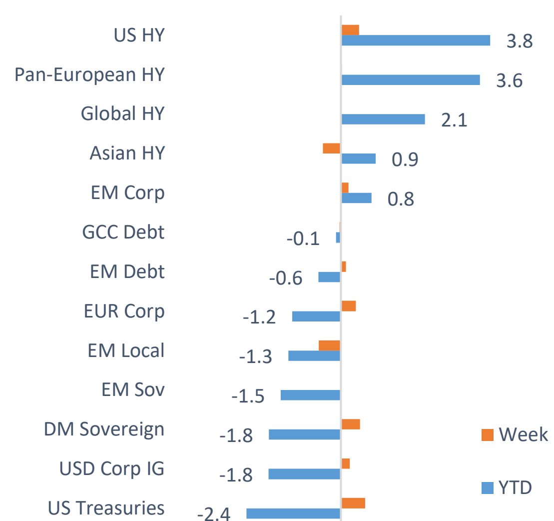
DEVELOPED MARKETS
UW DM Government
OW Credit (Cau. & Mod.)
OW High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

FIXED INCOME SUB ASSET CLASS RETURNS (YTD, LAST WEEK)



Source: Bloomberg

Emirates NBD PRIVATE BANKING

Equity Update

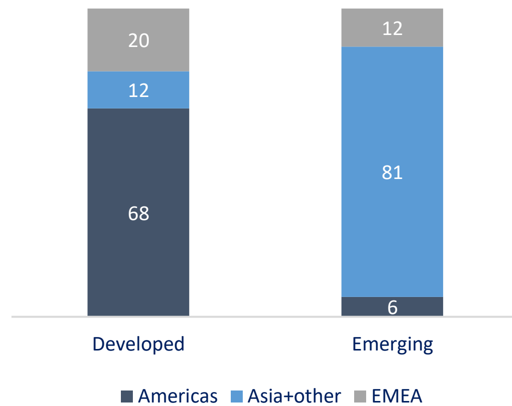
A good first half in 2021 for equities, continued into the first couple of trading days in July. The S&P 500 Index has posted seven straight days with new highs, as Technology which is 40% of the index incl. Communication Services, rallied amid a decline in Treasury yields, despite a stronger-than-expected June nonfarm payroll report. The gains of last week extend a strong stretch for stocks, that began post the pandemic induced sell off in March 2020. In H1 2021, developed market equities (+13%) saw an almost uninterrupted trajectory of gains from both Europe and the US, whilst Japan performance was choppy. Emerging market equities (+7.5%) were lower, with a large weight of China, which reversed its euphoric Jan start, ending H1 only slightly up. India ended H1 +12%, while the outstanding performer was the UAE with the Abu Dhabi Index +41% and the Dubai Index +16%. Global equities have rallied on exceptional Q1 earnings growth, with estimates for 2021 for 30 to 50% EPS growth across EM and DM economies with global economic growth estimates revised up and the reopening of vaccinated countries, leading to strong PMI's and consumer demand. Sovereign bond yields are back in a safe zone for growth stocks, as inflation fears are seen as transitionary and tightening by Central banks some time away. Excess savings have led to equities receiving record inflows at over $600 bn in H1 2021.

Whilst value has been the stronger factor in 2021, Q2 was positive for growth sectors. The tech sector, which was close to flat in Q1, rose +10% in Q2, in line with the 10 Year Treasury yield which moved from 1.74% to 1.47%. There should be more upside as tech valuations are no longer stretched and growth remains strong. In Europe, the reflation trade has dominated with shares in mining, industrial, and financial companies outperforming. Globally, it's been a broad-based rally and whilst energy and financials have seen the strongest performance this year, Q2 saw Real Estate, Tech and Telecom pick up. Financials recently gave up some of their gains with yields falling, but it's a good time to accumulate quality banking stocks as yields will start to rise, as we get closer to monetary policy tightening. Post a successful stress test, buybacks and dividends for the US banks are back as are dividends for European banks, no longer constrained by the ECB.

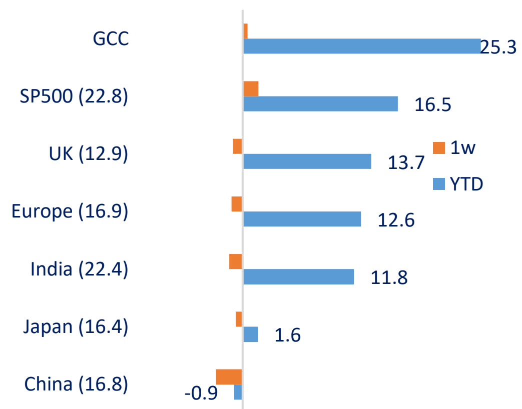
While a lot of the positive news is priced into markets, and we will see bouts of volatility, we remain constructive on further gains though not at the scale of H1. The Vix is at 15 compared to a 10 year average of 20, reflecting the current calmness of the markets which are taking the virus resurgence in their stride as the global vaccination programme accelerates.

Real estate globally is seeing a rebound as everyone wants a larger home post the pandemic lockdowns. The work culture has been redefined and many companies plan to allow employees to work 2-3 days from home on a permanent basis. Dubai Q2 villa prices are estimated to have risen by 6.3% y/y. The Case-Shiller U.S. home-price index for April rose 14.6% y/y, the fastest annual rate in more than 30 years. In the U.K. Nationwide said that British house prices rose 13.4% in June y/y the largest annual rise since 2004. Malls globally are also seeing increased footfall.

EQUITY RECOMMENDED REGIONAL POSITIONING

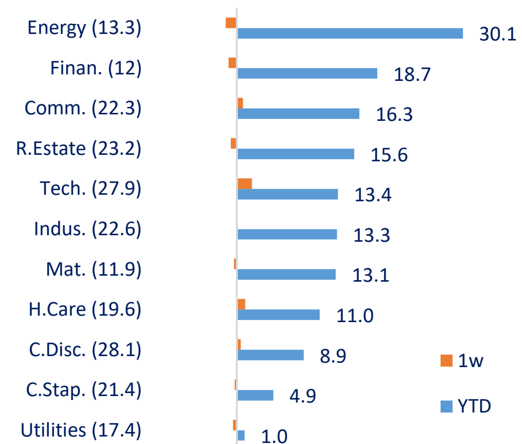


MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE



Source: Bloomberg consensus. MSCI Indices unless specified.

GLOBAL SECTOR PERFORMANCE (TR, US$) AND 2021PE



Source: Bloomberg consensus. MSCI All Country World sectors US$.

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