Turbulence ahead, risk-taking more selective

- **H1-2021 ended well, but H2 starts with volatility and dispersion**
- **This should continue, fueled by uncertainties on the virus, growth, inflation and policy responses**
- **We remain constructive but have made some tactical adjustments**

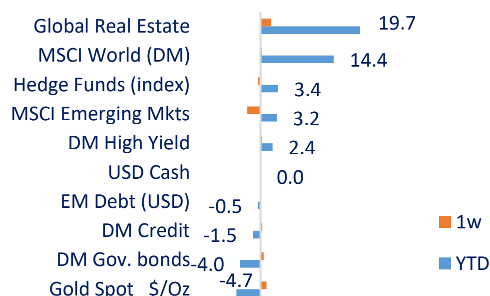
The first half of the year was one of the best on record for risk assets, especially for stocks and listed real estate from developed markets. Let’s be clear: the easiest part of the year may already be behind us.

At this level of valuations, markets will be sensitive to a trio of key questions. Will the current rise in infections derail growth? Will the current spike in inflation persist? And how will policy support evolve?

We do not have definite answers, but a scenario. On the virus front, we consider that hospitalizations matter much more for the economy than headline infections, and to that extent, we find comfort in data from the most vaccinated areas: the vaccines seem to work perfectly well in avoiding the most severe cases. With regards to inflation, we keep on believing the spikes are transitory, but acknowledge that it may last longer than we initially thought. As a result, both growth and inflation support the idea that interest rates are too low. Finally, we do not expect an imminent and material change in policy support, especially on the monetary side. The US should talk about tapering, but not start it in the coming months. The ECB has just shifted to a more dovish inflation target, and no country in Europe can afford a higher cost for their sovereign debt. Finally, China just announced a 50 basis points cut in its RRR, to support to growth, credit and signal flexibility.

Against this backdrop, we have adjusted our tactical asset allocation. We have downgraded High Yield to Neutral (from Overweight), and reinvested half of the proceeds into EM Debt. The other half has been spread between cash, as we expect volatility ahead, and hedge funds, for the asymmetrical returns. We remain overweight equities, especially in DM. Stay safe.

ASSET CLASSES USD % TOTAL RETURN, YTD 2021 LAST WEEK



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Cross-asset Update

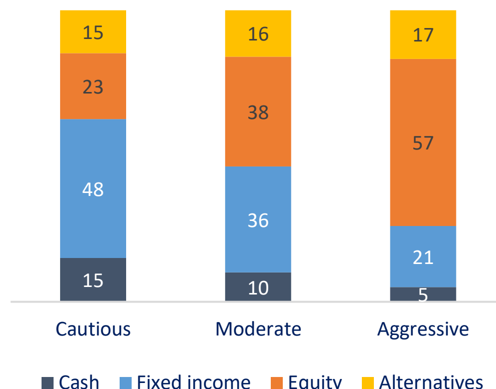
Emerging market performance has been uninspiring year to date, the MSCI EM Index is up a meagre 2% for the year, with China pursuing a more balanced growth model the main drag on the benchmark. Chinese equities as measured by the MSCI gauge are in negative territory by more than 5% and investors are wondering when they will start to see some light at the end of the tunnel. US equities may be expensive indeed, but continue to make new highs, while Chinese stocks go nowhere, pushing impatient momentum traders to keep on piling on expensive stuff. Our clients should not invest following these behavioral biases and we hold the view that they will be rewarded for patience.

Stock market weakness reflects Beijing deliberate policy decision to curb credit growth starting from late last year in order to avoid economic instability. The credit impulse, the ratio of total credit growth to GDP, peaked in November and has been falling ever since, driving a slowdown phase across the whole economy. The Chinese wariness of overstimulating activity sits in stark contrast with the absolute intention to 'go big' in America and this to an extent accounts for the difference in performance in favor of US equities. Also, in the past few months the Chinese authorities tightened regulations in a number of sectors, with interventions in data security, against monopolies and in favor of decarbonization. While in the long run these measures improve the structure of the economy, in the shorter term they may have had somewhat of a dampening effect and concerned investors. Indeed, the service PMI, a key measure of business confidence, fell significantly in June, but that should reflect temporary factors related to a virus outbreak and subsequent local restrictions, as well as to chip shortages.

Beijing is well aware of the state of the economy and the People Bank of China cut its Reserve Requirement Ratio by 0.5% in a bid to support activity via increased accommodation. The most likely source of demand remains government-led investments - exports have already peaked this year with the shift in the foreign economies to service-driven recoveries not helping Chinese manufacturers and households consumption at times hampered by local lockdowns improving slowly. This combination of factors should urge the government to increase investments in the second half, so extrapolating current economic and market weakness would not be appropriate in our view. Also, sequential growth in the US is expected to moderate significantly starting from Q4, so comparables for China should start to improve.

With Chinese policy more market-friendly by late H2 investors should be taking notice.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

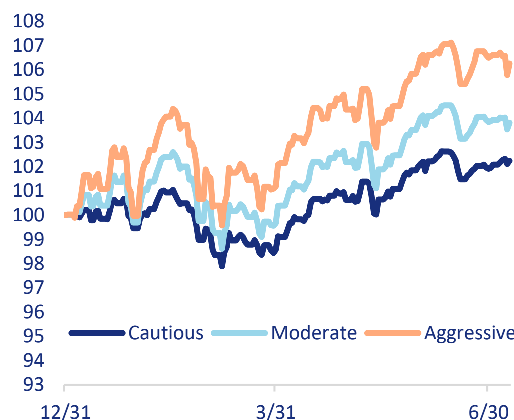


TAA – RELATIVE POSITIONING – MODERATE PROFILE

	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.

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Fixed Income Update

What a fascinating couple of weeks this have been! The US Treasury curve has bull-flattened significantly with the 10-year dipping below 1.25% and 30-year printing 1.85% intraday last Thursday, raising questions as to whether the reflation trade is about to end. Treasury yields have come up from their lows to end 11-15 bps higher at the close of the week. The core CPI-adjusted US 10-year real yield ended the week at a four-decade low -2.20%. The Fed's hawkish turn and recent mixed macro data are behind the rally, but fundamentals cannot entirely explain the phenomenon. Though the growth trends in the US have peaked, they are expected to remain extremely strong throughout 2022, and the Fed will not even think about tightening if unemployment rates stay stubbornly above 4%. Moreover, the recently released FOMC meeting minutes confirmed that the Fed is less hawkish than what the Dot Plots had portrayed. We have revised our year-end 10-year Treasury yield estimates to 1.75%. Hence, we remain short duration and advise clients to take duration exposure in tranches when the 10-year nominal yields move upwards of 1.45% at the least.

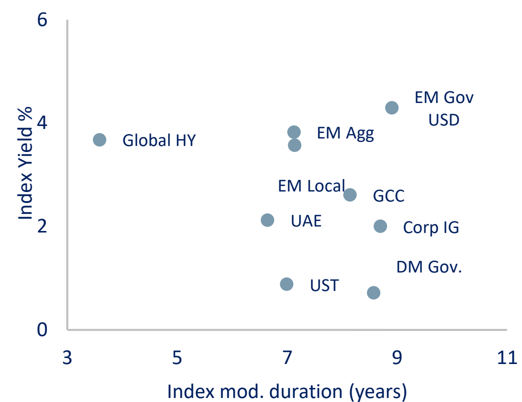
The market tends to become nervous whenever there are sharp drops in the US Treasury yields. The last couple of weeks were not exceptions. Spreads widened by 5-10 bps across sub-asset classes. The bullish rally in yields, however, mitigated the effects. All the asset classes were in the green except Asian High Yield that returned -0.5% last week. The asset class has given up two-thirds of its YTD returns, highlighting the perils of chasing yields and being concentrated in a single asset class. The upcoming summer times could lead to higher volatility. Clients should be reasonable with risk cutting excess leverage and allocating a portion of the portfolio to safe-haven asset classes.

In our latest TAA meeting held last week, we booked profit in our overweight to High Yield asset class. Even though the asset class fundamentals remain strong, valuations are expensive. High-Yield spreads have compressed by 65 bps which has helped the segment to be the best performer in Fixed Income and mitigate the effect of rising yields. There might be another 5-10 bps of spread compression left on the table, but it seems prudent to be neutral on the asset class. We increased our overweight in the Emerging Market Debt, which is the only segment to have current spreads near the historical medians. Though we must admit the long duration of the asset class poses a risk to our view. Fundamentally, the segment offers value. In addition, the only major hawkish central bank PBOC has cut its reserve ratio. This could signal a pitstop for the ongoing credit tightening and effort to spur growth. This move should be positive for the onshore China IG segment. We have been advising clients to have some portfolio allocation since it provides higher diversification benefits within emerging markets.

FIXED INCOME KEY CONVICTIONS

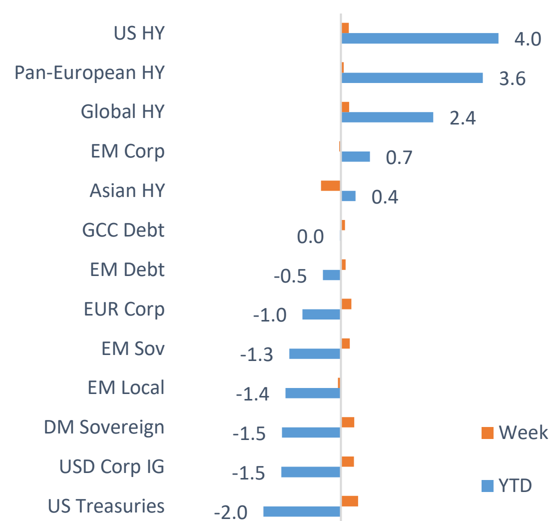
DEVELOPED MARKETS
UW DM Government
OW Credit (Cau. & Mod.)
N High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

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



Source: Bloomberg

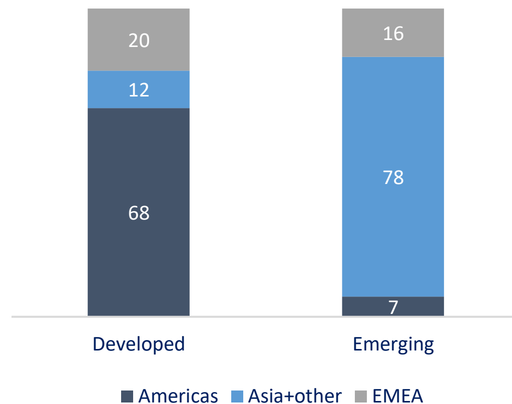
Equity Update

The first half of 2021 has seen global equities gain 12.3%, a number we had thought was a good return for the whole year. We analyse the various factors that drive equity returns to see what the rest of the year holds for equity performance. Developed markets have continued their outperformance into July with service sector activity picking up. In both the U.S. and Europe domestic leisure activities and travel is recovering – the last hurrah of recovery. In the US it is back to 80% of pre pandemic levels. The U.S. equity markets finished out a volatile week positively, increasing the weekly winning streak to three. Financials led returns, with Technology close behind as 10 year Treasuries yields seesawed, ending the week at 1.39%. This move fits in with our view to be agnostic to growth and value strategies as the strategy shift is going to continue. European markets gained in tandem with the U.S. and have mirrored US returns this year. The positive performance of DM equities came despite the potential impact of the spreading Delta coronavirus variant in the world, as hospitalizations are fewer. The technology sector shrugged off President Biden's executive order aimed at cracking down on anticompetitive practices among U.S. businesses. Asian markets however had a negative week, with China equities down 4.3% as further crackdown on China companies specially those listing in the US led to a broader market sell off.

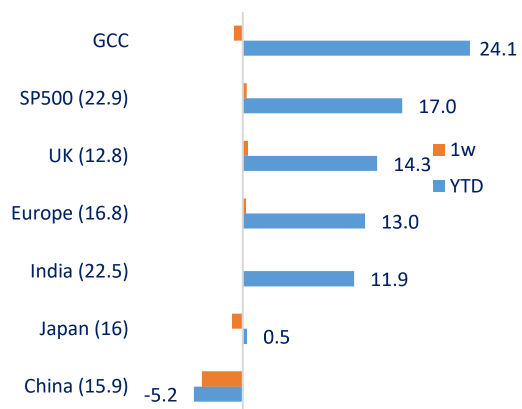
Our positioning going into the second half of 2021 is to remain overweight equities as monetary policy is still favourable and low interest rates are there for some time, strong inflows into equities continue with excess savings created by the huge fiscal stimulus and most importantly earnings growth of 30 to 50% across EM to DM economies mitigates valuation worries. We think the trajectory is still positive but definitely more volatile as seen last week. Our higher conviction on developed markets continues as they have a growth premium on both economic and earnings growth over emerging markets. Earning season kicks off next week in the US and expectations are for S&P 500 companies to grow EPS y/y by 62%, following Q1 where earnings grew by 52% y/y/. Within DM however, our tactical call is Europe on more attractive valuations and EPS growth expectations at 45% for 2021 compared to 37% for the US. European companies are a good way to position cyclically as they have a larger beta to the global recovery as 60% of revenue comes from overseas.

We think emerging markets performance awaits another quarter to pick up, as the economic recovery should follow the West. More significantly affecting China equities are regulatory issues and a US economic blacklist of 34 China entities adding to strained US-China relations. We have shifted our overweight Asia positioning to EMEA which should perform in synch with European equities. We continue our tactical overweight on the UAE. Oil prices are supportive of government revenue, trading volumes are improving, policies to encourage white collar expats is working as seen in the real estate end user volume growth. The Dubai real estate sector performance has lagged the broader market and this gap should narrow once the Dubai developers reinstate dividends. With improving cash flows this looks imminently possible.

EQUITY RECOMMENDED REGIONAL POSITIONING

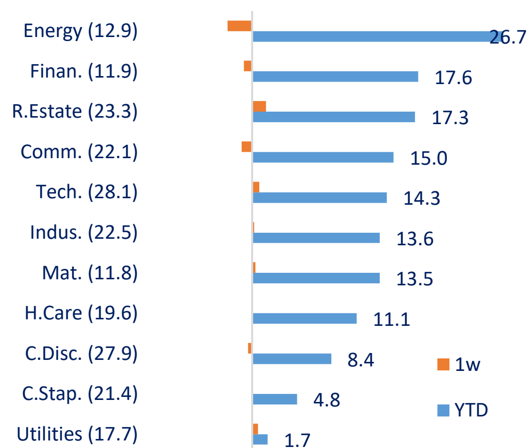


MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE



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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