One surprise can conceal another

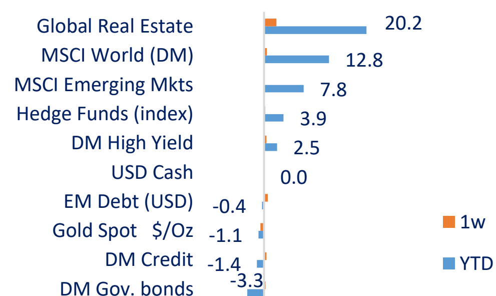
- **Inflation was stronger than expected in May, but the real surprise was to see interest rates falling**
- **The current market narrative is all about continued accommodative central bank policy**
- **We nevertheless decided some adjustments to our Tactical Asset Allocation**

Back in January, when we titled our yearly investment outlook "Investing in the Age of Magic Money", we knew that we had extraordinary times ahead. Still, we keep on being surprised. The headline US Consumer Price Index released Thursday showed a +5% year-on-year increase. There were obviously base effects, from airlines or car rentals, but the gain was higher than what the consensus had expected, including on a month. It is not just base effects. Signs of pressure abund, from the Brent crude closing at its highest level in two years (not one) to China producer prices rising 9% over 12 months. The real surprise however was the market reaction: the US 10-year treasury yield fell 10 basis points last week, and the same happened in Europe.

No doubt, magic money is at play: market participants' only focus is the Fed's monetary policy. Most of the inflation came from the reopening sectors, in line with the central bank's narrative of a short-lived phenomenon which doesn't require any action. The ECB on Thursday unanimously decided not to change anything, while the G-7 leaders all seem to agree that massive public spending is the way forward.

Markets liked it, and it was another positive week. We had many debates in our tactical asset allocation meeting. Yes, backdrop is a dream, but upside potential is shrinking and animal spirits are red hot. We decided to rebalance some of our active positions, mostly reducing our considerable overweight on stocks, to increase our positions in hedge funds. Don't get us wrong: we remain overweight equity and underweight fixed income. We are constructive for H2 but simply less outright bullish as we were in H1, and cannot exclude volatility episodes looking forward – they may even be opportunities to add to risk again. Stay safe.

ASSET CLASSES USD % TOTAL RETURN, YTD 2021 LAST WEEK



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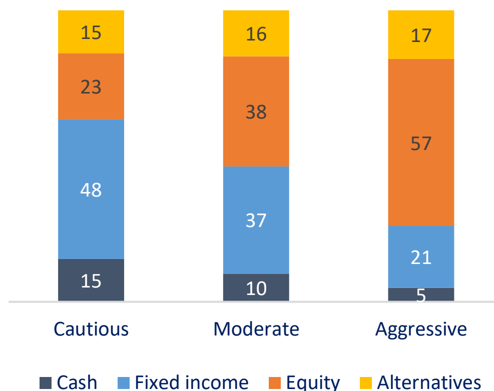
Cross-asset Update

Much ado about nothing. Despite one more strong inflation reading, US long-dated yields continue to remain stuck in a range, with markets celebrating an incredible goldilocks moment. Growth is as strong as it used to be in the good old days, liquidity is more plentiful than ever and investors are convinced that inflationary pressures will be temporary, giving credit to the Fed's claims in this sense. Many rounds of Quantitative Easing have brought the point home that monetary conditions are the most relevant market driver and one would be bothered about liquidity reaching dangerously low levels only sometime in H2 2022, when central bank balance sheets are expected to stop growing on net. What about the more immediate future? Most likely the forthcoming Fed's discussion about tapering will be enough to drive volatility, but not to upend the ongoing rally. As for the puzzle of falling yields in the face of a run up in the prices of goods, we would remark that supply shortages in full swing and households flush with savings should see inflation subside substantially only in 2022, leaving room for yields to rise eventually. Actually, past occurrences of an annualised 3-month rise in inflation in the high-single digits, which in short is what we have witnessed up to the May US CPI, saw on average yields drop rather than rise in the subsequent three months. This counterintuitive pattern could simply mean that the first-round effect of inflationary bursts is usually negative on consumer psychology, which then adjusts, so that eventually what matters is whether growth remains strong - it should this year. Bottom line: equities will keep on going up on plentiful liquidity, but watch out for tapering-induced volatility and still refrain from going long duration in spite of the lure of falling yields.

A possible pattern about a staggered recovery is starting to emerge. In simple language, China first exited the crisis and Chinese growth peaked early this year, the United States took the baton and US growth should peak in the current quarter, Europe is now catching up and its expansion rate is expected to top out in Q3. What could come next? Our best guess is that the emerging countries should benefit. In particular, it would be the EM complex ex China, as the latter is still committed to prioritising sustainability versus the shorter-term cycle. The global environment remains supportive, with above-trend growth and abundant liquidity, and the EM-ex-China GDP should swing from negative this quarter to mid-single-digit positive in the second half of 2021 according to some forecasts. Investors seem to be supporting a kind of similar narrative, as EM capital flows have remained healthy. EM equities also have a strong correlation to European stocks, currently outperforming, both falling under the value style category. We are not losing hope on the emerging countries, with EM bonds currently preferred versus DM high-yielding corporate debt and EM equities expected to stage a comeback later this year.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

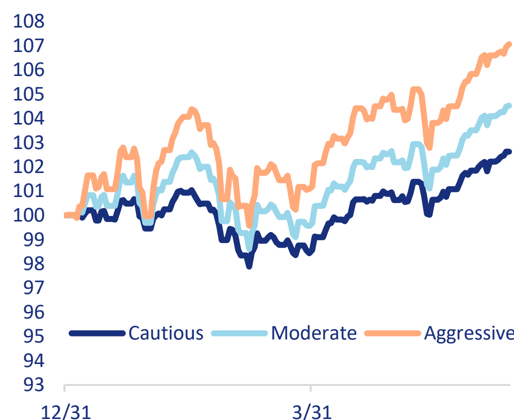


TAA – RELATIVE POSITIONING – MODERATE PROFILE

	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

Yields have done it again. This quarter, the 10-year treasury yield has come down by 30 bps from its peak despite strong inflation and low initial claims print. Various explanations are being offered, including short-covering by institutions and loss of purchasing power due to the higher inflation leading to constrained economic growth. It also seems like the market is finally coming around to trust The Fed's transitory inflation viewpoint. No doubt, there would be volatility leading up to the next FOMC meeting. However, we believe further rally from here would require dire economic data and a negative assessment of the ongoing recovery, which we think highly unlikely. Hence, our view is that the trend of yields would remain upwards. This could be a good time for clients who are stuck with long-duration bonds to redeem their positions. Both the spreads and the yields are at this quarter's lows for Emerging Market Sovereign long-duration bonds. We expect this low to be temporary before yields start moving up again.

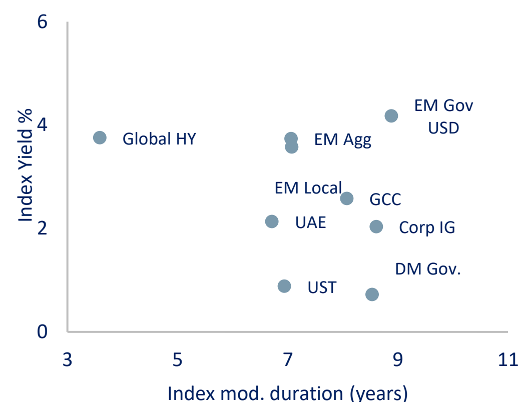
Spreads remained well-behaved across sub-asset classes. The yield volatility so far has had no effects on the spreads, and different sectors continued to derive the benefit of the lower yields. Last week marked the beginning of the unwinding of the Federal Reserve's Secondary Market Corporate Credit Facility's ETF holdings (SMCCF). So far, there has been no visible impact on the market's functioning. Thus, we expect the spreads to be well-behaved in the near term without any catalyst. However, we would do well to remember that spreads are mean-reverting, and at some point, we would see the reversal happening. Hence, selectivity remains critical in the spread products, including exposure to High Yield and Emerging Market Debt. There were 26 global corporate issuer defaults in the first quarter of 2021, the lowest quarterly defaults since the third quarter of 2019. According to S&P, default activity from the recession in 2020 has likely peaked, and the global trailing-12-month speculative-grade corporate default rate should fall in second-quarter 2021 to 4.8% from 5.4% as of March 2021. YTD total defaults stand at 45.

GCC Market saw a flurry of primary issuance last week with a mix of regular and rare issuers from the region. Saudi Aramco created a new record by selling the largest Sukuk tranche of $6 Bn in its first foray into this asset class. The three-tranche Sukuk is priced within the conventional curve according to investor expectations. Oman issued the first sovereign Sukuk of the region this year, plugging a gap in its debt maturity profile by issuing a 9-year Sukuk with 2030 maturity. Emirates Development Bank, the only Federal entity from the region to issue dollar bonds, tapped the markets for senior 5-year note. Al Ahli Bank of Kuwait issued a PNC 5.5 AT1 USD Sukuk priced at 3.875%. The pipeline continues to be firm, with DAE Funding announcing investor calls. In addition, there are expectations of KFH, Turkey, and Emaar to issue Sukuk in the coming weeks.

FIXED INCOME KEY CONVICTIONS

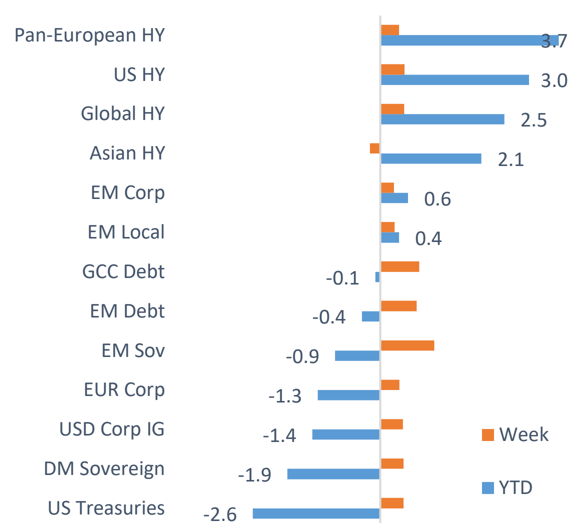
DEVELOPED MARKETS
UW DM Government
OW Credit (Cau. & Mod.)
OW High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

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



Source: Bloomberg

Equity Update

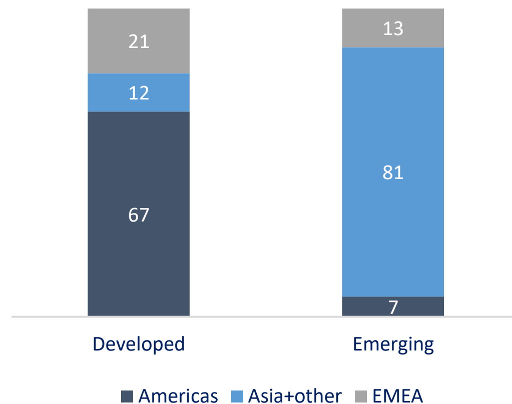
We saw a continuing pattern for stocks: global markets stay on a gradual upward trajectory, with gains of half a percent last week, no sharp drawdowns, taking ytd gains to 12%. Markets decided to ignore rising inflation pressures and enjoy the return of demand, especially in the mobility sector with OPEC forecasting strong oil demand growth, accelerated by the global economic recovery. This is reflected in energy which continues to lead global sector returns, as well the UAE and KSA markets which added to already strong ytd gains. Financials took a bit of a back seat last week, with technology stocks gaining as Treasury yields fell. Healthcare was the best performing sector with genomics and biotech stocks trading up, following Biogen announcing an Alzheimer's therapy. The high R&D spend in the healthcare sector is reflected in the continuing announcement of new discoveries whether it be vaccines or health tec innovation. The S&P 500 made a new high despite higher than expected U.S. consumer price inflation. European equities higher, with most sectors positive and supported by an unchanged monetary policy stance from the ECB which promised to continue to accelerate its bond-buying activity to solidify the economic recovery.

Post our monthly strategic review we retain our overweight on equities with record earnings growth offsetting the higher valuations and support on consumer spend from strong fiscal stimulus and benign monetary policy, with a low rate regime. Our slightly higher overweight positioning for DM continues, as the economies here have led the vaccination drive and economic growth is currently leading EM countries. Our bias however has shifted from the US where we now have a neutral stance and focus more on alpha generation through selection, to an Overweight positioning on Europe which has a relatively stronger eco and corporate profit outlook, following the US' path on recovery. On EM equities we are overweight but reduce our Asian bias to go neutral EMEA in line with Europe's recovery. Our strong UAE conviction is retained with many economic, tourism and housing data points supportive of corporate profits accelerating and the attractive continuing low valuations.

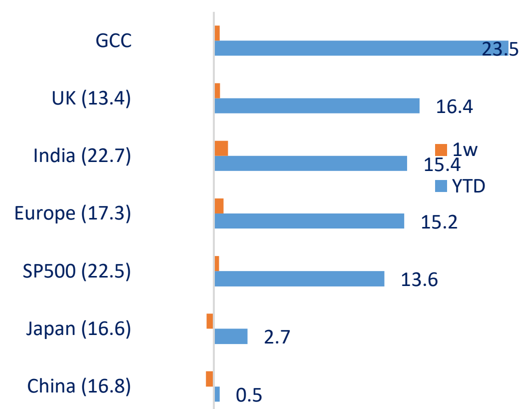
2021 has seen the threat of inflation halting the dizzy gains markets had grown to expect from tech stocks, which had led the post-pandemic market rebound. And yet, in spite of rising inflation, an about turn in rising 10-year yields which are the discounting factor for long term future cash flows led to a tech/ FAAMG rally last week, The Nasdaq rose 1.8%, catching up with the S&P 500. Shares in U.S. technology giants did not react to a deal agreed by the G7 for a minimum global corporate tax rate of 15% as the focus now shifts to the G20 countries for a wider agreement. The tax deal won't affect tech companies unless it's agreed with countries such as Ireland, where many have large bases.

On the value/ growth debate we advocate buying growth/ quality at reasonable valuations. Stay broadly diversified and follow the demand cycle. For the short term focus on recovery sectors but for the medium term keep cognizant of future global trends be it a focus on health and wearables or ESG concerns. EV and 5G are still nascent in adoption and plenty of room for further

EQUITY RECOMMENDED REGIONAL POSITIONING

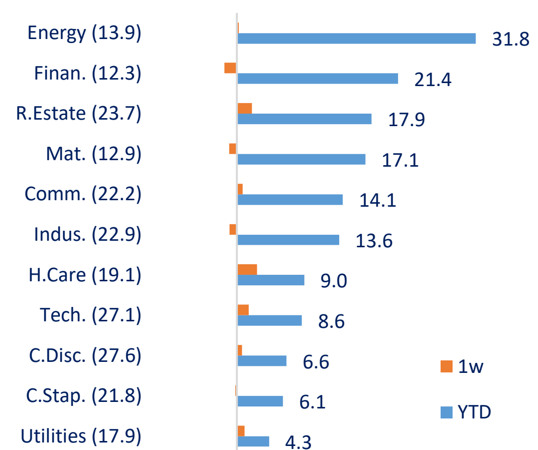


MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE



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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