Emirates NBD
PRIVATE BANKING

INSPIRING WHAT’S NEXT

Better policy visibility supports markets

- **Global stocks gained following US Congress significant progress on infrastructure stimulus**
- **Flash PMIs confirmed a strong global economy with Europe and Services now accelerating**
- **Our scenario is unfolding and we still believe that interest rates are too low. TAA positioning unchanged**

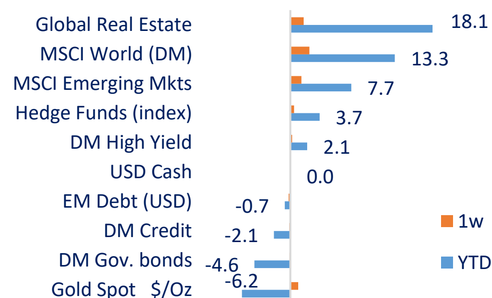
For most of last week, market participants were busy adjusting to an evolving monetary backdrop: the Fed had clearly taken note of better than expected growth by moving forward their interest rates projections at the June FOMC meeting, and the rise in inflation was confirmed by the core PCE data. Many Fed officials came out with various speeches, sometimes hawkish, sometimes dovish, which together reinforced a clear message: the economy is strong, the tapering debate is open, but inflation is transitory and the first hikes in interest rates should not happen before late 2022 at the earliest. Overall, the communication looks brilliant: the shift is now clear, but a shock was avoided.

Flash PMIs released at the same time indeed confirmed that the global economy is doing very well. The leadership for the US and from manufacturing sectors is gradually shifting to Europe, catching-up, and services, which benefit from the reopening. Of course, everything is not perfect on the virus front but so far the situation looks under control in most developed regions.

At the end of the week, another good news hit the tape: a bipartisan agreement on an infrastructure package in the US, which should inject $1.2 trillion over 8 years.

No surprise then that global stocks had an excellent week, adding 2.4% in DM and 1.4% in EM. Interest rates ended the week marginally higher, at 1.52% for the 10-year, which by contrast keeps on surprising us. While we largely agree with the fact that inflationary pressures are transitory, the transition could be long and the absolute level is too low for us. This is why we keep a clear underweight position on government bonds and expect some turbulence in the summer, even if the big picture remains overall favorable. Stay safe.

ASSET CLASSES USD % TOTAL RETURN, YTD 2021 LAST WEEK



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Cross-asset Update

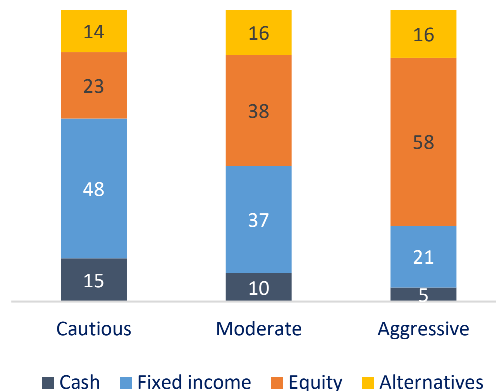
The main risk-event investors are focusing on for the second half of this year is the tapering of asset purchases, in other words the winding down of bond-buying programs which were started by the Federal Reserve in various rounds after the Great Financial Crisis, the largest one implemented after the pandemic and still ongoing. Jay Powell is expected to shed some clarity on tapering at the late-August Jackson Hole meeting and by year-end a public statement should be released about its implementation, planned by the Fed as per consensus for the beginning of 2022. This is key to the direction of long-dated Treasury yields, which were crushed by the Fed's asset purchases and are likely to be pushed higher by their reversal, Quantitative Tightening. If history is anything to go by, yields should rise from the Jackson Hole announcement into the early-2022 implementation timeline. This would constitute a headwind for long-duration assets like gold and EM market hard-currency debt, with most downside risk more likely for the former than the latter.

The tapering overhang should be weighing on gold and in our view it is hard to see material upside till investors get more visibility on Quantitative Tightening. Weakness should set in as we approach QT implementation, with some muddle-through in between. We hold the view that investors should stay sidelined till the Jackson Hole Symposium and then reassess based on the Fed's message. Key support levels for gold are at $1,700 and 1,600/oz, with the former likely to be breached, if real rates start rising later this year as per our assumptions. Former Treasury Secretary Larry Summers sees US inflation ending 2021 at 5%, not in line with that kind of 'temporary' notion in terms of price pressures advertised by the Fed.

Investors have been chasing EM debt for its appealing yield, though of late this has diminished substantially, with the main EM dollar debt benchmarks showing the lowest level of carry in decades. This leaves investors exposed to active risk, driven by rates and spreads. Barring any risk-off episodes which would see spreads widen, the total return of EM bonds remains capped due to the risk of rising US yields, as argued above. Assuming no change in US yields or EM spreads the yield-to-worst on the asset class is currently north of 3.5%,. which anyway is unlikely to be fully cashed in acting as a buffer for capital losses to be incurred as per our base case of rising US rates by year-end. We advise investors to bias their EM credit portfolios towards EM dollar sovereign and corporate debt, the former offering more value though longer duration, the latter being more defensive though not outright cheap. We hold the view that EM local debt remains exposed to a relevant dollar risk, following the recent shift in tone by the Federal Reserve likely to embolden dollar bulls. Indeed, inflation is now an issue in many EM countries as well, so local yields could rise alongside US yields, which would then be a double whammy for local bonds.

Hold your breath for Jackson Hole's and the following Fed announcements, especially if you are a gold or fixed-income investor.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

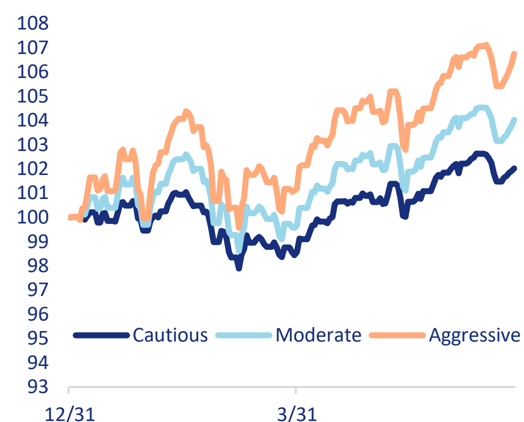


TAA – RELATIVE POSITIONING – MODERATE PROFILE

	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

In our opinion, there are umpteen rationales behind the recent and much analyzed US 10-year Treasury yield advance, which was the biggest weekly increase since March. While the earlier Fed's dovish stance was supposed to result in a red-hot economy leading to higher inflation and expectations of higher yields, the recent hawkish turn in the last FOMC meeting seems to have soothed market nerves regarding inflation. Now how long the relief permeates in the market is a thing to ponder about. However, a more important consideration from an asset allocation perspective is what the fair value of the US benchmark yield should be. We believe there is no rationale as to why the 10-year yield should be lower than pre-pandemic levels when the economy is on a growth path, and inflation expectations are higher now than ever in the last decade. That leads us to our conclusion that the 10-year should ideally be firmly above 1.6% in the current economic scenario.

Another question investors should worry about is how EM Debt would perform when developed market yields go up. A recent Fed report has observed that when yields go up as a result of unexpected monetary policy tightening, EM Assets suffer, while if the yields go up as a result of growth as observed by higher break-even inflations, EM Assets remain resilient. We believe the current scenario falls into the latter section, and hence EM assets should continue to perform. Moreover, EM, on the whole, looks a lot less vulnerable than in 2013 in terms of current account deficits and FX reserves. Hence, we advise investors to reduce their allocation to developed market High Yield, which looks quite rich valuation-wise, and increase allocation to EM Debt to improve portfolio performance.

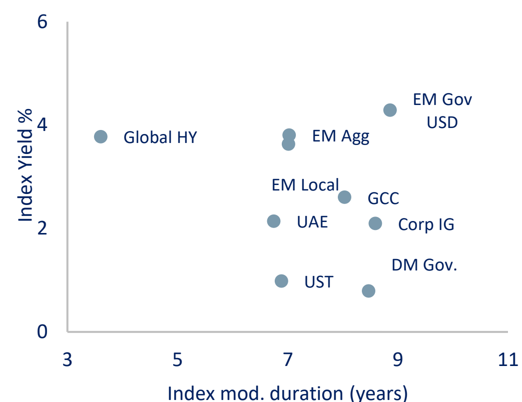
With the upcoming Fed taper announcements and inflation readings expected to continue their positive surprise, fixed-income investors should be wary of taking excessive risks. In addition, the labor department's June jobs data would be a big event for the market following underwhelming numbers in the previous two months. The Fed has signaled that the US reaching full employment is its key priority and would ultimately decide the timeline of tapering. The projections indicate the addition of 700k jobs, which would be the second-biggest since last September.

Under the above scenario, the volatility should increase ad it is as important to focus on the return as much on protection to the downside. Two asset classes clearly stand out for us. We have liked DM Financials' subordinated debt since the second half of 2020. Recently, Federal Reserve's stress tests showed the industry built up a stockpile of cash during the pandemic, which should provide a tailwind to the asset class. The second asset class is Chinese Govt Bonds that provide an opportunity for a pickup in yields of more than 3% while providing strong diversification to the portfolio as its correlation to the other EM Assets remains very low, as witnessed during the Dec 2018 and Mar 2020 market selloffs.

FIXED INCOME KEY CONVICTIONS

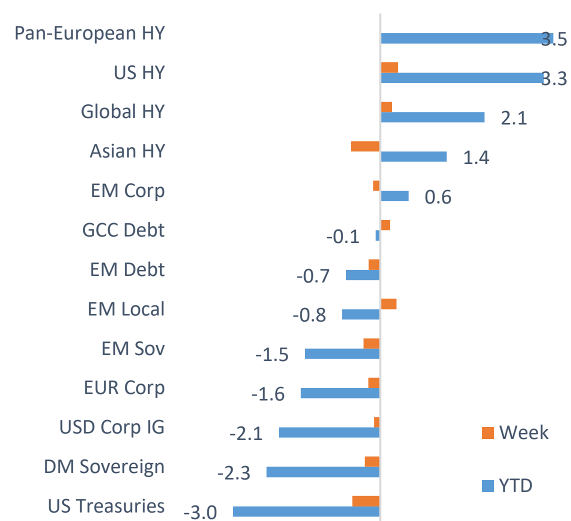
DEVELOPED MARKETS
UW DM Government
OW Credit (Cau. & Mod.)
OW High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

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



Source: Bloomberg

Equity Update

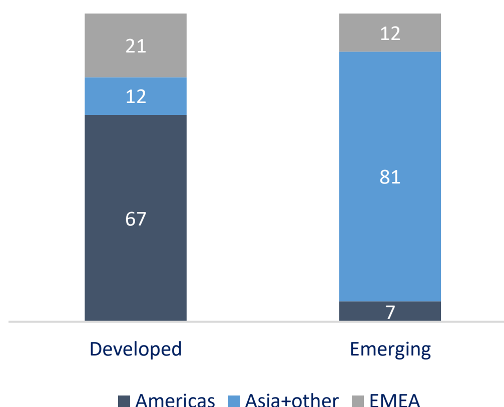
Global equities gained 2.3% last week, a reversal of the previous weeks 2% fall, buoyed by positive data releases on economic growth and manufacturing PMI's as well as optimism over additional fiscal stimulus. The gains of last week extend a trajectory of steady and strong performance. U.S. equities retained market leadership and the S&P 500 is at a record high, and the Nasdaq just short of one with investors shrugging off inflation worries and the Fed's more-aggressive "dot plot", reassured by the Fed Chair's conviction that inflation should subside soon. The agreement on a $1.2 trillion infrastructure package should further support demand. Consumer spending in the U.S. in May was well above pre-pandemic levels. Eurozone and U.K. equities also posted strong gains for the week, with the Fed's dovish tone echoed by the Bank of England. Asian equities finished higher, but after a choppy week that saw Japanese markets with some wild swings. The slight pullback in the U.S. dollar from last week's spike and recent actions out of China to crackdown on speculation in the commodity and cryptocurrency markets, helped Asian markets perform in line with their DM counterparts. UAE saw a flat Dubai market whilst the Abu Dhabi Index fell a percent last week. Real estate stocks are seeing some traction as sales data, both off - plan and secondary, remain strong.

Oil's rally with Brent above $76 a barrel saw the energy sector as the best performer for the week and retain its sector leadership for 2021. The higher treasury yields and improving economic data boosted the global financial sector, the second-best performer year to date and a continuing conviction call from us. Banks in the U.S. were supported by expectations for increases to share buyback programs and dividend payments, after a strong showing in the Fed's latest stress test. The large banks continue to have strong capital levels and buybacks could total $100bn over the next 18 months. US large cap banks are trading on a 10.5% yield to the end of FY22 (8% buyback and 2.5% dividend).

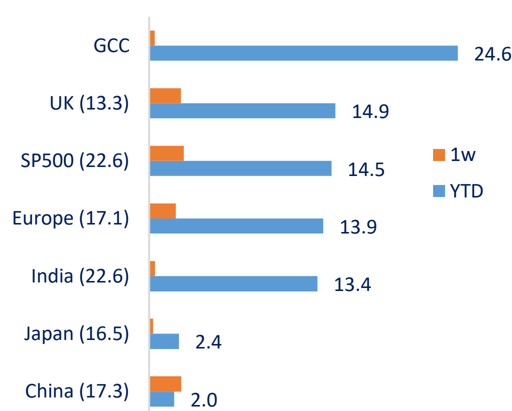
Earnings growth and the US 10-year treasury yield are currently the most dominant factors affecting sentiment. Both are favourable. However, whilst last week was buoyant for markets globally, with the VIX at year lows, the continuing yo-yoing over the past two weeks suggests there is still lingering uncertainty over the path of interest rates, inflation and monetary policy. Equities globally should continue to add to the year to date stellar returns, but there could be some bumpy stretches ahead in H2. Selectivity is key to higher returns from here on. Growth and value are more in sync, the former finding support from steady yields and the latter synchronous with cyclical sectors boosted by positive economic data.

The exponential performance seen by COVID winners in 2020 and recovery stocks in the first few months of 2021 may not continue, but demand trends in athleisure and cloud services remain strong. Nike posted strong quarterly profits and its focus on digital sales that were 73% higher y/y paid off, the stock rallying 15% on Friday. Microsoft continues to benefit from its dominance in operating systems and cloud services and is flirting with a $2 trillion market cap.

EQUITY RECOMMENDED REGIONAL POSITIONING

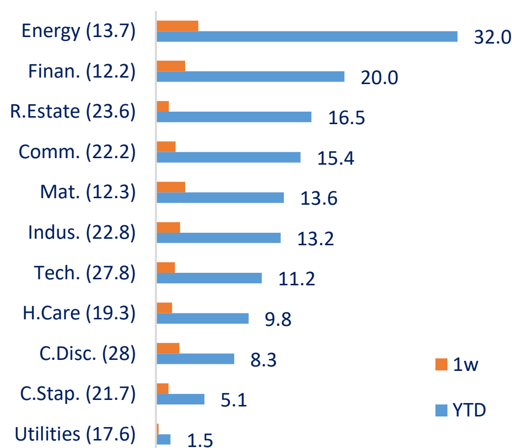


MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE



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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