No spill-over effects from crypto volatility for now

- **Last week was quiet and overall slightly positive on conventional assets …**
- **… But extremely volatile on crypto and digital assets**
- **Contagion if any, should be limited to the most speculative segments**

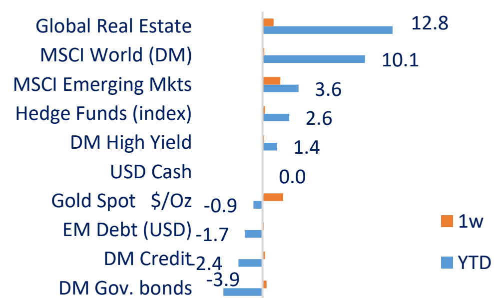
Last week was rich in potentially market-moving news, especially around the Fed's tapering agenda. The weekly return scorecard was however benign: apart from oil prices, all major asset classes were in the green, led by gold and emerging stocks. Importantly, interest rates were little changed, closing at 1.62% for the 10-year.

Volatility was elsewhere: crypto assets, led by Bitcoin, experienced massive swings. A crash, followed by a rebound, and another plunge, with a crackdown from Chinese authorities being the catalyst. Cryptos are not part of our advisory framework: while we are strong believers in the immense potential of the blockchain applications, we struggle to put a fundamental price tag on the value we see. The relevant question for us at the moment is thus the risk of contagion of the current crypto troubles to the conventional assets we invest in.

We find reasons to be on the hopeful side. Yes, cryptos are big, in the same order of market capitalization as the infamous US sub-prime mortgage market in 2007. Yes, volatility is considerable and could trigger some selling elsewhere to cover the losses. However, ownership is different: banks, insurers and institutions show neglectable direct exposure, which limits the systemic risk. Leverage is also not the norm. Of course, some crypto enthusiasts may decide to liquidate positions in other hot segments, such as SPACs, but we do not see a broader contagion, especially as the fundamental backdrop remains constructive, with better virus control in the West. Sentiment could though temporarily sour in case of a hawkish Fed in June.

The week ahead will be animated by speeches from central bank officials, and we will get the US PCE on 28th, before all monthly data in early June. Stay safe.

ASSET CLASSES USD % TOTAL RETURN, YTD 2021 LAST WEEK



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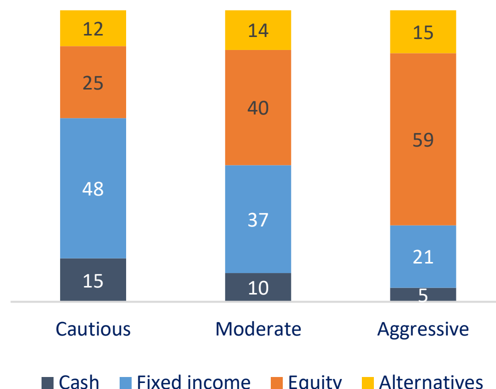
Cross-asset Update

Investors were rattled by bitcoin volatility last week, which saw the cryptocurrency close about 20% down and lose more than 30% at one point. Who is not directly exposed on digital currencies might be less interested, but actually losses on volatile markets can via contagion effects spread to other assets as well. Negative newsflow from China was the trigger for the loss of momentum, with downswings exacerbated by conditions of deteriorating liquidity. The failure of bitcoin to make new highs in March and April dented investor conviction of its never-ending upward trajectory, which in turn eventually caused a crash given scarce liquidity. Although price action suggests that a capitulation may have occurred, volume does not, as last week's volume peak is about only half the one registered in the March 2020 plunge. What is more relevant is that both the mentality of buying the dip and liquidity conditions are very relevant for equity markets as well, where the belief of an unstoppable rally has taken hold. To continue with the analogy, equity momentum could stall following the end of the reporting season while markets await the Fed June meeting to see if a second hawkish surprise is in store, after the tapering of asset purchases was mentioned in the FOMC April minutes. One more hawkish tone by Fed officials could well cause some ripples across stock markets, though in no way to the extent which we saw in digitals.

Investors do not seem to trust at all the durability of the rebound in energy stocks, which have lagged the tripling of crude prices since the March 2020 lows. The common narrative is that supply, now more flexible thanks to technology progress, will eventually respond and kill the advance. There is also the heightened concern about peak demand driven by decarbonisation trends. Do these claims stand the test of number crunching, once one does the painstaking homework and works out the demand-supply balance for the next decade? They do not seem to, according to major investment houses like Goldman Sachs and JPMorgan, that have called a commodity super-cycle for a while now. That they see oil demand remaining particularly strong into 2025 due to global unprecedented monetary and fiscal stimulus is not the bone of contention, while their view about persisting supply constraints is. It seems that not enough crude will be extracted to replenish current reserves due to the headwinds of debt, dividends and decarbonisation. Basically, oil companies are unlikely to put cash back to work in their core business and increase capital expenditure as they were used to in the past, but will rather pay down debt, distribute dividends and invest in alternative sources of energies. If this new corporate behaviour holds in the face of sturdy demand, an oil price of at least $70/bbl should be justified. We are not taking sides, but it would not be the first time that markets only gradually get round to taking stock of new trends, especially if they conflict with ingrained narratives.

Equities are not unstoppable and oil prices can be more resilient that expected. We must watch out for these sources of market surprises.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

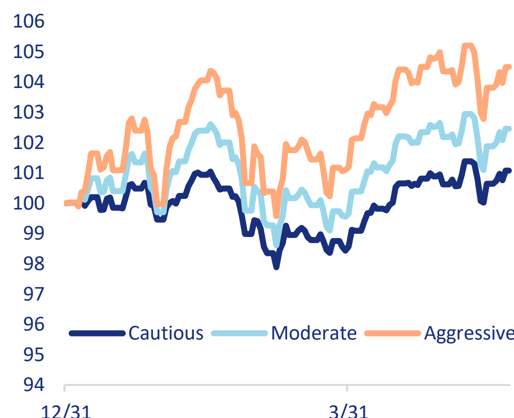


TAA – RELATIVE POSITIONING – MODERATE PROFILE

	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

The release of the FOMC minutes last Wednesday was supposed to be a placid affair for markets. But investors were in for a nasty surprise as some officials were open to a debate at "upcoming meetings" on scaling back their massive bond purchases. This came as a shock as Chairman Powell had mentioned in the press conference that there was no talk of talking about taper in one of his famous Powellisms. And just like that, talks about tapering in Q4 2021 and rate hikes in 2022 started gaining credibility. Thankfully, the movement in 10-year yield was more sedated with a seven bps increase on Wednesday, with the curve retracing back to 1.62% by the end of the week. We continue to believe there is a lack of clear catalysts to propel the 10-year yield out of its current range, and the next two to three months of macro data will remain crucial to add more colour to our view. For the time being, we are firmly in the Fed's camp that the inflation pressures should be temporary, hence continue to be overweight High Yield and Emerging Market Debt.

Stable yields supported the safer asset classes with longer duration, such as developed market treasuries and investment-grade credit, which returned +0.35% and +0.22%, respectively, last week. There was a bit of spread widening in High Yield and Emerging Market Debt of 4 and 1 bps, respectively, which resulted in muted returns on concerns about the tapering and country-specific idiosyncratic issues in the emerging markets.

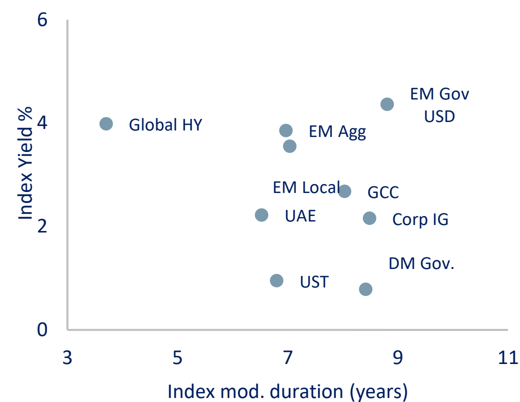
Fixed Income fund flows remained steady though lower than usual at + $6.8bn last week. In a repeat of the previous week's trends, both IG and HY funds saw net outflows. Emerging Market fund flows trickled down to only +$192mn over the week. This year's global corporate default tally has risen to 43. The proportion of global defaults from the U.S. in 2021 so far is 56%, which is lower than the previous year's defaults of 65%. Much of the decrease in the proportion of defaults can be attributed to rising defaults in Europe, with 11 defaults. As a comparison, at this point in 2020, 2019, and 2018, there had been 83, 47, and 40 global defaults, respectively.

GCC debt slightly underperformed versus EM last week due to lower duration demand from Real Money accounts. The IG curves steepened, with front-end yields coming down and long ends moving up by +5 to +6 bps across various sovereigns of the region. Emirates NBD issued a six-year non-callable $ perpetual bond priced at 4.25%. The order book was covered 2x times. This was the sole primary issuance from the region last week after the long Eid holidays the previous week.

FIXED INCOME KEY CONVICTIONS

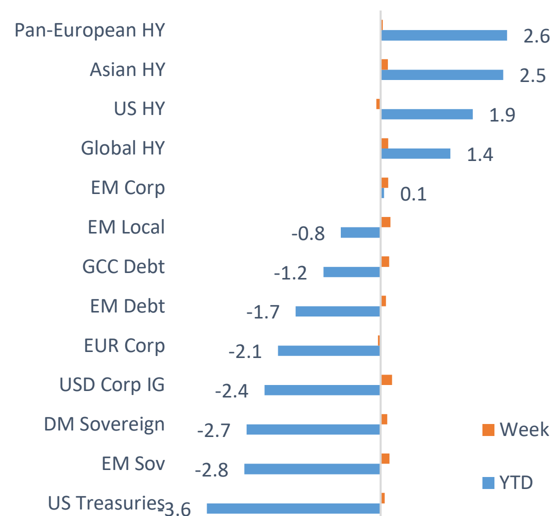
DEVELOPED MARKETS
UW DM Government
OW Credit (Cau. & Mod.)
OW High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

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



Source: Bloomberg

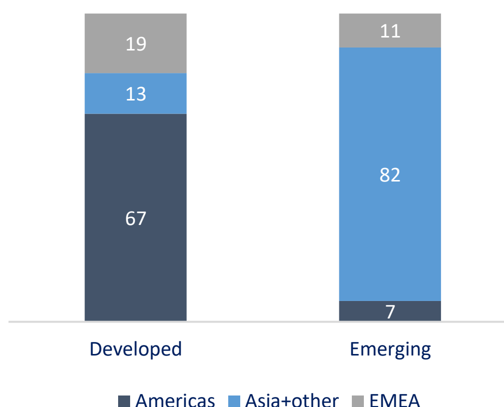
Equity Update

Equity performance was positive across regions last week, with the S&P 500 the only notable exception. Returns continue to be driven by strong growth, range bound yields and an easing of lockdowns, with cyclical stocks benefiting from the reopening of businesses. Supply chain constraints and inflation worries are on the anvil and like rising yields need to be kept in the radar screen, though currently margins remain unaffected and are the highest across global equities in many years. Cryptocurrency volatility is seen by some analysts as a possible liquidity squeeze but as institutional investors would not be affected and are not leveraged on this front, it may cause temporary equity volatility but should not a major catalyst for equity markets. The US remains one of the best performing markets year to date, though we think near term upside will rather come from Asia, with standout performance from the UAE, China and India last week. Though MSCI China is still not positive in 2021, India equities are up almost 10% year to date. Emerging markets had a good week, after much up and down performance the last 2 months. As US growth peaks and both economic and corporate profit strength shifts from DM to EM, the performance of the latter should accelerate. Global equity inflows are following much of the same pattern with financials, energy and materials receiving the bulk of them, while tech saw outflows in May. We continue to be overweight equities in both DM and EM.

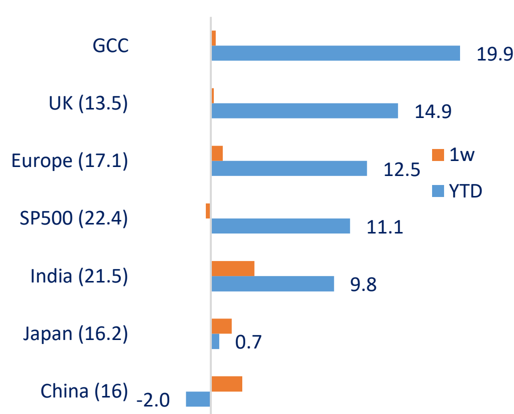
UAE equities continue their upward trajectory and the Abu Dhabi Index is now +34.5% year to date and the Dubai Index +13.5%, both amongst the highest returns globally. We have been reiterating the value and recovery play here, which even after this remarkable performance remains in place. Many real estate and banking stocks have forward P/E multiples in the low teens, some even in the mid-single digits. Whilst May saw all UAE sectors up, Dubai real estate developers and the UAE banking sectors, both cyclical, stood out. Improving economic data points support UAE bank profitability. The UAE real estate sector has recently received very positive coverage from global investment houses and this should boost foreign inflows into UAE real estate stocks. New launches have been subdued, improving the supply-demand balance. Residency visas have led to end-user demand increasing especially for villas, with families preferring open large spaces. Transaction volume is up for UAE real estate year to date, though last year same period forms a low base.

Value as a factor continues to outperform growth globally, but we stay focused on quality. Companies with earnings growth driven by sustainable businesses translating to strong cash flows that can service debt or dividend growth will continue driving up performance. Tech remains important as a large component of US equity indices with estimates that 45% of the S&P 500 is represented by digital companies. However, currently we are neutral the sector as we see more upside on the recovery stocks i.e. financials and industrials. Plenty of opportunities to generate returns, we have taken advantage of some recent pullbacks to add better valued stocks in the commodity, ESG and financial sectors to our recommended list.

EQUITY RECOMMENDED REGIONAL POSITIONING

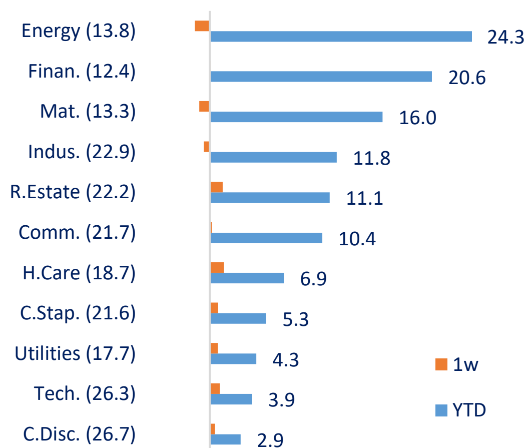


MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE



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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