Goldilocks?

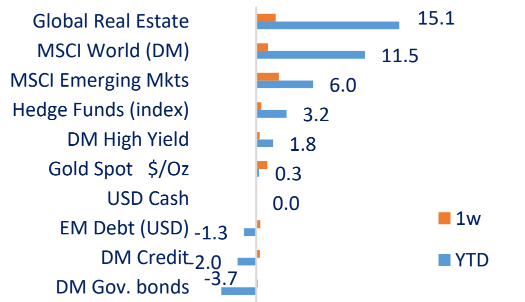
- **Economic growth confirms strength in the West but interest rates are not rising anymore…**
- **… Painting a perfect "Goldilocks" picture for markets, which had another good week.**
- **We however still expect volatility ahead and may consider reducing risk at some point.**

Our last weekly publication titled about the limited risk of volatility contagion from the crypto complex to conventional asset classes. Indeed, while daily price action remained explosive for digital tokens, global markets had an unanimously positive week with, maybe more importantly, abating volatility. Data confirmed a surging US economy and a high probability for Europe to follow, but also rising price pressures with a US core PCE coming out above expectations. Markets did not take it negatively, as they also had well scripted speeches from central bank officials every single day. Their message is simple: inflation is transitory, support will remain considerable, but discussions about tapering will start soon and be transparently communicated to avoid any bad surprise.

We thus had a great week in terms of risk-adjusted returns. Interest rates went gently down, stocks added between 1.5% and 2.5% across regions, and an overall weaker US dollar supported commodities and emerging assets. What's not to like about it?

Well, nothing, but it may look a bit too good to be true. Don't get us wrong: we are constructive, and our scenario is unfolding. Having said that, we are not sure that interest rates have peaked already, given the vitality of growth and the imminent start of tapering talks at the Fed. Lower realized volatility doesn't mean that risks have evaporated, but that they are considered benign by market participants. This, together with elevated valuations, could combine to create short term turbulence. We haven't changed our positioning yet but may consider trimming our current overweight risk at some point. In the meantime, the week ahead will provide an avalanche of monthly economic data to get a more precise picture of the backdrop. Stay safe.

ASSET CLASSES USD % TOTAL RETURN, YTD 2021 LAST WEEK



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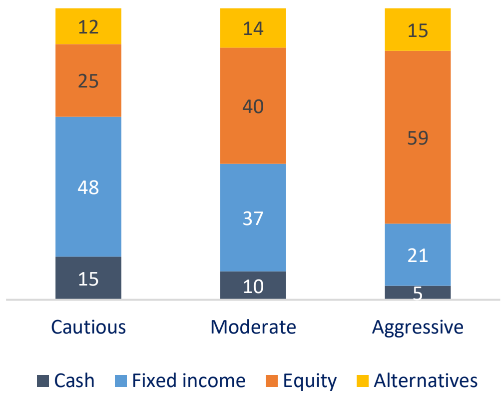
Cross-asset Update

The market reaction to yet another high US inflation reading was underwhelming, with the 10-year Treasury yield pulling back rather than backing up as one would have expected. Indeed, the personal consumption expenditures core price gauge, the inflation measure followed by the Fed, advanced well above expectations both on a monthly and yearly basis, but so did the CPI print for the same month of April. With the benefit of hindsight, we could dismiss the matter as a buy-the-rumour, sell-the-fact kind of response. After all, Fed officials continue to stick to their by now well-known script, whereby price pressures are seen as transient, so policy rates will be left untouched and longer-dated yields will be anchored and able to rise only so much. And the Fed will indeed not be easing anytime soon, minding more longer term expectations of price pressures, as indicated by the Fed Current Inflation Expectations Index, still hovering around a pretty subdued 2% reading, than the volatile gauges related to the cycle. Yet, the future direction of yields is for now not so much going to be a matter of policy, as of the liquidity provided to the system via Quantitative Easing. And since in the April FOMC minutes it was mentioned that it is appropriate to start to 'talk of talking' about the winding down of asset purchases, the stage is now set for the topic to be brought up at the June meeting again, with more clarifications coming most likely at the Jackson Hole Symposium.

The point is that investors are really not positioned for this kind of outlook. With yields range-bound since March and market-implied inflation rising relentlessly, real rates have collapsed and the 10-year Treasury real yield has retraced more than 50% of its year-to-date advance. US fixed income portfolio managers must have taken advantage of the higher yields, as their exposure to the US Aggregate Index, measured indirectly by the beta of their funds to that index, has risen to multi-year highs. This makes rates vulnerable to any kind of hawkish news flow that the market is absolutely unprepared for. The important data point to look at is the next payrolls release, due Friday. A stronger number would pull forward expectations of higher rates and reinforce the view that taper talk will intensify in summer. If this scenario comes to pass, then longer duration trades on gold and EM sovereign bonds should have limited upside and actually be due for some profit-taking. The euro has also been rising on an improved outlook and the potential for a slowdown in asset purchases to be signalled at the ECB June meeting. A strong US job report would on the contrary bring into sharper focus the limited ability of the ECB to follow the Fed on the path of policy normalization following years of failure to revive inflation.

Overall, the tailwind of the reduction of asset purchases could breathe some life back into the dollar, although we see the Fed ultimately doomed to deliver less than would be warranted due to the necessity for persistently negative real rates given the ever-growing federal debt burden. Hence, ultimately, the call on the longer term trend of the dollar cannot be that bullish.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

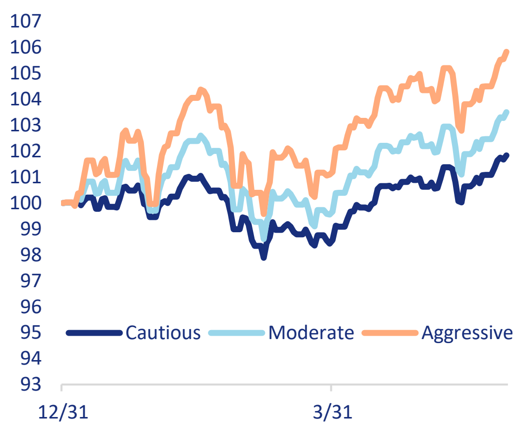


TAA – RELATIVE POSITIONING – MODERATE PROFILE

	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

Fixed Income investors currently seem to be in a No Man's land. There is no clear trend in the direction of yields as market players await more data points to make up their minds. The May employment numbers are considered to be a key indicator, and all the high-frequency data suggest a strong labor market. But we anticipate that this might not be enough to move the needle for the US Treasury yields.

Meanwhile, May has been another record month for primary markets even though spreads continued to grind down. It was the busiest May for US High yield issuers and the fourth busiest month overall with almost $47 Bn of bonds priced. This is the indication of the amount of liquidity present in the system. Usage of the Federal Reserve's reverse repo facility surged on Thursday to an unprecedented $485.3 billion. This massive build-up of cash is partly due to the amount of bonds FED buys every month and has given rise to a debate about asset purchase taper timings. However, this may not be the top concern for FED to dial down its support compared to inflation and employment numbers. Across the Atlantic, ECB seems to be a similar boat with markets anticipating the central bank to extend its emergency bond-buying at the June meeting. According to a Bloomberg report, issuance of green, social, and sustainability debt, including bonds and loans, is on track to top $1 trillion this year after the market got off to a strong start in the first quarter.

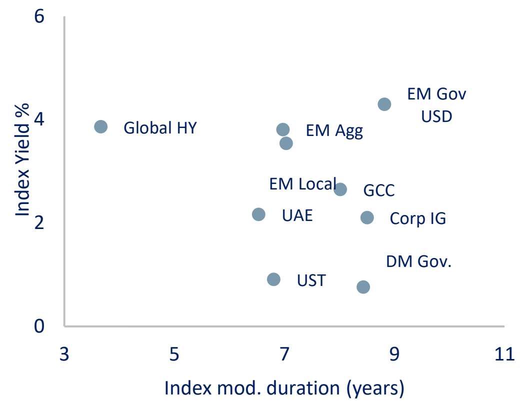
The subsectors were in the green last week as spreads across the asset classes came down. All the spreads currently trade at their lowest point in a decade. Emerging Market and High Yield benchmarks had their best week in a month with +0.36% and +0.23% returns. Flows into global fixed income funds were roughly steady at +$6bn. Government-only funds, as well as both IG and HY credit funds, saw moderate net outflows. Net inflows into EM fixed income products picked up, led by hard currency. In another positive news for High Yield, this year's global corporate default tally remained at 43. So far, May 2021 has had only five defaults, the lowest number since August 2019, as many speculative-grade issuers see an uptick in positive rating actions. 'CCC' rated issuers have led upgrades by rating category in the first quarter of 2021 with 42, an all-time quarterly high. The 12-month trailing default rate has decreased to 4.8%.

GCC Debt returned +0.2% last week, which is lower than the broader Emerging Market returns as riskier parts of the Emerging Market performed better. We saw three issuers tapping the primary market last week as Abu Dhabi issued a seven-year bond and Mubadala issued dual-tranche 10 and 30-year bonds. Oman Arab Bank issued its first AT1 perpetual in the international markets in a sign that more and more first-time issuers are confident of drawing investor interests.

FIXED INCOME KEY CONVICTIONS

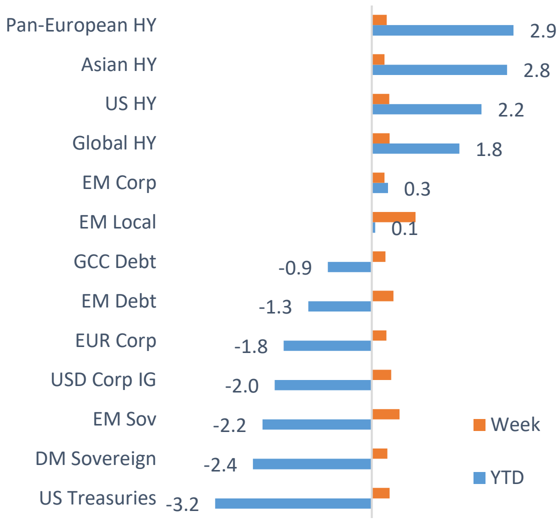
DEVELOPED MARKETS
UW DM Government
OW Credit (Cau. & Mod.)
OW High Yield
EMERGING MARKETS
OW Asia
OW IG Sovereigns
OW Latin America

FIXED INCOME VALUATIONS



Source: Bloomberg, indices modified duration and YTW

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



Source: Bloomberg

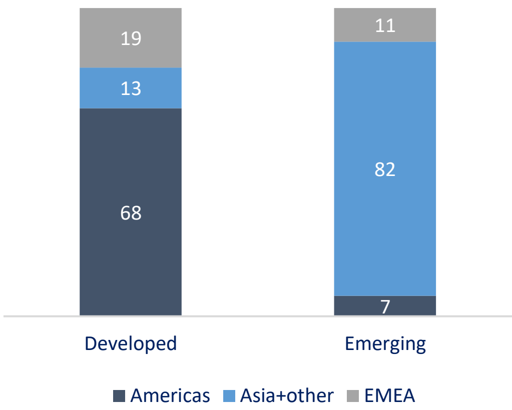
Equity Update

A good week for global equities, up 1.4%, with China, India and the UAE contributing to the stronger +2.4% Emerging Market performance. Asia is showing promising signs of a sustainable bounce. Developed markets, were up 1.3% for the week with US and European equity indices close to record levels. The S&P 500 is headed for a 4th consecutive month of gains, as is the Dow which celebrates its 125th year as a barometer of US stock sentiment. The rotation in the Dow's composition reflects industrial progression in the US with a higher weight to industrials compared to the tech heavy S&P 500. The Nasdaq whilst up 7% lags the S&P 500 +12.6% year to date total returns as the rotation into cyclical/recovery sectors continues. We think financials have even more room for upside with valuations still very reasonable. The month of May looks likely to end well for most global markets after seeing intense volatility in equity, commodity, sovereign yields and cryptocurrency markets. Continued above trend growth in the second half of 2021 in addition to central banks who are unlikely to change monetary policy in a hurry, should help sustain equity gains into year end, albeit with volatile. Our overweight positioning for both DM and EM equities remains unchanged.

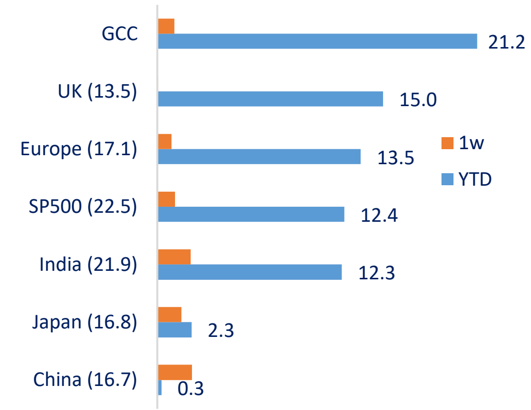
Equities have seen over half a trillion Dollars of inflows in 2021 so far, a record with a sizable chunk flowing into US equities. US exceptionalism continues as its economy is springs back to normalcy with restaurants, airlines and mobility indicators soaring, post the record vaccine roll out. The higher valuation is supported by a +50% Q1 earning growth (y/y) with an even higher number expected for Q2. Inflation worries continue, though margins are so far unaffected, as a surge in demand after Covid-19 restrictions were lifted, coupled with supply chain strains, which likely led to a rise in prices last month. Ecco data releases showed spending rose, the final read on May consumer sentiment was revised slightly higher, and Chicago manufacturing activity posted the highest level since the 1970s. We see this pattern flowing through to Europe, also high on vaccine rollout and reopening. This is also the case with the UAE where reopening has been reflected in the strong equity performance this year and a pickup in trading volumes. Economic data releases on PMI and a pick-up in residential sales are supportive of further gains in UAE real estate stocks backed by end user demand. Neighbouring countries such as the KSA easing travel restrictions should further boost retail spend.

Good results from Salesforce and Costco added to positive trading sentiment. However, the close to 50% fall in Bitcoin and Ethereum from their peak as well as a recurrence of high volume trading in momentum stocks such as GameStop and AMC increases liquidity concerns for leveraged retail investors. Environmental concerns around global warming have come to the forefront and Western oil producers Shell, Exxon and Chevron companies are under pressure from government and activist investors to cut carbon emissions. This reinforces our conviction on EV rollout and continued gains from the European and the US EV companies. In the 5G subsector we have identified telecom companies with strong growth, reasonable valuations which should provide upside as 5G rollouts accelerate.

EQUITY RECOMMENDED REGIONAL POSITIONING

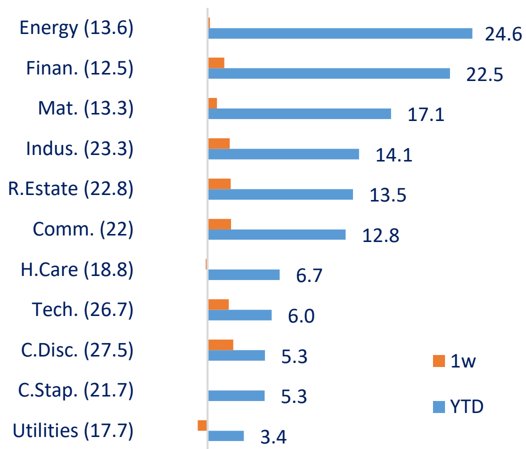


MAJOR INDICES PERFORMANCE (TR, US$) AND 2021PE



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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