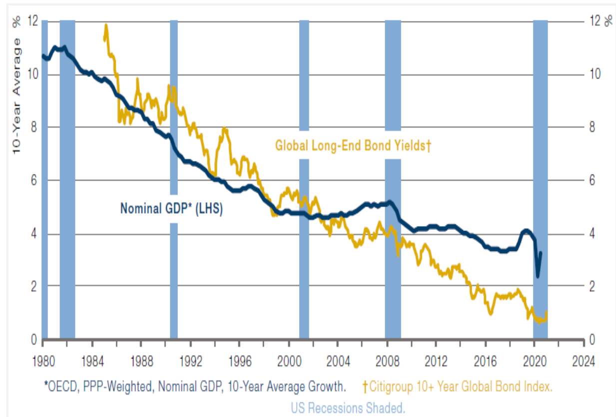
MARKET OUTLOOK

2021/July

PEPPERED RECOVERY

It was the end of the 1960s and the US finances were already stretched because of the Vietnam War, when under the lead of L.B. Johnson, the US government decided to embark on a debt-financed spending programme to eradicate poverty and redress racial inequalities. Simultaneously, the Federal Reserve (FED) was fighting against a rising unemployment rate, by introducing loose monetary policies. Does this sound familiar?



The parallels between the 1960s and today are evident; nowadays, governments are looking to spend as much as possible to revive their battered economies, the money supply has increased drastically, fiscal controls have disappeared, and central banks "seem to have become committed to social justice" (Gavekal, 2021).

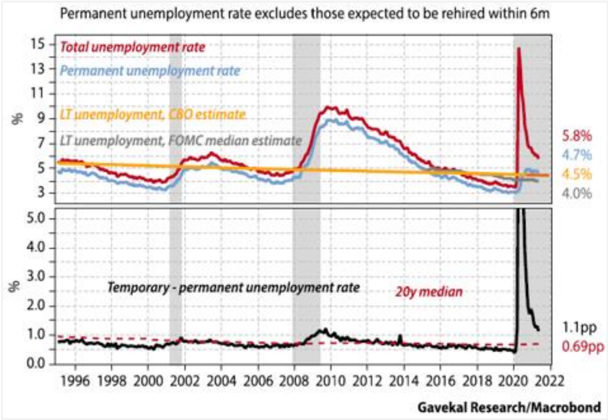
The real difference between the 1960s and today is that we are currently living in an environment characterised by debt overhangs and where central banks have taken over control of our economies, by injecting trillion of dollars into the system and financing most of the debt issued by governments. The influx of paper money to keep the economy from sinking has created massive imbalances; the wealth gap among social classes has never been this high in recent history, and interest rates are close to zero despite inflation expectations and nominal GDP growth rates well above 2%.

By the way, do you know what happened to inflation back in the days? With a lag of a few years, it jumped from 3% to almost 12%. Surely, there were other causes that led to this sudden rise, but we continue to believe that the transitory phase, so often referred to by FED Chairman Jowell, may not be so transitory after all. At the June meeting, the FED played its first hand well, and by bringing forward the expectations for the first rate hike, it successfully reduced inflation expectations.

However, the core CPI is rising (latest June figure is +5.4% YoY). These are numbers that will naturally mean revert, but the question is when. For example, the chip shortage is expected to last for at least another year. Meanwhile, what will happen to prices?

We see the increased risk that the FED may fall behind the curve. On top, after years of subdued inflation, it is almost ironical (and frightening) to see the FED changing its policy framework (allowing temporary inflation overshoots) right before the possible beginning of a sustained, inflationary period.

Wages play an important role in determining the future path of inflation expectations, as they usually kick-start the virtuous cycle that leads to higher inflation prints. At this moment, the job market is far from pre-COVID levels, and this is one reason the FED is keeping its foot on the accelerator. As state furlough are beginning to expire, it is probable that vacancies will be filled quickly, further reducing the gap between total unemployment and permanent unemployment, thus releasing some pressure of prices.

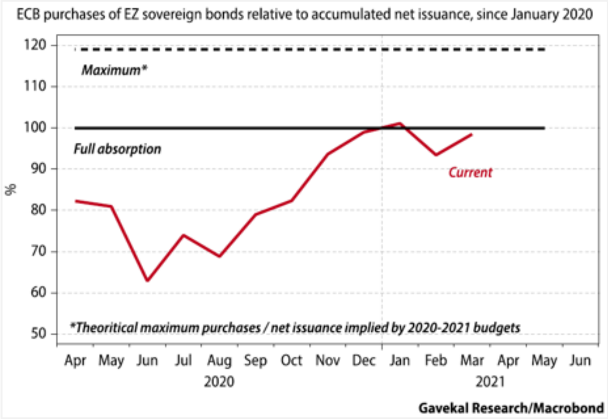


In our last Investment Committee, we mentioned that China could represent a window into the future, as early this year it has started to withdraw some of its monetary stimuli, leading to a deceleration of economic activity. We are now seeing the same happening in the US; after a sudden V-shaped recovery, most States have fully reopened, leaving both the FED and the US government with questions surrounding a galloping inflation, elevated debt levels, and a need to reduce inequality via social spending.

To summarize our view on the US economy, we expect inflation to be higher than what the consensus currently foresees, since loose monetary policies will persist until full employment is reached, and fiscal stimuli seem to be the weapon of choice of the new administration. Once the FED acknowledges the risk of inflation getting out of hand, it will intervene by raising rates and this in turn will have severe consequences on the economy, given its heavy indebtedness. Virus permitting.

One characteristic of the virus is that economic growth across nations is now less uniform than it was before the pandemic. The Chinese economy, for example, is experiencing a slow-down due to the efforts of the authorities to crack down on shadow financing, a plague that persists in the Chinese credit system. The good news is that such practice continues to decelerate thanks to a tighter regulations on asset management and stricter rules for local government bond issuance. Chinese authorities have continued to balance out the need to reduce their monetary stimuli (rising property inflation needs some tightening to maintain financial stability) while maintaining a sufficient level of support to an economy that is evidently mean reverting. Such daunting task is made even more difficult in an environment where public debt has ballooned to 280% of GDP.

On the geopolitical side, despite the rhetoric, China and the US need each other to fulfil their respective objectives. US companies need the Chinese consumer base to grow their revenues, while the Chinese need US technology and knowhow to gain credibility and trust worldwide. Therefore, China will continue to relax restrictions on inward investments in key sectors such as finance, pharmaceuticals, and autos, while Biden will try to strike a balance between national security and business interests, with the aim of becoming more predictable than the Trump-administration, to facilitate the day-to-day operations of US corporations.



Europe, on the other hand, is still at the beginning of its recovery. Less than a month ago, the ECB increased from 4.0% to 4.6% the expected Eurozone real GDP growth for the full year. However, at the same speed as the new Delta variant is spreading, we suspect this figure to be revised lower due to further restrictions to be imposed upon several European economies. But fear not, dear investor, as plenty of liquidity is and will be provided by the ECB, who is resembling the FED by the day; while "preserving eurozone financial stability is at least as important as the inflation mandate" (ECB, 2021), the central bank is ready to change the way the bank sets monetary policy, by including a new 2% inflation target and an increased tolerance for temporary moves above that level.

Given the high uncertainty regarding the economic recovery, the ECB has no intention of reducing its support and, in the near term, it is even looking to increase the asset purchases to a significantly higher pace than during the first quarter. De facto, it means European deficits will be fully funded by the central bank. Heard this one before.

All told, while the current situation in developed economies looks to be on an improving path, we see several potential risks that we feel consensus is not putting enough weight on. Firstly, inflation expectations seem too low compared to the possible outcome of a prolonged twin stimulus composed of monetary and fiscal support. Secondly, the evolution of the virus; the Delta variant is already forcing some nations to impose new restrictions and social distancing measures, which will have an economic impact on businesses and consumers.

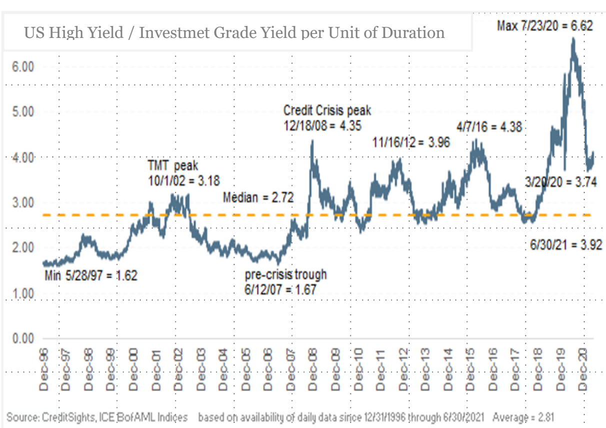
The influx of paper money to keep the economy from sinking has created massive imbalances.

With the virus spreading fiercely, it should not be ruled out that a new, vaccine-resistant variant emerges. At this point, renewed lockdown measures will be needed to contain it and safeguard the healthcare systems, but the economic costs will be dramatic. Lastly, but not less important, the evergreen of all risks: excessive public debt. With unprecedented debt-to-GDP ratios, we are walking on an unknown path. If a rise in inflation triggers a rapid reaction by central banks, is the economy going to sustain it, or will it collapse?

FIXED INCOME: HUNTING FOR YIELD

Notwithstanding the hawkish stance of the FED and a recent sky-rocketing inflation print, long term U.S. rates have been grinding lower in the second quarter of 2021, and more specifically the 10Y Treasury rate has fallen by more than 50 basis points (bps) from the top seen in March. Some disappointing macroeconomic data and resulting fears of economic deceleration likely played a role. A similar but laggard dynamic developed in Europe, as the German 10Y rate dropped by circa 30 bps from the top registered in May.

At this stage, taking into consideration still buoyant economic forecasts, inflation risks and the current low level of long-term rates, duration exposure remains clearly a risk.



Corporate investment grade bonds benefitted of the environment just described, offering investors satisfying returns, especially in the U.S. Valuations remained stable but look stretched on a historical comparison. Absolute yields are not compelling either, especially if one considers the recent deterioration in the average credit quality of the bond market.

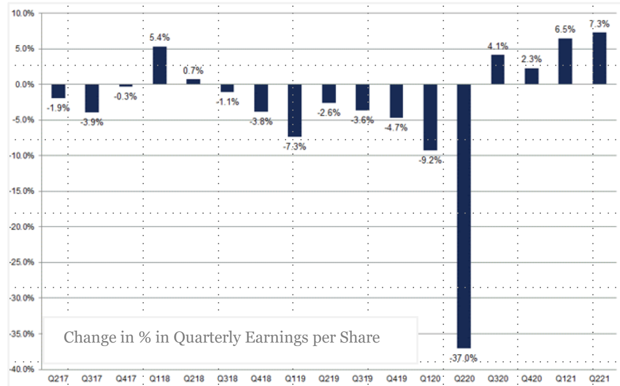
In relative terms, pockets of value are still left in some niches of the riskier buckets of the fixed income space, such as short-term high yield and certain emerging market (EM) corporate debt. Callable and/or short-term high yield bonds are supported by a falling default rate, and the recent positive price action is offering debtors a strong incentive to exercise the call option and refinance the debt at better market conditions. From an investor perspective, this incentive further reduces duration risk in a contest of a strong economic recovery, while offering still decent and relative attractive yields.

EM corporate debt displays better fundamentals in terms of credit metrics and a compelling risk/reward proposition. The asset class is also fast growing in terms of size, diversification, and liquidity. However, as we have mentioned during our last Market Outlook, EM investing is not without risks. Many countries are experiencing renewed lockdowns due to the spread of the Delta variant, and for some of them, food prices are rising, pushing inflation higher, which has led several EM central banks to raise rates. Rising rates with a faltering economy pose severe risks for bond investors.

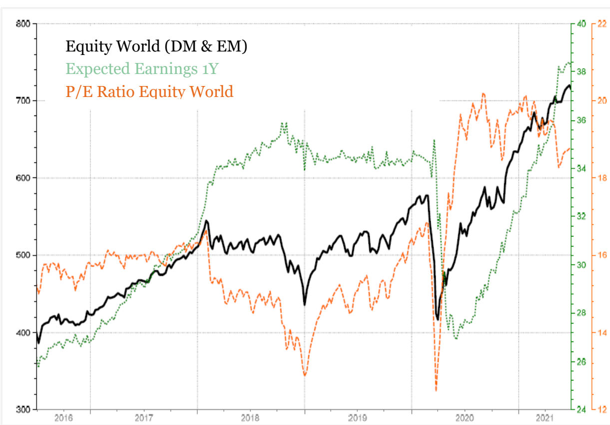
EQUITIES: INVESTING CAUTIOUSLY

US

The earning season just kicked off, and earnings revisions represent the largest increase since 2002. The main factors underpinning such euphoria are the reopening momentum, the successful vaccine campaign, and the expectations that consumers are eager to spend. Given these dynamics, it appears that US companies can momentarily pass through to consumers the increased input costs originating from the supply chains bottlenecks. Then again, the factor that weighs the most within the costs of a business is wages and these have not yet increased enough to erode companies' profits and margins. Should inflation expectations begin to rise, US companies will be forced to raise wages, which in turn will bite their profits, as there is a limit to how much inflation can be passed on to the end costumer.



Sadly enough, fundamental analysis is currently, totally useless. What matters is simply whether the FED continues to support financial markets with its liquidity provisions, keeping rates as low as possible. Otherwise, it is practically impossible to explain current valuations, which are at an all-time high, despite record positive earnings revisions. Once again, this market is priced for perfection, in a world that is light years away from perfection.

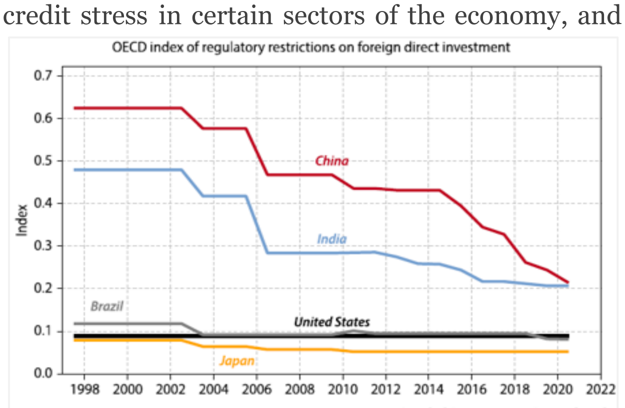


A rational investor may want to sell everything and wait on the sideline for better entry points; alas, many asset managers are irrational and have been creative in finding (or using) acronyms that would justify remaining invested, such as TINA (there is no alternative), FOMO (fear of missing out), or MOMO (momentum strategy). This is how financial bubbles are formed, and part of the US equity market is into one. It may take months or years before it bursts, but once the trigger is pulled, high valuations will make the market tumble. Therefore, the best strategy continues to be that of staying invested, but simultaneously taking advantage of the low volatility to purchase equity protections at cheap prices.

China

Chinese equities have severely lagged the global equity market so far this year. The MSCI China Index has been broadly flat since January compared to a rise of around 13% on the MSCI Global Index. The underperformance of Chinese stocks is to be attributed to a variety of factors, including monetary tightening, credit stress in certain sectors of the economy, and additional regulation towards the tech sector. Given the potential growth opportunities of this sector, the most relevant question is for how long Chinese regulators will impose their regulatory clampdown. Therefore, the outlook for large Chinese internet platforms companies remains foggy.

On the positive side, we see Chinese companies able to generate earnings growth, as rising domestic consumption and strong inward foreign direct investments are falling significantly.

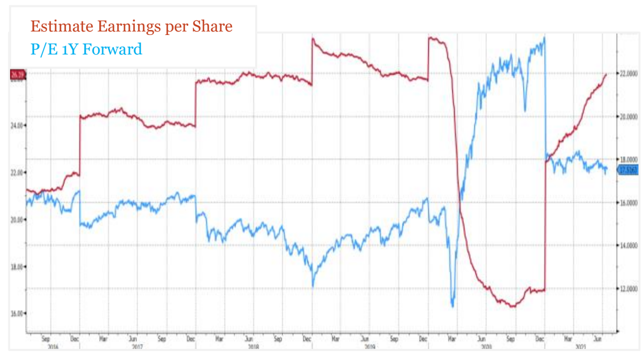


Overall, Chinese stocks have more attractive valuations than their American peers and offer the best medium-term growth potential outside the U.S.

Europe

The Eurozone economy has shown resilience in the face of restrictions, but a strong pickup in vaccinations and falling COVID-19 caseloads have paved a path to recovery. An economic rebound is underway, which we expect to continue into the second half of the year, supported by high levels of savings and pent-up demand for services, unless the Delta variant derails the summer season and calls into question the reopening of the economies.

In terms of earnings, margins, and valuations, the situation is very similar to what the US is experiencing, albeit with a slight time lag. Operating margins are on the rise, although still a few percentage points away from pre-pandemic levels, while earnings estimate have increased by 8% during the second quarter of this year. Therefore, expectations are very high and there is very little room for negative surprises, given forward-looking valuations are at all-time highs, if we exclude the one-time effect caused by the pandemic.



As we have mentioned already in the past, we do see an investment opportunity related to the recent announcement by the European Union to accelerate a shift away from fossil fuels to cut pollution. Just as the US is the home of technological innovation, we believe the European block seeks to position itself as a global leader on climate, creating investment opportunities among companies that are at the forefront of the green revolution, or have turned / are turning their businesses in a way as not to become subject of heavy green tax burdens.

COMMODITIES AND CURRENCIES: A NEW DAWN

We see two main reasons for being constructive on commodities. Firstly, during most of our working lives, we just have not had enough inflation to be bothered with allocating part of our investments to real assets. Thus, the role of commodities has always been clouded by more traditional asset classes such as bonds and equities (rightly so). The result is that sovereign wealth and very large pension funds have not held commodities and those that did, allocated a mere 2%. We believe retail investors' portfolios are in a similar position, which brings us to conclude commodities have been highly unpopular in recent years.

Commodity Exposure in Institutional and Pension Funds

Asset owner	Country	AUM ($M)	Commodities
A	Japan	1'555'550	0%
B	Norway	1'066'380	0%
C	China	940'600	0%
D	South Korea	637'279	0%
E	US	601'030	0%
F	UAE	579'620	0%
G	Netherlands	523'310	0%
H	Singapore	440'000	0%
I	US	384'435	0%
J	Singapore	375'383	0%
K	China	361'087	0%
L	Saudi Arabia	320'000	0%
M	Canada	315'344	2%
Total Assets / Weighted Allocation %		**8'100'018**	**0%**

Secondly, due to a 10-years structural bear market that only found its bottom last year, businesses have implemented very pronounce capex cuts, creating a supply deficit that will probably take years to close. The demand/supply imbalance is made worse by the large-scale global infrastructure rollouts, which are commodity-intensive in nature. Thus, commodities and their role into traditional portfolios may be at the dawn of a new era.

Most commodities are traded in US dollars (USD), therefore there is a fairly strong negative correlation between the two. Given the plethora of liquidity injected into the system, we believe the USD will continue to depreciate (which supports

commodity prices). Currencies of other developed economies do not fare much better but, in some cases, their financial accounts are healthier (i.e., the Euro), providing an advantage versus the USD, which is also suffering from the country's twin-deficit.

Finally, the case for some Asian currencies, mainly the Chinese Renminbi (CNY) and the Korean Won, still looks compelling from several points of view; attractive valuations, strong economic growth potential and solid while improving current accounts underpin a rosy future. Diversifying the currency exposure has never been as important as it is nowadays.

OUR STANCE

Liquidity: Equalweight =	**Bonds**: Underweight ▼	**Equities**: Underweight❶ ▼	**Alternatives**: Overweight ▲	**Commodities**: Overweight ▲

❶Including protection.

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