CBH | Asset Management

Quarterly Insight

Summer 2021

Creativity within Excellence

Composition abstraite - Félix AUBLET
1961 - Huile sur toile

Index

Asset Allocation

		Neutral	Underweight		Overweight	Change
CASH	**$** **€**	**5%**		**10%** **14%**		
Cash	$	5%			10%	-2%
Cash	€				14%	-5%
CORE BONDS	**$** **€**	**50%**		**30%** **26%**		
Government 1-5Y	$	15%	5%			
	€		0%			
Government 5-10Y	$	10%	5%			
	€		5%			
Investment Grade 1-5Y	$	15%			17%	-3%
	€				18%	
Investment Grade 5-10Y	$	10%	3%			
	€		3%			
SATELLITE BONDS		**0%**		**10%**		
High Yield 1 - 5 years					4%	2%
EM Hard currency					4%	
EM Local currency				0%		
Senior loans				0%		
Convertible					2%	
EQUITIES		**40%**		**40%**		
North America		17%		17%		2%
Europe		8%		8%		1%
Asia Pacific & Japan		4%	3%			
China		2%			3%	
Emerging Markets		3%		3%		
Global		6%		6%		
OTHERS		**5%**		**10%**		
Gold		2%			3%	
Other investments		3%			7%	

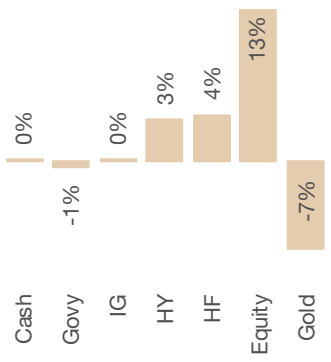
Asset Commentary

Prospects for the economic recovery of 2021 to even out are rising as developed nations near the last phase of their vaccination campaign and developing nations accelerate theirs. Variants of concern create some risks but recent data show resilience within vaccinated populations for the time being. The strong economic backdrop of the second quarter should lead to a positive results season in July, potentially bringing additional comfort for risk assets despite arguably stretched valuations and hovering inflationary pressures. We reduce our position in investment grade bonds following the re-flattening of treasury curves to add to the high yield segment. Similarly, we raise slightly our allocation to equities in North America and Europe to close in our benchmark.

Economic background

The giant vaccination effort of the first half is bearing economic fruits even if questions arise concerning the delta variants and the proportion of the vaccinated population needed to put the worst of Covid behind us.
The US and the European economies are in full recovery with support programs likely to carry this expansion into 2022.
The Chinese economy continues to perform apace with tailwinds coming from other jurisdictions rather than government stimulus.
Other large emerging economies are coming out of the Covid third wave and look set to reopen gradually.

Market performances (in %)



Inflationary pressures resulting from the resetting of global supply chains are accompanying this economic revival and all eyes are turning on central monetary authorities to gauge when they will start tapering their asset purchase programs. To date and despite a more hawkish news flow neither the Fed nor the ECB has deviated in its stated desire to support the recovery.

Cash

Central monetary authorities will continue to implement an accommodative policy for months to come. Recent statements continue to indicate that one should not expect higher rates until 2023. We reduce our cash balances to deploy them in risk assets.

Fixed Income

After their March sudden spike, long dated government curves flattened from April onwards. At current levels, we see more downside than upside for underlying government yields in the US and Europe and therefore pare down our allocation into the highly duration sensitive investment grade market. Conversely, we continue to expect positive news from the high yield market. Calmer waters on the rating agency front and better fundamentals pointing at tighter credit spreads going forward lead us to raise our allocation slightly. In that vein, we believe that emerging market debt in hard currency is also poised to perform well with supportive fundamentals. Subordinated debt for investors with the appropriate risk profile remains an interesting play in a fixed income allocation weighted towards credit spreads rather than duration assets.

Equities

The technology sector has experienced a strong revival as long rates eased off from April and positive results came in for first quarter performance. As the reflation trade gained in strength, this helped to propel developed market indices towards news highs. Economic data suggests that current elevated valuations will find some validation in second quarter results. This leads us to raise slightly our exposure to North American and European equities. That latter segment despite this year's catch up in valuations continues to trade at a discount to the US, pointing at some additional performance potential.

Others

Oil prices continue to be well supported with Opec+ raising production at a measured pace. The barrel is now above our target range and could stay there in the coming months. After a strong rally in May, gold failed to hold on to its gains, setting the scene for a measured comeback in the coming months and providing an entry point for investors wanting to gain exposure.

Past performance is not a reliable indicator of future performance and should not be solely relied upon.

Macroeconomic Scenario

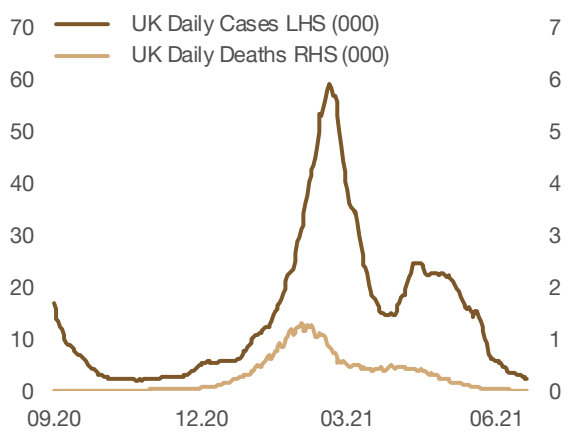
The Covid vaccination campaign is entering its last stages in developed countries and is well underway in the developing world. Variants notwithstanding, this sets the scene for the global economic recovery to even out in the second half of the year. In the meantime, the rebuilding of supply chains broken down by the 2020 lockdowns is turning into a lengthy and costly process, generating higher inflation levels than had been deemed acceptable in recent monetary policy history. It adds to a comprehensive list of questions that are all pointing at Central Banks' exit strategies amid a continuous roll out of government support packages. At this juncture, avoiding policy mistakes without adding fuel to existing financial bubbles could prove difficult for central monetary authorities.

Covid vaccines – hitting the glass ceiling?

The vaccination campaign has entered its last phase in developed countries with the number of people lined up for their first shot dropping markedly in the last few weeks. This is good news but also potentially an issue since the most vaccinated countries seem to meet difficulties to get a vaccination rate above 60%. The younger part of the population (12 and above) has still not been vaccinated but studies show that a rate of 80% and above is necessary in order to significantly reduce the risks of lockdowns in the presence of the delta and delta+ variants. This means in turn that governments will likely have to take measures to raise vaccination rates before this autumn, particularly now that doses are widely available.

Yet, it does not necessarily mean that a flare up in infection rates will lead to the kind of sanitary lockdowns developed countries are just coming out of. The vaccination of the more vulnerable cross section of the population is reducing the risk of economically damaging lockdowns. The situation in the UK shows for the time being that mass vaccination is key in breaking down the correlation between contaminations, hospitalizations and deaths. In addition, populations have adapted and the negative economic effects of lockdowns are becoming increasingly less damaging overall.

Covid struggles in vaccinated territories – the UK example

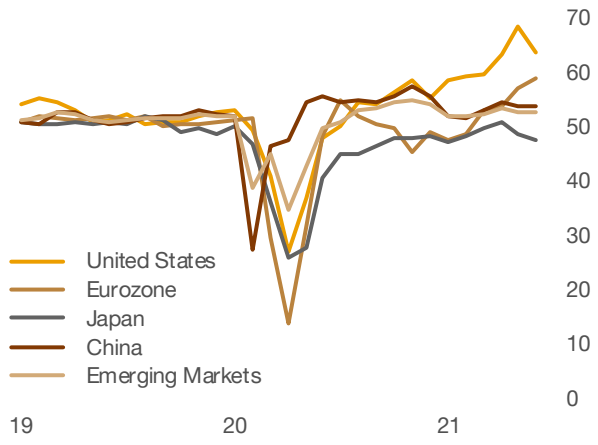


The picture in developing economies is substantially different and highly contrasted. After a very damaging episode in May, the situation in India looks back under control. In Brazil, Colombia and Argentina notably, the third Covid wave is wreaking havoc, placing these countries' health systems under strain and damaging the economy. China on the other hand continues to do well with the recent epidemic flare ups brought quickly under control.

Economic recovery – accordion rather than V shaped

Far from being a straight line, the 2021 economic recovery has been submitted to the stop and go linked to government imposed restrictions. Nevertheless, the latest PMI readings in Europe and the US are running at historically high levels, pointing at a strong improvement in economic conditions in the coming months. In most sectors, the recovery in economic activity has been strong, helped by pent up demand and excess savings during lockdowns as well as government's support packages. Yet a number of industries, in particular the ones linked to international travel are being left behind with restrictions and regulatory impediments still in place for international air travel.

PMIs look strong all around



What happens at sector level is also true from a macroeconomic prospective with the US and Europe in

clear recovery mode, China at cruising speed and unfortunately large parts of the global economy still left behind. It is but a question of time for these economies to gain escape velocity in their vaccination programs and subsequently join in the global recovery. At the mid-year point, it is worth updating our view on the economic performance of the main jurisdictions.

United States: The country has executed its vaccination program with customary American efficacy and is now at c45% second dose coverage. The sharp upturn in recent GDP data points at a full growth number close to or in excess of 6% for the year in our view.

China: Having recovered earlier than the other large economic blocks, the country will continue on its expansionary path with significant tail winds coming from the economic recovery in other jurisdictions. Despite the government's actions to rein in credit and constrain tech giants, consensus GDP growth at 8.5% for this year looks achievable.

Eurozone: after a dire start in its vaccine roll out, the old continent has been catching up with the US and the UK at breakneck speed. However, as much as the coming months look positive, the start to the year has been missed. We upgrade our target for the year to 3% GDP growth, thinking that anything beyond that looks optimistic at this juncture.

India and South East Asia: Despite the setback from the severe bout of Covid experienced by India in May, the country should record strong economic growth this year. To reflect this, consensus was pared down from 11% to a still decent 9.6% growth rate for the year. Other economies in the region will continue to benefit from the rise in commodity prices and a better internal economic backdrop.

Latam: The outlook is patchier as the region continues to grapple with the sanitary emergency and an overall low vaccination rate. That said, the second part to the year should bring better economic news, in particular for Mexico, which stands to benefit from the strong economic growth of its northern neighbor. Brazil should however continue to lag, not benefitting from the same proximity with the US.

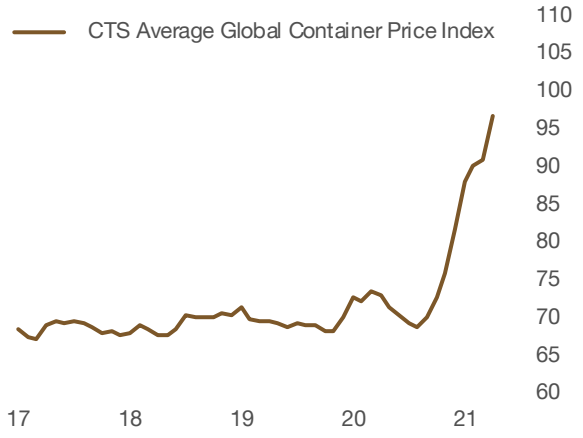
Overall and given the sizeable support packages that are being rolled out in the US and Europe, we see the current economic recovery extending well into next year. Amid this continuous fiscal support deployment, a gradual withdrawal of the monetary support mechanisms seems increasingly likely over time. Nevertheless, we are still far from what could be described as a normal functioning for the global economy.

Supply chains – no easy mending

The spring 2020 hard lockdowns have caused deep damage in the global and local supply chains, which are coming to light now as the global economy strongly restarts. The well-publicized shortage in computer chips is just one of many but we could cite lumber, rental cars, shipping containers and generally an array of industrial metals: aluminum, copper, iron ore or lithium.

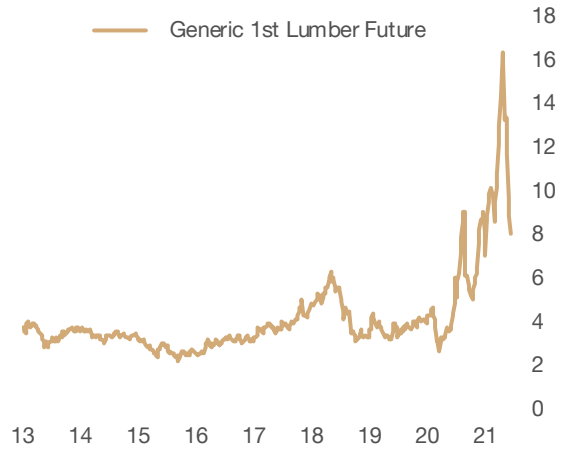
The strong rise in demand for electric cars is also tightening supply and means of transportation for key metals. As an illustration, the cost of shipping goods in containers remains stubbornly high – a reflection of the lack of available shipping capacity and a lack of containers.

Shipping container: the cost remains high



That said, according to Fitch ratings, a normalization and lower rates are in the cards for the second half of the year. This is supported by a rapidly growing containership order book – in particular for large ships. There is of course a time lag of two to three years but orders have grown to represent 12% of the existing capacity vs 9% at the start to the year. This in turn points at longer term shipping tariff moderation.

Lumber in the US: the shape of things to come?

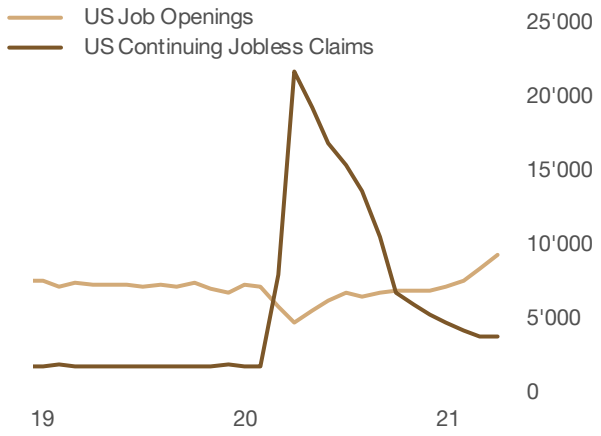


Another striking example is the recent history of lumber prices. Following a general increase in construction demand, inventories plummeted and prices soared as a result. Two interesting phenomenon subsequently

happened. Clients faced with rising construction costs postponed or cancelled their projects and instead spent their money in newly reopened restaurants, bars and other service based experiences. The second phenomenon was the re-opening of sawmills and a rise in wood processing capacity. The combined result of these two trends was a sudden and sharp decrease in the price of lumber. We take the view that this accordion behavior of supply and demand for certain types of goods is a key driver behind the recently observed increase in consumer inflation. This will likely remain the case until supply chains are restored in the main, something that is unlikely to happen until at least six to nine months. There will naturally be differences on how fast this reset happens, depending on the complexity of each individual supply chain and on the adaptability of companies.

The job market is experiencing a similar predicament. For some part, individuals laid off during the multiple lockdowns of 2020-21 have for some part left the sector they were involved with and moved on. As various economies suddenly restarts, companies realize that the work capacity for the jobs they are trying to fill has simply disappeared. In the case of lower skilled jobs, the end of direct help to households may push people to look for a job, although recent data in US states that have curtailed federal help are inconclusive. In the case of higher skilled jobs in the sectors that have been most affected by lockdowns, a return to capacity will prove tricky, delay and make the restart of these sectors costlier.

US job openings are soaring (000)



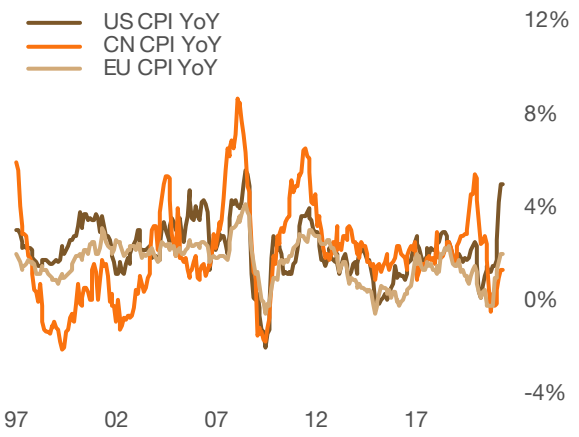
In our Quarterly Insight edition from the summer of 2020, we wrote that one key goal of governments and central monetary authorities was to maintain the integrity of the economic fabric to avoid destroying capacity in a way that would make the restart more difficult.

It now looks like despite these measures, the various stop and go decisions made in the last year have negatively affected a number of sectors and created inflation generating scarcity effects. In a way, the exceptional measures deployed last year have helped avoiding the worst but have had a large number of unintended consequences.

Inflation: data point at a transitory phenomenon

Inflation has been one of the most talked about subjects of the last three months. As anticipations rose on both sides of the Atlantic, the US numbers went above expectations in April and May with US CPI rising by 5% in May yoy and 4.2% in April yoy. In Europe, things have looked typically less dramatic with inflation in the Eurozone rising by 2% in May and up from 1.6% in April. China, which experienced only one sharp lockdown, is not confronted to the same degree as the other large economic ensembles with the resetting of supply chains. CPI numbers from the country are therefore tamer showing an increase of 0.9% yoy in April and 1.3% in May.

CPI Chart for the US, China and the Eurozone

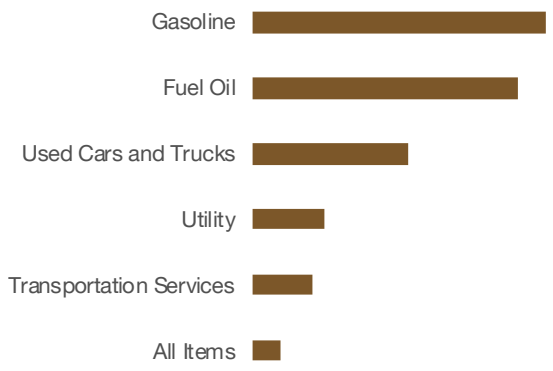


Considering that a year ago, the global economy ground to a halt for about a quarter, a rise in inflation is to be expected as the economy recovers. After all US CPI in May of 2020 came at 0.1% annualized, implying an average annual increase of 2.5% over the last two years.

Central monetary authorities are on message with the Fed indicating that the board will look at actual inflation and job data rather than forecasts before reaching monetary policy decisions. The ECB's rhetoric is very much in the same vein, which in turn reduces the probability of a policy mistake at least in the near term.

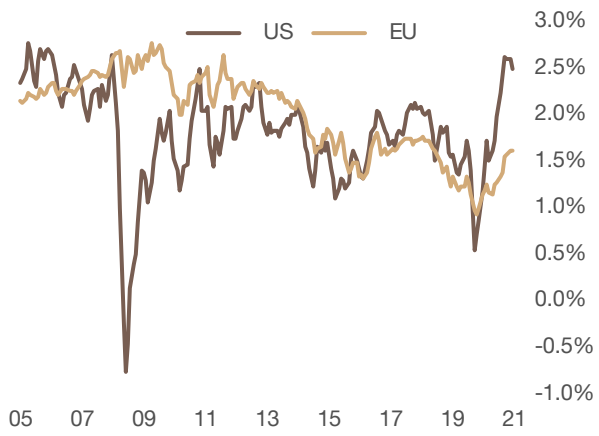
The key word when discussing inflationary pressures is 'transitory'. A closer examination of inflation sources in the US gives credence to the Fed and the ECB views as to the transitory nature of the current rise in inflation.

CPI components – energy and second hand cars



As shown in the chart above, the May inflation numbers in the US are primarily driven by second hand car price increases and energy. The rise in used car prices in the US comes directly from the chip shortages experienced by the car manufacturing industry. This tension is unlikely to decrease the coming months but will eventually subside once supply chains function again. The rise in energy prices with oil trading above USD70p.b. is self-explanatory, considering that a year ago, a barrel of brent crude was trading at USD45p.b.

Inflation break-even 5 year dollar and euro



The key question is: should one hedge against inflation? In our view, it is only worth to look at inflation hedging if one is convinced that the economy has moved into a new inflationary regime. At this stage, we simply have not enough data points against what has been a dire start in 2020 to make that call. For inflation to set itself up as a phenomenon, one would need to see a permanent increase in wages coming in steps with rising prices. This relationship has been broken in the 1980s and we do not see it coming back sustainably in the coming quarters.

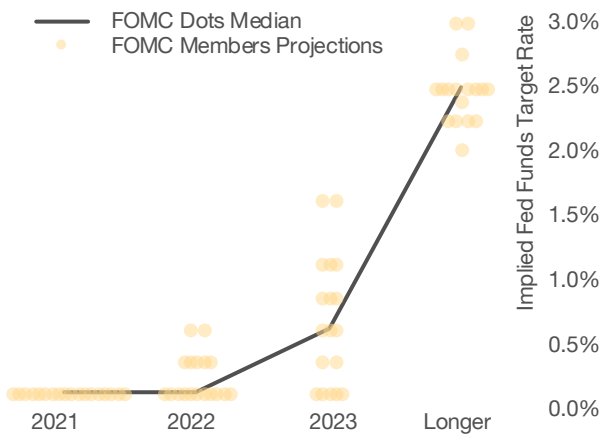
In addition, inflation linked bonds look expensive even after the recent pull back in prices that has followed the June Fed meeting. Assurances from central banks and a close analysis of the recent drivers suggest that index linked buyers could actually be overpaying for an insurance that they may not need. In addition, the liquidity of such instruments is relatively poor and may result in disappointing execution terms, should a significant proportion of holders find that inflation is not such a big problem after all.

After an aggressive pull back in March, the US and the Euro yield curve have flattened. As we write, the US 10 year treasury yield is hovering around 1.5% and the Bund is at -0.17%. This suggests a calmer backdrop in fixed income against the high of 1.77% for the US 10 year treasury yield attained end of March this year. In our view one should not be fooled by the favorable technical conditions prevailing in the US and European government bond markets. The curve steepening theme is highly likely to come back before this autumn but more through GDP expansion than inflationary fears.

Central monetary authorities: intersections ahead

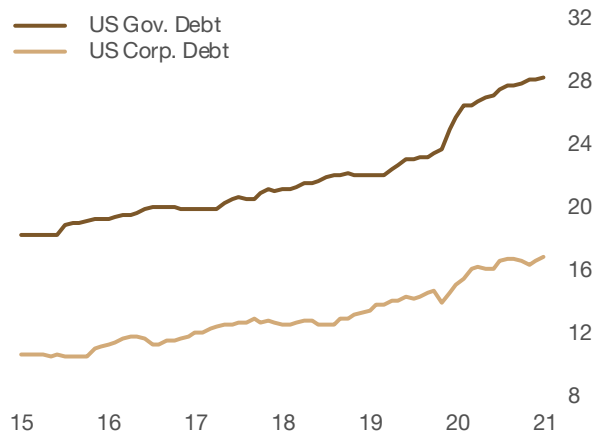
After all these years of intervention, we are still amazed at how little market participants are listening to what Central Monetary authorities are saying. True, the Fed board is becoming more hawkish as shown in the dot plot evolution. However, it is not because on average, the Fed board members call a QE tapering for 2022 with two rate hikes in 2023 that this will necessarily happen. After all we are still away from a seamlessly functioning economy but as market participants are influenced by prevailing market themes, so it seems are the Fed members.

The dot plot is showing the way… or is it?



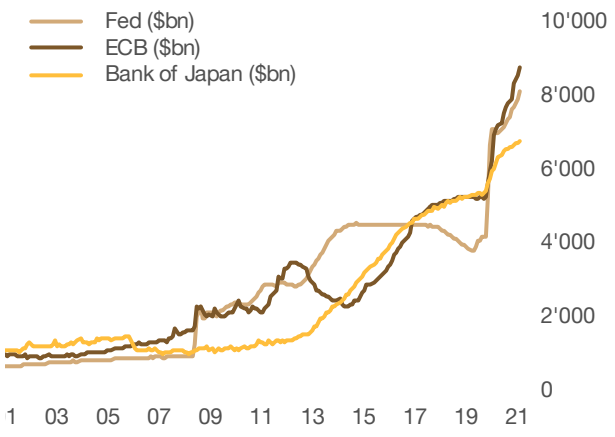
So when will the Fed start tapering? The line is clear: when the actual data shows it is the time, which can be translated as when GDP growth and employment reach cruising speed. If we are to expect anything at a key moment, this would be this year's Jackson Hole conference – to be held on 26-28 August. The title of the symposium seems to leave the door open: 'macroeconomic policies in an uneven economy'.

US government and corporate debt aggregate



The consequences of a policy mistake are made worse by the amount of debt taken on by the major economic ensembles – outside of China. This in turn means that a 25bp fed fund rate hike of today has a vastly different impact from a 25bp increase 15 years ago. It mechanically increases the cost of monetary policy mistakes as the Fed found out in December 2018. To be sure, before anything happens on the rates front, we will be looking at the paring down of bond purchases and in that respect, the tide has turned already with the Fed announcing that it would stop buying credit ETFs. Finally, we think it unlikely that the 'taper tantrum' we collectively anticipate will be similar to the one the markets experienced after the Bernanke announcement of July of 2013.

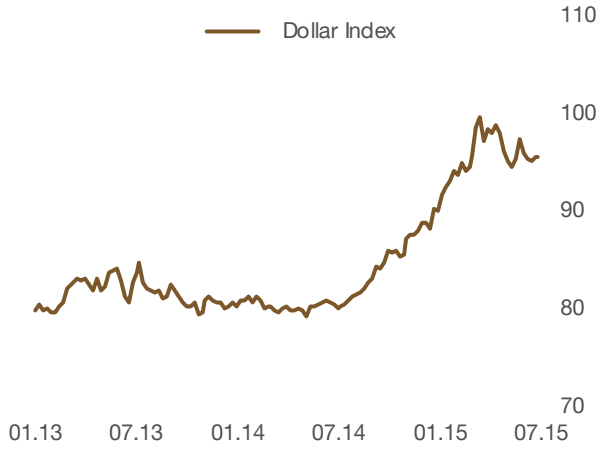
The Fed and the ECB are still growing their balance sheet



Dollar to pursue its recovery

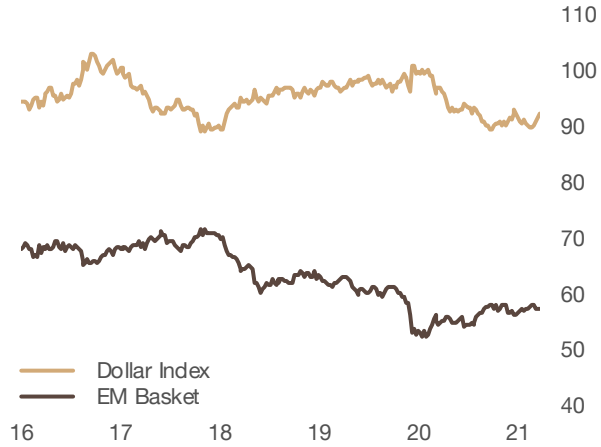
Taper or no taper, the US economy is powering strongly and GDP numbers are moving up on the back of the efficient execution of the country's vaccination program. As highlighted above, there are uncertainties pertaining to the last stage of that program and the spread of the delta variant. None the less, should the US economy continue to expand as is our central scenario, then we should gradually witness the steepening of the US treasury yield curve. As shown in March of this year, higher yields tend to result in buying interest for dollar bonds and a stronger dollar.

After the 2013 taper announcement, the USD soared



As the chart above shows, the USD moved aggressively higher against pretty much all currencies following the July 2013 announcement that the Fed was to tighten its monetary policy. Despite our expectations that the Fed taper announcement will come through differently, the consequence for the dollar should be the same in our view.

The dollar recent strengthening



Against that constructive medium term view, the recent appreciation in the dollar against a basket of developed and emerging market currencies seems to show rising anticipations towards a tightening in monetary policy. In our view this is premature.

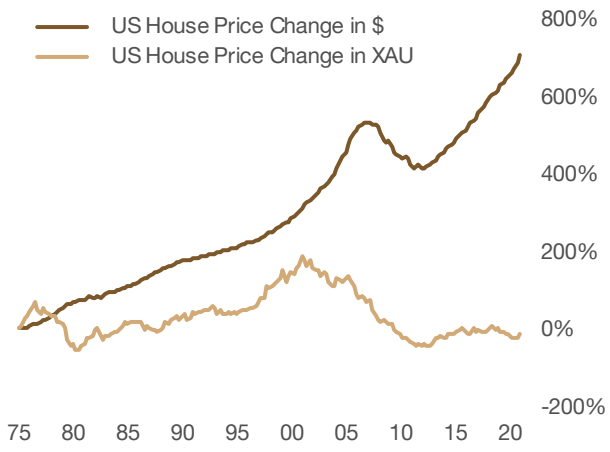
The future costs of easy money

We thought we would close this section with a word of warning. The longer term consequences of the largest

monetary and fiscal expansion realized in peacetime are almost impossible to anticipate.

None the less, the strong rise in risk assets, the increase in crypto currency values as well as the increase in house prices are amber signs of alert. Yet, given that the promised infrastructure and support programs are still to be rolled out in many jurisdictions, we see a continuation of the fiscal expansion well into 2022, likely accompanied by accommodative monetary conditions.

US House prices: in dollar and gold



The average house in the US has never been this costly in dollar terms – even before the great financial crisis of 2007-09, which was housing fuelled. The recent increase is of course partly a result of the Fed's expansionary monetary policy but also caused by the rise in property valuations outside of city centers as hybrid working arrangements get implemented throughout the economy.

All of that will likely work fine until central banks tighten the bolts and government yields start to rise. This too will have unintended consequences of a more negative nature. We are not there yet but it is worth keeping an eye on the frothy areas of the economy to assess the developing risks.

Past performance is not a reliable indicator of future performance and should not be solely relied upon.

Our 2021 economic scenario in brief

US GDP growth 6%

The breakneck pace of vaccinations and the historically large stimulus package will close the US output gap fast

US CPI 2%

Inflationary pressures have materialized as activity normalizes. We expect high inflation readings in Q3 and Q4 but these should be lower than the Q2 point.

US Fed Funds rate 0.25%

The Fed continues to be very accommodative without committing to specific bond yield targeting. Any language variation if any would likely come towards the year end.

US 10-year yield 1.8%

The steepening pace of the US treasury curve has eased in Q2 and long yields has moved down. We do not think this is over and maintain our target.

China GDP growth 8%

The only large economy that grew in 2020 continues on its expansion path into 2021, helped by the re-opening of the larger economies.

Eurozone growth 3%

In our view, consensus on growth is still overly optimistic on the Eurozone, even at the revised down 4.2% consensus rate.

Eurozone CPI 1%

In the same vein, we see inflation struggling to rise significantly above one percent in 2021 even taking into account the high Q2 readings.

EUR Refinancing Rate 0bp

The ECB has left the refinancing rate untouched at the worst of the crisis. The likely course of action is thus to continue using quantitative easing and other tools to support credit and the economic recovery.

German 10-year yield 0%

The Bund has followed US treasuries and the curve is now steeper. The ECB seems to want to contain a lift off in long yields with greater zeal than the Fed.

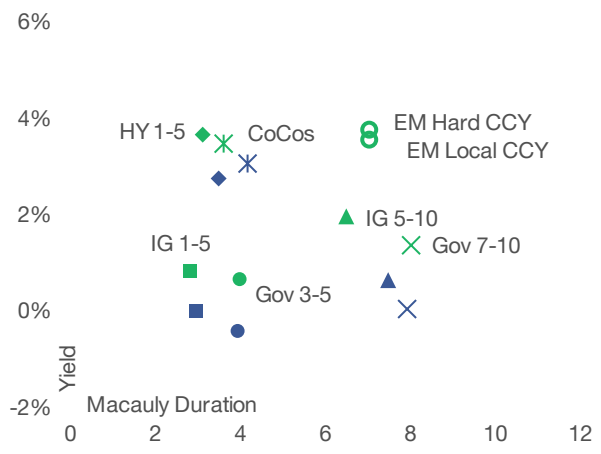
Fixed Income

High yield and subordinated debt have stolen the show in the first half of the year. As the economic recovery gathers pace and with continuous fiscal and monetary support, credit quality in the high yield segment is poised to improve and defaults to remain relatively low at least in the short term. Yet this is no reason to go too far down in credit quality. Emerging market debt in the context of high commodity prices should continue to do well. After the recent pull back in long government bond yield, we see duration as tactically unattractive with limited catalysts for yields to come further down. We thus stay away from duration risk in government bonds and in the investment grade credit market where there is little carry protection against a rise in long rates.

The Fixed Income value map

Despite the retracement in credit spreads and a stability underpinned by Central Bank buying activity, we continue to prefer credit assets. For investors with the right risk tolerance profile, subordinated debt, including AT1 bonds (Coco bonds) can be an interesting additional vehicle.

The Fixed Income value map – EUR in blue – USD in green

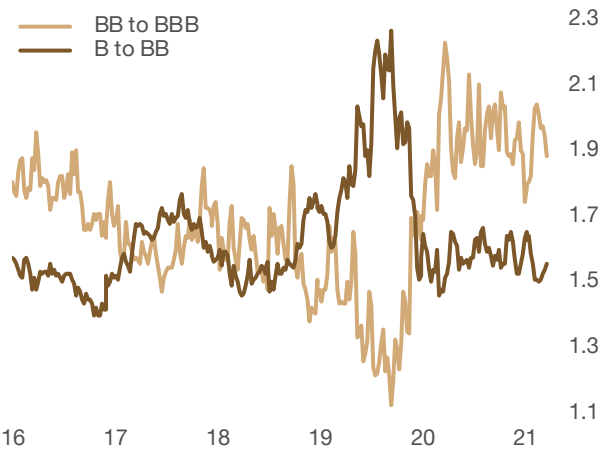


We plot in the chart above the different sub-indices of the Fixed Income market, showing average yield vs duration to maturity and for AT1s (contingent convertible bonds) yield vs duration to call.

We continue to favor quality High Yield and EM debt

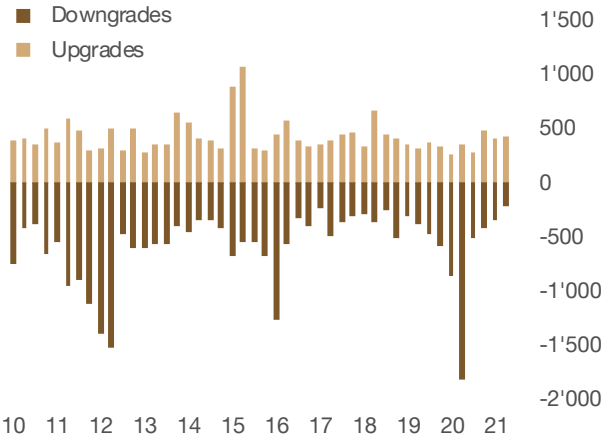
The High Yield market has been powering ahead this year with credit spreads improving as a number of companies saw their activity returning gradually to normal. The all-important energy sector in the US high yield indices has been a strong performance contributor. In an environment where Central Bank buying activity continues and with additional support likely to come from positive rating actions, we continue to favor the segment in both dollar and euro.

BB rated bonds continue to look cheap



BB rated debt still looks well positioned but not so much any longer for its attractive technical aspects as a Central Bank purchase crowding out play. Indeed, as the global economy recovers, a number of BB rated issuers should experience positive credit rating pressure. This in turn will likely result in incremental performance as these names get closer to the investment grade ratings barrier, thus becoming eligible for purchase by the Fed and the ECB.

Rating agencies – cooling off the guns



This is supported by a more balanced panorama of rating agencies' decisions. After an abysmal year for credit ratings in 2020, the number of credit rating upgrades outpaced the number of downgrades in the first quarter of this year. In the second quarter so far, we are at two upgrades for one downgrade based on Moody's data.

Default statistics are also showing the same trend with the peak in defaults seemingly passed at the end of last year around the 6% mark. This does not mean however that we are getting comfortable moving down the credit curve into the deeper end of the High Yield market. Even if the economic recovery is accompanied by government spending, this may not be positive for all the issuers evolving at the bottom end of the ratings spectrum.

Duration is no longer attractive

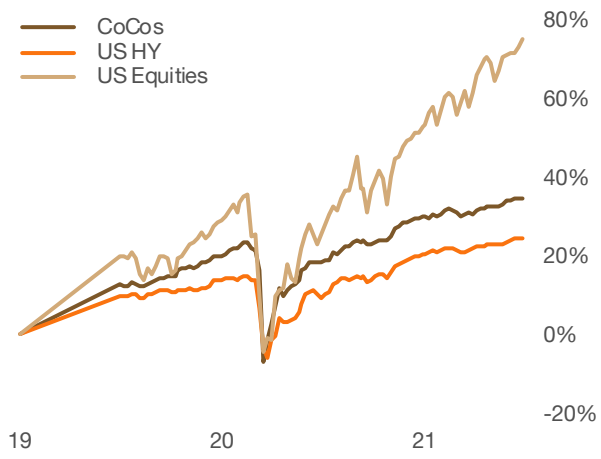
After the recent flattening of the US and the Bund yield curves, duration looks far less appealing than in our last edition. The combination of rising PMIs and GDP numbers as well as the currently high inflation readings are more likely than not to cause a lift off in long rates in line with what we saw at the end of March.

The low carry protection offered by both the government bond and the investment grade markets offers little protection against such potential downside risks at this stage.

Subordinated debt to continue delivering

As we wrote previously, the fact that governments bore the economic burden of the lockdowns left the banking sector relatively unscathed. This also means that in the recovery phase, banks are poised to release part of the provisions that they put aside over the last year. The effect on the AT1 sub asset class should be positive on the whole.

Performance of AT1s (Coco bonds)

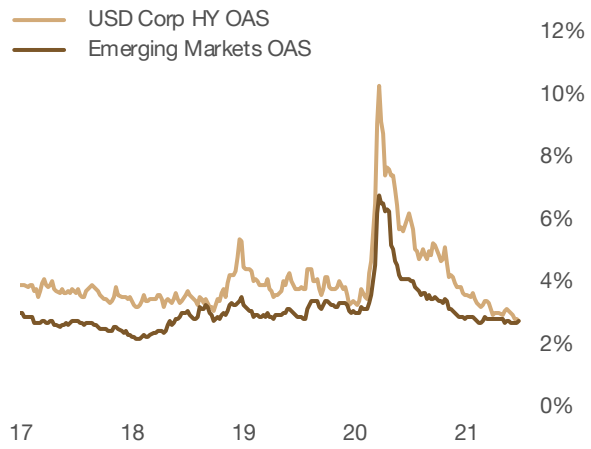


Yet one should not forget that the solidity of banks' balance sheets during Covid has also been helped by regulatory decisions to restrict shareholder payouts. As remuneration policies normalize, risks in the banking sector are therefore likely to become more idiosyncratic for subordinated debt investors.

Emerging markets – a return to performance

The flattening of government yield curves has helped overall performance. None the less, emerging market debt has also benefited from tighter credit spreads as sentiment on Brazil and Turkey improved in the recent months.

Same credit spreads – better overall credit rating



It is true that emerging market debt presents typically a longer duration profile than the high yield segment. However the average credit quality and liquidity are also higher, making it a cornerstone of a fixed income portfolio following a credit spread based strategy.

Chinese issuers of intrinsic good quality should continue to perform well. These have brushed aside the pall cast by the government's uncommon indecisiveness in the Huarong case, which at some point was threatening a re-pricing of bonds issued by sovereign owned enterprises.

Asian issuers should continue to benefit from the rise in metals and energy raw material prices as well as an improvement in their situation in relation to Covid outbreaks. India and Indonesia fall in that category.

In Latam, sentiment and fundamentals are turning positive for Mexico on account of higher oil prices but also from the strong growth currently moving the US economy. Even if the situation in Brazil looks only slightly better, our cautionary stance remains given the growing proximity of the next elections and the associated rise in political risk.

In Turkey, the market has seemingly digested the latest intervention of president Erdogan in the management of the Central Bank. After a 10 points fall in long dated Turkish dollar bonds, prices are now closing in to their pre-announcement levels.

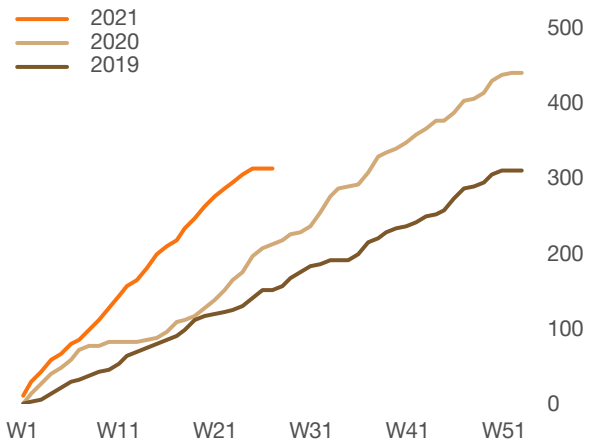
For Russia, earlier sanctions have hit but the situation

seems to have stabilized on the surface. The geopolitical risks are still there but seem to have taken a back seat for now – to the benefit of the larger Russian issuers.

Buoyant High Yield issuance – IG took a spring pause

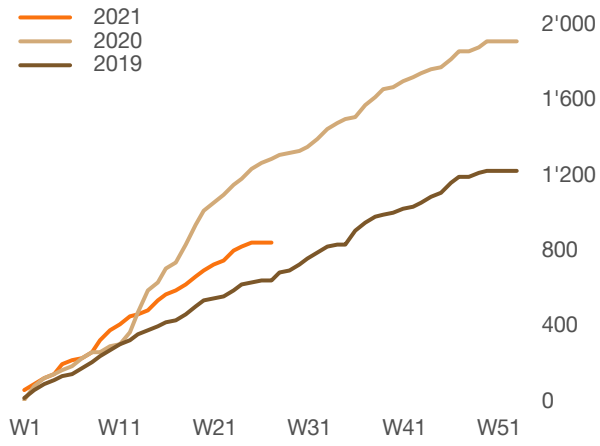
Investor appetite for yield has been matched by a desire from corporates to access cheaper funding than in the stressed days of the Covid lockdown. In what looks like a funding rationalization phase, corporates have managed to raise and extend funding at relatively cheap level.

Strong HY issuance as companies seek longer funding



The situation has been broadly the same in the investment grade market. However the March yield curve steepening phase can be seen in the issuance volumes as investors at the time were facing clear underperformance from newly purchased assets. We contend that this situation could come back in a credit market that is now awash with bonds.

IG returns after the March pause



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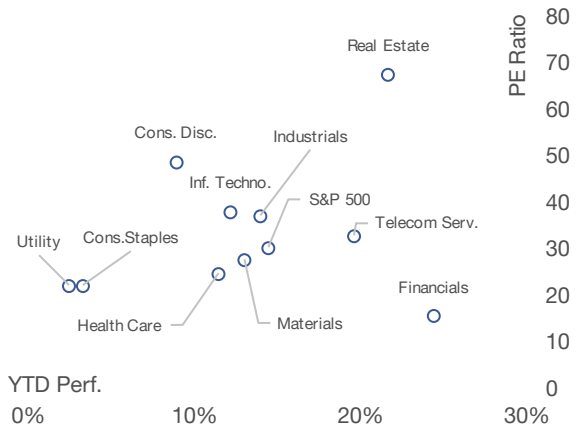
Equities

Whoever sold in May to go away has lost out so far. Equity markets seem to show an increased level of resistance to negative news as valuations - particularly in the US tech segment - walk into thinner air. Europe has continued its performance upswing and despite the significant increases witnessed year to date on the beaten up sectors of 2020, we still find pockets of value in the global reflation trade. Chinese equities have enjoyed a comeback in recent weeks mostly due to a lack of government intervention. We see additional potential in the months to come considering the central position of China in key growth themes such as electrification and digital transformation. From a valuation and momentum standpoint, emerging market equities outside of China also look well positioned.

The value map in US equities

Calmer waters on the rates front has rekindled US tech as the reflation trade in equities provided a strong tailwind for the commodities, industrials and financials sectors. Europe naturally benefitted strongly from the return to favor of value based equities.

The US Equities value map – ex energy

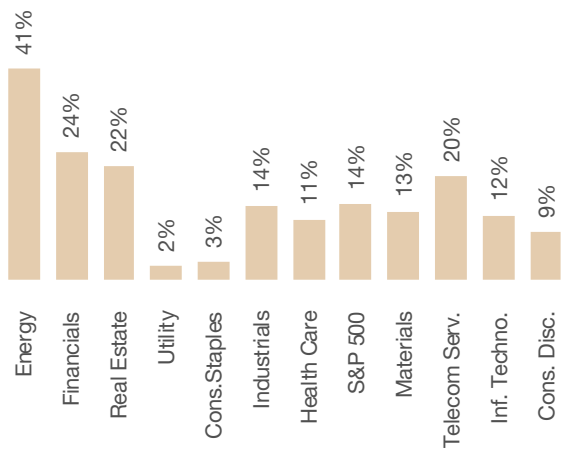


US stocks and US tech – into thinner air

US equity valuations have continued their advance in late spring buoyed by the decline in long bond yields and also by a strong set of first quarter results that largely met or exceeded expectations. At this stage, valuations continue to look stretched and will likely seek validation in the second quarter results wave that will take place end of July.

Given the strong economic backdrop evidenced in the early economic indicators, we believe that second quarter results are likely to come out very strongly – also helped by the base effects of last year's disastrous showing. Inflationary pressures in raw materials are likely to dent profitability but we expect management teams to confirm guidance for the year end in the main.

US Sector performance: energy on top



Looking at individual sector performance in the US, the second quarter has been about the reflation trade. At a point when banks are talking about returning cash to shareholders by reversing their Covid provision, we see additional catalysts for the reflation trade to continue performing.

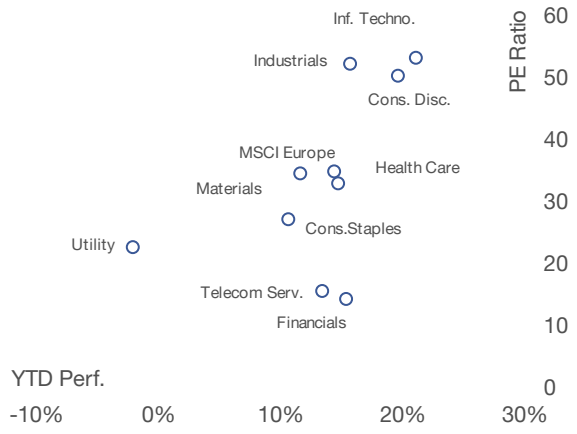
For growth equities, and in particular tech, calmer waters on long rates have clearly caused the terms 'duration stocks' to disappear from screens. None the less the threat represented by higher long yields on sentiment is still present and could resurface later on in the year. That said the US tech complex looks to have met the economic re-opening challenge well, validating our view that an even larger proportion of the so called 'real world' economy is now relying on digital technologies.

Finally, the year end and 2022 should herald the return of dividends in a number of sectors namely energy, commodities, financials and consumer goods. This has been priced in to some degree but we still find that large groups with a relatively low business risk offer decent dividend yields – certainly by comparison with the yield paid by the market on their bonds.

Europe : still at a discount

The old continent has been the prime beneficiary of the reflation trade of the late 2020 - early 2021 period, coming from much further out that the US. After initial delays in the early stages of the vaccination process, the European economy has caught up on vaccines and started its recovery. Variants notwithstanding, European stocks should continue to benefit from that improved backdrop.

European equities value map



Despite exhibiting strong returns year to date, the European stock market is still showing a significant valuation discount relative to the US on a sector by sector basis. This is due to structural factors, notably the absence of significant pension fund buyers and a less widespread general equity culture.

This discount is particularly evident when comparing the returns year to date of similarly large companies operating in the same sector on a global basis. In some cases, the performance gap can be in excess of 20%, which still makes European stocks laggards in the recovery trade but also increases their relative attractiveness.

The last stages of the reflation trade look riskier

Given the strong performance of the sectors that were the first to benefit from the reopening of the global economy, investors could be tempted to go for sectors that still need to re-open, namely airlines, tourism and the hospitality industry. In reality, the emergence of the delta variant has significantly tempered enthusiasm to relax air travel restrictions with quarantines still in place even for individuals that have been fully vaccinated.

At this stage, we would stay out of these sectors given the uncertainties associated with the restart of international air travel. Until more regulatory hurdles are cleared and the fears associated with recent variants of concern are put behind us, these sectors could prove disappointing investments.

China : improved sentiment

The government rhetoric and regulatory actions towards the Chinese tech issuers have calmed down, creating a more positive backdrop for performance in Chinese equities going forward. Despite the recent improved returns, Chinese equity issuers – particularly in the technological sector - remain cheap relative to their US counterparts despite addressing a significantly larger potential market.

China tech at a discount

It is clear to us that the Chinese government is not deploying a lot of support to its economy in the current recovery phase compared to the US or even Europe. Nevertheless, the strong growth expected in the Chinese economy this year should continue to provide strong tailwinds for the equity market - particularly in the absence of significant government regulatory action.

EM ex China : a good place to chase laggards

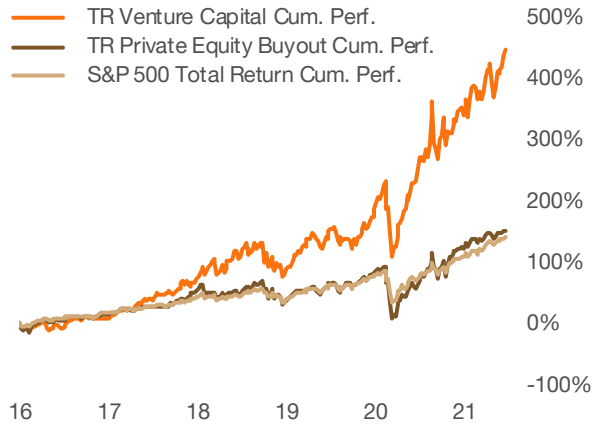
The same positive fundamental reasons that apply to emerging market debt also apply to equities. As EM economies move out of the third Covid wave towards recovery, they could prove a fertile hunting ground for investors chasing performance laggards.

Commodity based issuers in emerging markets as well as financials stand to benefit from the reflation trade. So far, the gap between cheap and expensive names has closed only slowly with a potential for the rotation trade to accelerate within the emerging market equity segment.

Private Equity – the right environment

As rates remain low and opportunities for corporate restructurings abound in an environment of economic recovery, all lights are green for private equity to do well in the coming quarters. Amongst the key elements, we can cite in particular attractive valuations at the asset exit point either through a sale or an IPO. Performance of buyout and venture strategies

Private Equity strategy returns : Venture and Buyout



For investors with the right risk profile and willing to capture an illiquidity risk premium, this could be an element of diversification into a sub assets class that has historically outperformed listed equity markets over longer time periods.

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Commodities

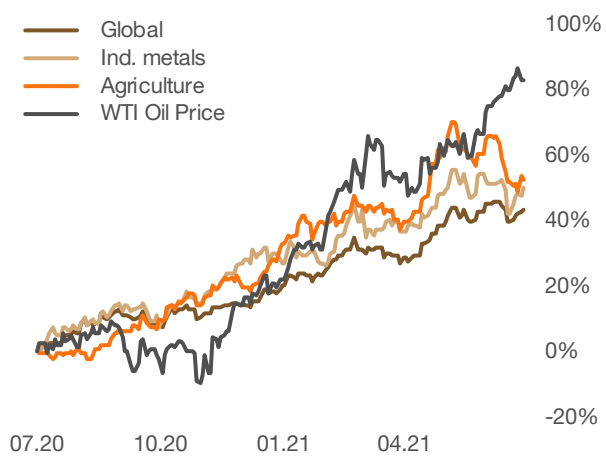
What a difference a year makes in the oil market! The barrel is now sitting comfortably above USD70 as a result of the recent Opec decisions and the likely delay in the Iran nuclear deal. Base metals have pulled back following the intervention of the Chinese government against hoarding practices but remain well supported in the current global economic recovery. Gold prices have come back somewhat but then have failed to hold onto their gains from mid-June onwards as fears around a change in the inflation regime receded on the back of the Fed meeting.

Oil : limited upside catalysts

Opec+ is managing supply well in 2021 and seems to have learnt the lessons from the spring 2020 fiasco. The decision by the cartel to raise output by 2.1m in its recent meeting amid tense supply conditions has enabled a good level of price control.

We thus would be surprised should Opec+ decided to raise production by more than 500k barrels a day for August. In addition, the election of ultra conservative Ebrahim Raisi to the Iranian presidency is likely to create a significant obstacle to the conclusion of nuclear deal with Europe and the US, delaying further the release of Iranian oil capacity in the market and structurally supporting prices.

Commodity price panorama



Amid the economic recovery, data points at a supply deficit for August and in the third quarter, which could potentially push prices up into the autumn. That said, the US shale production has moved up but is still 10% below its pre-Covid level of 9.3m barrels per day. Should prices shot upwards, then we believe that the re-opening of capacity in the US would look increasingly likely and weigh on the supply equation.

Base metals: driven back somewhat

Soaring demand for industrial metals in the early part to the year was compounded with hoarding behaviors from metal processing industries – including the ones linked to vehicle electrification - that led to a significant jump in prices. Following the intervention of the Chinese government, which tried to curtail these practices, base metal prices have staged a pullback but remain elevated. As an example, spot copper reached an all-time high in early May at USD10.5k a ton to recede closer to USD9k, still a 50% increase year to date.

Base metals – a slight pull back

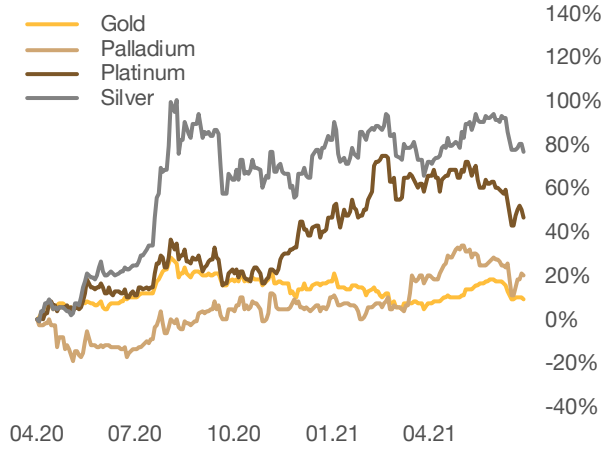
We continue to be surprised by the capital discipline of the larger commodity players, which potentially also see this increase in prices as transitory. The prospect of higher taxes and netbacks from the producing countries currently facing this commodity bonanza may also discourage mining companies from investing. Lastly, even if we believe that prices will remain elevated in the coming months on account of the global economic recovery, the normalization of supply chains and consumer behavior creates risks to the downside for metal prices.

Gold : failing to hold onto gains

After a poor start to the year that did not reflect the inflation fears prevailing at the time, the yellow metal has staged a comeback only to fall again in June – notably

following the Fed reiteration that inflationary pressures would prove transitory and that the Central Bank had the means to combat those. As we are back to the levels seen last at the back end of April, we do not exclude seeing gold making a comeback to above 1800 in the relatively near term.

Precious metals: temporary weakness



Despite sustained industrial demand, Silver has come off its highs – more in line with Gold this time than other industrial metals. Platinum and palladium also fell slightly in recent weeks but lack of supply and increase usage from a car industry that is becoming metals hungry should provide the backdrop for prices to remain elevated.

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Currencies Market Expectations

Major Currencies

		Q3-21	Q4-21	Q1-22	Q2-22	Q4-22
EURUSD	1.19	1.21	1.21	1.21	1.24	1.23
EURCHF	1.10	1.11	1.12	1.12	1.13	1.13
EURGBP	0.86	0.86	0.85	0.86	0.86	0.85
EURJPY	132	132.5	132.0	132.0	132.0	131.0
EURNOK	10.20	9.93	9.88	9.82	9.80	9.55
USDCAD	1.24	1.22	1.22	1.22	1.22	1.21
USDCHF	0.93	0.92	0.92	0.92	0.91	0.92
USDJPY	111	110.0	110.0	110.0	110.0	110.0
USDCNY	6.46	6.40	6.40	6.36	6.33	6.30
GBPUSD	1.38	1.41	1.42	1.42	1.42	1.44
NZDUSD	0.70	0.73	0.73	0.74	0.74	0.74
AUDUSD	0.75	0.78	0.78	0.79	0.79	0.78

Other Currencies

		Q3-21	Q4-21	Q1-22	Q2-22	Q4-22
USDMXN	19.9	20.0	20.0	19.8	19.7	20.3
USDBRL	4.97	5.2	5.1	5.1	5.2	5.3
USDARS	95.7	100.5	112.1	123.9	128.0	122.5
USDTRY	8.71	9.0	9.2	9.3	9.5	9.5
USDILS	3.26	3.3	3.2	3.2	3.2	3.2
USDHKD	7.77	7.8	7.8	7.8	7.8	7.8
USDINR	74.3	73.5	73.0	73.3	73.5	73.1
USDRUB	73.1	72.0	71.0	71.0	70.8	71.3
USDPLN	3.81	3.7	3.7	3.7	3.7	3.7

The table above provides an overview of market forecasts for major currencies. It is composed of dozens of individual forecast providers and delivers a consensus forecast. These consensus forecasts represent a median number and all forecasts evaluated correspond to calendar quarter-end dates.

Future forecasts do not guarantee future performance and should only be used for indicative purposes.

Market Performances

	Name	QTD *	YTD**	2020	2019	2018	2017	2016
Cash	Dollar 3m Total Return	0.0%	0.1%	1.0%	2.5%	2.4%	1.1%	0.6%
	Euro 3m Total Return	-0.2%	-0.3%	-0.5%	-0.4%	-0.4%	-0.4%	-0.2%
Government bonds	US 3-5	0.3%	-1.0%	6.2%	5.3%	1.5%	1.0%	1.3%
	Eurozone 3-5	-0.2%	-0.6%	1.3%	1.9%	0.1%	0.1%	1.5%
	US 7-10	2.5%	-3.4%	10.0%	8.5%	0.9%	2.6%	0.8%
	Eurozone 7-10	-0.5%	-2.1%	4.5%	6.7%	1.4%	1.3%	3.5%
Corporate bonds IG	USD Corp 1-5	0.7%	0.1%	5.4%	7.0%	1.0%	2.6%	2.9%
	EUR Corp 1-5	0.2%	0.2%	1.1%	2.8%	-0.5%	1.2%	2.6%
	USD Corp 5-10	2.8%	-1.2%	9.7%	14.3%	-1.7%	5.6%	5.6%
	EUR Corp 7-10	0.4%	-1.0%	4.4%	10.9%	-2.4%	4.2%	7.0%
Corporate bonds HY	USD Corp 1-5	2.5%	3.5%	5.8%	13.9%	-1.8%	7.0%	16.5%
	EUR Corp 1-5	1.4%	3.1%	2.3%	11.3%	-3.8%	6.9%	9.1%
	USD Corp 5-10	2.3%	3.3%	-2.0%	9.1%	-1.9%	7.6%	7.3%
	EUR Corp 5-10	1.3%	2.3%	2.8%	13.2%	-4.4%	8.0%	10.8%
EM bonds (in $)	Hard currency	3.0%	-0.6%	6.5%	13.1%	-2.5%	8.2%	9.9%
	Local currency	2.9%	-1.0%	5.3%	9.5%	-3.4%	14.3%	5.9%
	Chinese Yuan	2.8%	3.5%	9.3%	2.8%	3.0%	5.0%	-4.7%
Others	S&P Leverage Loan Index	1.5%	3.3%	3.1%	8.6%	0.4%	4.1%	10.2%
	Global Convertible	2%	6%	26%	18.2%	-1.2%	7.2%	4.6%
Equities	North America	9%	14%	19%	29%	-6%	19%	9%
	Europe	5%	14%	-5%	22%	-13%	7%	0%
	Japan	0%	8%	7%	16%	-17%	18%	-3%
	Asia Pacific	2%	4%	17%	16%	-16%	29%	2%
	Developed Markets	7%	12%	14%	25%	-10%	20%	5%
	China	1%	-1%	23%	38%	-21%	32%	-7%
	Latin America	14%	7%	-16%	14%	-9%	21%	28%
	Emerging Markets	4%	6%	16%	15%	-17%	34%	9%
Other investments	HFRX Alternative	2%	4%	7%	9%	-7%	6%	3%
	VIX	-18%	-30%	65%	-46%	130%	-21%	-23%
	G7 Currency Volatility	-10%	-15%	23%	-34%	21%	-36%	22%
	DJ Global Commodity	13%	21%	-4%	5%	-13%	1%	11%
	Gold	4%	-7%	25%	18%	-2%	14%	8%
	Industrial metals	9%	18%	16%	5%	-21%	28%	20%
	Agriculture index	13%	20%	16%	0%	-13%	-12%	2%
	WTI Oil	24%	51%	-21%	34%	-25%	12%	45%
Currencies (vs. $)	Dollar Index	-1%	3%	-7%	0%	4%	-10%	4%
	EM Currency Index	2%	-1%	-6%	-1%	-11%	6%	0%
	Euro	1%	-3%	9%	-2%	-4%	14%	-3%
	British Pounds	0%	1%	3%	4%	-6%	10%	-16%
	Swiss Francs	2%	-4%	9%	1%	-1%	5%	-2%
	Japanese Yen	0%	-7%	5%	1%	3%	4%	3%
	Chinese Yuan	1%	1%	7%	-1%	-5%	7%	-7%

* Quarter to date
** Year to date

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