

HOUSE VIEWS

JUNE 2022



FED'S BALANCING ACT

Repeatedly in 2021, central banks told markets not to worry about inflation – and investors gleefully did as told. Even as inflation kept rising in 2022, markets were relatively sanguine – many thought it had peaked in March as it was being driven by relatively small-weighted items in the inflation basket surging due to the War in Ukraine and covid-related supply issues in China. The expectation was that such pressures – while acute – would eventually dissipate. The belief that inflation would subside naturally further solidified when the April inflation figure, while still high, was lower than the previous month. However, US inflation data released on Friday shattered that belief. The inflation figure hit 8.6%, a 40-year high. Moreover, many of the of the sub-components appear to be gaining momentum.

What is different this time?

As of May, motor fuel, gas and electricity in the US were 49%, 30% and 12% more expensive, respectively, compared to the year before. The price of meats, poultry, fish, and eggs collectively rose by over 14%. Flights became nearly 40% more expensive. All of this contributed to a year-on-year inflation reading of 8.5% in March, the highest the US has seen in four decades. Such pressures are even more pronounced in the UK. The good news is that the items mentioned have had huge percentage increases often because their prices were deeply depressed in the early post-pandemic recovery. They should eventually begin contributing less to the overall inflation calculation as such huge percentage gains are unlikely to persist. The bad news, however, is that these items account for relatively small weight in the basket making up the Consumer Price Index. Far more important is the cost of shelter, which alone makes up one-third of the inflation basket. And here there is clear evidence of inflationary pressures that are likely to be more long-term.

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Sticky business

In developed economies, the biggest expenditure for consumers tends to be housing: the average Briton or American spends about 33% of their monthly pay cheque on rent. Cost of shelter did not rise as fast as other components of the CPI – 5.5% in the US in the twelve months to May– but given its prominent weighting likely provided the most painful squeeze to consumers’ finances. Worse yet, compared to other components of the index, rent prices tend to be “sticky”. Whereas the cost of, say, used cars tends to fluctuate with supply and demand, and patient buyers could hold out for a better deal, tenants signing a new, pricier lease will be locked in with the higher cost for years. Further, rent prices tend to not be correlated with real estate prices on the downside: even if house prices fell, tenants are unlikely to benefit from a downward revision of their equivalent rent.

This move from transitory to more systemic inflation has – more than anything else – spurred central banks to action and uncertainty has crept into economic expectations for consumers, corporates, and ultimately financial markets. The S&P 500, a global bellwether, has fallen into a bear market. Sentiment has come down markedly, in some asset classes verging on over-sold territory. Crucially, bond markets suggest that central banks will be able to control inflation in the medium term: 10-year breakeven yields are pricing in an average inflation rate of 2.7% over the next decade. This is important, and signals central banks have not lost the critical battle against long-run inflation expectations becoming unanchored. Nonetheless, many markets participants believe policymakers to be behind the “rate-hike curve”, and now making up for it by aggressive action – with 200 basis points of tightening being priced in over the rest of 2022. That aggressive pace of monetary tightening is at root of the angst in markets today and has clearly increased the possibility of recession.

Stay calm and carry on

Much of Western monetary policy – and indeed the fate of global financial markets - rests on inflation numbers over the course of this year. Fortunately, some evidence suggests that price pressures have already begun to subside. Firstly, many of the smaller CPI items that drove inflation throughout and immediately following the pandemic, such as homewares or used cars, have already started to retract. Even those items impacted by the war in the Ukraine, such as oil, energy, and other commodities, are unlikely to experience further significant price pressures from today’s high bases.

Secondly, house prices, which tend to lead rent prices by about a year, are one of the few factors central banks can target more effectively to combat inflation. Even in anticipation of monetary tightening, 10-year fixed mortgage rates in the US began have shot up to 5.5% from 2.5% at the start of the year, causing house price growth to retract. This development is not restricted to the US - in the UK, house price growth has dropped to single digits for the first time this year, easing from a high of 13.3% year-on-year in 2021.

Solid foundations

The balance of probabilities is currently not pointing towards a recession this year. Monetary policy remains loose by historical standards, and there is no evidence of significant degrading of financial conditions: access to loans, whether private or corporate, is still easy. Corporate earnings continue to climb to new record highs. Household savings are unusually high following the past few years of fiscal stimulus, and financial regulation has greatly improved the robustness of both banks’ balance sheets as well as their credit approval processes over the past decade, backstopping another potential Great Financial Crisis. Indeed, a record-low housing stock will likely provide a bottom to prices even in the case of a Fed-sponsored contraction of the housing market.

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Bottom Line

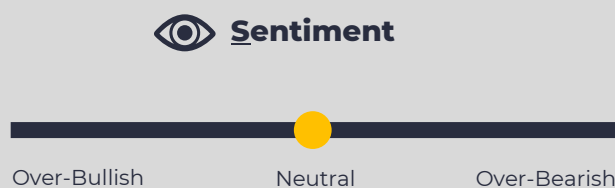
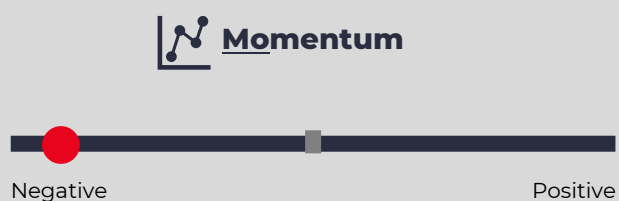
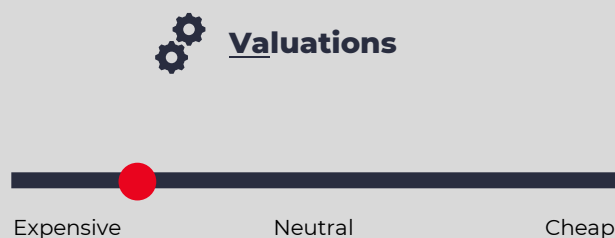
In uncertain times like these it pays to not panic, stay disciplined, and trust the process. It is currently telling us the following:

- **The economic outlook remains in slowdown** judging by the forward-looking indicators we measure. This is favourable for risk assets. Recession does not appear on the horizon. While financial conditions are tightening, it remains relatively easy and cheap for most households and companies to borrow money. Jobs are plentiful. Corporate earnings are at (or near) record territory.
- **Valuations had been our biggest source of concern coming into this year but have moderated**, as prices for equities have fallen this year while earnings expectations have remained anchored or even risen, leading to affordable if not cheap assets compared to their own recent history.
- **Momentum for equities remains negative** by the 10-month moving-average metric that we favour. This is cause for caution.
- **Sentiment in markets is neutral** but has deteriorated sharply over the past weeks, mainly impacted by negative equity outflows and a strong dollar. Over-bearishness would provide a strong buying signal; however, we are not there yet.

A robust economic outlook paired with fair(er) valuations support the case for risk-taking. On the other hand, momentum of equity prices remains negative for the time being: a signal to seek a conservative stance in the near-term. We prefer a neutral allocation to risk assets supplemented by a range of diversifiers, including cash, government bonds, gold, hedge funds and a Tail Risk Protection Note. This provides a resilient positioning in the wake of rising volatility and sufficient flexibility to adjust our views should conditions change: to further cut risk in case of deteriorating economic environment or add to it should momentum turn or if rate hike cycles prove to be drastically overestimated.

PROCESS AND CONVICTIONS

Our **VaMoS™ framework** puts our investment philosophy into practice



We have a **neutral allocation to equities**, reflecting a slowdown in the **economic scenario**.



Valuations continue to soften but **momentum is negative**, giving us some cause for concern. As such, we hold an increased **stable of diversifiers: cash, government bonds, gold, hedge funds, commodities** and a **Tail Risk Protection Note**.



We favour **cheaper regions**, which are **less sensitive to a rising rate environment** such as the **UK and the Eurozone**.



Environmentally-linked policymaking, legislation and consumer behaviour are irreversible. We favour companies that are contributing positively to these long-term themes.

OUR ASSET ALLOCATION

The table below presents the latest conclusions of the Kleinwort Hambros Investment Committee:

		Summary house views					Change since last KHIC	
		Strong UW	UW	N	OW	Strong OW		
EQUITY	GLOBAL EQUITY			■				
	United States		■					
	Eurozone				■			
	United Kingdom				■			
	Japan	■						
	Emerging			■				
FIXED INCOME	SOVEREIGN	GLOBAL RATES		■				
		U.S. Treasuries		■				
		German Bunds		■				
		UK Gilts		■				
		EM Government Bonds (\$)	■					
	CORPORATE	Duration USD*				■		
		Duration EUR*				■		
		Duration GBP*				■		
		US Investment Grade		■				
		Eurozone Investment Grade		■				
		UK Investment Grade		■				
		High Yield	■					
FOREX	EURUSD			■				
	USDJPY				■			
	GBPUSD			■				
	EM FX (vs. USD)			■				
ALTERNATIVE	COMMODITIES	Brent			■			
		Gold				■		
		Diversified Commodities				■		
	ALT. STRATEGIES	L/S Equity			■			
		Event-Driven				■		
		FI Arbitrage		■				
		Global Macro		■				
		CTAs				■		

Source: Kleinwort Hambros 9-June-2022

*Duration: underweight/short = Up to 5 years, neutral/medium = 5-7 years, overweight/long = 7+ years. HY = High Yield bonds (higher return but greater risks), IG = Investment Grade bonds (higher quality but lower return)



Bond markets reacted sharply to the latest inflation print in early July, pricing in a more aggressive monetary tightening strategy by central banks. We are reducing our Underweight to Sovereigns, which have become considerably more attractive in terms of income and protection over the past few months.

Sovereign

United States. Following a month of relative stability with 10-year Treasury yields hovering between 2.75% and 3.10%, bond markets suddenly sprung into action following a worse-than-expected inflation reading in early June: yields spiked as high as 3.35% as investors digested the news and began pricing in more aggressive Fed action. After increasing its policy rate by 0.5% to 1.0% in May, the Fed was previously expected to follow up with a steady series of 25bps hikes, whereas some market participants now expect hikes of up to 75bps in response to the ongoing inflationary pressures. The rise is expected to continue to 3.5% in early 2023, reflecting worries about the uptrend in the most stubborn components of inflation such as rents. However, house price growth – which leads rent price growth – has already begun softening in anticipation of the rate hike cycle and may well provide the Fed with sufficient breathing room to hold off the most aggressive policy action. Much negative news has now been priced in and we are reducing our Underweight to take advantage of more attractive valuations.

United Kingdom. The Bank of England (BoE) will continue to tighten rates in an effort to counter the rampant inflation sweeping through the UK economy, which hit 9% in April and is projected to continue further for the remainder of the year. Despite a gloomy economic forecast, the BoE has few options but to keep raising rates to avoid even worse implications resulting from long-term, systemic inflationary pressures. Following its most recent hike to 1.0% in May, money markets are pricing in a base rate of 2.8% at year-end. As in the US, we are taking the opportunity of the spike in yields to reduce our Underweight.

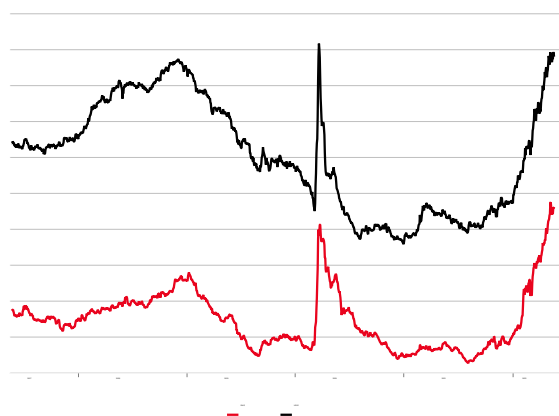
Eurozone. In line with US yields, European sovereign yields held generally steady throughout May before surging further in early June, as 10-year bund yields continued their rise to 1.63%. With inflation still on the rise and underlying inflation running above 3%, the ECB decided to tighten policy significantly sooner than previously planned. It will likely halt net asset purchases in June and is set to start raising rates in July, with the aim of exiting its negative-rate policy. Nonetheless, given its options for reinvesting its various asset purchase programmes, we think the ECB still has the dry powder to deal with unforeseen issues arising in weaker economies. Overall, we remain Underweight.

Credit

Developed Markets. As sovereign yields rose and spreads reacted to mounting economic uncertainties, Credit indices took significant losses in the year to date. The asset class is likely to face more headwinds amidst rising rates and declining growth and we have increased our Underweight in favor of Sovereign debt.

Emerging markets. We remain Underweight emerging market debt. Developed economies are tightening monetary policy, which usually sucks value out of EM assets. Also, further lockdowns in China and decoupling of the PBoC's monetary policy will put downward pressure on Chinese bond values.

Investment grade corporate bond yield



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We are retaining our overall Neutral exposure to equities. Equities have been facing multiple headwinds since the start of the year. Many of these have, however, already been priced in by the market. Furthermore, the outlook for revenue growth remains positive in a context of significant nominal growth.

United States. Tech stocks were hardest hit by the trend in rates, with the Nasdaq temporarily posting losses comparable to those seen in March 2020. While the Q1 earnings reported by companies (including those in the Nasdaq) mostly surprised on the upside, revenue risks are on the downside. For one thing, deteriorating households' confidence is likely to translate into softer consumption. For another, rising wages and production cost inflation are putting pressure on company margins. Recession risk remains, though it is not our base-case, and is largely priced into markets at this point. The labour market continues to boom, and the near-energy independence of the US economy means it can mitigate the commodities shock. We are Underweight.

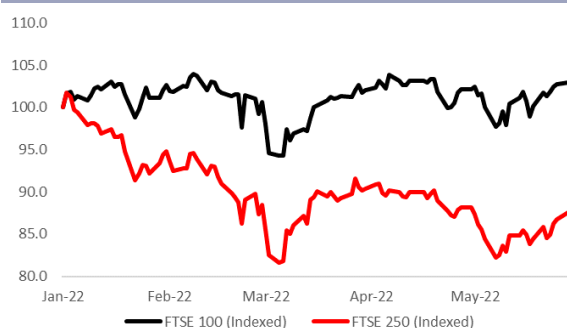
United Kingdom. The UK equity market is one of few developed countries to have performed well since the start of the year, thanks to its advantageous sector composition. On the other hand, the British economy itself is skirting recession, with household incomes especially hard hit. This is evident in the performance of the region's two main equity indices: The FTSE 100 large-cap index, propelled by energy stocks, returned 3% in the year through 31st May. The FTSE 250 however, its small- and mid-cap cousin, returned -13% over the same time period, reflecting worries about the "real economy". We remain Overweight given attractive valuations and favorable sector composition.

Eurozone. Eurozone equity markets continue to suffer from the war raging in neighboring Ukraine. Inflationary pressures are mainly stemming from energy and food prices. Underlying inflation is lower than in the United States and salary rises much lower. Consumer confidence fell back to the levels seen in March 2020, just as the ECB is bracing to speed up its monetary tightening calendar and a first policy rate rise is now expected in July 2022. In these circumstances, we reckon much of the correction to European equity indices has already happened. The value on offer in equity markets is attractive and we are Overweight.

Japan. The Japanese equity market, is at the mercy of growth trends in wider Asia. Ongoing health clampdowns in China are likely to hurt earnings at the leading Japanese groups. Also, the correlation between a weak yen and improving company profits has weakened over recent years. We remain Underweight.

Emerging markets. Emerging market equities are currently being hard hit by the shutdown to activity in China. The brutal drop in the Chinese economy is also creating bottlenecks, raising fears of possible supply problems and fresh pressures on inflation, particularly for emerging economies. Nonetheless, medium- to long-term growth prospects remain attractive and we are Neutral.

Energy stocks propelled the FTSE 100



Source: Kleinwort Hambros, Bloomberg, 09/06/2022

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FX RATES

More Hawkish Fed



The higher-than-expected US inflation figures for May means the Federal Reserve will send a stronger signal to tame it with a more hawkish stance. This is likely to continue to support a strong Dollar.

Dollar index (DXY). With risks significantly on the rise, the dollar continues to make gains against main currencies. The higher-than-expected inflation number for May means the Federal Reserve will have to tighten faster; the relatively robust pace of US economic growth combined with a persistence of geopolitical risks over coming weeks, should translate into continued support for the USD.

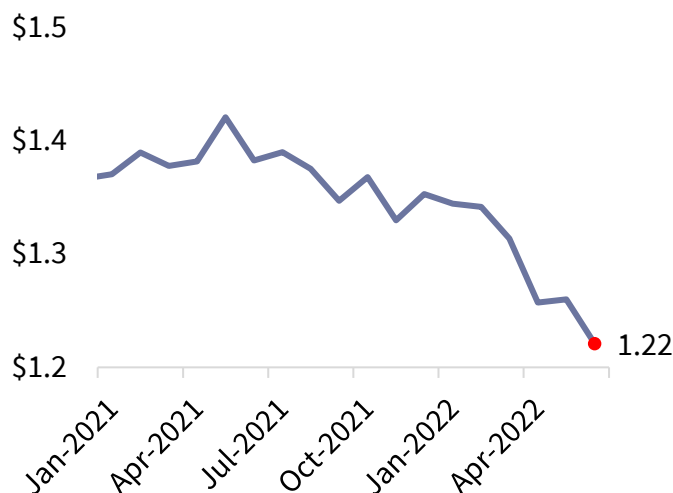
EUR/USD. Ongoing geopolitical risks, mounting threats to European growth reported by the ECB and the Fed's intensified pace of monetary policy tightening will continue to support the USD for the next few months. The EUR/USD currency pair is at a three-month low.

GBP/USD. The currency pair is at a four-week low at 1.22. The pound has had some weakness given the fractured state of Boris Johnson's future and more Brexit legislation troubles. Macro data showed an unexpected contraction in economic growth by -0.3%, the first back-to-back monthly figure to be negative since the pandemic. The prospects of a more aggressive Fed and the safe-haven qualities of the greenback support dollar strengthening.

GBP/EUR. Downbeat UK economic news continues to see the pair trade at around 1.7. The ECB left rates unchanged in its recent June meeting and signalled a 25bps increase for July, the market consensus was higher at 50bps.

EM. Emerging currencies remain on a downward trend. On the one hand, the extension of new recent lockdowns in China have put Asian currencies as well as those of countries exporting mining products at a disadvantage. In addition, the Fed's accelerated tightening adds downward pressure to currencies like the TRY that are dependent on capital flows. The only exception to this downward trend is the BRL, which still benefits from positive real rates.

US dollar per British pound continues to fall



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ALTERNATIVES

An environment still favourable to alternative assets



Since the start of 2022, the economic backdrop of sustained inflation and uncertain growth prospects has been bad for traditional assets but good for alternative investments. We maintain our Overweights to gold hedge funds and commodities.

Commodities

Oil. Having briefly dipped below USD 100/bbl last month, oil continues its upward trajectory and is trading at USD 118/bbl and looks set to stay high, albeit with plenty of volatility to come. Supply side, exporter countries are capping production and have no plans to raise it. Demand side, the Chinese economy looks poised to start growing again but another fresh lockdown in Shanghai could temper this slightly. Europe's plan to cut off its supply from Russia by the end of the year is helping put upward pressure on prices. Recession fears are likely to cause oil to be volatile, but the supply issues clearly tilt the pressure towards higher prices.

Gold. The gold price fell over the month to just above USD 1,800/ounce, back where it was before the Ukraine war. The trend is explained by strong gains in the dollar and rising fixed-income yields – both factors that make it less attractive to hold gold. However, at its current price, gold is looking tempting again, particularly compared to fiduciary currencies other than the dollar, which are losing purchasing power, and following the recent plunge in crypto assets. Crypto was sold, like gold, as offering some hedge against inflation. Obviously, though, gold remains the go-to safe-haven asset. As inflation and economic uncertainty look set to last some time yet, we are maintaining our Overweight.

Hedge Funds

Hedge Funds. In unstable market conditions hedge funds can help a portfolio, but selectivity is key. We prefer strategies which hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short. These strategies provide relatively safe, uncorrelated sources of returns from equities, our most significant allocation across balanced and growth multi-asset strategies and provide positive contributions to returns – and lowered risk – especially during periods of volatility.

Tail Risk Protection Note. Tail risks are typically understood as unlikely but severe crisis events which shock markets and dramatically impact the value of risk assets negatively. The dot-com bust at the turn of the century and the Great Financial Crisis in 2008 and 2009 are examples of such events.

We believe the Tail Risk Protection Note offers our portfolios yet another critical source of safety and complements the existing diversifiers.

US Oil per barrel continues to climb

2015 – June 2022



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- The investment management methodology implies a degree of risk linked, among other factors, to the use of derivatives, leverage and short selling; and
- The terms and conditions applicable to redemption may continue to expose you to risk during the period between the redemption request and execution (usually prior notice of 45 calendar days before the last business day of the end of each quarter is required but can be longer for some investments).

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