Summary of high conviction asset class views

Defensive Bonds

The outlook is now more mixed for defensive bonds with real interest rates very rich and implied inflation now above realised historical levels. This is now true across developed markets, with inflation premium recovering in Europe to catch up with the recovery we had already seen in the US. The US curve is increasingly looking distorted given excessively rich real yield valuation and mispricing of the imminent Fed policy tightening. Other areas such as New Zealand and Korea which have already repriced significantly above medium-term fair value remain attractive.

Positive – China, New Zealand, Korea
Negative – Implied inflation to fall, real rates to rise, US nominal bonds

Growth Bonds

The EM macro score remains negative, whilst our quality scores continue to move more negative reflecting higher inflation which has eroded institutional strength scores, as well as a deterioration in fiscal scores. Valuations remain attractive across the board, in particular real interest rates on a relative basis. We are neutral the asset class but favour those areas that have nominal and real rate advantages to DM, as well as attractive carry dynamics as these should continue to benefit from yield advantages to DM.

Positive – Mexico, Peru, Colombia, Brazil, Chile
Negative - Peripheral spreads

Commodities

Whilst the initial reaction to Russia's invasion was rapid as companies worried about supply, very few actual sanctions have been imposed on commodities. Therefore, the problem is less one of volume but more one of distribution. Bulk commodities and those linked to them are the ones where price rises have stuck as it is much harder and more expensive to redirect them, particularly with the Black Sea almost closed to ships. With such an uncertain outlook to the war, it is difficult to make forecasts, but it must be emphasised that many markets were already tight before the invasion. Now, the demand for materials to supply the energy transition looks set to increase as Europe attempts to wean itself off Russian energy.

Positive — Fertiliser, Energy, Aluminium, Copper, Zinc
Neutral — Iron ore, Nickel, Steel

FX

The Federal Reserve continues to guide for a quicker policy normalisation than expected by the market. This comes at a time when the slowdown in the Chinese credit cycle is feeding through into economic data and we have seen growth momentum decline rapidly. Hence there appears to be upside risk to the US dollar over the next year as macro and policy divergence emerge between the US and major regions. We believe it is likely we will see weakness in China spill over to global growth, notably EM.

Positive – US dollar, Sterling, Czech koruna
Negative - Swiss franc, Chinese yuan, Taiwanese dollar, New Zealand dollar

Regional Equity

Asia has structural tailwinds and is beginning to see earning dynamics trough after a challenging year as regulatory incursion lessens and macro policy becomes more supportive. While the US benefits from further evidence of resilient capital allocation, elevated valuations and the threat of tighter policy offset this and drive a negative outlook on the region. Cyclical growth catchup in Europe ex UK is offset by structural headwinds and expensive valuations.

Positive – Asia ex Japan
Negative – Europe ex UK, US

Sector Equity

Prefer asset light compounders with structural growth underpinning although increasingly wary of high valuations in some areas. Substantial opportunities which benefit from accelerating structural change in cyclical technology and consumer sectors. Pharmaceutical and Consumer Staples sectors offer an attractive combination of high quality and reasonable valuations.

Positive – Materials, Cyclical Tech, Staples, Pharma, Healthcare Tech, Financials
Negative – Telcos & Utilities, Real Estate, Consumer Goods

Credit

Spread widening has driven material changes in valuation scoring particularly for high yield assets. European and EM have generally underperformed the US. Underlying credit metrics remain healthy however with robust 4Q21 earnings within investment grade. Outflows continue across all credit asset classes although were more modest in investment grade. Defensive carry in high yield is preferred on a relative basis particularly in areas where spreads have moved beyond fundamentals.

Positive – Asian high yield
Negative - US/EU high yield

Equity views

Having downgraded the **US equity market** to neutral in the final quarter of 2021, we have now further downgraded it to negative as the valuation risk in that market has continued to grow as we move into a tighter policy environment. Exceptional monetary accommodation has had an outsized impact on asset prices over the last few years, inflating them considerably, particularly in the large cap segment of the US market. As we move into a period where interest rates are being raised and liquidity withdrawn at the same, we believe that the downside risk from valuations is now greater than the positive impact of ongoing earnings growth. This is especially true as the growth outlook for the global economy has deteriorated in recent months as a result of worsening inflationary pressures eating into disposable incomes and a manufacturing sector confronting renewed supply disruption alongside weaker end demand.

We have upgraded **Asia ex Japan**; the pivot in Chinese policy towards easing creates a supportive macro backdrop for Asian equities, in our view. Chinese policymakers have clearly communicated this pivot over recent months, such that the market can begin to look through its previous concerns surrounding the policy and regulatory outlooks. Given the US market's size in the global index, and the clear policy divergence with Asia, these rating changes have implications for broader equity views. We have therefore upgraded emerging market equities versus developed markets.

We retain our maximum negative view on **Europe ex UK**, which has underperformed substantially amid the Ukraine crisis. The near-term risks to growth are most intense in Europe and uncertainty over the duration of the conflict, scope for intensification of direct disruption and second order impacts suggest that significant risk premium will continue to be required. Rising credit costs pose a new challenge for European corporates and with ECB asset purchases nearing an end, there are further upside risks to corporate credit and peripheral sovereign spreads. There are, however, selective opportunities to add to high quality European companies at discounted valuations but overall, it remains too early to upgrade the whole market.

We retain our neutral views on both the **UK** and **Japan**, which are the relatively more attractive pockets within developed markets. The UK market is well aligned with current conditions given its exposure to resources, pharmaceuticals and staples, but other drivers including currency and the UK and broader European growth cycle are potential headwinds. Japan stands out from a valuation perspective and benefits from a more accommodative policy outlook and a currency which has weakened and could continue to do so as policy and yields diverge from the US in particular.

At the sector level, we have upgraded **financials** and added **US banks** to our conviction views. Higher interest rates will positively impact profitability for financials as long as growth rates remain reasonable. Our positive stance on the US banks is predicated on the view that the loan growth outlook has strengthened beyond current consensus pricing. Demand remains healthy across the board with unsecured consumer lending rebounding from the pandemic sharply, structural demand for housing which can support mortgage demand even at higher interest rates and clear potential for upside surprises in corporate lending, in our view. There are well understood challenges on the cost side, with larger banks increasing spending on their employee base and tech solutions, however we believe that strong net revenue growth can more than offset this.

Consumer staples has been downgraded to positive from maximum positive. With raw materials accounting for a large proportion of the sector's cost base, companies are directly impacted by the commodity price inflation that has accelerated dramatically and looks set to remain a headwind for the foreseeable future. We have focused on finding companies with the strongest brands and market positions, providing scope to pass costs on to consumers and maintain margins. Pricing power has tended to be greatest for premium brands, but cyclicality can also be higher at these price points as consumers have the option to trade down to standard or discount products when real incomes are impacted by slowing growth and/or higher inflation. We believe the consolidated market structure and strategic approach of leading consumer staples businesses is attractive, with many demonstrating strong levels of reinvestment in their brands, helping them maintain market share.

Fixed Income views

As detailed in the policy review, following the Russian invasion of Ukraine, very little has changed in terms of the Fed's communication. Whilst inflation is still surprising to the upside and is much more persistent than initially expected, notably as a result of the upside pressure placed on energy prices from the war in Ukraine, meaning inflation is set to continue increasing over next few months.

Government bonds: The more inflationary backdrop has resulted in lower real interest rates despite a significant hawkish shift in communication from major DM central banks. In particular, the Fed has continued to signal the need for a step-change in policy to get rates back to neutral alongside the process of normalising its balance sheet through quantitative tightening. As a result, our conviction in the need for a significant increase in **US rates** over the coming months has increased and we believe the current backdrop poses significant upside risks to real interest rates.

Emerging market local currency: While growth levels were healthy going into Russia/Ukraine crisis, the combination of tighter financial conditions and higher inflation are likely to weigh on growth in parts of EM. The continued disappointment in Chinese macro data and risks of further lockdowns there also raises growth risks, while the balance of payments divergence between commodity importers and exporters has increased, especially as oil prices start to bite on the external balances of countries such as **India** and **Turkey**.

Emerging market hard currency: Although the asset class benefits from its exposure to rising commodity prices, we believe there are significant risks from the tighter global liquidity backdrop as a result of central bank efforts to tackle inflation despite a less supportive growth backdrop. The resulting tightening of financial conditions and the impact on spreads is also likely to weigh on growth, with the biggest risks in those economies where market access has been cut off.

Developed market credit: DM credit spreads widened across the board. We maintain our negative view overall on credit asset classes given the negative macro and policy backdrop and expensive valuations. As an asset class, credit tends to be highly sensitive to cyclical downturns and policy tightening. Consequently, a large valuation buffer needs to be present to cushion performance as we move into the rest of the year if we are to change this stance. Although backward looking credit metrics appear healthy today with record low default rates in both **high yield** and **loans**.

Currency views

The **euro** has been upgraded to neutral after the shift in ECB policy. We had previously been expecting large divergence between the ECB and Fed, with the former not expected to change policy within its forecast horizon. However, with the recent guidance on changes to the inflation outlook, it is expected that the ECB will now move towards tightening sooner, diminishing the degree of divergence with the Fed. We have added the **US dollar (USD)** versus the **Swiss franc** as a conviction view. The Swiss central bank failed to ease as aggressively as other developed central banks during the pandemic and therefore saw its balance sheet grow less substantially. This means that it has not seen the same inflationary pressures and is not under as much pressure to tighten policy. The team therefore expects a policy divergence with the US over the coming months as the Fed moves towards quickly removing accommodation and as a result expect the USD to outperform its Swiss counterpart.

The **USD** remains maximum positive to reflect the prospect of aggressive policy withdrawal and divergent economic fundamentals. The US economy remains strong and supported by high excess savings, which contrasts with weak growth in China. We therefore have a long USD position against both the **Chinese yuan** and **Taiwanese dollar**, and continue to see upside risk to the USD over the next 12 months if the market prices a further acceleration in policy withdrawal from the Fed.

We retain our high conviction negative on **US real interest** rates, which are a good proxy for the real policy stance. Real rates are currently close to their lows, and therefore as the Fed moves incrementally towards tighter policy at the same time as inflation peaks, our view is that they are likely to rise, which should remove support for **gold** and as a result we maintain our maximum negative conviction on gold. In the short term, we acknowledge that gold benefits from strong momentum and increased uncertainty because of the Ukraine situation, and as a result may remain well supported. However, longer term, we continue to believe that as the market's focus shifts towards policy tightening from central banks there is an increasing likelihood of gold coming under pressure.

Commodity views

Energy supplies facing huge disruption

Russia's invasion of Ukraine has laid bare Europe's lack of a co-ordinated and rational energy policy. With gas and power prices hitting record levels, Europe faces a major challenge to accelerate a transition away from dependency on Russian fossil fuels. At the same time, high power prices and disrupted supply chains are hitting European manufacturers as well as consumers, raising inflation and threatening growth. Whilst oil prices have settled back to around US$100 per barrel at the time of writing, it has taken large releases from US special reserves and lockdowns in China reducing demand to restore some calm. Clearly, a seasonal lull in April may help in the short term but with the summer driving season due to begin in the US, where the economy is booming, and air travel rebuilding in the West, the risk to oil prices remains firmly to the upside, in our view.

Metals tightness not fully reflected in prices

Most base metals have risen since the invasion began, but the gains for copper are less than 5% and aluminium has fallen more than 3%. With Russia being a major supplier of aluminium and a not insignificant copper exporter, this seems at odds with moves elsewhere. It appears that – whilst supply fears boosted prices initially – poor activity data in China as lockdowns increased and worries about recession in the West have weighed on prices. It also seems likely that many traders have had to reduce positions as margin calls increased and as many were long, this has suppressed the reaction in these metals.

Fundamentals suggest that unless there is a prolonged downturn, whether due to COVID, in China or a rapid worsening of demand in the West, then stock levels look very low and shortages could appear, supporting prices. With China boosting infrastructure spend in Q1, if this metal demand hits the market in Q2, then copper inventories could fall to critical levels and the aluminium market in the West could also destock (LME stocks are already down close to 40% this year). Recession and demand destruction fears are often cited as reasons to be negative, but one would have to see prices rise materially for the latter fear to be realised.

Agriculture markets facing major dislocations

Grains and other agriculture commodities came into 2022 with strong fundamentals. After a near-decade surplus in major markets such as corn and soybeans, balances started improving in late 2020 and throughout 2021 when South American production declined, and Chinese demand took a step up. However, the deficit markets expected for large parts of the complex became significantly tighter the moment Russia crossed the border into Ukrainian territory. While wheat caught the headlines in the days and weeks following the invasion (Russia and Ukraine combined exports 29% of the world's wheat), we expect larger impacts for markets such as corn and sunflower (Ukraine had an 18% share of corn exports last year as well as being China's largest supplier for the grain, and in sunflower markets Ukraine and Russia together grew nearly 60% of global output).

This may sound like good news for farmers in the rest of the world but there has been similar inflation in key inputs such as fertiliser, meaning that crop economics have not improved for all producers. Potash mining has seen a step up in profit margins, as has phosphate fertiliser production for companies who are integrated with their own ammonia production. Nitrogen fertiliser production is more nuanced, with producers in Western Europe suffering from unaffordable natural gas prices and having to temporarily shut down plants, compared to Middle East, US and Canada-based manufacturers who are enjoying a lower cost base and strong export demand for their urea, nitrates and ammonia products.

The commodities market is facing an extraordinary combination of circumstances which will take a number of years to untangle. Russia's invasion of Ukraine has added significant stress to an industry already squeezed by the post-COVID surge in demand, the transition away from fossil fuels and the previous five years of underinvestment in the resources industry. Given that there is no quick fix to any of these issues, prices should – we believe – remain supported.

Please note that this document should be read in context of the full communication as it contains important information regarding the manager, performance and associated risks. Read the full document here.