

MONTHLY HOUSE VIEWS

August 2020

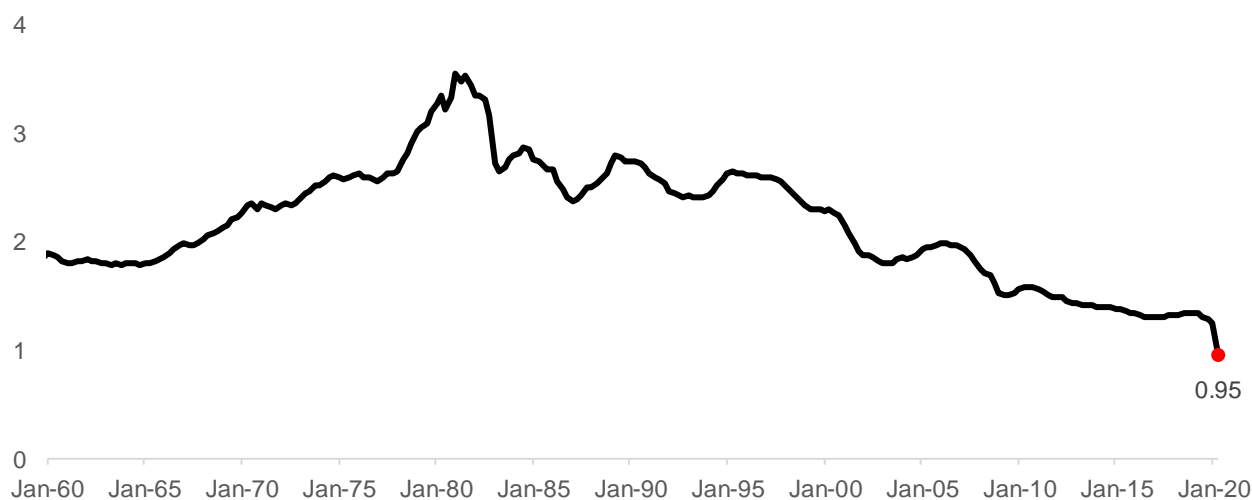
Inflation a big risk, but not a major worry

Inflation always matters. In the conduct of economic policy and in the management of portfolios it is always a factor to be considered. In an era of unabashed money printing on the part of central banks, it matters more than usual – and it is, perhaps, the most important single factor affecting the way in which we manage investments.

However, **while inflation is potentially a big risk, we are not particularly worried about it at present.** The Federal Reserve quintupled its balance sheet during 2009-12 in response to the havoc wreaked by the Global Financial Crisis, and there were fears that an inflationary wave would be triggered. Instead, prices have remained muted over the past decade despite massive quantitative easing (QE). Essentially, for “liquidity” to result in inflation, **money velocity** (i.e. companies/consumer spending) must stay high as must the **money multiplier** (i.e. companies/consumer borrowing); both tend to collapse in a recession. **It is true that the scale of the central banks’ bazookas is much bigger this time, but so is the demand destruction being wrought across the global landscape.** The chart below shows money velocity for the US: money has been created but the slowdown in circulation has more than offset it, and inflation has been falling. Inflation is likely to remain tepid due to huge slack that occurs in recessionary times such as now. And **there is plenty of slack** given double-digit unemployment in the US; a similar level is likely in the UK as the tapering furlough schemes fully cease in October.

Velocity of MZM Money Stock (Ratio, Quarterly, Seasonally Adjusted)

1960 - 2020



Source: Kleinwort Hambros; Federal Reserve Bank of St. Louis Economic Data

Our view on inflation is premised on the current fiscal (i.e. double-digit fiscal deficits) and monetary paradigms (i.e. helicopter money) not becoming oft-used, but remaining rare and crisis-linked. If such expansive policy does become the norm, then inflation would likely result. However, we have faith in the independence and competence of central banks and other policymaking institutions not being profligate, and therefore this imprudent use of these extraordinary tools is unlikely.

Nonetheless, we are not complacent to the threat should we be wrong. Should inflation rise, the risks to markets – across asset classes – are severe. While central banks would surely tolerate above-target inflation for a time, at some point base rates would have to rise to bring rising prices under control. **Rising rates would directly bring the prices of bonds down and lead equities to be less attractive** as future cash flows would have to be discounted at higher rates. Furthermore, the current very low level of rates means that it is relatively cheap for banks to support

weak borrowers through the recession. Higher rates would make that more difficult and would be likely to trigger increased loan losses and a deeper recession.

Other assets will likely be impacted too, but not in ways one might expect. Gold has performed well in the current environment, being bought both by those who fear inflation as well as those who fear the consequences of the Coronavirus-linked recession. But gold tends to be quite sensitive to the real yield available on safe-haven government bonds. **Paradoxically, therefore, rising inflation might well undermine the gold price.**

In the event inflation were to rise unexpectedly, we would likely move towards real assets, inflation-linked bonds, and hedge funds that are able to exploit such conditions. Having said that, we are not close to such a state, and neither do we expect to be.

Bottom line

At present, we remain underweight risk-assets in general. However, **the equities we do hold are largely tilted towards the US market** where returns have generally exceeded those from other regions. US equities are expensive, there is no doubt. However, with rates near zero, there is a good case for a higher than usual tolerance to elevated valuations, particularly for large-cap technology companies that appear to be immune to the business cycle ("secular growth").

We also continue to hold long-duration government bonds in multi-asset strategies. We recognise that government bond yields are very unattractive (i.e. low) in comparison with their long-run history. However, we believe the probability is asymmetrically tilted towards yields falling from current levels, as opposed to rising. This view is anchored by the current subdued economic conditions and heightened market volatility, as well as the continuation of central bank bond buying which will all but ensure rates remain low for the foreseeable future. Indeed, as Federal Reserve Chairman Jerome Powell said recently, "*We're not even thinking about thinking about raising rates.*"

Sterling remains cheap; our portfolios have been generally underweight sterling for some time and have benefitted from this. There is a risk that a successful outcome of the Brexit negotiations and market confidence in British policy will lead to a revaluation of Sterling and British assets. We believe that a successful outcome to the negotiations will not appear until much later in the year and there is considerable uncertainty about British economic policy. Lastly, the composition of the FTSE 100, which is heavy in financials and energy companies – as well as uncertainty about commercial real estate values in a world where work patterns have changed – suggest there is unlikely to be a flood of foreign money into British assets.

We also continue to have significant position in gold and low-volatility alternative assets (i.e. hedge funds). Both have provided critical diversification to portfolios this year as well as positive returns.

OUR ASSET ALLOCATION

The table below presents the latest conclusions of the KH 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	GLOBAL RATES				■		
	U.S. Treasuries				■		
	German Bunds				■		
	UK Gilts				■		
	EM Government Bonds (\$)				■		
	DURATION				■		
	Duration USD*				■		
	Duration EUR*				■		
	Duration GBP*				■		
	CORPORATE		■				
US Investment Grade		■					
Eurozone Investment Grade		■					
UK Investment Grade		■					
High Yield	■						
FOREX	EURUSD			■			
	JPYUSD			■			
	GBPUSD				■		
	EM FX (vs. USD)		■				
ALTERNATIVE	COMMODITIES				■		
	Brent		■				
	Gold					■	
	ALT. STRATEGIES			■			
	L/S Equity				■		
	Event-Driven				■		
	FI Arbitrage		■				
Global Macro		■					
CTAs				■			

O/W	Positioning	*Duration
N	Overweight	Long – 7+ years
U/W	Neutral	Intermediate – 5-7 years
	Underweight	Short – up to 5 years

Source: Kleinwort Hambros 07-August-2020

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

EQUITIES

United States	The US is still mired in its fight against the Coronavirus, which will act as a headwind to its fragile economic recovery. Nonetheless, the reimposition of a nationwide lockdown appears unlikely. It is also the centre of the global technology industry, which is driving global equity momentum. We are Overweight.
Europe	Business confidence has rebounded sharply reflecting the shift from lockdown to gradual reopening. An additional boost has been provided by approval of the proposed €750bn recovery fund. Nonetheless, the economy is still in contraction, and we are Neutral.
UK	The country has been harder hit by the pandemic than many continental economies, but valuations are extremely cheap. We remain Neutral.
Japan	The government's support package for the economy is the largest on offer among advanced economies as a percentage of GDP and lockdown measures have been less restrictive than elsewhere. We are Neutral.
Emerging (EM)	China's equity market is one of the few to be showing positive performance year-to-date. However, Brazil, India and Russia are facing deep recessions. We remain Underweight for the time being.

FIXED INCOME

Sovereigns	Government bonds remain unattractive from a yield and valuation perspective, but they are critical in dampening portfolio volatility. Moreover, with inflation well below target and central banks continuing to buy large amounts of government bonds, long rates are unlikely to rise significantly.
Duration*	We have medium-to-long duration positions across most portfolios as a bulwark against wide volatility in risk assets.
Investment Grade**	Spreads have come down markedly since the height of the pandemic fears. However, absolute yields remain low.
High Yield**	Given the current macroeconomic backdrop, HY issuers remain vulnerable, and dependent on policy support. We are Underweight.
Emerging debt (in \$)	Yield spreads have narrowed but are well above pre-virus levels. In addition, many EM issuers have supportive fundamentals. We remain Overweight.

CURRENCIES

EUR/USD	Our reservations on the Euro were unfounded, as the single currency rallied hard against the Dollar in July.
GBP/USD	We are adjusting our Q4 forecast higher to account for the significant Dollar sell-off, opposing forces later in the year could keep the pair suppressed around 1.3000.
EUR/GBP	We expect the pair to continue to trade near current levels and adjust our forecast slightly to 0.9000 over the next three months.
USD/JPY	Due to the severity and widespread nature of the Coronavirus, concerned investors are focusing mainly on precious metals for safety, limiting the gains for the Yen ahead.
Emerging	Emerging Market currencies have begun to settle again after huge spikes in volatility during March and May.

ALTERNATIVES

Hedge funds	We prefer strategies which can hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short.
Gold	Gold continues to register new eight-year highs on robust demand from central banks and ETF investors.
Oil	Oil prices may retrace some of recent gains as demand remains rather sluggish.
Income producing Alts.	Attractive opportunities exist in infrastructure, selected real estate and specialist lenders for Target Return and income-focused strategies.

Source: Kleinwort Hambros 07-August-2020

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FIXED INCOME

Expectations vs liquidity

Low long-term rates on sovereign bonds imply investors expecting dire economic straits, while tighter corporate bond yield differentials (“spreads”) suggest a much more benign outlook fuelled by central bank largesse and abundant liquidity. We remain Overweight with a focus on the diversification benefits of long-duration government bonds.

In an economic slowdown it is reasonable to expect central banks to lower rates and drive sovereign yields down, while riskier assets like corporate and emerging bonds struggle under the weight of increased risk aversion and deteriorating financial conditions. However, this playbook doesn’t work in today’s peculiar environment, where a deep economic recession, triggered by an external shock, has been met with unprecedented policies. Central banks worldwide have flooded financial markets with huge amounts of fresh money, blurring the lines between optimism and pessimism.

Sovereigns

US. The Federal Reserve (Fed) will continue to provide exceptional support for the economy via low rates and asset purchases. In addition, they now plan to enhance monetary policy further, with ongoing discussions about forward guidance and yield curve targets. No decisions have been taken so far, but the framework review is likely to be completed soon. Bond yields are therefore likely to stay low across all maturities. The recent 30-year bond auction confirms strong appetite even for ultra-long-dated securities, a sign of low-for-long rate expectations and the need to put liquidity to work.

UK. The Bank of England (BoE), while optimistic about a recovery, continues to reserve the possibility of a negative rate policy. Sceptical about the effectiveness of such measures, markets price in little chance of a move into sub-zero territory, though the sheer possibility continues to weigh on the curve. A recent £30bn government package provides significant stimulus to the economy, but the resulting extra funding needs are unlikely to drive rates up given continued central bank purchases.

Eurozone. The European Central Bank (ECB) is also stepping up efforts to keep rates low and convince markets that this is where they will stay. The recent downward revisions to growth and inflation projections, coupled with the central bank’s reassurances about the proportionality of its asset purchases, suggest the ECB will maintain an ultra-accommodative stance.

Credit

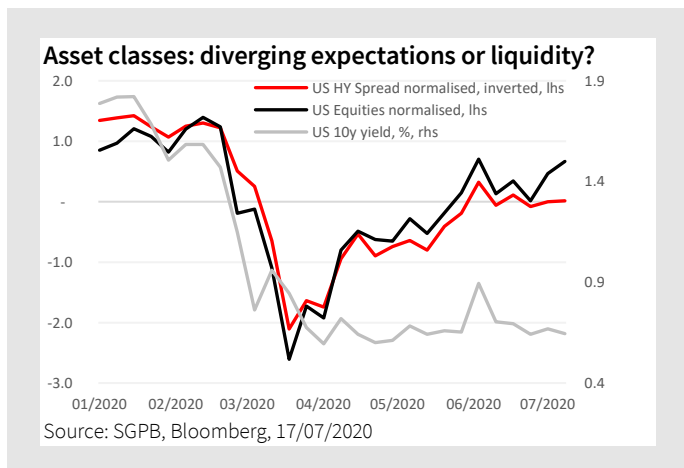
US. Since the beginning of June, spreads have traded close to 150 bps for Investment Grade (IG) and 600 bps for High Yield (HY) bonds. The health emergency in the US has intensified recently, but support from fiscal and monetary policy remains the main driver for credit markets. We continue to like IG bonds, given the support from Fed purchases and investors’ search for alternatives to Treasuries with a yield pick-up. We remain Underweight on HY on the grounds of elevated default risks.

UK. The Bank of England (BoE) has added \$6.8bn to its Corporate Bond Purchase Scheme since the beginning of April, with IG spreads narrowing slightly over the last month.

Eurozone. ECB purchases target a specific sub-group of “eligible” IG corporate bonds which, like in 2016, have unsurprisingly outperformed. But as time passes, substitution effects mean that investors end up increasing exposure to non-eligible bonds as well, helping tighten spreads.

Emerging Market (EM) debt

Surveys indicate that investors are keen on hard-currency emerging debt and recent fund inflows have been positive amidst steadily narrowing spreads. However, many EM countries face a worsening health crisis and resulting economic risks. Again, liquidity may offset fundamentals for now and we remain Neutral.



Past performance should not be seen as an indication of future performance. Investments may be subject to market fluctuations, and the price and value of investments and the income derived from them can go down as well as up. Your capital may be at risk and you may not get back the amount you invest.

EQUITIES

All eyes on earnings

Markets have rallied hard since late March leaving little further upside potential, especially given the recent acceleration in COVID-19 infections. However, the gradual exit from lockdowns and ample support from fiscal and monetary policies are powerful supports. All in all, we remain Underweight.

US. The second-quarter earnings season is well underway: At the time of writing, about 90% of S&P500 companies reported a profit decline of -33% year-on-year (YoY), marginally ahead of analysts' initial forecasts of a -45% fall. Despite this relative upside surprise, this earnings season recorded the sharpest decline since 2008-2009. The bar will be higher in Q3 and Q4 when the consensus is expecting quarterly bounces of 36% and 15%, respectively.

In dollar-terms, US equities have rallied over 50% from their late-March low despite the collapse in earnings expectations. Valuations look extended at first glance – the forward price-to-earnings ratio (PER) is the highest since the tech bubble in 2001 – however a continuing low-rate environment suggests greater tolerance to these expensive regimes. In this context, we remain Overweight.

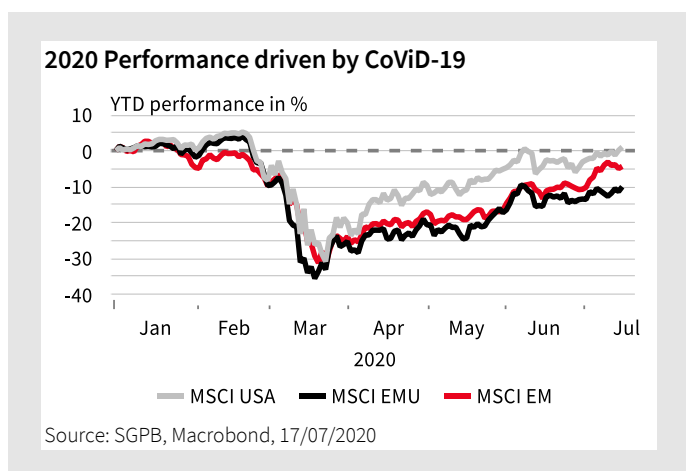
UK. A recent surge in sterling and its impact on earnings of multinational companies provided headwinds to the FTSE100, which continued to lag behind the performance of European and Global equities. Despite the UK's considerably slower emergence from lockdown restrictions compared to continental Europe, the Bank of England's surprisingly upbeat view on economic recovery suggests a lower than expected chance for further easing of monetary policy, though the ongoing asset purchase program continues to underpin a cautiously optimistic outlook for UK equities. Finally, considerable uncertainty around British economic policy following the lack of progress in negotiations with the EU weighs on prices, resulting in attractive valuations compared to overseas markets. We remain Neutral.

Eurozone. Halfway through the reporting period, analysts have further revised down Q2 earnings forecasts to -67% from a previously expected -59% fall YoY. Further, while the region has overall fared better in terms of crisis response, COVID-19 hotspots have been flaring up recently in France and Germany, adding to fears of new lockdowns and restrictions on economic activity.

Nonetheless, the planned EU recovery fund should help allay market worries about eurozone break-up and comparatively less stretched valuations may encourage investors back to the region. We remain Neutral.

Japan. Tokyo has proved resilient so far, helped no doubt by consensus expectations of +2.1% earnings growth this fiscal year. The government's support package for the economy is the largest on offer among advanced economies as a percentage of GDP and lockdown measures have been less restrictive than elsewhere. Moreover, the market is trading close to decade lows on cyclically-adjusted PER. We maintain a Neutral position.

Emerging Markets. Q2 GDP data confirms that China is growing again, at 3.2% YoY versus -6.8% in the first quarter. Perhaps in anticipation, Chinese domestic equities have outperformed other global stock markets so far this year. Other regions, notably Latin America, continue to struggle with high COVID-19 infection rates and are likely to lag behind Asia. We remain Neutral.



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CURRENCIES

Dollar safe-haven diminishing

As economies begin to rebound from the initial impact of the pandemic, it is still the safe-haven currencies that are performing best. Notably absent from this list however is the US Dollar which has seen huge losses in July.

Macro. The US has seen a rebound in economic data over the past month, but consumer sentiment remains low as the country struggles to control the spread of Coronavirus. The Dollar Index has plummeted by 4.7% since the start of July and shows no signs of stopping just yet. Moving to the east, we see European countries faring better, with only a handful of secondary virus outbreaks and an agreed recovery fund for the worst-hit economies. Nevertheless, rates are expected to remain low, or even head lower, for a considerable amount of time as the recovery pushes on. In the UK, Brexit risks are rising steadily as well, but that has yet to factor significantly into FX markets, with the Pound holding its own against the majors. Unsurprisingly though, the best performers have been the safe havens of the Swiss Franc and Gold, accelerating their moves higher.

GBP/USD. July saw the largest monthly rise in Cable for over 10 years (+6.0%) as it broke out of the low 1.20s where it had been languishing since the Coronavirus crash. This move was mostly fuelled by heavy US dollar selling, but the Pound has held its own against the other majors too. There are risks ahead for Sterling however, as trade negotiations with the EU continue at a snail's pace and speculation that the Bank of England may introduce negative rates still lingers. Therefore, whilst we are adjusting our Q4 forecast higher to account for the significant Dollar sell-off, opposing forces later in the year could keep the pair suppressed around 1.3000.

EUR/USD. Our reservations on the Euro were unfounded, as the single currency rallied hard against the Dollar in July. Again, much like the story with the Pound, it has been mostly a tale of the US Dollar's fall from grace. That being said, EU leaders did manage to agree a €750 billion recovery fund to help their hardest hit economies, which will ease the burden on the European Central Bank (ECB). For now, it looks like we will see further gains for the pair, but we remain wary of the increasing number of Coronavirus outbreaks across the continent. For these reasons we raise our forecast to a modest 1.1700 for Q4.

EUR/GBP. Much like the UK, which is struggling to separate itself from the EU, the Pound seems inextricably correlated to the Euro. The European cross has been pinned to the 0.9000 level for most of the last 3 months, barely able to move more than 2% in either direction. It should be noted that the trend has been very slightly positive, but when the range over this period equates to only two or three times that of a typical daily range, this is negligible. Therefore, we expect the pair to continue to trade near current levels and adjust our forecast slightly to 0.9000 over the next three months.

USD/JPY. July finally gave the pair some direction, after a year of sideways trading mostly between 105.00 and 110.00, save for spikes in both directions in March. Unsurprisingly this direction is positive for the Yen, and whilst the Bank of Japan are not going to be in favour of this, we find it unlikely that they will look to counter just yet. This means that the door is open for a push towards 100, which has not been seen since mid-2016. Normally during times of crisis we would expect that target to be easily attainable, but the Yen has actually underperformed versus the Euro and Sterling since April. It seems that due to the severity and widespread nature of the Coronavirus, concerned investors are focussing mainly on precious metals for safety, limiting the gains for the Yen ahead.

EM currencies. Emerging Market currencies have begun to settle again after huge spikes in volatility during March and May. Year to date it is Latin America and South Africa that have performed the worst, with Brazil leading the pack having shed 22% against the Dollar. EMEA currencies have fared much better throughout, and have gained on the Dollar since January, helped by their proximity to Eurozone countries. Expect more of the same here as the southern hemisphere struggles with coronavirus during its winter months.

US Dollar Index



Source: Bloomberg 31/07/20

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ALTERNATIVES

Diversification benefits

With little sign of a sustained pick-up in demand, oil prices may trade lower. Gold demand shows little sign of flagging despite higher prices and we remain Overweight. We prefer hedge fund strategies which hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short.

Commodities

Oil

Since March, the slump in oil prices has pushed many shale producers to retrench, with the rig count tumbling from 683 in March to 185 at present, just above its 2009 recession low. Worries about the long-term impact of the transition to renewables on the value of oil and gas reserves have caused some energy majors to write down asset values. In recent weeks, BP and Shell have slashed almost \$40bn from their reserves.

The International Energy Agency (IEA) warned recently that risks to its market outlook were “almost certainly to the downside” given the resurgence in COVID-19 cases across the globe. The IEA forecasts an average decline in oil demand of 8.1 million barrels per day (mb/d) this year – the largest in history – with supply set to fall 7.2 mb/d, leaving the market facing continued oversupply and downward pressure on prices.

With OPEC and Russia confirming an easing in output cuts, we expect oil prices to trade slightly lower in coming months.

Gold

Gold supply was severely constrained during the pandemic lockdown. Output from mines fell 3% year-on-year (YoY) in Q1 while recycling – which accounts for over one quarter of total supply – fell 4% YoY to its lowest level since 2017. So far, there has been little sign of a pick-up in gold supply.

Despite higher prices (up 19.3% year-to-date), gold demand has been strong. New purchases of ETFs generated 104 tonnes (t) of purchases in June, taking the first-half total to 734t, well above the highest-ever annual total of 646t in 2009. In addition, central banks continue to add gold to their currency reserves with another 40t of net purchases in May. Moreover, the opportunity

cost of holding gold remains low with central banks having fixed rates close to zero or below while ramping up their purchases of sovereigns, keeping yield curves rather flat.

We continue to Overweight gold for its diversification benefits and upside potential.

Hedge funds

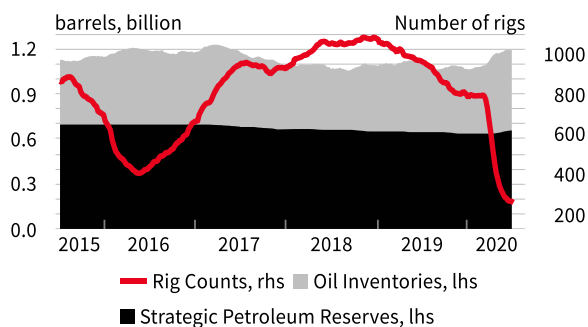
Prefer Merger Arbitrage type strategies

Hedge funds can help in unstable market conditions, 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. These investments have been positive contributors of returns – and lowered risk – especially during periods of volatility. In the recent market volatility, our hedge fund selections have all held their own and performed exactly as we would have wished them to.

Income Producing

In Target Return and income strategies, we are exploiting several niche investment opportunities in selected real estate (e.g. medical centres, student accommodation), infrastructure and specialist lending (e.g. pharmaceutical royalties, economic infrastructure).

The number of US rigs in operation has collapsed



Source: SGPB, Macrobond, 17/07/2020

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- 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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Channel Islands

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Please note the Channel Islands are not part of the UK and when you conduct business with SG Kleinwort Hambros Bank (CI) Limited you will not be eligible for: (a) the protections provided under the UK's Financial Services and Markets Act 2000 other than protections relating specifically to UK regulated mortgage business; or (b) referring complaints to the UK's Financial Ombudsman Service. However SG Kleinwort Hambros Bank (CI) Limited's UK regulated mortgage business is covered under the UK's Financial Services Compensation Scheme ("FSCS"). You may be entitled to compensation from the FSCS if SG Kleinwort Hambros Bank (CI) Limited cannot meet its obligations in relation to UK regulated mortgage business. This depends on the circumstances of the claim. For further information about the FSCS (including the amounts covered and eligibility to claim) please contact your Private Banker or refer to the FSCS website: www.fscs.org.uk.

Gibraltar

SG Kleinwort Hambros Bank (Gibraltar) Limited is a participant in the Gibraltar Deposit Guarantee Scheme (the "Deposit Scheme"). Most deposits denominated in currencies of the European Economic Area and Euros are covered. Further details of the Deposit Scheme are available on request or can be found at www.gdgb.gi. The Deposit Scheme does not apply to fiduciary deposits.

SG Kleinwort Hambros Bank (Gibraltar) Limited is a participant in the Gibraltar Investor Compensation Scheme (the "Investor Scheme"). [Payments under the Investor Scheme are limited to 90% of a client's total eligible investments which qualify for

compensation subject to a maximum payment to any one client of €20,000 (or the sterling equivalent).] [Note: include the limit wording if the document is not a Financial Promotion (limits not required for Financial Promotions/Advertisements.)] You may be entitled to compensation from the Investment Scheme if we cannot meet our obligations. Further details of the Investor Scheme are available on request or can be found at www.gics.gi. If you would not normally be classified as a retail client you may not be eligible for this scheme.

General

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Further information on the Kleinwort Hambros Group including additional legal and regulatory details can be found at: www.kleinworthambros.com

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