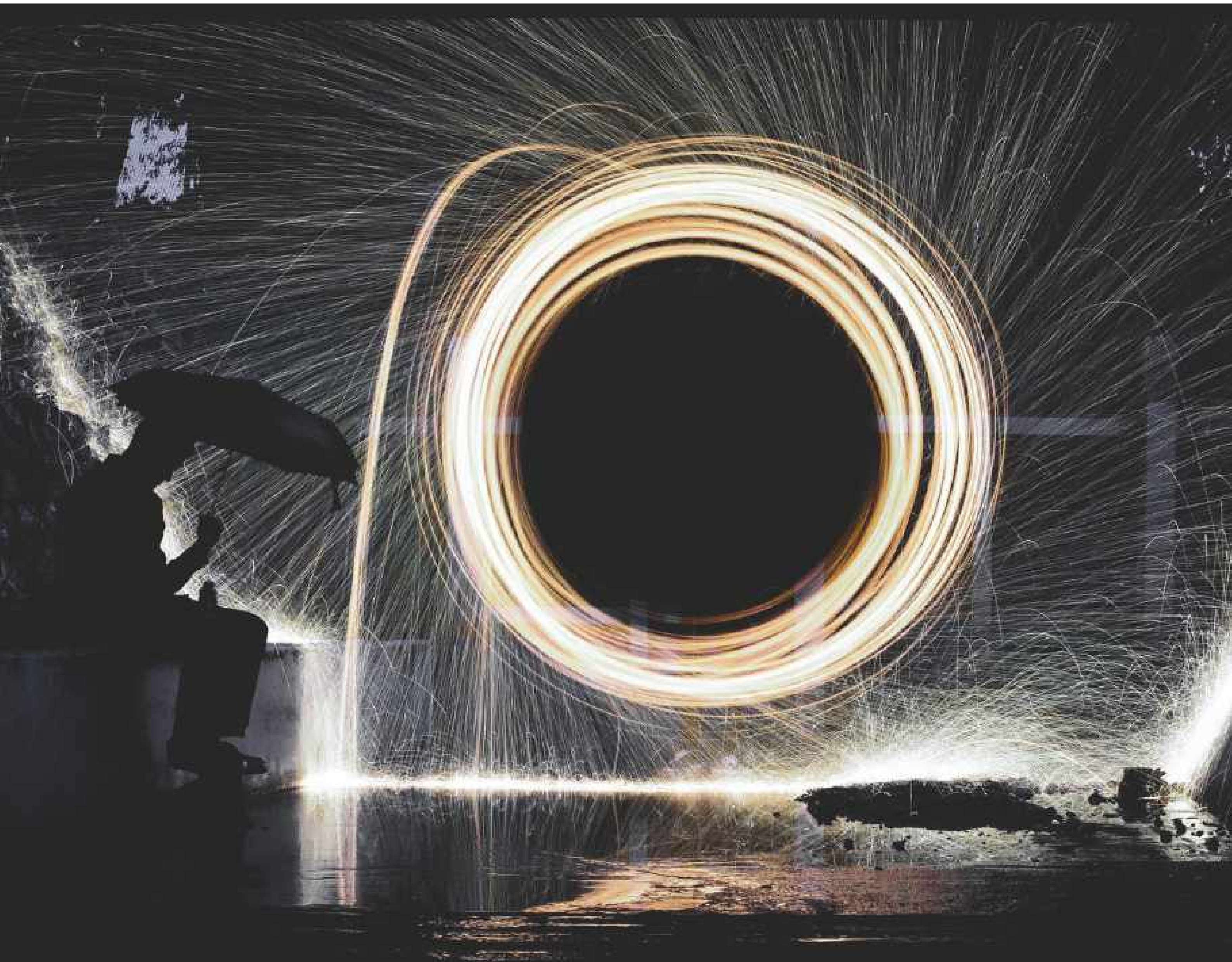
MID YEAR OUTLOOK
JULY 2021



Office 712, Level 7, Al Khatem
Tower 4, Abu Dhabi Global
Market Square, Al Maryah Island,
P.O. Box 764618, Abu Dhabi,
U.A.E

Ashish Marwah
Chief Investment Officer
+971 2 5469 555
info@ads-investments.com
www.ads-investments.com

HYPERCYCLICAL

There are days where nothing happens and then in six months, you live through a whole economic cycle. We have gone from a sharp cyclical rally and a scare of inflation getting out of control to peak growth narratives driving bond yields lower and curves flatter and technology leading again. In an environment where certainty is hard to find, the market is losing control over narratives faster than C grade movies. The truth is that in an environment still controlled by residuals from a fiscal push and supplies constrained by COVID issues, this fluctuation is to be expected. Even as the overall direction of volatility measures remains lower, there continue to be spikes and churn making it harder for fund managers to do their jobs effectively.

To some extent, the current environment is just a more ferocious version of an early cycle recovery and needs to be thought about as such. While the market churns, some trends around current market drivers are becoming clearer. Regarding COVID, vaccinations are rising and while most economies (apart from some East Asian countries) have opened activity domestically, deaths are not rising at the same rate even if globally cases are rising. The UK is the primary testbed of vaccine efficacy and Government acceptance of the fact that the virus is now endemic. The question is now how quickly the developing world can get access to vaccines and how quickly international travel can start resuming, which is the last and possibly the most testing part of this process. It seems like this process will take longer than we expected.

While Asia deals with the virus, the supply chain constraints can persist for a while, but they will ease as we progress towards the end of the year. However, it is hard to see aggregate demand going down dramatically if the economy opens. Thus, a supply response is desperately needed. The hope for the developed world, especially in the Northern Hemisphere is that the UK experiment will provide enough comfort and supply constraints, especially on labour can be remedied.

Trends on labour shortages are becoming harder to explain as theories around unemployment incentives being a key factor in discouraging work are being tested and falling short as an explanation[1], and that leads to potentially stronger evidence emerging for an increase in wages and employment costs. As we have said previously, while manufacturing constraints will ease, the real impact will be felt in services that are much more dependent on people wanting to return to the kind of jobs that were most impacted by this pandemic. That has an impact on inflation expectations.

Our overall return expectations for the rest of the year are less promising than the first half even if economic growth stays strong. For equities, we stick to the view that liquidity and discount rate-driven factors have already played their part and now it's solely up to earnings. We expect earnings for Q2 being declared right now to be still good, but the stock price impacts mostly priced in. Q3 earnings for us will be a cleaner

1] https://www.msn.com/en-us/money/markets/theres-little-sign-that-ending-unemployment-benefits-early-pushed-people-back-to-work-jpmorgan-says/ar-AALYyc7 guide as by that time, a lot of uncertainty will have dissipated (hopefully). For Fixed Income, our expectation is for a moderate rise in yields after what has been a severe compression driven by again liquidity and fears of peak growth. We do not expect the Fed to spring another surprise at us like the last meeting as market expectations of the Fed's rate path have already adjusted . In addition, the Fed has not yet disavowed its average inflation targeting policy. We expect the dollar to remain muted for the next few months with some upside bias, but we will be sellers of any dollar strength as clarity emerges on inflation and rates outlook with the Fed still choosing to be behind the curve.

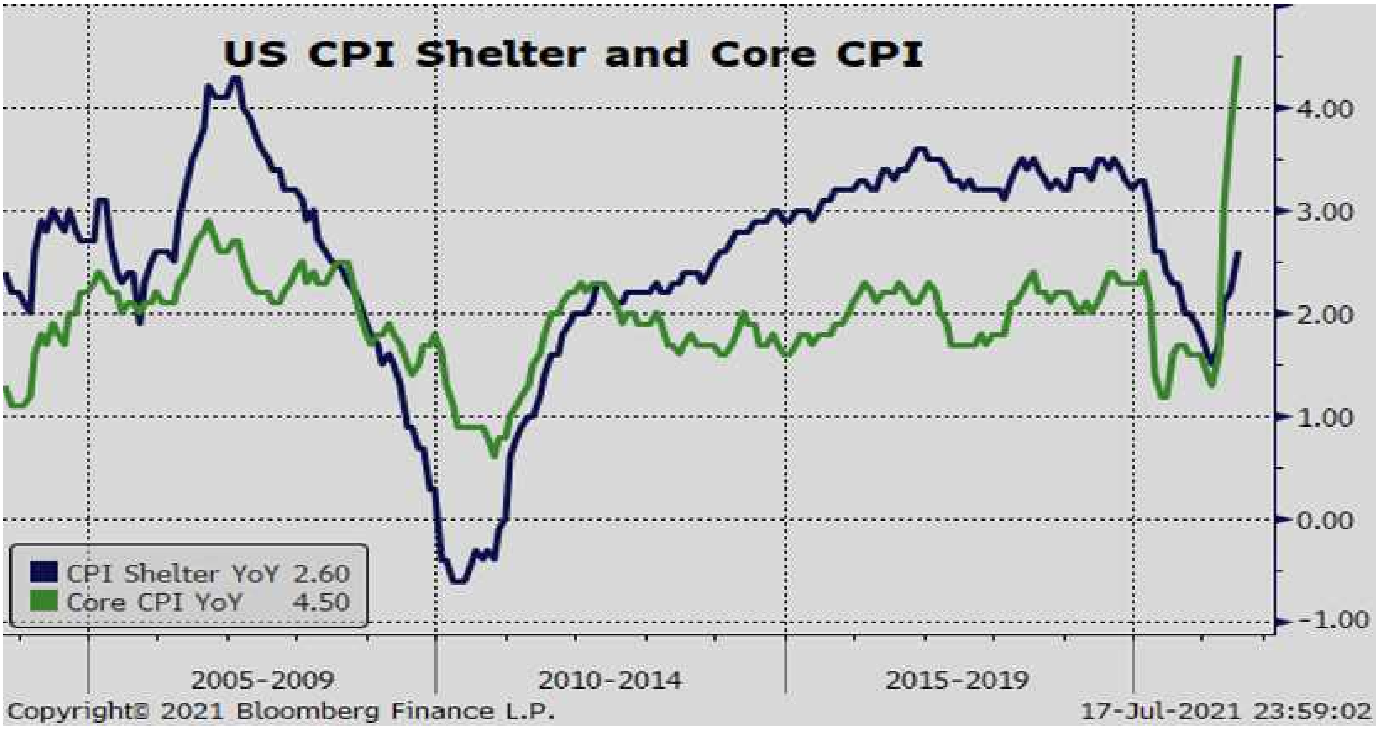
If all this doesn't sound convincing, that's because there is little to back a table-thumping view on for the next 6 months. Beyond this apparent mid-cycle slowdown, we don't see a reason for us to be overly concerned and are looking for an opportunity to re-enter cyclical trades. Funding costs are and will remain low, consumer incomes will rise as economies return to normal and grow and there is no willingness anywhere to not provide both fiscal and monetary support if activity weakens. We are thus for now, relative to a balanced portfolio, marginally underweight in equities, underweight fixed income (primarily coming from credit) and yes, holding cash to buy further into risk assets on any significant weakness.

FIXED INCOME

To say that this year's gyration in bond yields have had less to do with fundamentals and more with market positioning and transitory factors is partly correct. Some of the impulses that drove the growth and inflation spurt since late last year are going away – China is slowing, goods demand is receding, the large consumer spending surge driven by fiscal incentives is fading. Real Yields on the ten years in the US practically where they started the year at, despite nominal yields being higher. This highlights the inability of the market to discern direction on inflation and growth and the unpredictability of the central bank response to these factors. Somehow the market is expecting not only an easy Fed, but easing further.

The volatility in the bond market is driven less by what is going to happen in the near term, but rather by medium to longer-term guesstimates of Fed response to current data. Our conviction has been that while the near-term discourse around inflation must consider transitory factors, in the medium term. Some upward pressure is to be expected because of fiscal measures, a somewhat improved wage picture and a revival in one of the key determinants of past rising inflation periods – housing prices.

Shelter carries a weight of nearly a third in CPI indices. Composed of both actual rental prices as well as estimated rentals through Owner's Equivalent Rent calculations. These measures have been generally depressed as rental growth came down quite dramatically in the pandemic and has only now started recovering.

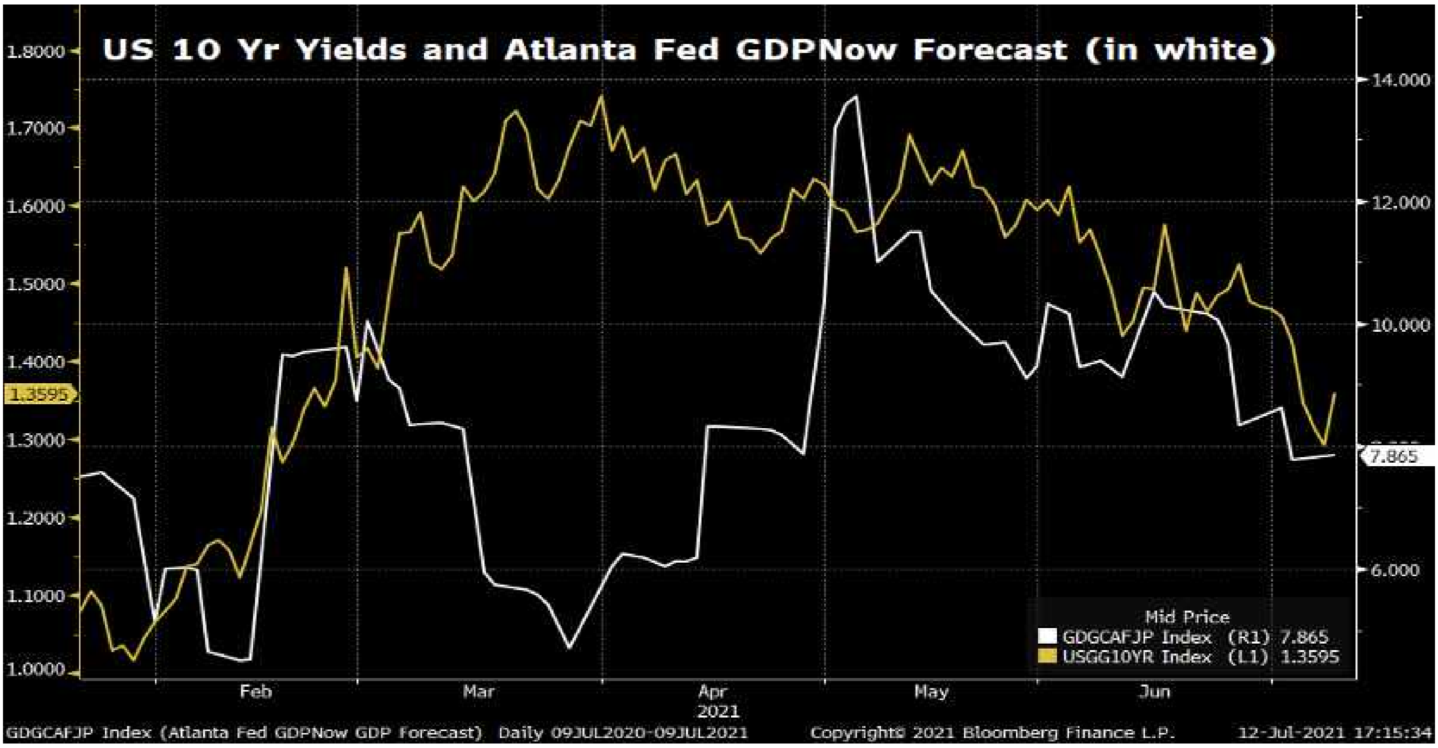


US housing demand remains strong and there has been an interesting spike in US Household formation during the pandemic and while it has come off, the impact of such a strong formation period can keep demand for housing higher.

This means that both actual rents and owners equivalent rent should continue to rise at a rate that is somewhat higher than we have seen pre-pandemic. While it is still hard to judge if the impact on inflation would be dramatic, it is one factor that is important and worth keeping an eye on. Another factor for consideration is that this rise in prices should not have a similar impact on inflation as the 2003 to ‘07 cycle which was primarily driven by investors releasing equity from existing houses and speculating.

While services continue to be constrained near term by labour shortages, the need to pay more wages and increase pricing to compensate for the business model changes demanded by the pandemic, service inflation should follow a similar trend of cooling down after the initial rush of re-opening demand and labour supply shortages fades away. There is a case for wages settling at higher levels and then percolating into prices over time, but there is no case for sustained growth in wages once the reopening is fully effective. In conclusion, we reiterate our conviction from last quarter that we will see higher rates of inflation, but not runaway inflation, nor one that sustains into next year.

For now, long-term interest rates are more sensitive to growth than to inflation, and it is the growth outlook that will determine where yields go. It was no surprise to see yields peak with the peak in GDP growth forecasts, but it is the levels that are telling the story of a very severe downside to growth coming from these heady levels. We may continue to see yields move around directionless as base effects on growth wear out after the June GDP number is released at the end of July. A revised base of GDP forecasts then forms a better guide to future projection of yields.



The Drag from the Rest of the World

While US growth, inflation and policy outlook are important for US Yields, it is easy to forget the impact the rest of the world has. China's recent efforts to boost liquidity by cutting reserve ratios shows the lack of concern around inflation and the pressure to boost growth again as it comes off the high of an industrial recovery . We do not see upward growth momentum re-ignite soon, but we hope to see a renewed focus on Fixed Asset Investment at year-end, which will potentially focus again on commodity imports for electrification and the like.

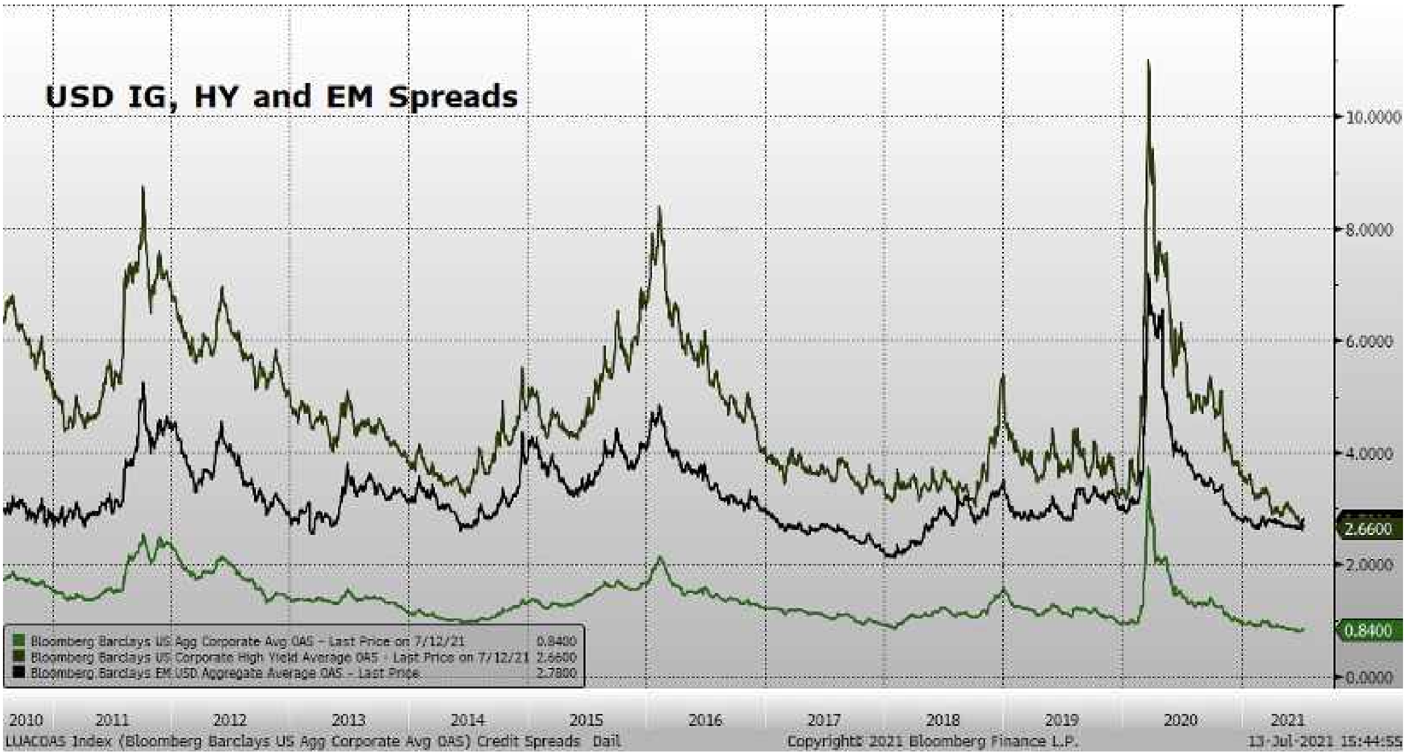
Europe has committed to its version of Average Inflation Targeting, with ECB in no mood yet to withdraw liquidity and if needed provide more to get to its inflation target. Despite conflicting voices, we see better coordination between fiscal and monetary authorities especially as the Recovery Plan spending supplements reforms, especially in Italy. It is quite possible that these measures lift the expected growth rate in Europe and consequently lift bond yields higher. We admit that we have been in this situation a few times in the past, with hopes of a lift-off constantly dashed. However, it seems that the ECB is keener than ever to drive home the AIT point, and this should help bond yields move higher. We expect the next ECB meeting to reinforce this view.

Japan remains in limbo, with little that policy can do to impact conditions. It may be interesting for the reader to note that Japanese CPI for May was at -0.1%.

In Emerging Markets, some countries like Russia and Brazil have chosen to be quite hawkish in their approach while others like India have effectively decided to wait and watch or provide additional economic support until the effects of the pandemic are behind them. As derivatives of the US consumption and China spending trade, their impact comes primarily from their current account surpluses and the need to buy US treasuries. EM current accounts have overall been rising, as a corollary to the expanding US trade deficit. Domestic activity should improve over time as vaccinations progress which should to some extent reduce the need to recycle flows into USTs, but the still strong US consumer should support EM current accounts.

Credit - Unexciting

With spreads at a record tight, it is hard to get excited about credit. Yields low and spreads tight is never a great combination for future returns. However, the market may not see much wider spreads due to the improvement in credit metrics, strong growth and lessening defaults.



As we have observed from bond yields and bank balance sheets, we are still in an environment of surplus capital that continues to support spreads, but unexciting yields make for dull forward returns. While there may still be some return to make in High Yield and EM Credit, the case for credit is primarily about earning carry. We prefer to earn higher quality carry and selective emerging market credit rather than go down in quality.

We do see a downside case leading to wider spreads and more discrimination coming into the market than it has until now. That is driven partly by rising rates and partly by capital going towards businesses that are less leveraged and can expand their capital spend; while the more leveraged ones get left behind. While the low rates boat has lifted all credit, an economic re-opening may only offer them an ability to survive rather than grow, which will then bring the focus back squarely to their indebtedness. Thus, a step-up in quality as we get mid-cycle behaviour is warranted, even at the risk of higher sensitivity to duration.

Bond Positioning

We continue to favour the belly of the curve in the US over both front and longer-dated positions, primarily driven by carrying and roll preference. Longer-dated positions outperformed in Q2 and we do not see the conditions for continued outperformance into the year-end. That would require a very sharp slowdown which is contrary to our expectation of easing bottlenecks. We do not see the conditions to take conviction positions further out in the curve without accepting unnecessary volatility.

We see conditions for EUR to start performing again driven by the change in ECB policy which again makes for shorter to medium dated positioning in the EUR curve.

In EM we still prefer higher beta currencies that have done a lot of the heavy work on rates and thus offer good carry and as a clearer picture of the world emerges, volatility of these currencies would come down. Our bias remains towards increasing EM holdings as explained above.

EQUITIES

Against our expectations for a pause in Q2, equities kept going with the S&P up over 8% and the MSCI World slightly behind at just under 7% with EM being the laggard. However, as we expected, the outperformers for the quarter were Technology and Energy while Healthcare was in line, cyclical groups like Materials and Industrials underperforming though for the Financial and Consumer Discretionary sectors, the underperformance was marginal.

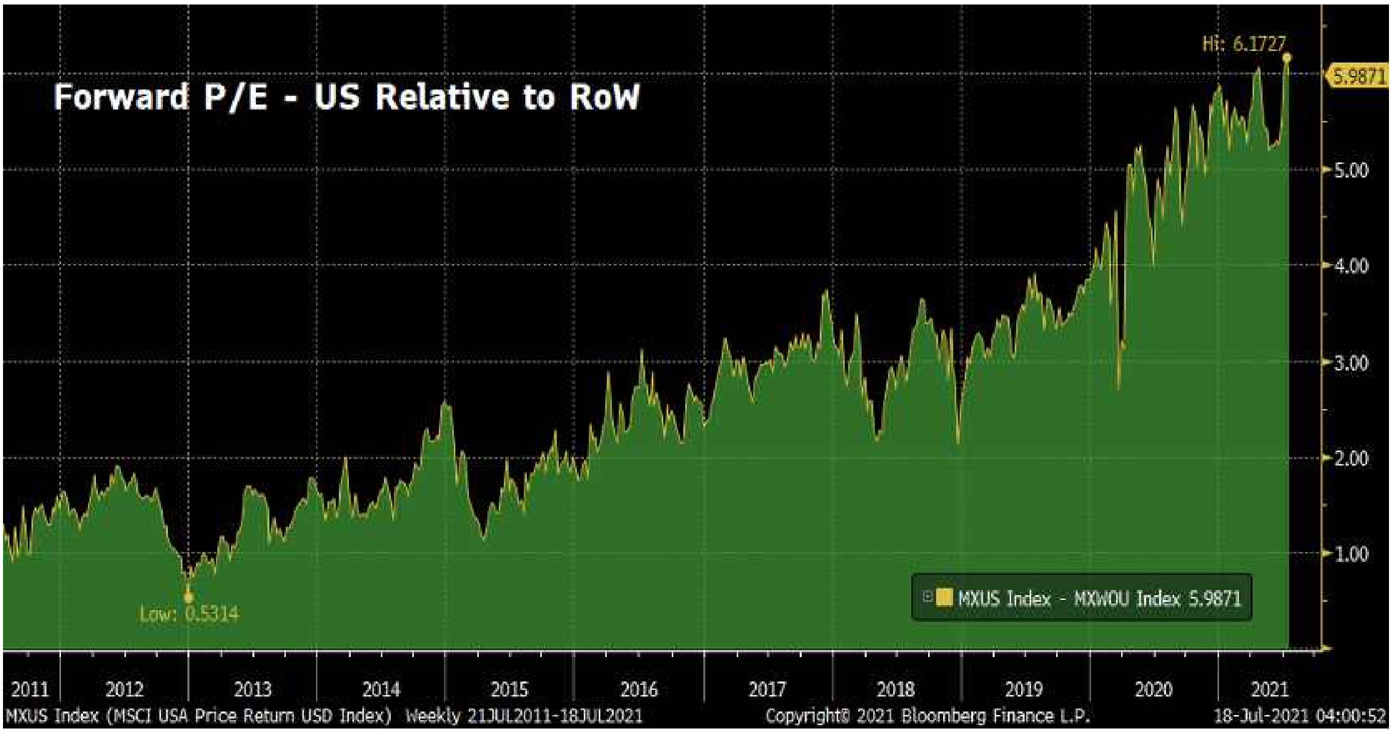
We are at an interesting stage in the market where we can see the consumer, especially in developed markets remaining well-positioned to spend, but valuations in Consumer Discretionary are not leaving much room for upside and certainly very little margin of safety. While US Consumer Discretionary Index is dominated by Amazon and Tesla, even in other parts of the index, there is less room for earnings upgrades left. In Speciality Retail, valuations are quite full though there is more room in parts like Leisure and Autos, where earnings have significant room to catch up and deliver outperformance. Of course, these sectors are still impacted by the virus outlook to some extent and supply chain constraints in both labour and inputs, but we expect these to continue dissipating over the coming months as vaccinations spread globally and the realisation that the virus is now endemic forces a growing relaxation of constraints.

While over the medium term there is not a great case to be bearish the consumer discretionary space considering the latent spending power that still exists and the forecasts for economic growth, a valid case can be made or it to not be the outperforming sector in the next few quarters. The interesting aspect of this consumer growth is the needed to grow capacity. It is reasonable to expect that in this strong demand environment capital expenditures will rise to pressure-free cash flows. This is what the Industrials complex has been expecting. There is additional pressure from re-shoring driven both by politics as well as the recent supply chain experience.

Before going further into sectoral and regional expectations, it probably needs to be established where we are in valuation terms and what has transpired over the last few months. A quick look at forward valuations of the S&P will make one thing clear – while the levels are expensive relative to history, the rise this year has not come from multiple expansion; in fact, multiples are down this year from the end of last year.

We seem to have been underappreciative of the earnings rebound in the US; expectations of earnings for the full year remain extraordinarily strong. However, even with these strong earnings expectations, the market will end up at a P/E multiple that simply makes little sense going forward so a multiple compression is to be expected. Thus, a decision needs to be made – either earnings are going to be significantly stronger than current expectations for the market to move higher from here, or modestly higher than expectations for the market to end the year say at 20x trailing earnings (needing a 12.5% earnings surprise to get to an EPS of 216 giving a P/E of 20x at today's price). Alternatively, we can say that there is a significant downside to the market if expectations are not met, and even if they are, current prices in the US are about 10% too high.

Outside of the US, things remain slightly better. Even if the Rest of the World valuations are elevated too, the valuation gap with the US is so elevated that it is increasingly harder to justify an overweight to the US.



It has been easy in the past to justify US exceptionalism due to the large growth factor that works in the favour of the US, especially driven by the prominent tech sector. However, even in the Value space, the US premium is near all-time highs.

The rationale provided for this generally is the larger fiscal spend in the US relative to the Rest of the World (RoW), but this remains a red herring. Any US fiscal spend that increases US demand is a stimulus for the RoW and consequently, RoW earnings should rise faster, narrowing any valuation gap. We have in fact started seeing that since Q4 2020. The valuation and the performance gap between the US and the Rest of the World should start to narrow.

The risk is that US consumption decelerates sharply whether due to reasons of covid or other factors that we may not be anticipating leading to a sharp contraction in the US trade deficit. If that happens, it would be a temporary hiccup to this view as both fiscal and monetary levers would again kick in to provide support. It is quite clear that fiscal inhibitions in the US are much lower than they have ever been, especially as demand stimulation is now the default policy of the Democratic party. Also, unlike the US and Europe, EM ex-China is only just starting to recover from the Covid driven slump. This means that EM equities will get a domestic consumption boost along with the external demand boost they have already been receiving.

China remains a risk to our pro EM view. Chinese growth, while still robust, has been slowing down for a bit and the government is starting to respond by easing liquidity again. We expect this easing to turn to outright support later in the year as fixed asset investment takes over from industrial growth which is coming off a high base.

Thus, we think the second leg of cyclical outperformance driven by ex-US equities are upon us. The only question is whether this reset will be a smooth one like it took place late last year or will be a more violent one. While in the near term it pays to be cautious due to valuation concerns, we feel that H2 will offer an attractive entry point to a medium-term trend of ex-US outperformance driven both by currency and asset price returns. In the meantime, we like sectors like Healthcare which offer a mix of defensive characteristics and re-opening boost and still like Energy, which despite its strong outperformance this year remains underinvested.

For longer-term outperformance, we would also look to boost positioning in renewables which have this year suffered from rising costs expensive multiples keeping investors away. The transition away from fossil fuels continues to get both consumer and policy support and while the road will be bumpy, this is a decade-long theme that investors will profit from staying invested in.

JULY 2021

DR RYAN LEMAND
SENIOR EXECUTIVE OFFICER & BOARD DIRECTOR

ASHISH MARWAH
CHIEF INVESTMENT OFFICER

SONJA SUESSENBACH
HEAD OF WEALTH MANAGEMENT