Focus on short-term fixed income

Q2 in Review: Central banks boost economic outlooks but hold policy steady

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IN BRIEF

UK

- UK economic activity continued to rebound strongly in the second quarter, helped by a successful vaccine rollout, sustained reopening and supportive fiscal and monetary policies.
- Although inflation has increased, the Bank of England (BoE) views the projected inflation overshoot as transitory and has prioritised safeguarding the recovery.
- The recovery is expected to strengthen into the second half of 2021, however, downside risks including a resurgence of the virus and the roll-off of fiscal stimulus remain a concern.

Europe

- At its June policy meeting, the European Central Bank (ECB) revised up its growth and inflation forecasts for 2021 and 2022, though the longer-term inflation forecast remains significantly below target at 1.4%.
- Despite these revisions, the central bank made no changes to its policies and confirmed its dovish stance.
- Short-term interest rates remain firmly anchored, with money market rates close to record lows.

UK – RECOVERY CONTINUES AS RESTRICTIONS EASE, REDUCING THE PROBABILITY OF FURTHER BOE EASING

MARKET REVIEW

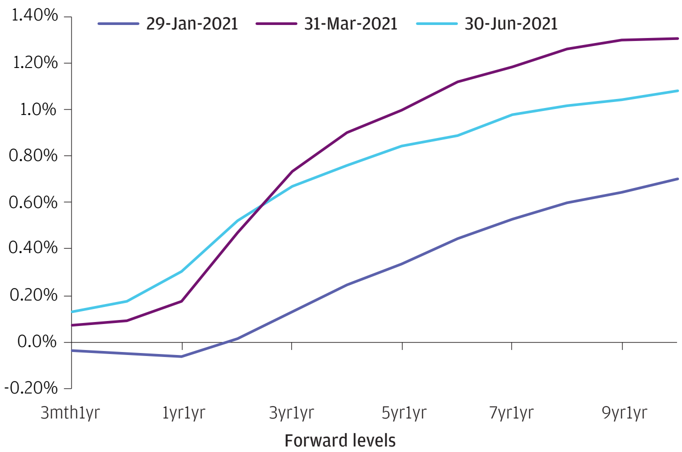
At the start of Q2, continued momentum in the successful vaccine rollout, diminishing COVID-19 cases and a government guide-path to lift all restrictions before the end of June 2021 fueled growing optimism in the UK recovery. Loose monetary conditions and supportive fiscal policies, combined with record household savings rates, boosted confidence and spending so that as lockdowns eased, the economy generally delivered on this positive outlook.

First quarter GDP fell 1.5% quarter on quarter (q/q) as weaker consumption and investment components dragged. However, activity continued to improve, and in April, the economy grew 2.3% month on month (m/m) to just 3.8% below pre-pandemic levels. Headline Consumer Price Inflation (CPI) rose 2.1% year on year (y/y) in May, spurred by spending on travel, energy and clothing. An improving employment picture also contributed to inflation: weekly earnings (ex-bonus) were the highest on record over the three months to April, while the unemployment rate was the lowest since mid-2020 at 4.7%.

In its May Monetary Policy Report, guidance from the BoE was more symmetrical around the outlook, with further stimulus only warranted if data severely disappoints as fiscal support is removed. Although the final lifting of all restrictions was postponed in the face of rising cases of the Delta variant, prospects for a negative Bank Rate have faded and the market path for a faster liftoff to higher rates is implicitly supported by the BoE's forecasts.

Rates are expected to lift off sooner

SONIA FORWARD CURVE



Source: Bloomberg, as of 30 June 2021.

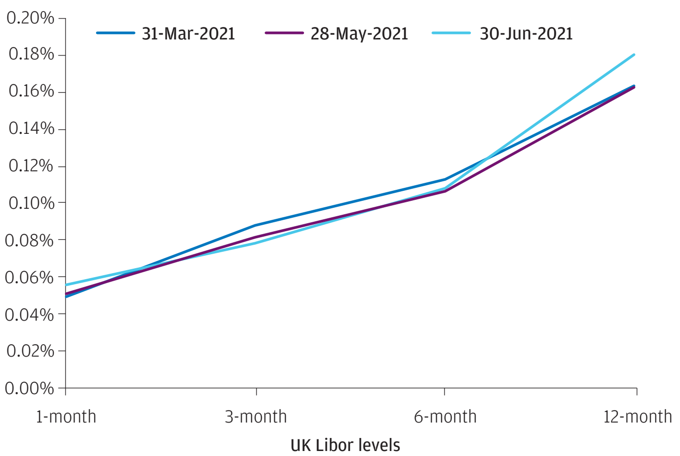
PORTFOLIO COMMENTARY

Liquidity strategies

Despite the continued economic recovery and expectation for higher rates, the front end of the curve in one- to 12-month maturities remained well anchored throughout the quarter. We continued to look for opportunities to extend into higher yields while focusing on maintaining robust levels of weekly liquid assets (WLA) around 45% to 50%, comfortably above regulatory minimums. Duration on the GBP Liquidity strategies remained at the longer end of our target range of 45 to 55 days weighted average maturity (WAM) and 70 to 75 days weighted average life (WAL).

UK Libor yields remain well anchored

UK LIBOR CURVE



Source: Bloomberg, as of 30 June 2021.

Managed Reserve strategies

In comparison to the rates volatility we witnessed in Q1, as negative interest rates were quickly priced out, UK front-end rates were pretty well behaved in Q2. Two-year UK Gilts traded in a relatively tight range, between 5 and 10 basis points (bps). Strategically, our GBP Managed Reserve strategy and Ultra-Short ETF remain well positioned, benefiting from the improved roll-down dynamics, especially in corporate credit. We continue to view credit as attractive, with strong fundamentals and technicals outweighing the tight valuations.

With the Monetary Policy Committee (MPC) in wait-and-see mode and the potential for curve steepening ahead, we have maintained duration at 0.43 years (with a focus on two years and in maturities) for the GBP Managed Reserves Strategy and 0.76 years for the Ultra-Short ETF. We anticipate adding to this duration position as opportunities present themselves.

OUTLOOK

Acknowledging the recent stronger economic data, the BoE projects that inflation is likely to exceed 3% for a temporary period in 2021, and that Q2 GDP could top 5.5%. However, it continues to view the inflation overshoot as transitory, and with the labour market supported through the end of September by government employment support schemes, there is no clear evidence of higher medium-term inflation expectations.

Whether these inflationary pressures prove temporary or not, potential downside risks remain from a rise in cases of the Delta variant and the approaching end of furlough. We expect the BoE to adopt a cautious holding pattern, mindful that any premature tightening in monetary conditions could undermine the recovery; policy is likely to remain accommodative until it becomes clearer whether the quicker-than-expected return to pre-pandemic economic output ultimately translates into sustained higher demand.

EUROPE - ECB MAINTAINS A STEADY HAND, DESPITE HIGHER FORECASTS

MARKET REVIEW

Vaccination rates picked up pace across Europe in Q2, fueling optimism that the eurozone economy can rebound strongly during the second half of 2021. Consumer confidence soared to a three-year high; business confidence also surged, with the composite Purchasing Managers' Index (PMI) adding seven points in the last three months, reaching 59.5. Short-term work schemes kept unemployment relatively low – May's measure was 7.9% versus a peak of 8.5% in September 2020. The successful ratification of the European Union (EU) Recovery Fund, combined with the continued recovery in global demand, should create additional economic tailwinds.

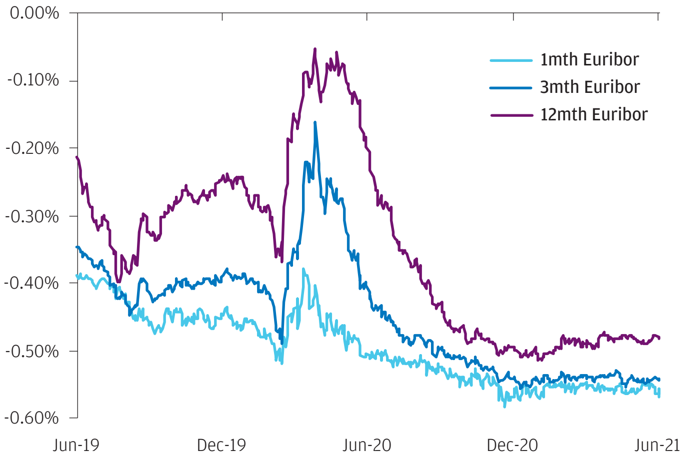
The ECB has become more optimistic on the economic outlook, upgrading its June growth forecasts to 4.6% in 2021 and 4.7% in 2022 versus the 4% and 4.1% respective forecasts in March. The ECB's Harmonized Index of Consumer Prices (HICP) is now forecast to average close to the ECB's target in 2021 at 1.9% (versus 1.5% forecast in March), but significantly, the longer-term HICP forecast is unchanged for 2023 at 1.4%, still well below target. This allows the central bank to maintain an extremely accommodative policy, pledging to conduct

Pandemic Emergency Purchase Programme (PEPP) purchases "at a significantly higher pace than during the first months of the year", mirroring the decision taken in March.

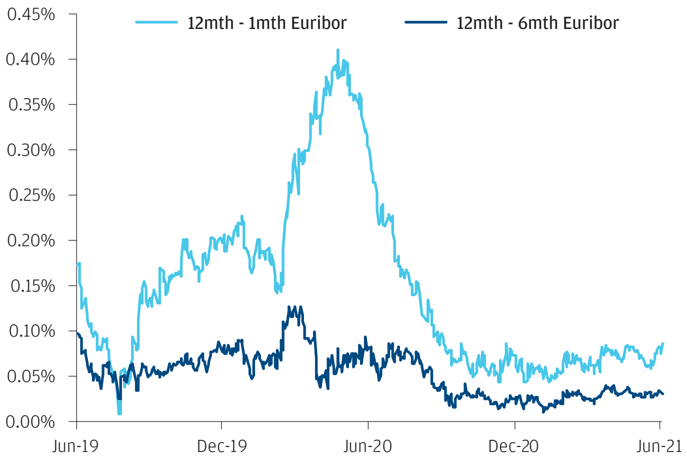
The central bank's commitment to keep base rates low and liquidity high continues to anchor short-term euro rates. The Euribor curve remains very flat, with nearly all maturity tenors continuing to fix below the ECB Deposit Rate.

Euribor levels remain near all-time lows

EURIBOR YIELDS



EURIBOR CURVES



Source: Bloomberg, as of 30 June 2021.

PORTFOLIO COMMENTARY

Liquidity strategies

Over the quarter the WAM and WAL of our Euro Liquidity strategies was positioned mainly between 46 and 56 days, unchanged from the prior quarter. While the money market curve remains relatively flat, we continued to look for opportunities to pick up yield further along the curve in six- to nine-month maturities. We remained focused on maintaining robust WLA in the region of 45% to 55%, comfortably above regulatory minimums.

Managed Reserve strategies

With front-end rates anchored and credit spreads continuing to grind tighter, our Managed Reserve strategies, once again, had a relatively strong quarter. Forward guidance and quantitative easing (QE) programmes remain firmly in place, and we do not foresee any near-term moves in monetary policy coming from the ECB. Despite this, we continue to position for steeper curves (three years and out) mainly due to the repricing of US curves. We continue to add credit opportunistically and still prefer new issues over secondary market bond purchases, especially when we are rewarded with a new issue premium. We remained strategically positioned in corporate credit, given the improved fundamental picture as well as exceptionally strong technical support from the ECB, supply and fund inflows. Improving supply dynamics also allowed us to marginally increase our securitised credit position, including auto-backed asset backed securities and collateralised loan obligations.

OUTLOOK

Hard data will hopefully continue to improve over the summer months as economies reopen more fully, though the impact of the recent growth in the Delta variant will need to be monitored closely. Markets will likely debate whether a potential tapering of PEPP purchases is in play for the September ECB meeting. The ECB will remain watchful as to how the concurrent debate around US tapering impacts European markets and will guard against any unwarranted tightening in financial conditions.

While the ECB has pivoted to a more optimistic outlook for the economy, it is not yet comfortable removing any policy accommodation until it sees the recovery become more firmly entrenched. The central bank characterised the recent inflation trend as transitory and its second half strategic review is likely to confirm that medium-term inflation forecasts remain well below target. This implies that euro short-end rates will remain well anchored in negative territory and close to current levels for the foreseeable future.

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