AXIOMA

Wealth Management AG

2021 Investment Strategy
First Quarter Update

Market Overview

The year has started on a high note, as money continued to pour into bond funds with markets taking more comfort in the Democratic sweep in the US elections. Political stability and assurances of fiscal support have prevailed over all other concerns.

Covid-19 vaccination campaigns have started to gain traction, especially in developed countries, and this, coupled with the huge new fiscal stimulus package passed in the US in March, has nudged the markets to start pricing in a rapid return to normal conditions and a strong economic recovery. In fact, markets priced in such a strong economic rebound that it has fueled widespread fears over high inflation in the near to mid-term. Long-term US Treasury yields have gone up as the result, the rise has been fast enough to start weighing on the financial markets.

Fig 1: 10-year US benchmark yield sees the fastest 3-month rise since 2016

Source: Bloomberg

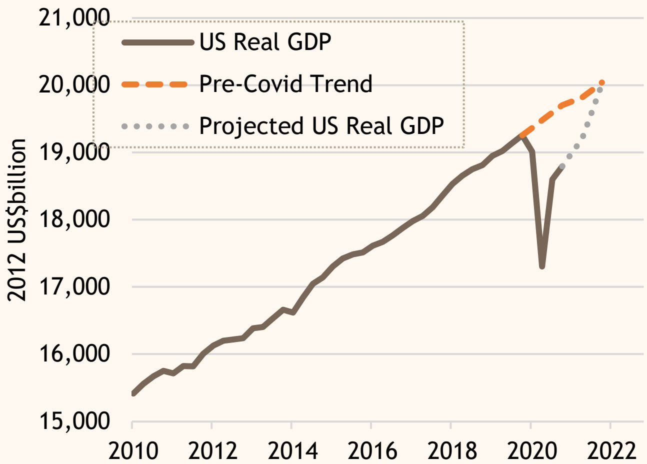
Thus, the debate around inflation has topped the list of dominant themes for the first quarter of the year. The concerns are mainly over the sizable portion of the fiscal stimulus being oriented towards demand. Supply chains are already showing signs of disruptions and many believe that when the pent-up demand is released following the vaccination, the US economy will get dangerously overheated, and Fed will have to turn hawkish. Perhaps the memory of the 2013 Taper Tantrum is still vivid. Back then, the then Fed's chairman announced the deceleration of purchases of the US government bonds after five years of quantitative easing following the financial crisis. That led to a flight to quality.

Another aspect of the story is that the structural disinflationary factors, like ageing population and low productivity, will continue to exert disinflationary pressures. We believe that inflation will indeed rise above 2% in the near to mid-term, but this will be a temporary phenomenon. In addition, Fed had learned its lesson from the 2013 crisis and will avoid reversing policy prematurely.

Global GDP projections have been revised upward, as economies have adapted to restrictions on mobility. Even though infections continue to rise, we expect the global economy to stay on its path to recovery as vaccination gains traction. However, there is still much uncertainty about lasting effects on consumption, investment and spending, and the structural changes this crisis may leave behind, which will only be visible after we emerge from the pandemic. Besides that, many sectors of the economy will take longer than the current year to recover.

Other major sources of risk to the near-term outlook will be the US-China tensions and the potential step-up in market regulations imposed by the Biden administration. At the same time, US monetary policy and the search for yield remain supportive for the bond markets.

Fig 2: US GDP still below trend, a 6.5% growth in 2021, as projected by Fed, will bring the US gross product close to the pre-covid growth trend

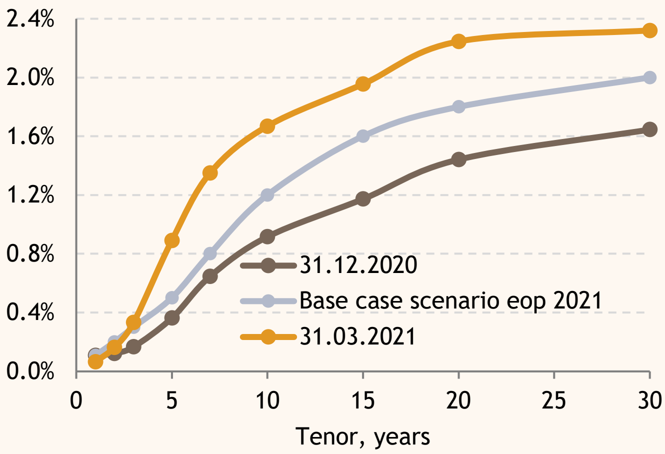


Source: Bloomberg

US Monetary Policy

Latest dot-plot projections have revealed that the US financial regulator members do not expect changes in the policy rate through 2023. Thus, the short end of the US Treasuries curve would remain anchored close to zero. Benchmark 10-year yield reached 1.74% by the end of the quarter, up from 0.91% at the start of 2021. Yields may see a further rise; however, the major part of the movement has already happened, in our view. We believe that if long-term rates go out of control, Fed will intervene with targeted-maturity government bonds' purchases.

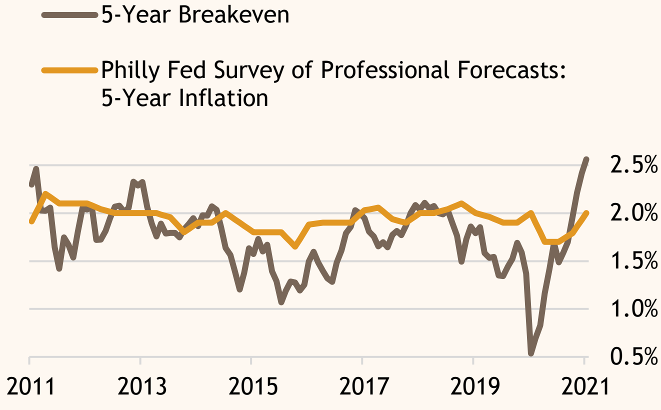
Fig. 3: US Treasuries yield curve



After almost a year under the 'don't fight the Fed' market motto, markets and the US bank regulator have parted ways and are now diverging in their views. On the one hand, Fed's Chairman Jerome Powel keeps insisting that there is still a long way to achieve 'full recovery', and an inflation spike would be a temporary and manageable one. More so, after Fed has adopted a new policy framework last year which would allow inflation to overshoot the 2% inflation target. On the other hand, markets are already fretting over the prospects of higher-than-expected inflation and higher interest rates, now anticipated as early as 2022, contrary to Fed's forecasts.

To avoid further disruptions on the market, Fed may want to choose to alter its rhetoric to avoid ambiguity that can unsettle markets. Namely, Fed should specify more clearly what it means by 'full recovery'.

Fig. 4: Fed and market diverge in their inflation expectations



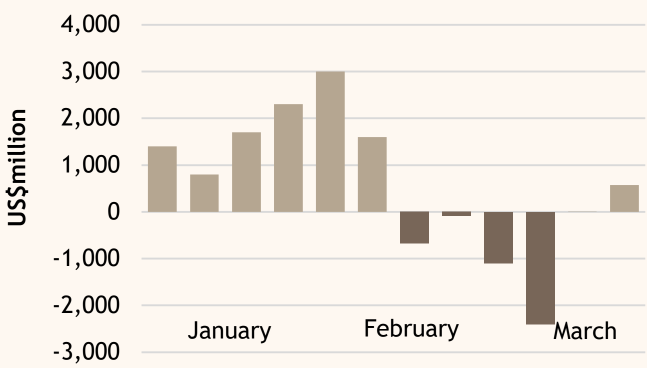
Source: Bloomberg

Low rates environment has prompted corporate issuers to extend the maturity profile of their bond issues. On a historical perspective, the average duration for the broad bond market is now higher than ever before. Thus, the average option-adjusted duration for Bloomberg Barclays Global Aggregate Corporate Index has risen from 4.5 years at the end of 2009 to 6.4 years as of 31 March 2021.

Our target-portfolio duration (4.7 years) is lower than both the Bloomberg Barclays US Aggregate (6.4 years) and the Bloomberg Barclays emerging markets hard-currency (6.7 years) indices average duration.

Credit Spreads

Fig. 5: Flows to emerging market bond funds



Source: JPMorgan

Inflows in the first weeks of the year drove credit spreads to historically low levels and they have remained more or less flat for the quarter. This has left less of a cushion to absorb the movement in benchmark yields, especially for the investment-grade part of the market, which has seen negative total returns year-to-date. Despite increased volatility on the markets due to concerns over the potential rise in inflation, primary market issuance has remained sought-after, which drove down premiums.

Fig. 6: Five worst performers of the quarter among Axioma's USD bond universe, by total return. Investment-grade long-maturity bonds have seen negative total returns year-to-date due to higher sensitivity to rising benchmark yields.

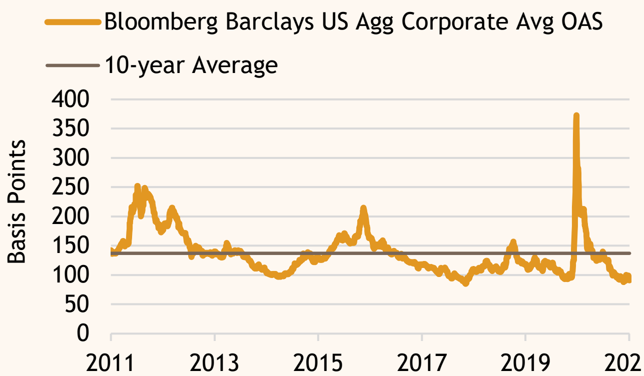
Bottom-5 Bonds	Issuer	Country	YTD TR
MOROC 4 12/15/50	MOROCCO	MO	-12.95%
EQNR 3.7 04/06/50	EQUINOR ASA	NO	-11.18%
TENCNT 3.29 06/03/60	TENCENT HOLDINGS	CN	-11.12%
EQNR 3 5/8 04/06/40	EQUINOR	NO	-10.23%
ARAMCO 3 1/4 11/24/50	SAUDI ARABIAN OIL	SA	-9.82%

Fig. 7 Five best performers of the quarter among Axioma's USD bond universe, by total return. Our bet on Oman has proven profitable, all our Omani bond holdings have seen a significant surged following the recovery of oil prices.

Top-5 Bonds	Issuer	Country	YTD TR
WAL 5 1/4 06/01/30	WESTERN ALL. BANK	US	5.41%
NBOBOM 5 5/8 09/25/23	NAT. BANK OF OMAN	OM	4.75%
OMAN 4 3/4 06/15/26	OMAN GOVERNMENT	OM	4.73%
OMGRID 5.196 05/16/27	OMGRID FUNDING	OM	3.54%
MAZOON 5.2 11/08/27	MAZOON	OM	3.46%

As the global economy continues to reopen, corporate fundamentals are gradually improving. Companies have been repairing their balance sheets and we believe we can expect more credit rating upgrades by the end of the year.

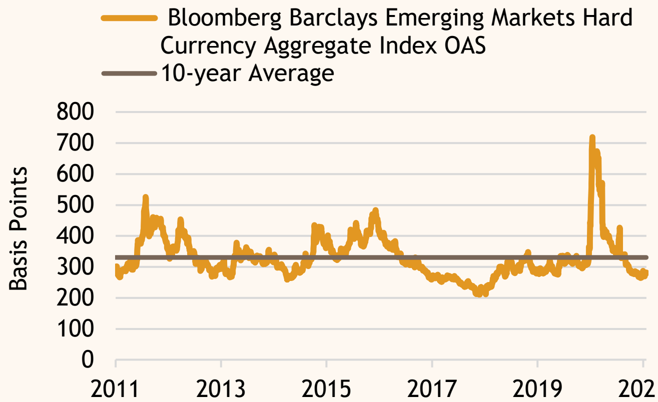
Fig. 8: US IG Credit spreads



Source: Bloomberg

Credit spreads for selective emerging market regions remain slightly above their historical averages, we therefore believe there is a compression potential for bonds from Asia and Africa.

Fig. 9: EM Credit Spreads



Source: Bloomberg

Some worldwide leaders have reminded investors of the 'country risk' when investing in emerging markets. First, it was Brazilian President Bolsonaro who disappointed markets, after ousting the CEO of Petrobras, the state-owned oil giant, amid disagreements over fuel prices. It is a sign that the President is abandoning his market-friendly agenda in favour of populistic policies, with the approaching 2022 elections in mind. Then, it was Turkey's turn after President Recep Erdogan dismissed the central bank governor two days after a 200-bps interest rate hike. This is a third change of leadership in the bank regulator in two years and it has further undermined the independence of the central bank and its ability to fight inflation.

Given the volatile and undeveloped political systems in the emerging market countries, the importance of geographical diversification in this context is paramount.

Strategy

We have kept the duration low and credit quality high, as there have been a lot of uncertainties around economic recovery and the slightest disappointment on the market could have led to a serious correction. At the same time, fiscal stimulus has poised an inflation risk. We share Fed's view that any inflation spike will not be long-term, however, we have believed that high inflation figures would spook market participants and they would resort to the golden rule of investment: 'First sell, then think'.

Our strategy of short duration has proven to be right, so a severe sell-off in long-term IG bonds has not brought serious mark-down to our portfolios. Looking further we believe that there will be a right moment to increase duration, as we do not believe the inflation would be long-term and would result in the early hike of the interest rate. However, we would like to do it through EM bonds which have a cushion in credit spread to smooth the price volatility. In 1Q21 EM bonds have proven to be resilient to sell-off in Treasuries and have not reached our target price levels. Spread wise, many EM bonds look fair or even overbought given the slow vaccination progress and other problems inherent to EM. We will keep a close eye on the situation and will turn the buying mode on should we see opportunities.

Performance Forecast

In our base-case scenario we had UST5 yields at 0.5% by the end of the year and spread compression of 25 basis points for the Fund portfolio, which is a model portfolio for the strategy. While we are on track with spread compression - 1Q21 brought almost 15 basis points, we are at Negative scenario for UST yields (1%).

We would like to stay conservative in our base case assumptions, thus we have moved our base case scenario for UST yields to the current level and kept spread compression prospects unchanged. That would result in 2.9% for the entire 2021.

The chances are quite high that the monetary and fiscal stimulus will keep markets optimistic. In this case, our optimistic scenario would yield 4.9% for the whole of 2021 before any use of leverage.

Worst case scenario is based on a sell-of among EM bonds which could be driven by either geo-political factors or economic growth disappointment due to vaccination delays or new vaccine-resistant strains which would plunge the world back into lockdown depression.

We hope that the market will grant opportunities for us to take on leverage and multiply expected return with a modest risk profile.

Table 1. Strategy performance forecast, 2021

Spread (bp)	5 years UST yield to maturity						
	-1.0%	-0.5%	0.0%	**0.5%**	1.0%	1.5%	2.0%
-45	14.0%	11.7%	9.4%	7.2%	4.9%	2.6%	0.3%
-30	13.4%	11.1%	8.8%	6.5%	4.2%	1.9%	-0.4%
-15	12.7%	10.4%	8.1%	**5.8%**	3.6%	1.3%	-1.0%
base	12.1%	9.8%	7.5%	**5.2%**	**2.9%**	0.6%	-1.7%
49	9.9%	7.6%	5.3%	**3.0%**	0.7%	-1.6%	-3.9%
99	7.7%	5.4%	3.1%	**0.8%**	-1.5%	-3.8%	-6.1%
148	5.5%	3.2%	0.9%	**-1.4%**	-3.7%	-5.9%	-8.2%
198	3.3%	1.0%	-1.3%	**-3.5%**	-5.8%	-8.1%	-10.4%

Strategy return	**Optimistic scenario**	**Base case scenario**	**Negative scenario**
01.01.2021-31.03.2021	-1.7%	-1.7%	-1.7%
9 month return (no Lev)	6.6%	4.6%	-2.8%
9 month return (25% Lev)	8.1%	5.6%	-3.7%
9 month return (50% Lev)	9.6%	6.6%	-4.5%
FY2021 (no lev)	**4.9%**	**2.9%**	**-4.5%**
FY2021 (25% lev)	6.2%	3.8%	-5.3%
FY2021 (50% lev)	7.7%	4.8%	-6.2%

Source: AXIOMA

- **Optimistic case** – UST yields stay at current levels (around 1%) and credit spreads recover another 50bps on average getting in line with their long-time average.
- **Base case** – UST yields stay at current levels (around 1%) and credit spreads have another 10bps compression potential.
- **Negative case** - Credit spreads widen 200 bps on average due to a sell-off in EM bond market, however flight to quality drives UST yields 50bps lower back to the level of the beginning of the year (0.5%). We assume a default rate of 1,0% for this scenario.

Table 2. Strategy performance forecast, 9 months 1 April 2021 - 31 December 2021

Strategy return	**Optimistic scenario**	**Base case scenario**	**Negative scenario**
Coupon component	3.1%	3.1%	3.1%
Price change due to change in UST yields and duration	*1.0%*	*1.0%*	3.1%
Price change due to spread narrowing or widening	*2.5%*	*0.5%*	-8.0%
Default	*0.0%*	0.0%	-1.0%
Total:	**6.6%**	**4.6%**	**-2.8%**
Return subject to 25% leverage	8.1%	5.6%	-3.7%
Return subject to 50% leverage	9.6%	6.6%	-4.5%

Source: AXIOMA

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We hope you find this information useful and will be glad to answer your questions

Disclaimer