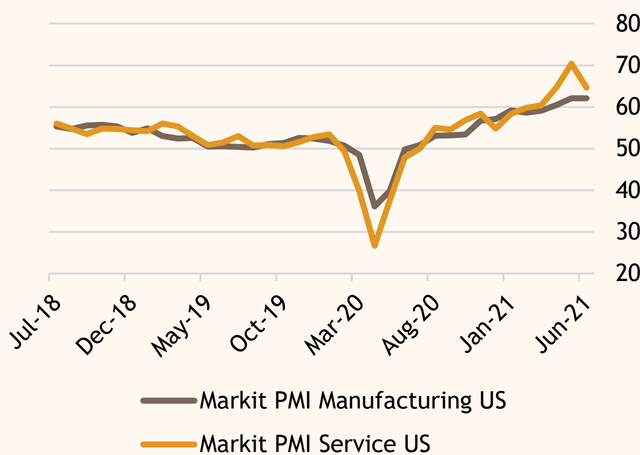
2021 Investment Strategy
Second Quarter Update

Market Overview

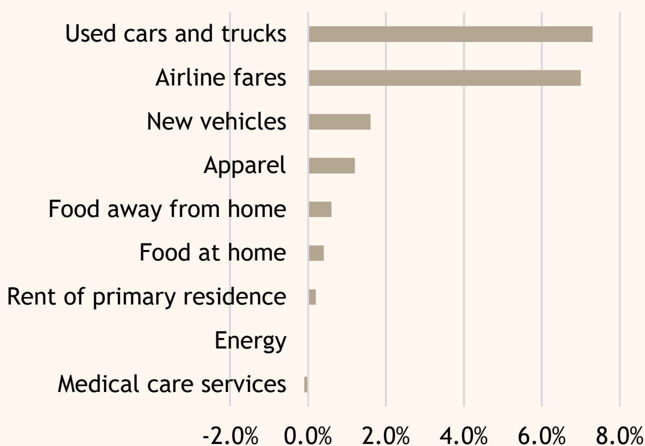
The second quarter has ended on a higher note compared to the previous one. As the pace of vaccination has gained traction, in the developed countries in particular, the uncertainty regarding the economic recovery, especially in the US, has receded. Economic data regarding the activity in manufacturing and services is pointing to a robust growth across all sectors. Many indicators are suggesting that the growth momentum in the current economic cycle may have peaked in the US. Nonetheless, we expect growth to proceed at a strong pace in the following quarters. The consensus estimate for the 2021 US GDP expansion is 6.6%, with the 2022 figure at 4.2%.

Fig. 1: Growth momentum in the US may have peaked in the second quarter



Source: Bloomberg, Markit

Fig. 2: Surge in US Inflation driven by easing of restrictions and supply shortages (based on May CPI data, increase from April)

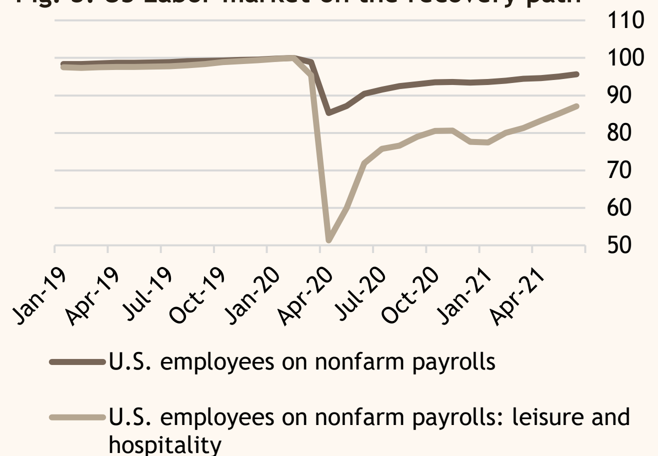


Source: Federal Reserve

Supply chain disruptions and high commodity prices have led to a significant surge in inflation. Analysis of the CPI index components which have seen the largest increase indicates that a big part of the price pressures will be temporary. Nonetheless, we acknowledge that the current data fails to capture pricing pressures accurately and surprises are not excluded.

US labor market is showing a slow gradual recovery. As of June, unemployment rate stood at 5.9%, with the absolute number of unemployment claims still at a high 3.34 million. Pre-pandemic, the full unemployment rate was considered to be around 4.5% but the number might have altered. Fed will need to be more specific as to the meaning of the "maximum employment" target, a prerequisite for the policy tightening. For everyone, the picture regarding unemployment will be much clearer once the augmented employment benefits program will expire in September, incentivizing unemployed to get back to work.

Fig. 3: US Labor market on the recovery path



Source: U.S. Bureau of Labor Statistics

The commodities boom has been aiding the recovery process in many emerging markets. Growth has been lagging in developing countries compared to their developed counterparts but will likely continue at a faster pace in the second half of the year. Mid-term, the US Fed monetary policy will be a key driver for the emerging market bonds.

One of the main risks to the market outlook is the uncertainty regarding the timing of the inevitable tightening of financial conditions.

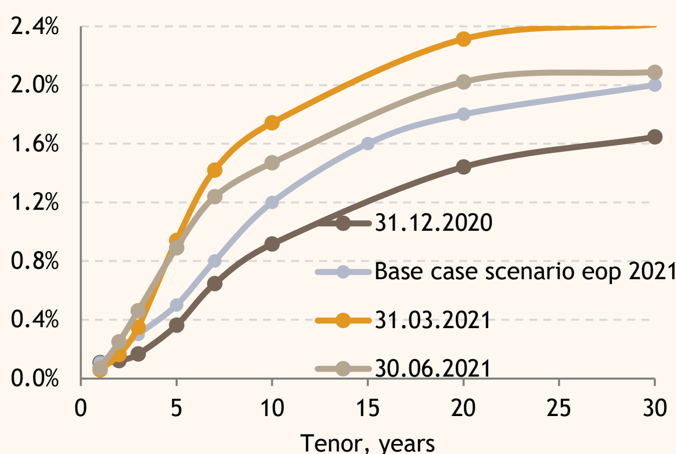
However, many unknowns persist regarding the path the economy will take following this pandemic. Covid-19 has left its mark on consumption habits, labor skill demands, the propensity to save, to name just a few. It is not possible to ascertain the structural changes to the economy that may have occurred, and what trajectory will the growth take from here. With this in mind we can state that we are not over this pandemic just yet.

US Monetary Policy

Despite the increasing inflationary pressures, Federal Reserve has retained its view that the inflation will be transitory. Nevertheless, the latest FOMC meeting has come in with a hawkish surprise, as it has signaled an earlier-than-expected policy normalization. Dot plot data has revealed two rate hikes in 2023, - a significant shift from the last meeting's forecast of just one hike in 2024. Market reaction has been somewhat muted, as the move has been taken as an "appropriate policy" and as an assurance that Fed is on top of the situation.

Having seen a significant surge in the first quarter, 10-year US government bonds yields stabilized at about 1.50% at the end of June, suggesting that the market's view of transitory inflation pressures is in unison with that of Fed. Technical factors have also played a role.

Fig. 4: US Treasuries Curve



Source: Bloomberg, AXIOMA

Tapering is likely to be announced at some point in the following quarters. It is unclear yet, and there is a divergence among the FOMC members regarding its timing. Fed is currently still buying assets worth US$120 billion/month. The reduction will be gradual, but it will eventually exercise an upward pressure on bond yields.

To sum it up, not only growth may have peaked, but also the monetary policy accommodation. This may cause some challenges for the US central bank in its journey to policy normalization, while clashes with the market due to miscommunications or divergent views may still be on the cards.

Credit Spreads

Positive macro environment and ultra-accommodating monetary policy have been providing strong support for credit spreads. "Fear of missing out" and high liquidity have pushed credit spreads retreating to historically low levels.

Overall, fundamentals are positive, considering that we are in the middle of the cycle, with corporate profit margins back to record highs and default rates on a downtrend.

OAS spreads for US high yield are down 38 basis points from the first quarter, while spreads for the US IG segment remained flat from the previous quarter. EM spreads tightened marginally, by 7 basis points and we believe that there is still potential for credit spread tightening on some EM segments of the bond market.

Fig. 5: Emerging market debt still offers attractive yield premium to developed market debt

Source: Bloomberg (Bloomberg Barclays Emerging Markets High Yield Total Return Index vs. Bloomberg Barclays US Corporate High Yield Bond Index)

Strategy

As inflation has rocketed in 2Q21, we have kept the duration practically unchanged at about 5 years, roughly 2 times lower for any given broad fixed-income index. The portfolio has changed a little as there has been a flood of tender offers from companies who rushed to the market to refinance via tendering short bonds and placing longer ones. We have actively participated in this rush, as companies were ready to offer premiums for both tenders and primary placements.

The ratings breakdown has remained practically unchanged, while we believe that the road to recovery may turn out bumpy and we will not be surprised to see credit spreads widening at some point. While rotating the portfolio we have put an extra focus on keeping the average portfolio credit quality at the same high level.

All these measures have helped us to outperform fixed income indices both in the 1Q21 and in the 2Q21. Major EM indices have finished 1H21 around -1.5% - -0.5%, while most our accounts were +0.5% - +1% in net performance.

Looking forward, we believe that the summer may stay calm for fixed-income, however the tailwinds of the fiscal stimulus, monetary support, upsurge in GDP growth and subsequent corporate earnings increase and vaccination optimism will start to fade as the year-end gets closer, with markets starting to notice the lack of support. However, in EM there are still places where bonds could outperform; the market could also provide us with other opportunities to earn more, as the Peruvian and Colombian issuers demonstrated in the 2Q21. That means, that bold risk is not justified at current valuations and the economic outlook but combining a conservative duration (5 to 6 years) with a diversified portfolio of issuers with good credit quality and participating in market opportunities could give us an edge without assuming too much risk.

Performance Forecast

The performance forecast does not differ much from the one of 1Q21. We are still on track with credit spreads tightening while UST5 yields have increased in comparison with our initial forecast and have not changed during 2Q21.

We have kept our base case scenario close to the current level of UST yields, which means that the entire 2021 would earn +2.9% in base case scenario and +4.9% in best-case before any use of leverage.

We have not made any changes to our worst-case scenario which is based on a sell-off among EM bonds due to either geo-political factors or severe worsening of the pandemic situation due to the spread of the DELTA variant, for instance. Having said that, we do not believe that any country in the world is ready to re-introduce massive lockdown measures as it was in 2020.

We may use some leverage to enhance the result given our overall conservative stance and thus low expected volatility.

Table 1. Strategy performance forecast, 2021

		5 years UST yield to maturity						
		-1.0%	-0.5%	0.0%	**0.5%**	1.0%	1.5%	2.0%
Spread (bp)	-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%

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%) as well as credit spreads.
- **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, 2021

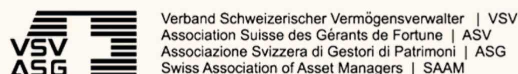
Strategy return FY2021	Optimistic scenario	Base case scenario	Negative scenario
1H2021	0.8%	0.8%	0.8%
6 month return (no Lev)	4.1%	2.1%	-5.4%
6 month return (25% Lev)	5.0%	2.5%	-6.8%
6 month return (50% Lev)	5.9%	3.0%	-8.2%
FY2021 (no lev)	**4.9%**	**2.9%**	**-4.5%**
FY2021 (25% lev)	5.8%	3.3%	-6.0%
FY2021 (50% lev)	6.8%	3.8%	-7.5%

Table 3. Strategy performance forecast, 6 months 1 July 2021 - 31 December 2021

Strategy return for next 6 months	Optimistic scenario	Base case scenario	Negative scenario
Coupon component	2.0%	2.0%	2.0%
Price change due to change in UST yields	*-0.6%*	*-0.6%*	1.9%
Price change due to spread narrowing or widening	*2.6%*	*0.6%*	-8.3%
Default	*0.0%*	0.0%	-1.0%
Total:	**4.1%**	**2.1%**	**-5.4%**
Return subject to 25% leverage	5.0%	2.5%	-6.8%
Return subject to 50% leverage	5.9%	3.0%	-8.2%

Source: AXIOMA

AXIOMA Wealth Management AG
Bleicherweg 50, CH-8002 Zurich
Tel.: + 41 43 305 07 10
info@axiomag.ch
www.axiomag.ch



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

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