May 2021

The Problem is the P not the E

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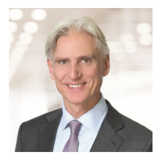
US and European equities continued their upward momentum. The S&P 500 led the charge in developed markets as expected, reaching new all-time highs, returning 5.3% over the month (USD) and the Euro Stoxx 50 returning 1.9% (EUR)[1]. However, the Nikkei 225 lagged, ending the month slightly down, returning -1.3% (JPY)[1]. Volatility continued to subside, as reflected in the VIX which moved down to 18.6 by April month-end, close to its 5-year median and during the month reached its lowest level since before the pandemic[1]. This continued trend downward of the VIX and realised volatility comes against a backdrop of encouraging economic data releases.



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US initial jobless claims were the lowest since the start of the pandemic at 553K[2] and March retail sales reached 9.8%[3], exceeding the expected 5.8%. The US and UK continued their positive trajectory in controlling the virus, given vaccine programmes and reopenings and now appear to be past the peak. In contrast, India is suffering a catastrophic escalation in COVID-19 cases, after a new variant emerged, though remarkably the market remains resilient.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

1. Bloomberg, 30 April 2021.
2. For the week ending 24 April 2021, the advanced figure for the seasonally adjusted initial claims. News release 29 April 2021. US Department of Labor, Unemployment Insurance Weekly Claims. www.dol.gov
3. US Census Bureau. Advanced monthly sales for retail and food services, March 2021. Advanced monthly sales. Released 15 April 2021 www.census.gov/retail/marts/www/marts_current.pdf

Equity valuations - the problem is the P not the E: Equities are currently expensive, but valuations do not yet appear extreme enough relative to historical norms to qualify as a bubble, especially given strong earnings growth and current low interest rates. In particular, for example, the current 12-month forward PE for the S&P 500 is elevated at 21.7 compared to the 5-year median of 17.2[4]. Strong growth in Q2 earnings could help sustain these high valuations in the short term. Generally, the earnings season has, in fact, been strong in the US and Europe, with the market "surprised" by how well large-cap tech has fared. Given the ample fiscal support and liquidity, we see limited downside risk for equities at this time. This constructive near-term outlook as activity normalises, may explain the recent decline in risk indices such as the VIX. That said, as we move into the second half of the year, potential US tax hikes should offset strong earnings growth and, if economic growth continues strong, the risk of central banks pulling back liquidity rises, making valuations even more stretched and increasing downside risk.

Geopolitical risk is rising - not falling: When Biden became President, there was some expectation that uncertainty would reduce. However, a number of geopolitical risks have flared up in recent months, including renewed tensions between the US and Russia. In addition, the Alaska summit in March underlined the increased tensions between the US and China. These tensions are not only related to economic issues, which may make them harder to resolve. We monitor geopolitical risk carefully, as this can disproportionately impact investor sentiment. We aim to act to help mitigate any drawdown should risks materialise from this or other factors.

Investment Implications

We increased our exposure to risk assets to maintain alignment of each portfolio to its volatility target. The reflation environment should continue to support risk assets in the short term – we favour equities over credit, with a pro-cyclical bias within equities. However, we continue to monitor risks which could disrupt our positive outlook of the economic recovery, including delays in vaccine rollouts - especially emerging markets, runaway inflation and geopolitical risks, amongst others.

We have made a number of tactical trades over the month, which we detail below:

Asia ex-Japan Equities

We initiated a small overweight to Asia ex-Japan in February, but moved back to neutral towards the end of April. This is in view of multiple near-term headwinds, most of which are emanating from China, the largest weight in the region and which has driven the underperformance this year. Whilst growth is stable in the region, we believe it is likely to lag compared to developed markets, partly due to vaccine access. US - China relations continue to deteriorate, with US sanctions on Chinese companies and more expected. In addition China's liquidity is tightening.

US Value Equities

We continue to tilt towards cyclicals and value equities, which should continue to benefit from reopening and strong economic recovery, moving overweight value equities in mid-April. With respect to valuations, US value should outperform growth in view of the valuation gap and its relationship with real yields.

4. Bloomberg, 2 April 2021.

Tactical positioning

We have provided our latest tactical views below:

Asset Class	--	-	=	+	++
Equity					
US			X		
US Value				X	
US Growth		X			
Eurozone			X		
Germany				X	
UK				X	
Japan			X		
Asia ex Japan			X		
China A-Shares			X		
Emerging Markets			X		
LatAm			X		
Global Infrastructure			X		
Global Property			X		
Global Clean Energy			X		
Global Financials				X	
Global Conventional Energy				X	

Asset Class	--	-	=	+	++
Fixed Income					
IG Credit			X		
US High Yield			X		
European High Yield			X		
EM Sovereign Debt HC			X		
EM Sovereign Debt LC			X		
US Treasuries		X			
US Inflation			X		
German Bunds		X			
EU Peripheral Bonds			X		
JGBs			X		
Commodities					
Gold			X		
Industrial Metals			X		

Source: MSIM GBaR team, as of 30 April 2021. For informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The tactical views expressed above are a broad reflection of our team's views and implementations, expressed for client communication purposes. The information herein does not contend to address the financial objectives, situation or specific needs of any individual investor.

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INDEX DEFINITIONS

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Euro STOXX 50 Index: Provides a blue-chip representation of supersector leaders in the Eurozone.

Forward to price earnings (P/E) is a measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation. Sometimes called the multiple, P/E gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting.

MSCI All-Country World ex USA Index (MSCI ACWI): A free-float-adjusted market-capitalization index that is designed to measure equity market performance in developed and emerging markets, excluding the United States.

NIKKEI 225 Index: This price-weighted index is comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange.

S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.

VIX: This is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 Index options. Often referred to as the fear index or the fear gauge, it represents one measure of the market's expectation of stock market volatility over the next 30-day period.

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