April 2024

MONTHLY HOUSE VIEWS

NO NEED TO REBALANCE

Macro

Positive economic surprises in the US continue to boost the outlook for global growth this year. The consensus estimate for real US GDP growth this year has shot up from only 0.6% last August to 2.2% at present. Interestingly, the laggard regions are beginning to show signs of catching up with the US. The composite purchasing manager index (PMI) for the Eurozone hit 49.9 points in February, the highest level since last May and just below the 50-point frontier between contraction and expansion. And in China, domestic activity started the year well – industrial production in January and February rose 7.0% year-on-year, the fastest pace since early 2022, while retail sales advanced by 5.5%. Importantly, the improvement is broad-based – Citi's economic surprise indices, which measure the proportion of data releases which beat expectations, are back in positive territory for both China and Eurozone.

Central Banks

The first quarter of 2024 has seen a marked reversal in consensus expectations about central banks' rate cut plans. For the US Federal Reserve (Fed) for example, traders have slashed their projections from seven -25bp reductions to less than three, while forecasts for European Central Bank (ECB) rate cuts have been chopped from seven to just over three. The reassessments have been driven by some hawkish talk from policymakers but also by some rather sticky inflation reports – in the US, the annualised rate of the last three months of core inflation is 3.7%, up from 2.8% in Q3 and well above the Fed's target. Although the Fed and the ECB held rates steady in March, other central banks hit the headlines – the Bank of Japan hiked rates for the first time in 17 years, ending its experiment with negative rates, while the Swiss National Bank was the first G10 central bank to cut rates in this cycle, from 1.75% to 1.5%.

Markets

The rapid rally in global equities continued for the fourth month in a row with the MSCI World index of global equities adding 3.0% to take its performance since late October to 25.8%. However, there was a marked shift in March away from Growth towards Value, which outperformed for the first time this year. America's "Magnificent Seven" stocks, which have led much of the gains in recent quarters, lagged last month with a 2.7% advance versus 8.8% for global energy stocks. Commodities also rallied hard – the GSCI spot index added 4.4% over the month, led by gold which jumped 9.1%. On currency markets, the dollar was generally strong again, adding 0.9% against the yen.

Bottom Line

Having kept our recommended equity allocation at the upper end of the Neutral band for several months, price performance has pushed weights out of that band. Our Investment Committee has decided not to rebalance equity allocations for now, and we now reflect a modestly Overweight allocation to equity markets. Our geographic picks remain unchanged, with the US preferred to Europe and Europe to Asia. Our allocation to US duration (i.e., sensitivity to changes in rates) remains at Neutral while historically tight credit spreads (the difference in yields between corporate and sovereign bonds) suggest investors should remain very selective.

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Summary House Views

OUR ASSET ALLOCATION

The tables below present the latest conclusions of our Global Investment Committee.

Equities	Equity performance has pushed allocations into slightly Overweight territory. We continue to recommend investors strike a balance between Value and Growth. We prefer the US to Europe, and Europe to Asia.	Overweight
United States	We have adjusted our US allocation to achieve a better balance between Growth and Value. Quality and Growth stocks have dominated recent market performance, but their valuations are getting stretched.	Overweight
Eurozone	The bear story for Eurozone equity markets is well-known. However, the markets are still cheap, still under-owned and still in an uptrend.	Neutral
UK	Recent macro data in the UK has shown some improvement, but the equity market – which is heavily skewed towards international resource companies – continues to lag its neighbours.	Underweight
Switzerland	The Swiss market is dominated by high-quality, defensive stocks, which should help cushion any downside, while inflationary pressures remain well below those suffered by its neighbours.	Neutral
Japan	The Tokyo Stock Exchange's efforts to improve corporate governance to focus on shareholder returns, combined with cheap valuations, have fostered a bull run in Japanese stocks.	Neutral
Emerging (EM)	The Chinese authorities have taken some measures to shore up domestic equity markets and Chinese stocks look cheap in light of expected earnings growth.	Neutral

Fixed Income	Today's environment of sticky inflation, elevated policy rates, quantitative tightening and inverted yield curves will continue to prove challenging for fixed income investors.	Underweight
Sovereigns	The sharp rise in policy rates and the inverted yield curve have created attractive opportunities in short-dated bonds. Nonetheless, the risk of a downturn led us to rebuild exposure to duration.	Underweight
Duration	We have now rebuilt a Neutral allocation in duration which has both reduced our Underweight compared to the market and provided a hedge against macro weakness and Fed easing.	Neutral
Inflation-linked	Inflation-protected securities tend to have very high duration, making then extremely sensitive to small shifts in inflation expectations.	Neutral
Investment Grade	The sharp rise in policy rates and inverted yield curve have created some buying opportunities in short-dated EUR-denominated high-quality corporate bonds. We remain Underweight nonetheless.	Underweight
High Yield	Credit spreads have tightened to unattractive levels, especially if growth weakens which could penalise risk assets like high yield bonds, given the potential for a deterioration in credit quality.	Underweight
Emerging debt (in € and $)	The best opportunities lie in Latin America where central banks have hiked rates far enough to take yields above inflation. However, political risk requires careful monitoring.	Neutral

↗ Upgrade ↘ Downgrade ⊕ Overweight ⊜ Neutral ⊖ Underweight

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Commodities	Although reopening in China likely to gradually boost demand for raw materials, worries about a slowdown in advanced economies in H2 have led us to reduce allocations to commodities to Neutral.	↘ Downgrade	Neutral
Energy	With OPEC+ cutting output and oil majors reluctant to invest in new production capacity, crude oil supply is constrained. However, fears of economic slowdown in the west have kept prices rangebound.		Neutral
Industrial metals	The key driver for industrial metal prices will be Chinese demand as the economy picks up. We also continue to highlight the attractions of transition metals like copper and nickel.		Neutral
Precious metals	Central bank demand for gold remains strong and bullion continues to provide useful diversification benefits in terms of portfolio construction.		Overweight

Currencies	After weakening in Q4, the rangebound dollar index has gained 3.1% so far in 2024, as traders have turned less optimistic on Fed rate cuts this year.	
EUR/USD	The European Central Bank (ECB) president has insisted that rate cuts are coming this summer, which may remove one of the single currency's supports.	Neutral
GBP/USD	Although the growth outlook still looks bleak given the UK's structural weaknesses, sterling remains heavily under-valued.	Neutral
EUR/GBP	Both currencies face strikes and political challenges, and the advantage conferred by the Eurozone's better budget discipline is offset by sterling's higher rates.	Neutral
USD/JPY	The shift in official statements about yen weakness suggests that the authorities may intervene to prevent further dollar strength at some point.	Neutral
EUR/CHF	Switzerland's success in bringing inflation back in line has allowed the Swiss National Bank to start cutting rates ahead of the ECB which has accentuated the downward pressure on the Swiss franc.	Neutral
Emerging	Attempts by EM currencies to build a base after recent lows against the US dollar in early October have run out of steam.	Underweight

↗ Upgrade ↘ Downgrade ⊕ Overweight ⊜ Neutral ⊖ Underweight

Economic Outlook

GRABBING THE BATON?

As highlighted in last month's macro focus, the US economy has been the locomotive in recent quarters, clearly leading other regions in upgrades to the macro outlook. Bloomberg's consensus forecasts show that the expectation for 2024 GDP growth has shot up from 0.6% last summer to 2.2% at present, whereas those for the Eurozone have been cut from 1.0% to 0.5% and China's have only edged up 10bp to 4.6% over the same period. However, there have been some recent signs of life in some leading indicators such as business confidence surveys. According to Caixin/Markit, China's composite purchasing manager index has been above 50 points, the dividing line between contraction and expansion, for 15 consecutive months. Which prompts the question – is it time for China to grab the growth baton from the US?

The lunar new year holiday in China has an outsized impact on economic activity – many businesses close for the whole week and many hundreds of millions of workers travel to celebrate the festival with family. It is often termed the world's largest human migration event. However, the vagaries of the lunar calendar mean that it sometimes falls in January and sometimes in February, thereby skewing the relevance of year-on-year comparisons for those months. This is why Chinese statisticians tend to lump the two months together.

This year, the number of new year trips finally rose above pre-pandemic norms. The authorities reported a total of 5.1bn trips over the week, 12.9% above the 2019 total, while domestic tourism spending reached 633bn CNY ($88bn), a 47% increase on pre-pandemic levels. This spending in turn appears to have boosted Q1 activity – real GDP growth reached 5.3% year-on-year, above expectations and also Q4's 5.2% pace.

It is also higher than the authorities' new growth target for this year of "around 5.0%", which was set at the recent National People's Congress. The NPC also decided on a modest fiscal expansion of around 1.5% of GDP to support economic growth, with a focus on investment rather than consumption. However, the stimulus measures have been rather half-hearted so far. Government bond issuance has been sluggish while bank lending growth has been weak on the back of sluggish credit demand. Indeed, the cumulative total of new yuan loans at end-March was -10.8% lower than the same period last year. Moreover, the government's efforts to stem the weakness in the property market have yielded little to date and vice-premier He Lifeng recently called for further support. These efforts could take the form of funding support to finish existing projects, refinancing local government debt via bank loans and the issuance of ultra-long sovereign bonds to support key projects.

However, Q1's robust headline growth could mean less incentive to intensify efforts, which might be problematic if the new year burst of activity proves short-lived. Already, industrial production growth slowed to 4.5% YoY in March from 7.0% while retail sales growth slumped to 3.1% YoY after 5.5% in January and February. March also saw particularly weak auto sales which fell -3.7%. It would appear that activity levels have begun to fade after the new year boost.

In addition, investors should not ignore the pernicious effects of falling prices in China – nominal GDP growth has been lower than real growth for five of the last six quarters, culminating in deflation of -1.1% in Q1, the worst outcome since 2009. And, arguably, nominal growth matters more for businesses and families than real growth, given that it better reflects corporate turnover and household incomes. Moreover, China's consumer price index was back at 0.1% YoY in March, perilously close to deflation again after February's acceleration to a still modest 0.7%. In addition, factory prices continue to deflate – the producer price index tumbled -2.8% in March, its 18th consecutive month in negative territory.

In this context, it is scarcely surprising that consumer confidence in China remains so low – it has barely recovered from the all-time low set during the height on the "zero-Covid" lockdowns in November 2022. So it is hardly surprising that families are saving more and spending less. This has pushed household deposits up to almost 110% of GDP. It is estimated that lower consumption, fewer home purchases and reduced investment in financial markets represent a total of around 15% of GDP in excess deposits.

Domestic demand in China remains weak, while companies have been encouraged by targeted stimulus to ramp up production – of electric cars, solar panels etc. – which has forced them to step up their efforts in export markets. The generous subsidies and deflating prices mean that these cheap exports are drawing the ire of major trading partners, as witnessed by the recent trips to Beijing made by US Treasury Secretary Yellen and German Chancellor Scholz. However, global demand may not be sufficient to absorb China's products – exports fell -7.5% YoY in March, the sharpest decline since last August.

Bottom Line

In recent decades, the rapid growth and sheer size of the Chinese economy meant that it was the single largest contributor to global growth. However, those days are over, at least for now. Adding the Bloomberg consensus estimates for Q1 real annualised US GDP growth of 2.5% and for a GDP price index of 3.0% together shows nominal GDP growth of 5.5%, comfortably above the 4.2% recorded in China. And with consumer sentiment in the doldrums and prices deflating, it does not seem likely that China will wrest the growth baton from US hands in coming quarters.

EQUITIES

March saw a 3.0% jump in the MSCI World index of global equities, its fifth consecutive monthly advance, recording six new all-time highs in the process. After driving the US market higher in recent months, the Magnificent Seven group of stocks underperformed last month, adding only 2.0%, while the pan-European STOXX 600 index outperformed the US S&P 500 index, gaining 3.6% versus 3.1% respectively. Emerging market stocks lagged global equities for the fifth time in six months with a 2.2% advance (all data in dollar terms).

US . Participation in the rally remained broad-based – the proportion of stocks trading above their 200-day moving average (DMA) hit 86% at end March, the highest level since mid-2021. There was a notable reversal of leadership among equity factors – MSCI's US factor index for Value outperformed for the first time since December, gaining 4.6%, while Growth lagged with a modest 1.6% advance. All eleven sectors gained ground in March for the second straight month. Energy led the way with a 10.2% surge, followed by utilities which jumped 6.7% and industrials which gained 6.2%, while laggards included real estate and consumer discretionary, which only rose 0.8% and 0.2% over the month respectively. Small and medium-sized stocks outperformed in February for the third time in four months with the Russell 2000 small-cap index rising 3.4%.

The recent surge in prices has pushed S&P 500 valuations considerably higher, from 19.1x trailing earnings at end October to 23.5x at present. The 25.3% pace of the advance in prices since end-October has not been matched by upward revisions in forward earnings expectations, which have risen 4.1% since then according to Bloomberg. Moreover, the trailing valuation premium over European stocks rose sharply over the period, from 7.9 to 9.8 points. This premium has little to do with the market-dominant positions of the Magnificent Seven stocks – US information technology stocks trade at a premium of only 23.8% over their European peers while the biggest overvaluations are in consumer discretionary and financial stocks, which are 113.5% and 99.8% more expensive respectively. The same holds true for factor indices - according to MSCI, US Growth stocks trade at a 56.7% premium to Europe and US Value 81.7% higher. We continue to call for a blend of Growth and Value stocks in portfolios.

Europe . The bear case for European equities is well known. Economic growth is sluggish at best – the consensus forecast for 2024 's real GDP growth has been revised steadily lower from 1.2% this time last year to 0.5% at present. As a result, corporate earnings have disappointed – according to Bloomberg, earnings for the MSCI Europe index fell -3.9% last year and are now expected to fall -3.0% in 2024. Moreover, investors have been steady sellers of European equity funds in recent quarters – Europe is the only region to have seen outflows year-to-date according to EPFR, adding to 56 weeks of steady outflows in the past 57. And finally, the geopolitical backdrop remains worrisome – the war in Ukraine may be turning in Russia's favour while Israel's war with Hamas has spilled over to the broader region and Houthi attacks on cargo ships in the Red Sea are disrupting supply chains, adding to inflationary pressures. However, there are early signs of a turn higher in business confidence – the Eurozone's composite PMI survey returned to expansion territory in March for the first time since May last year. Moreover, Eurozone equity markets continue to perform satisfactorily – since bottoming at end September 2022, the STOXX 600 index has provided a 36.9% net total return versus 32.9% for the S&P 500 in euros.

In valuation terms, European equities continue to look cheap compared to history and to other markets, notably the US. As highlighted above, the MSCI Europe index trades at 14.0x trailing earnings versus 23.8x for its US counterpart. Moreover, European stocks are expected to pay investors a handsome 3.5% dividend yield in 2024, well above the forecast 1.5% yield on the MSCI US index.

Emerging Markets . After lagging the broad emerging market index throughout 2023, emerging Asian equities have staged a recovery since mid-January, recording advances of 5.8% and 2.8% in February and March respectively. The other major regions lagged last month with Latin America and Eastern Europe edging 0.6% and 0.2% higher. Argentinian stocks continued their yoyo performance, jumping 17.4% in March after tumbling -21.0% in February and soaring 32.7% in January. In Asia, tech-heavy Taiwan and South Korea led the region again, adding 5.7% and 3.2% respectively, while regional heavyweight China only inched 0.1% higher (all data in dollar terms).

Despite recent strong performance, Taiwan and South Korea still look reasonably attractive in comparative valuation terms. Forecast earnings growth is the best in the region – the Bloomberg analyst consensus expects 34.2% and 82.5% over the next twelve months, which means forward price / earnings ratios of 17.7x and 10.7x respectively. These levels of earnings growth and valuation compare favourably with tech-heavy indices in the US – expected earnings growth for the Nasdaq 100 index is 18.3% while it trades at 26x forward earnings.

Bottom Line

Having kept our recommended equity allocation at the upper end of the Neutral band for several months, price performance has pushed weights out of that band. Our Investment Committee has decided not to rebalance equity allocations for now, and we now reflect a modestly Overweight allocation to equity markets. Our geographic picks remain unchanged, with the US preferred to Europe and Europe to Asia.

FIXED INCOME

The Bloomberg Global Aggregate Bond Index inched 0.6% higher in March, its first monthly advance this year so far.

US . US macroeconomic indicators have rebounded from their year-end low but still remain well below their highs of last summer, according to Citi's index of economic surprises. Job creation has been robust in recent months, but the unemployment rate has edged up from last winter's 55-year low at 3.4% to 3.8% in March. The Federal Reserve (Fed) continues to pencil in three -25bp rate cuts this year, but market expectations have shifted dramatically from almost seven cuts at the start of the year to less than three at end March. This rethink has been driven by sticky inflation, robust growth expectations and consistent messaging from Fed policymakers. Although core inflation has come down from the peak reached in 2022, it is still well above the Fed's 2.0% target and the annualised rate of inflation over three and six months has been moving higher. Moreover, the return to positive real interest rates has had little discernible impact on the economy which continues its above-potential growth – if the Fed does go ahead will easing policy, the cutting cycle will probably be slow.

In previous editions of House Views, we have discussed the fact that the impact of shrinking the Fed's balance sheet by -$95bn per month ("quantitative tightening" or QT) has been somewhat offset by the decrease in the Fed's reverse repo facility and by the Treasury's preference for issuing short-dated bills. Money market funds have been scaling back their reverse repo holdings (which they had built up in 2021) to take advantage of the attractive bill yields on offer from the Treasury, which neutralises the impact on liquidity and reduces the quantities of longer-dated bonds to be issued. However, this process is almost complete and so it was welcome news (from the perspective of supply/demand balance in T-bonds) when Chair Powell announced in his last press conference that the pace of QT will likely slow "fairly soon" – less QT means less supply for bond investors to digest.

Nonetheless, there are factors which could push yields higher again. For one, the Fed made an adjustment to the "terminal rate" at its last meeting, raising it for the first time since June 2019, from 2.5% to 2.6%. While this increase may seem completely incidental, we believe that its message is significant – that the Fed's long-term target for key rates is moving higher in reaction to inflation and growth dynamics. The forthcoming updates to the Summary of Economic Projections (which contain the terminal rate) will warrant close scrutiny – if further increases are in the pipeline, that might signal a toughening of Fed policy going forward. Moreover, core inflation has risen at an annualised rate of over 4.0% over recent months, which means that ten-year (10y) Treasury yields at 4.2% will offer little real yield until inflation turns lower or yields move higher.

Europe . GDP in Eurozone has barely grown since Q3 2022, as the continent has been hit by sanctions on energy imports from Russia and by a sluggish Chinese economy. Unemployment does remain low relative to historical standards, but this low growth could prompt the ECB to cut rates more aggressively than the Fed. This reduction in short-term rates would continue the flattening of the yield curve which commenced at the turn of the year. It is also interesting to note that Italy is outperforming Germany – growth is higher, and inflation is falling faster. This will continue to support a tight yield spread between German and Italian 10y yields.

Asia . In Asia, the main event last month was the Bank of Japan's rate hike – from -0.1% to 0.0% –marking the end of negative interest rates with the first hike in 17 years. Nonetheless, government yields across all maturities remain well below current inflation rates and the trend is clearly towards higher yields, which makes Japanese bonds unattractive.

China is bucking the global trend. The economy is flirting with deflation (see page 4), forcing the People's Bank of China to cut rates recently, while government bond yields are lower than Germany's across the whole yield curve. While this makes Chinese bonds potentially attractive from a fundamental point of view, we would caution that the market can be heavily influenced by government policy – it can be a risky market for those not well versed in Chinese politics.

Credit . In the US, credit spreads are at multi-year lows for BB and B rated bonds. While the economy is improving, these spreads offer little reward for the risks ahead, given tighter monetary policy and still-elevated inflation. Leverage is also rather high in the high yield segment, with the exception of CCC-rated issuers. This being said, higher inflation does tend to benefit borrowers rather than lenders as it reduces the real level of debt. We have also noted a number of reports about companies using cash to deleverage rather than for new projects.

In Europe, there is a bit more room for spread compression. CCC yields are high relative to history but have been driven by a few special situations in recent weeks, including Intrum and Altice France, the latter being a large issuer with a high weight in the index.

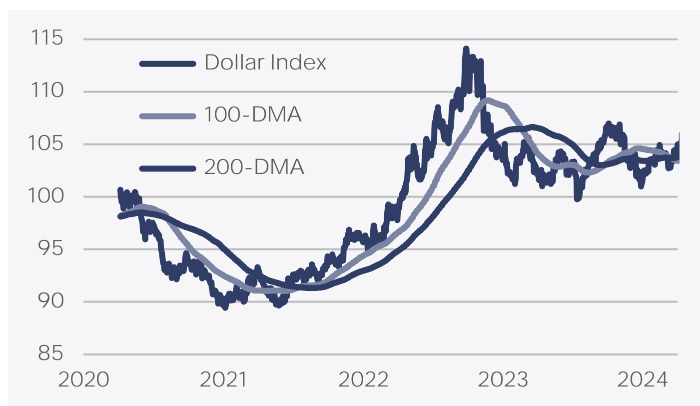
Bottom Line

Although we remain defensive overall in our fixed income allocations, with a clear focus on high quality credit, we have now rebuilt a Neutral allocation in duration given the likelihood of some economic weakness later this year.

CURRENCIES

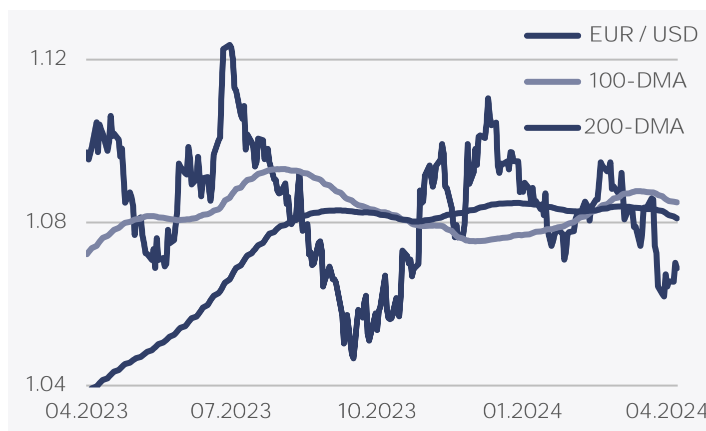
Currency markets have been surprisingly quiet despite uncertainty about rates and inflation.

USD . The US economy remains strong and there is a clear probability that interest rates will not be cut as fast as in Europe, which could support the currency. The main driver so far this year in foreign exchange markets has been real rate differentials, and a wider gap would further support the USD against its G10 peers. This factor should also be supportive of Latin American currencies where real policy rates are even higher.



Source: Bloomberg

EUR . In previous reports, we have made the case that the return to positive yields in Europe might attract capital back after years of European investors being forced to look abroad for positive returns. For a while, we did see a decrease in the net international investment position of European investors as they rebuilt bond positions in their home market, but then it stabilised. Europe's weak economy in recent quarters has certainly given investors reason to slow their capital repatriation. Moreover, as highlighted on page 5, European equity funds have seen almost uninterrupted outflows over the past year, despite registering solid absolute and relative performance.



Source: Bloomberg

COMMODITIES

Global spot commodity prices rose a further 4.4% in March, with all main areas contributing to the advance.

Energy . After a sharp -19.2% correction in Q4, Brent crude prices have started the year with a 13.6% jump, including 4.6% last month. This rally has been driven by a number of factors, most notably rising geopolitical tensions in the Middle East – the retaliatory strikes by the US and the UK on Houthi rebels have raised concerns that the flow of oil from the Persian Gulf could be disrupted while the Israeli attack on the Iranian embassy in Damascus has cemented fears that the war on Hamas could escalate across the region. Moreover, the OPEC+ cartel has prolonged its late-November decision to implement output cuts totalling some 5.3m barrels per day (mb/d), around 5% of global supply.

These cuts were designed initially to keep supply tight in light of fears of economic weakness leading to lower energy demand. Since then, however, economic data has mostly surprised on the upside, helping bolster this year's rally in crude prices. However, the outlook for oil remains uncertain. According to the International Energy Agency (IEA) March report, global oil demand in Q1 is likely to increase by a higher-than-expected 1.7mb/d year-on-year, mainly thanks to robust US growth. For 2024 as a whole, however, demand growth is projected to slow further to 1.3mb/d this year from 2.3mb/d last year, taking this year's forecast demand to 103mb/d. On the other hand, the IEA has revised its estimate for 2024 world oil supply down to 102.9mb/d, leaving the market close to equilibrium. All in all, crude prices should continue to trade in a wide band this year.

Gold . Gold prices surged 9.1% higher in March to a new all-time high at $2,230 per ounce. As noted in previous months, the previous peaks above $2,000 – in August 2020, August 2022 and March 2023 – were all short-lived but gold's ability to rally recently despite dollar strength and rising bond yields looks encouraging. The dollar index has risen 3.1% since the start of the year while 10y Treasury yields have jumped 32bp. Gold is of course traded in dollars and tends to strengthen when the greenback falls, while the opportunity cost of holding gold, a non-interest-bearing asset, tends to fall when rates decline. Interestingly, gold's strong performance has still not attracted buyers of gold-backed ETFs – February saw redemptions equivalent to 49 tonnes, the ninth consecutive month of outflows.

On the other hand, demand for gold from emerging world central banks and consumers in China and India remains robust. With little growth forecast in mining output, the longer-term picture for gold prices remains bright.

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