August 2024

MONTHLY HOUSE VIEWS

SLOWDOWN OR RECOVERY?

Macro

Citi's global economic surprise index dropped sharply in late July as negative surprises outnumbered the positives, hitting its lowest level since July 2022. However, the dip into negative territory has not had any impact so far on 2024 GDP growth forecasts – indeed, economists revised estimates higher in July to 3.05%, up from 2.6% at the start of the year. The weakness in economic surprises was broad-based last month. In the US, the unemployment rate outstripped forecasts to reach the highest level since October 2021. In the Eurozone, manufacturing confidence has been in contraction territory for the past 25 months, while in China total building starts are down -23.7% year-to-date. On the other hand, consumer spending on goods and services has held up better than industrial production thanks to rising wages and resilient consumer sentiment.

Central Banks

The Bank of England became the fifth G10 central bank to ease policy, cutting rates by -25bp at its August 1st meeting. The US Federal Reserve (Fed) eschewed easing in late July but weakening macro data have encouraged traders to factor in -125bp in rate cuts by the end of this year. China's macro slowdown has prompted the People's Bank of China (PBoC) to cut all its main policy rates in the wake of a recent economic policy meeting. The outlier among major central banks is the Bank of Japan which hiked rates by 15bp to 0.25% at its July 31st meeting while laying out a plan to halve its asset purchases over the next two years, a policy mix which saw the yen shoot higher and Japanese stock prices wobble dramatically. All these moves came against a backdrop of more benign inflation readings – however, we would caution that monthly data remain highly volatile.

Markets

July was another good month for the MSCI World index of global equities which advanced 1.7% – its eighth gain in the last nine months – after reaching another all-time high in mid-month. However, August started on a much weaker footing. At the factor level, Value outperformed Growth for the first time in three months while only two out of the eleven global sectors posted negative returns, with information technology and communication services shedding -2.1% and -3.2% respectively. Weaker macro data pushed Bloomberg's Global Aggregate bond index up 2.8%, its third consecutive monthly advance. The weakness also punished energy prices in July with Brent crude oil dropping -6.6%, leaving prices up only 4.8% year-to-date.

Bottom Line

Our recommended equity allocations remain unchanged at modestly Overweight, despite the drop in prices in early August. Our suggestion last month to lock in some profits on US technology and internet platform stocks and to reinvest in small and mid-cap stocks helped rebalance portfolios away from highly-valued Growth stocks and towards undervalued segments which had lagged the broad market. Our geographic preferences 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 suggest investors should remain very selective.

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.	+
United States	We have adjusted our US allocation to achieve a better balance between Growth and Value. Quality and Growth stocks have dominated this year's market performance, but their valuations are getting stretched.	+
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.	=
UK	Recent macro data in the UK has shown some improvement, and the equity market has begun to catch up with its neighbours.	=
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.	=
Japan	Recent strength in the yen against the US dollar could encourage investors to reassess the outlook for Japanese stocks which could in turn interrupt their bull run for now.	=
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.	=

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.	−
Sovereigns	Elevated policy rates and the still-inverted yield curve have created attractive opportunities in short-dated bonds. Nonetheless, the risk of an economic downturn led us to rebuild exposure to duration.	−
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.	=
Inflation-linked	Inflation-protected securities tend to have very high duration, making then extremely sensitive to small shifts in inflation expectations.	=
Investment Grade	Elevated policy rates and inverted yield curve have created some buying opportunities in short-dated high-quality corporate bonds. We remain Underweight nonetheless.	−
High Yield	Credit spreads have tightened to unattractive levels, especially if growth weakens. Investors should remain very selective given the potential for a deterioration in credit quality.	−
Emerging debt (in € and $)	In recent months, we have warned that political risk in Latin America required careful monitoring. The reaction to June's presidential elections in Mexico underlined this point.	=

↗ Upgrade ↘ Downgrade + Overweight = Neutral − Underweight

Commodities	Although the long-awaited recovery in China will eventually boost demand for raw materials, worries about a slowdown in advanced economies in H2 lead us to keep allocations to commodities at Neutral.		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 once the economy finally picks up. We also continue to highlight the attractions of transition metals like copper.		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	Since late 2022, the dollar index has been stuck in wide range. The 2.7% rally this year has been fostered by favourable interest rate and growth differentials.		
EUR/USD	With the European Central Bank (ECB) and the Federal Reserve (Fed) both set to cut rates, the exit from the euro's pennant technical formation could well be to the upside.	Upgrade	Overweight
GBP/USD	The UK's growth outlook has begun to improve despite its structural weaknesses, and the strong majority won by Labour means the country faces little political uncertainty over the next few years.	Upgrade	Overweight
EUR/GBP	Both currencies face numerous challenges, and the advantage conferred by the Eurozone's better budget discipline is offset by sterling's higher rates.		Neutral
USD/JPY	Global investors began to unwind some of their "yen carry trades" (constructed by borrowing in yen to invest in higher-yielding assets in foreign currencies), which could mean further upside for the yen.	Downgrade	Underweight
EUR/CHF	Switzerland's success in bringing inflation back in line allowed the Swiss National Bank to start cutting rates ahead of the ECB which accentuated the downward pressure on the Swiss franc.		Neutral
Emerging	EM currencies have tracked generally sideways against the US dollar in recent months and could begin to build a base for recovery from their recent all-time lows.	Upgrade	Neutral

↗ Upgrade ↘ Downgrade ⊕ Overweight ⊜ Neutral ⊖ Underweight

Economic Outlook

SLOWDOWN OR RECOVERY?

In our 2024 Outlook analysis of the US economy, we stated that end-2023's positive economic momentum would continue over the first part of this year but that storm clouds would then "gather [...] ahead of a second-half slowdown in activity". Eight months later, has the US outlook changed? And what does this mean for financial markets?

One of the distinguishing features of Joe Biden's presidency has been his embrace of industrial policy, which has long been decried by US economists and investors – how could politicians make better decisions about which industries to support than the entrepreneurs who run the businesses? However, the supply chain difficulties which emerged during the pandemic lockdowns prompted a lot of soul-searching about how much productive capacity had been hollowed out by years of offshoring to emerging economies, often on the other side of the world. The White House reacted with three signature pieces of legislation to bring manufacturing back onshore, which have begun to bear fruit – manufacturing investment spending contributed around 0.4 percentage points to last year's GDP growth rate.

Despite the billions being invested in industrial policy, business confidence in manufacturing remains very weak. The Institute of Supply Management's (ISM) monthly survey for July made depressing reading. The headline index has been in contraction territory for 18 of the past 19 months while the employment component hit levels last seen during the 2008-2009 recession and the pandemic lockdowns in spring 2020. However, manufacturing represents just over 10% of GDP nowadays and is dwarfed by the 65-70% spent on services. And ISM's July services survey made more encouraging reading – the headline index returned to expansion territory while the employment component rose to the highest level since last September.

A lot of comment was generated when the July unemployment rate triggered the Sahm rule, which holds that a 50bp increase in its three-month moving average from its twelve-month low suggests a recession is already underway. However, Claudia Sahm, who created the rule, has distanced herself from such a literal interpretation. Be that as it may, July's report was rather weak – the work week fell to only 34.2 hours, back to the low for the cycle, the economy created 114'000 new jobs according to the establishment survey, well below expectations, and only 67'000 on the household survey, while temporary employment has fallen -9% since January 2023. On the other hand, the size of the civilian labour force rose by 420'000 in July to reach 168.4m, the highest total on record, a sign that Americans remain confident in the US job market.

The two main consumer confidence surveys in the US have diverged considerably since 2021. The main explanation behind this divergence is the emphasis each survey places on different factors – the Conference Board index tends to be heavily influenced by swings in the job market while the University of Michigan's poll is more shaped by trends in consumer price inflation. The most recent surveys show that consumers remain relatively upbeat about the job market but that they have yet to recover from the 2021-2022 spike in inflation.

The billions spent on Biden's industrial policy come on top of the generous handouts made by both Donald Trump and his successor to mitigate the impact of Covid-19. According to USASpending.gov, the US spent $4.4 trillion in support for businesses and households during the pandemic, equivalent to 21.0% of 2020 GDP compared to the 8.0% of GDP spent by Eurozone governments.

Given that the tax cuts enshrined in Trump's 2019 Tax Cuts and Jobs Act (TCJA) remain in place for now, the result has been a sizeable expansion of the budget deficit. The Congressional Budget Office (CBO) expects the deficit to reach 7.0% of GDP this year, an unusually high deficit during an economic expansion. With federal debt to GDP currently standing at 122.9% according to USDebtClock.org, the US faces a massive expansion of its deficit and debt when the next recession hits, all of which means that the cost of simply servicing the debt is likely to shoot up. According to the CBO, debt service will reach 3.4% of GDP next year, the highest level since World War II, rising to 4.1% in 2034 assuming no recession in the interim.

Bottom Line

Looking ahead, the second-half slowdown we expected appears to be unfolding but does not look likely to turn into a recession. Generous deficit spending, a historically low unemployment rate, resilient consumer spending and confidence all argue for continued growth, albeit at a slower pace than in the first half. Indeed, the Atlanta Fed's GDPNow model – which uses the most up-to-date macro reports – currently projects 2.4% annualised growth in Q3.

Moreover, the Q2 earnings season has been encouraging – S&P500 index earnings are up 11.1% year-on-year so far according to Bloomberg, 5.2% above expectations. And looking ahead, analysts have revised their twelve-month forward earnings per share (EPS) forecasts 0.9% higher over the past four weeks to 15.5%, one of the fastest paces in recent years. Nonetheless, we expect that upside will be limited – the S&P500 index is currently trading at an elevated 23.4x trailing earnings. We suggest that investors consider taking advantage of any recovery in prices to rebalance portfolios towards small and mid-cap equities – the equal-weight version of the S&P500 is trading at 18.5x trailing earnings while analysts expect 11.2% growth in EPS over the next twelve months.

EQUITIES

The MSCI World index of global equities completed its recovery from the -3.9% drop in April with a 1.7% gain in July, its eighth advance in nine months, after hitting a new all-time high mid-month. However, there was a marked rotation away from the very largest companies, as epitomised by the Magnificent Seven group of US stocks, and towards small and mid-cap stocks – the MSCI World Small Cap index soared 6.8% over the month. At the regional level, Europe slightly outperformed the US (2.0% vs 0.3% on the MSCI indices) while emerging markets lagged with a -0.1% monthly return. There were also surprising swings in Japanese assets – the Topix index gained 6.3% last month as the yen surged 7.3% against the dollar, more than compensating for a local-currency fall in prices (all data in dollar terms).

US . The rotation from Growth to Value and from megacap to small-cap also played out in the US equity market, as witnessed by the proportion of stocks trading above their 50-day moving average (DMA), which jumped from 49% to 70% over the month. At the sector level, technology and communication services, which house five of the Magnificent Seven, both fell in July while the leader board was dominated by interest-rate-sensitive sectors like real estate (7.0%), utilities (6.7%) and financials (6.1%), and cyclicals like materials and industrials (both up 5.1% last month). Moreover, the Magnificent Seven index of the very largest US stocks shed -0.6% while the Russell 2000 small-cap index soared 10.1%.

The rally in stock since last October has pushed S&P 500 valuations up from 19.1x trailing earnings to 24.2x. At these levels, hopes are high that Q1's encouraging trend in earnings will continue. According to Bloomberg, Q2 earnings have increased 11.1% year-on-year so far and revenue growth by 5.0% with 75% of S&P500 members having reported. This is the best quarterly performance since the 9.9% jump in earnings in Q1 2022. This has kept the trailing valuation premium over European stocks at 10.2 percentage points on MSCI data, well above end October's 7.9 points. This premium cannot fully be explained by the market-dominant valuations of the Magnificent Seven stocks – the valuation premium of US information technology stocks over their European peers is one of the lowest among sectors at 11.2%, well below consumer discretionary and financial stocks, which are 124.7% and 90.9% more expensive respectively. The same holds true for factor indices – according to MSCI, US Growth stocks trade at a 58.2% premium to Europe and US Value 77.7% higher. We continue to call for a blend of Growth and Value stocks in portfolios.

Europe . Investors have long been bearish on European equities. Indeed, the geopolitical backdrop remains worrisome – the war in Ukraine continues to drag on while Israel's war with Hamas has spilled over to the broader region as witnessed by the assassination in Tehran of the Hamas political chief. Moreover, Houthi attacks on cargo ships in the Red Sea continue to disrupt supply chains, adding to inflationary pressures on the key Asia-Europe freight route. In addition, investors continue to shy away from European equity funds – according to EPFR, redemptions since the start of this year now total -$31.9bn. Moreover, the macro outlook has darkened and Citi's Economic Surprise Index has fallen further into negative territory. For the second consecutive month, a big part of the decline came when the flash purchasing manager indices (PMI) for July were published, on June 24th – confidence in manufacturing continued to deteriorate while the services survey came in well below expectations. Nonetheless, equity analysts are becoming more optimistic – according to Bloomberg, they now expect 5.8% growth in 2024 MSCI Europe earnings compared to last year. Finally, Eurozone equity markets continue to perform satisfactorily – since bottoming at the end of September 2022, the STOXX 600 index has provided a 40.4% net total return versus 42.3% for the S&P 500 in euro terms.

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 14.2 x trailing earnings versus 24.4x for its US counterpart. Moreover, European stocks are expected to pay investors a handsome 3.4% dividend yield in 2024, more than twice the forecast 1.3% yield on the MSCI US index.

Emerging Markets . After lagging other regions in recent months, Latin American stocks outperformed in July with a modest 0.9% increase while both Asia and emerging Europe eased lower, by -0.8% and -2.2% respectively. In LatAm, a 1.6% rise in Brazil's Ibovespa index more than compensated for the -8.5% drop in Argentina. In Asia, the reversal in technology pushed Taiwan down -4.8% while Thailand led the way with an 6.6% advance, followed by India and Indonesia which rose 3.5% and 3.2% respectively. Finally, regional heavyweight China slightly outperformed the region as a whole – the CSI300 index gained 0.1% in July, its first advance in three months (all data in dollar terms).

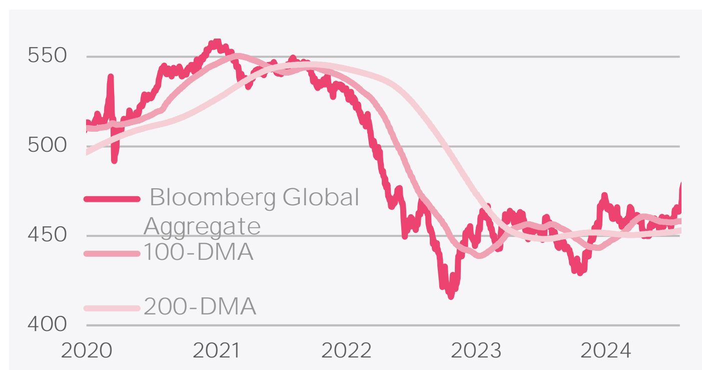
Factors . Value stocks outperformed Growth for the first time in three months according to MSCI's factor indices. As is to be expected, earnings forecasts for Value are modest – the consensus expects only 7.9% growth over the next twelve months versus 15.1% for Growth. But this is reflected in valuations – global Value stocks trade at 15.2x trailing earnings versus 31.2x for Growth.

Bottom Line

Our Investment Committee has decided to keep equity allocations unchanged for now, at a modestly Overweight allocation to stock markets. Our geographic picks remain unchanged, with the US preferred to Europe and Europe to Asia. The discrepancy between Value and Growth has become extreme and we reaffirm our suggestion to take some profits in megacap technology stocks and to add to small and mid-caps.

FIXED INCOME

Bloomberg's Global Aggregate bond index rose 2.8% in July, reducing year-to-date losses to -0.5%. As illustrated on the chart below, the index has commenced a pattern of higher highs and higher lows since its -25.7% swoon between January 2021 and October 2022.



Source: Bloomberg

US . Citi's economic surprise index hit its lowest level in almost two years in early July as several macro reports undershot expectations, notably as regards the job market. In addition, price pressures continued to ease which has reinforced expectations that the Federal Reserve (Fed) will feel comfortable easing policy at their next meeting in mid-September. The probability of a -25bp rate cut at that meeting increased from 68% in late June to 114% at end July. This in turn helped longer-dated Treasury bonds rally – ten-year (10y) yields tumbled -37bp last month helping the 7-10y Treasury index jump 2.9%, its third straight gain and the best month so far this year. This move was then accentuated in early August on the back of the weak July job report, the unwinding of yen carry trades and a flight to safety as equity markets continued their late-July reversal.

However, fiscal policy remains very stimulative – the CBO expects this year's budget deficit to reach 7% of GDP – which should continue to support economic activity. Moreover, financial conditions have continued to improve throughout the year and remained very supportive at month end. Furthermore, Fed policymakers have been careful to avoid adding fuel to market calls for emergency rate cuts in the wake of the drawdown in equities in early August.

On the inflation front, the Fed's preferred measure is known as core PCE, which measures personal consumption expenditure prices ex-food and energy. Core PCE has been improving in recent months but the longer-term picture looks less rosy – annualised core PCE inflation over the last three months has been 2.3%, just above the Fed's 2% target, but the six-month annualised and year-on-year rates hit 3.4% and 2.6% respectively.

Over the course of last month, Treasury yields fell across the board, with the biggest declines coming on shorter maturities – 10y yields fell -37bp in July while 2y yields dropped -50bp, thereby flattening the yield curve (the relationship between yields for bonds of different maturities). Inversions (when short yields are higher than for longer maturities) are rare occurrences and have often acted as an early-warning signal for recessions, which tend to occur after the inversion has been corrected.

If a recession is in the pipeline, 10y yields may have further to fall. However, the downside may well be limited by any lingering inflationary pressures and by the vast supply of new issuance which will be necessary to finance the huge budget deficits which are likely to persist irrespective of who wins the race to the White House.

Europe . After cutting interest rates in June, the European Central Bank (ECB) held rates steady at its mid-July meeting, despite the fact that the core consumer price index (CPI) has flatlined at 2.9% year-on-year over the past three months, while its annualised rate over those three months has been 2.4%. The reason the ECB didn't move last month is likely linked to some lingering stickiness in inflation – for example the annualised six-month rate of core CPI was 6.4%. More worryingly still, services inflation has not really subsided – the month-on-month increase in July was 1.2%, which takes the annualised six and three-month rates to 10.2% and 10.5% respectively. With services representing 75% of Eurozone GDP, the ECB will want to see inflation there coming under control in coming months.

German Bund yields followed Treasury yields lower in July with 10y yields falling -20bp and 2y yields down -30bp as investors fretted about weak macro data, notably from Germany. Citi's economic surprise index for the Eurozone has dropped precipitously into negative territory on the back of weak business confidence data from the monthly purchasing manager index (PMI) surveys. In Germany for example, the manufacturing PMI has been in contraction territory since July 2022 and the index has weakened significantly since the start of this year.

The ECB is likely to cut rates again next month with further rate cuts in the pipeline before year end. However, this is likely to see short rates fall further than long-dated yields as the yield curve normalises. Like in the US, sticky inflationary pressures will limit the downside in 10y yields for now,

Credit . Although corporate bond yield spreads – the difference in yields between corporate and sovereign bonds – have begun to tick higher, they still remain very close to the lowest levels on record. We continue to expect further divergence between the weakest credits, which were not prepared for yields to remain so high for so long, and stronger companies which have been able to deleverage and extend maturities. However, the narrow spreads on the latter's bonds make for a poor risk/reward trade-off and we remain cautious.

Bottom Line

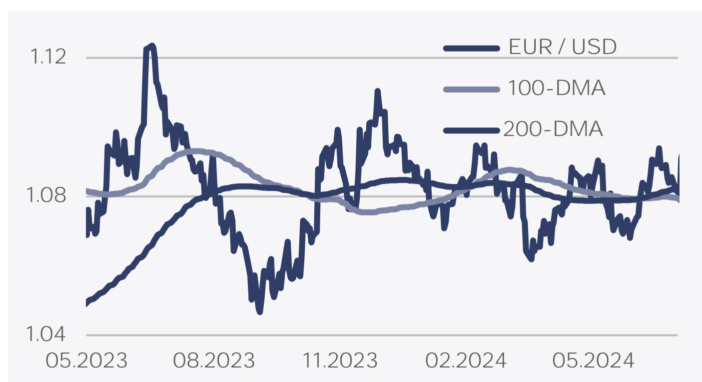
Although we remain defensive overall in our fixed income allocations, with a clear focus on high quality credit, we have now rebuilt a Neutral allocation in duration given the possibility of some economic weakness later this year.

CURRENCIES

Since late 2022, the dollar index has been stuck in a wide trading range. The 2.7% rally this year has been fostered by favourable interest rate and growth differentials.

USD . The dollar index shed -1.7% in July, trading down towards the bottom of its 20-month trading range. Economic weakness fears have prompted a reassessment of the likely path of Fed rate cuts, thereby weakening one of the key props behind dollar strength over H1 2024. Despite last month's decline, the dollar index remains in the middle of the broad trading range which has prevailed since December 2022. Further weakness looks likely.

EUR . The euro's trading range against the dollar has narrowed since mid-2023 in a series of lower highs and higher lows, creating a pennant pattern. Typically, the next major move would be a breakout – given the changing policy rate expectations and the euro's undervaluation, the exit from this technical formation could well be to the upside.



Source: Bloomberg

JPY . On the last day of July, the Bank of Japan (BoJ) took markets by surprise with only its second rate hike in 17 years, taking rates up 15bp to 0.25%. Its first rate hike, in mid-March, had little discernible impact on the USD/JPY exchange rate and the dollar continued its march upwards to hit its highest level since 1986. The second cut came just after a substantial rally in the yen as global investors began to unwind some of their "yen carry trades" (constructed by borrowing in yen to invest in higher-yielding assets in foreign currencies). Here again, more upside beckons for the yen.

CNY . The renminbi also began to recover against the US dollar last month, albeit by a modest 0.6%. The authorities have demonstrated their commitment to keep the currency strong, as witnessed by the divergence between the market rate and the fixed midpoint rate. The renminbi is not fully convertible, and the People's Bank of China run a managed floating rate – it fixes a midpoint rate daily and allows the spot rate to trade within a +/- 2% band around it. Many investors have concluded that ongoing weakness in the economy should trigger a devaluation of the currency to kickstart growth. However, it is by no means clear that CNY strength is harming China's export performance – the monthly trade surplus reached an enormous $84.7bn in July, up from an average of only $35.2bn per month in 2019.

COMMODITIES

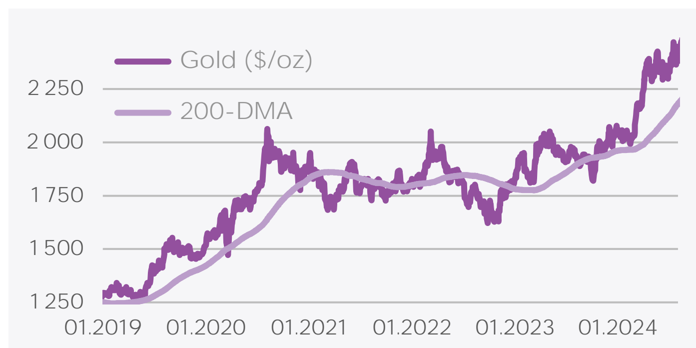
Global spot commodity prices tumbled -4.7% in July, their second decline in the last three months, pulled lower by weakness in energy and industrial metal prices.

Energy . Brent's recovery from May's sharp -7.1% tumble proved short-lived and prices fell another -6.6% in July, taking year-to-date performance to 4.8%. Brent has been stuck in a broad trading range between $75 and $90 per barrel (/b) since the start of this year. As highlighted last month, the OPEC+ cartel has decided to keep a cap on its output in an attempt to stem further downside in crude prices. Their early-June agreement means that potential supply equivalent to between 3.2% and 5.7% of global demand will remain offline over the next 18 months.

In its July report, the International Energy Agency (IEA) forecast that strong output growth from non-OPEC producers this year will help compensate for these curbs, pushing world crude production up 0.77mb/d to a new all-time high at 103.0mb/d. On the demand side, the IEA kept its 2024 forecast for demand growth largely unchanged at 0.97mb/d, leaving this year's total estimated demand at 102.8mb/d. With supply and demand close to equilibrium and both at all-time highs, we would expect crude oil prices to continue to trade in a wide band for the rest of the year.

Gold . Gold prices rose 5.2% in July after hitting a new all-time high at $2'469 per ounce in mid-month, taking year-to-date performance to 18.6%. Central banks, notably in developing markets, have emerged as a significant source of demand as they seek to diversify their reserves away from G7 currencies – in H1 2024, their buying was up 5.6% year-on-year at 183 tonnes. However, despite the recent all-time highs, retail and institutional investors in Europe and the US have not participated – global gold ETF holdings declined -7.2 tonnes in Q2 taking redemptions over the past twelve months to -314.7 tonnes. Moreover, investment in bars and coins has declined by -4.6% over the past year.

Once investors wake up to the bull market in gold prices, we anticipate these outflows turning to inflows. Notwithstanding these sales, total gold demand has increased by 4.2% over the past twelve months, reaching the highest Q2 total on record. Finally, gold historically has had a low correlation with other asset classes which makes it an excellent diversifier in portfolios.



Source: Bloomberg

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