June 2023

MONTHLY HOUSE VIEWS

CONFLICTING SIGNALS

Macro

Over recent months, global economic data has sent conflicting signals. For example, the global purchasing manager index (PMI) of manufacturing confidence has been in contraction territory since last September while the sister survey for services is at the highest level in 18 months. Unemployment rates in Europe and the US are at or close to historical lows but this has done little to bolster consumer confidence – the European Commission's index is well below its average since the start of the century, as is the University of Michigan's survey in the US. Given the swirling crosscurrents, consensus forecasts for subpar global growth this year and next – at 2.6% and 2.7% respectively – look about right.

Central Banks

The post-pandemic surge in inflation appears to be moderating, at least at the headline level, thanks to sharp falls in energy prices from their spring 2022 highs. Nonetheless, central bankers continue to sound hawkish notes regarding further rate hikes after what has been the fastest tightening cycle in the US and Europe in the past 40 years. Their worries continue to centre on sticky levels of core inflation – which strip out volatile items like food and energy – which have lagged declines in headline prices. The only major central bank with the flexibility to ease policy is the People's Bank of China – headline inflation has tumbled from 2.8% year-on-year last September to only 0.2% in May.

Markets

Although global equity markets dropped -1.2% last month, divergences in returns between countries and sectors remained extremely high. Global Value dropped -5.0% while Growth added 2.3% to its year-to-date outperformance. However, the concentration of stock gains narrowed further with a handful of US tech giants accounting for essentially all of the market's gains in May – the S&P500 index inched 0.2% higher while the ten-member NYSE FANG+ index soared 17.1%. Despite the quality of these companies, valuations are becoming rather stretched – the FANG+ stocks trade at 48.7x trailing earnings and 7.1x revenues. Bond market valuations are also expensive – the yields in almost all ten-year sovereign bond markets are lower than current levels of consumer price inflation.

Bottom Line

Although our recommendation for exposure to equities remains at Neutral, we have continued to reduce our Overweight in China and to add to positions in the US. Specifically, we suggest increasing diversification across broad equal-weighted exposure to both large and small companies, given just how narrowly the market has relied on a small number of leaders like Nvidia in recent times. Moreover, rising conviction that the Federal Reserve (Fed) might hike rates again this summer could penalise Growth stocks whose valuations tend to be sensitive to swings in yields. Within fixed income allocations, we continue to like short-dated bonds, which offer relatively attractive yields and low sensitivity to swings in key rates, and high-quality credit, also of short duration. Among currencies, the dollar has benefited from safe-haven flows driven – paradoxically – by the US debt ceiling crisis, but we still expect the euro to resume its outperformance after completing its consolidation.

Summary House Views

OUR ASSET ALLOCATION

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

Equities	We maintain equity allocations at Neutral and recommend investors strike a balance between Value and Growth.		=
United States	We have adjusted our US allocation to achieve a better balance between Growth and Value. Market consensus that macro weakness will force the Fed to pivot plays in favour of quality Growth stocks.	↗	=
Eurozone	Eurozone equity markets are still cheap and still under-owned. We anticipate a bounce in relative terms after May's sharp underperformance.		=
UK	The normalisation of relations with the European Union is good news for UK exporters, but the government's switch to austerity has done little to address the UK's growth deficit.		−
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	The new central bank governor has surprised many by sticking to his predecessor's ultra-accommodative stance, helping boost equities to a 33-year high.		=
Emerging (EM)	The reopening of the Chinese economy has underwhelmed investors, and we suggest scaling back exposure until it gathers steam,	↘	+

Fixed Income	Today's environment of high inflation, rising policy rates, quantitative tightening and impending economic slowdown will continue to prove challenging for fixed income investors.	−
Sovereigns	The sharp rise in policy rates and inverted yield curve have created attractive opportunities in short-dated Treasuries. We remain Underweight nonetheless.	−
Duration	We still prefer shorter-dated bonds – which are less sensitive to any rises in rates – across all markets. Sticky inflation means longer-dated real yields are negative.	−
Inflation-linked	Inflation-protected securities tend to have very high duration, making then extremely sensitive to small shifts in inflation expectations.	=
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.	−
High Yield	The macro backdrop will blow strong headwinds against risk assets like high yield bonds, given the potential for a deterioration in credit quality.	−
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.	=

↗ Upgrade ↘ Downgrade + Overweight = Neutral − Underweight

Commodities	With reopening in China likely to gradually boost demand for raw materials, we maintain our modestly Overweight allocation to commodities.	+
Energy	With OPEC+ cutting output, China reopening and oil majors reluctant to invest in new production capacity, we believe that crude oil prices may soon find a floor.	=
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.	=
Precious metals	Central bank demand for gold remains strong and bullion continues to provide useful diversification benefits in terms of portfolio construction.	+

Currencies	The debt ceiling crisis generated some safe-haven flows into the US currency, but the shrinking interest rate advantage over Europe means the strength might not last.	
EUR/USD	Now that the Fed has paused its rate hikes, traders may pivot towards currencies like the euro where the central bank has stepped up its hawkish rhetoric.	+
GBP/USD	Sterling has experienced a relief rally since Sunak and Hunt arrived in Downing Street. Although the growth outlook still looks bleak given the UK's structural weaknesses, sterling remains heavily under-valued.	=
EUR/GBP	Both currencies face strikes and political challenges, but the Eurozone's budget discipline should help the euro continue to strengthen against sterling.	+
USD/JPY	The negative cost of carry on long Japanese yen positions will continue to act as a drag for the foreseeable future.	=
EUR/CHF	The Swiss National Bank is set to hike rates again in the wake of European Central Bank (ECB) tightening – CHF strength remains key to the SNB's strategy to keep inflation under control.	=
Emerging	EM currencies have begun to stabilise above their multi-decade low against the dollar. However, they remain vulnerable to any switch back to risk-off sentiment.	=

↗ Upgrade ↘ Downgrade + Overweight = Neutral − Underweight

WOOD MAN.

Economic Outlook

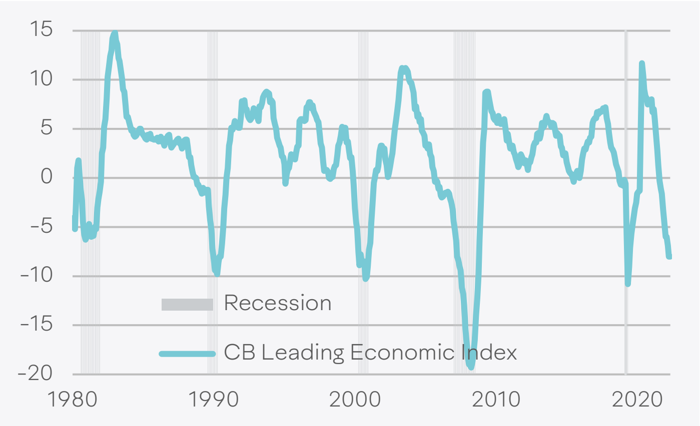
THE MODELS THAT CRIED WOLF?

For decades, economists have tried to build models to predict when recessions might occur. This focus on negative outcomes is not surprising – recessions inflict widespread economic and financial pain and so it makes sense to attempt to prepare for them.

These models take a number of forms. For example, many economists follow the shape of the yield curve, i.e. the difference between near-term rates and longer-dated yields. The thinking here is that central bank rate hikes will raise borrowing costs to such painful levels that bond market traders will begin to speculate that policymakers will have to cut rates in the future, and push bond yields lower in anticipation. When the spread between three-month (3m) Treasury bill rates and ten-year (10y) bond yields inverts – that is, when 10y yields fall below 3m rates – recessions tend to follow.

Another popular indicator has been the spread between companies' new orders and their inventories, which makes intuitive sense – if new orders are falling faster than inventory, then companies will have to cut production to avoid excess stocks. Indeed, over time this spread has tended to lead changes in the Institute of Supply Management's manufacturing index, which itself tends to lead changes in actual industrial production. Until very recently, the trend in the spread has been sharply negative.

Other models blend a selection of measures of impending changes in activity to create a composite indicator such as the one created by the Conference Board (CB). Their leading economic index (LEI) blends ten separate data series together – weekly hours worked, initial jobless claims, new consumer goods orders, ISM new orders, non-defence capital goods orders excluding aircraft, building permits, equity prices, yield spreads, credit conditions, consumer confidence. Again, this indicator has a solid record of predicting recessions – as shown on the chart below, it has never been as low as it is today without one ensuing.



Source:Bloomberg

Woodman's proprietary US Cycle Indicator is an adaptation of the CB's approach but replaces several variables – notably, financial market data like stock prices or credit spreads – with other data series such as personal incomes, capacity utilisation and money supply. The reason we remove financial variables is because our indicator is designed to provide a guide to allocation across financial markets – it would be somewhat circular to use the performance of those assets in the model. Today, our US Cycle Indicator has been stuck in Downturn territory for the past three months.

Despite this barrage of worrying projections, many economic statistics remain surprisingly resilient. Business confidence in services is consistent with continued expansion in the most important contributor to GDP growth. The labour market remains extremely strong – in May, non-farm payrolls rose by 339 000, over 75% above expectations. And corporate profit margins – which tend to precede swings in activity – remain extraordinarily high. S&P500 trailing earnings represent 12.7% of revenues at present, well above the 12.2% pre-pandemic high.

There are many contributing factors behind the discrepancy between these tried and tested indicators and the resilient activity levels, but one stands out in our view – fiscal policy. The Congressional Budget Office estimates that the budget deficit will average -6.1% over the next ten years, a marked worsening compared to -3.5% average over the first two decades of this century. Moreover, the pandemic-era stimulus cheques sent to American households by the Trump and Biden administrations have not been fully spent. Household deposits are still five times larger than they were before the pandemic, helping explain why service businesses are finding consumer demand so resilient.

Bottom Line

Looking ahead, this happy combination may not last. The Fed may feel compelled to resume policy tightening to quell the animal spirits that are keeping inflation uncomfortably high. Higher interest rates and rising wages could put downward pressure on corporate margins, which in turn might force companies to cut their wage bills via layoffs. This would eat away at confidence among service businesses and force households to draw on their cushion of savings, at a time when the recent debt ceiling agreement is set to constrain the White House's fiscal flexibility. The recession may not have been avoided, but simply postponed, perhaps until next year.

EQUITIES

Global equities gave back mostof April's 1.6% advance with the MSCI World index shedding -1.2% in May. Emerging markets continued their run of underperformance with a -1.9% decline which leaves the EM index barely positive year-to-date. US equities outperformed Europe handsomely, thanks to the AI-related frenzy in tech stocks – the NYSE FANG+ index soared 17.1% – and a 3.1% rally in the dollar against the euro.

US . Megacap Growth stocks – as epitomised by the NYSE FANG+ index – dominated returns last month. According to Goldman Sachs, just seven stocks – Meta, Amazon, Apple, Microsoft, Alphabet, Tesla and Nvidia – have accounted for all of the S&P500's gains so far this year. Unsurprisingly, this meant sharp underperformance for Value stocks – the Russell 1000 Value index lost -4.1% in May, badly trailing the Growth index which jumped 4.4%, taking year-to-date returns to -2.4% and 20.2% respectively. The valuation differential remains extremely large – the Russell Value index trades at 14.5x forward earnings according to Bloomberg against 25.9x for the Growth index. It is true that earnings revisions over the past four weeks have been slightly better (+2.0%) for Growth than for Value (+0.4%), but the difference is not enormous. We continue to call for a blend of Growth and Value stocks in portfolios.

Looking at the broader market, valuations remain rather demanding – the S&P500 index trades at a trailing 19.6x price/earnings ratio (PER), well above levels in Europe and Asia. Moreover, earnings are expected to decline this year in the US by -1.3% versus increases in other regions. Interestingly, small cap stocks are expected to show slightly better earnings growth this year than the S&P500 – the Bloomberg consensus estimate for the Russell 2000 index is +0.9% – although their performance has lagged, by -0.7% versus 8.9% so far this year.

Europe . European equity markets underperformed the US sharply in May – the STOXX600 index of pan-European large caps lost -3.2% and the Eurozone-only EuroSTOXX index dropped -3.5% while the S&P500 surged 4.0% in euro terms. Despite strong outperformance between last October and April, Europe's equity markets remain unloved. According to EPFR, investors have redeemed a total of -$20.2bn from European equity funds so far this year, after last year's massive -$106bn in outflows.

There are of course legitimate reasons to worry about the continent – the Eurozone slipped into recession in Q1 and business confidence in manufacturing suggests the contraction might continue, the war in Ukraine shows no sign of resolution and sticky inflation remains a thorn in households' sides – but none of these factors are particularly new. Moreover, these headwinds are already reflected in valuations – the EuroSTOXX trades at 12.8x trailing earnings and the STOXX600 at 12.6x, versus 19.7x for the S&P500, and both will pay estimated dividend yields of 3.5% this year, over twice the 1.6% yield on offer in the US. Moreover, our models continue to suggest that this is a period of consolidation rather than the start of a bear phase. We continue to highlight the attractions of the smaller market capitalisation segment, which contains many under-researched gems and where forecast earnings growth for 2023 at 18.7% is well above the 2.5% and -1.3% expected for the EuroSTOXX and S&P500 respectively.

Asia . Asian equities modestly outperformed other emerging regions in April, gaining 2.4% versus 2.2% for Latin America and -1.1% in Eastern Europe. The standout performance in the region came in Taiwan which soared 10.3% on investor euphoria for semiconductor stocks, an area which dominates the market in Taipei. As highlighted in recent reports, China's reopening has not provided the immediate surge in activity which many had hoped for, which has penalised the onshore stock market which shed -5.0% last month (all figures in euro terms). Nevertheless, the market still looks attractively positioned. The Bloomberg consensus expects 23.2% EPS growth over the next twelve months for the onshore CSI300 index, well above forecasts for the US and the Eurozone. Moreover, the index trades at 11.5x forward earnings and offers an estimated 2.7% dividend yield.

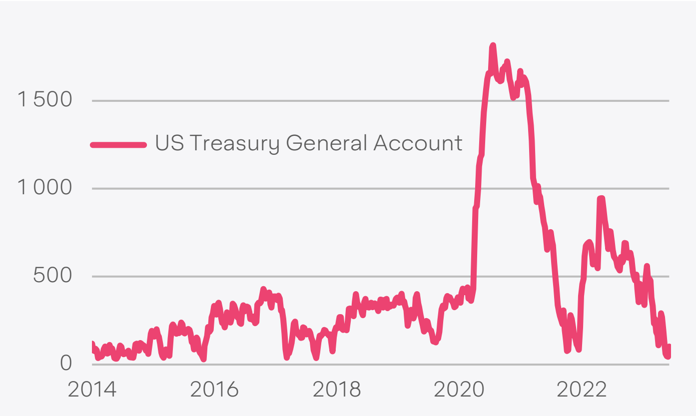
Factors . So far this year, Quality and Growth factors have dominated returns across global equities. And as we suggested in the May **House Views**, the month saw another surge of outperformance. The MSCI World Quality and Growth indices gained 1.7% and 2.3% while Value and momentum slumped -5.0% and -4.9% respectively, taking them back into negative territory for the year to date. Traders seem keen to rotate back towards the winners of the last decade – mainly megacap tech and internet platforms – especially those which stand to benefit from the euphoria surrounding artificial intelligence, companies such as Nvidia and Microsoft which have soared 158.9% and 36.9% respectively year-to-date. However, the valuation differential is rather extreme – Growth trades at 30.1x trailing earnings versus 11.8x for Value – and we recommend to balance positions across factors.

Bottom Line

We maintain equity allocations at Neutral. Given recent strong performance from megacap tech stocks, we suggest taking some profits and adding to positions in small and mid-sized US stocks. Across markets, we recommend investors strike a balance between Value and Growth.

FIXED INCOME

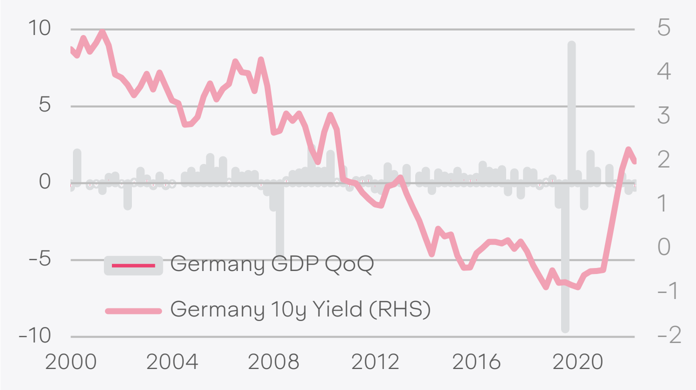
US . The main event of the month for US fixed income was the end of debt ceiling saga. This should have a significant impact on liquidity as the Treasury, restrained in its ability to issue new debt in recent weeks, was forced to withdraw cash from its general account (TGA) at the Federal Reserve. This had the effect of boosting liquidity in the system, partly offsetting the ongoing quantitative tightening (QT) from the Fed, i.e., the sale of bonds from its balance sheet. The debt ceiling resolution, however, will lead to high issuance of Treasury bills to replenish the TGA. Some analysts estimate that the issuance over the next three months could be as high as five times what we see in a typical three-month period. This will negatively impact market liquidity and could take bond yields higher.



Source: Bloomberg

On the monetary policy front, while the focus is on whether the Fed will hike in June, we believe that the QT in the background is probably more significant. For the moment, there seems to be a good amount of cash in households' deposit accounts as we are still working through the White House's handouts during the pandemic, but we will be on the lookout for signs that excess cash levels are getting low. In any case, we remain underweight duration – the government sector in western countries is where there has been biggest increase in leverage and so we prefer to limit exposure to interest rate risk.

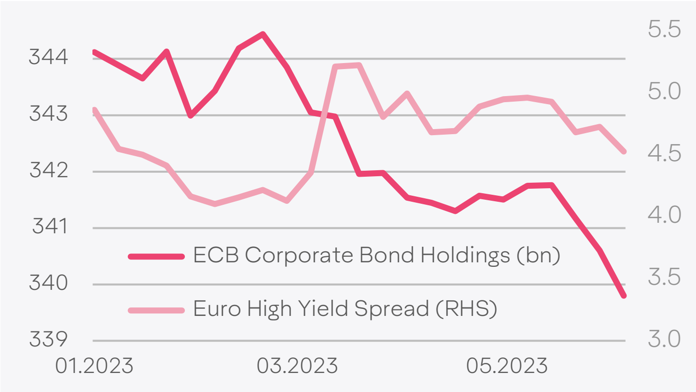
Europe . In Europe, yields are still negative in real terms and the risk / reward prospects for duration are also poor. Germany officially entered a recession in Q1, a development which usually sees a decrease in bond yields. However, nominal yields on 10-year German Bunds are still near the highest level in ten years. This supports our view that there is an asymmetric return profile for the asset class – more downside risk for bond prices than upside potential.



Source: Bloomberg

Credit . US corporate bonds continue to offer minimal pickup in yields compared to three-month (3m) Treasuries, given the inverted yield curve and relatively tight credit spreads. We remain very selective with issuers and try to avoid companies that have borrowed mostly at floating rates. These are the first to be impacted by tighter financial conditions and so it is extremely important to assess their ability to withstand higher interest rates.

In Europe, corporate yields offer a better pickup over risk-free 3m rates and we find some attractive opportunities. However, we also remain selective there and very wary about floating rates – while they offer protection to investors against central bank hikes, they can make it difficult for borrowers to service their debt.



Source: Bloomberg

Bottom Line

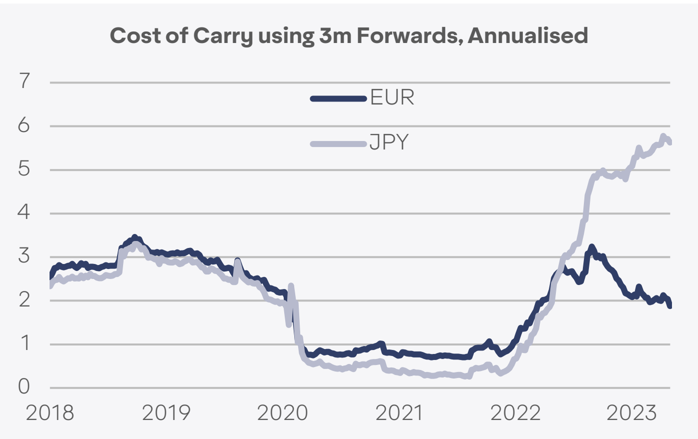
Overall, we remain defensive in our fixed income allocations, with a clear focus on high quality credit and short duration.

CURRENCIES

Last year's strong dollar uptrend peaked last autumn when headline inflation began to undershoot forecasts.

EUR . Although the dollar rebounded in May, we remain positive on the euro. As discussed in past reports, negative interest rates in the Eurozone in recent years pushed bond investors to seek higher yields abroad. Now that short term euro rates are positive again, we are beginning to see the tide turn. The net international position of European investors continues to increase but the fixed income part has clearly turned lower over the last year. Moreover, if European stock markets resume their October to April outperformance, that should also attract international portfolio flows in the medium term. There was recent widening in the cost of carry in favour of the USD, which we believe drove the setback of the euro, but this should now reverse given the ECB's rate hike plans. Further tightening in the interest rate spread should represent another supportive factor for the Euro in the medium term. This being said, the dollar remains the number one safe haven currency and we could see it strengthen significantly on any economic shock. All in all, we remain cautiously optimistic for the euro.

JPY . After rallying 4.9% over the past two months, it may be tempting to lock in profits on long USDJPY positions. Nonetheless, we still hold a negative outlook on the yen. With inflation continuing to climb, the Bank of Japan will eventually be forced to abandon its yield curve control policy, although that may take more time than the market anticipates. Policy makers in Japan have tried hard to generate some inflation for a very long time and may be reluctant to slam on the brakes so soon after it has finally emerged. Keeping policy ultra-accommodative is likely to be a drag on the currency.



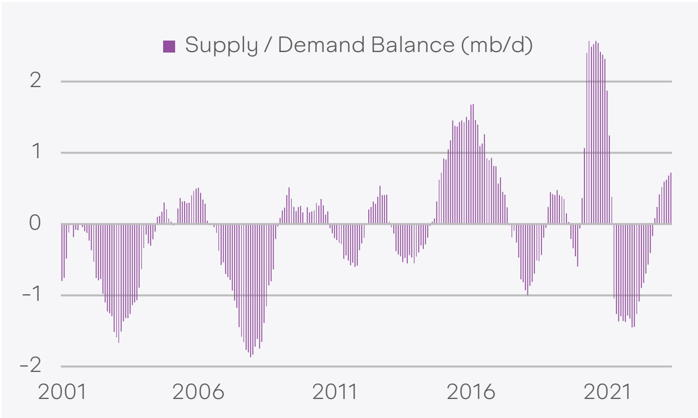
Source: Bloomberg

COMMODITIES

Precious metals, led by gold, have outperformed other commodity markets so far this year.

Energy . As we suggested last month, the sell-off in crude oil prices which followed OPEC+'s output cut announcement in early April continued in May – Brent fell -8.6% per barrel – which duly triggered a reaction from the cartel. Saudi Arabia announced on June 4th that the kingdom would cut output in July by 1 million barrels per day (mb/d), equivalent to 1% of current global production, on top of the 1.6 mb/d cuts announced in April. These cuts are designed to act as an insurance policy against any recession-induced slowdown in global demand and to return the global oil market to balance. In reaction, the US has temporarily shelved plans to rebuild its Strategic Petroleum Reserve and has in fact released a total of -18.0 million barrels over the past eleven weeks, taking the SPR to its lowest level since August 1983.

As shown on the chart below, the supply/demand balance has turned less supportive in recent months, which has put downward pressure on crude prices. However, the International Energy Agency expects this to turn round before year-end. For 2023 as a whole, oil demand is projected to expand by 2.2 mb/d whereas supply will only increase by 1.2 mb/d, led by the US and Brazil. Moreover, oil majors' preference for returning capital to shareholders over capital expenditure in new oil fields will constrain output for years to come. All in all, we see a looming supply/demand imbalance which should underpin higher prices in due course.



Source: Bloomberg

Gold . After adding a net 228 tonnes (t) added to their reserves in Q1, the strongest first quarter on record, the world's central banks reduced their holdings by -71 t in April according to the World Gold Council. However, this was entirely due to Turkey which sold -81 t in the run-up to the May presidential election. On the other hand, global gold ETFs received net inflows for the third consecutive month in May – total purchases reached 19 t.

With little growth forecast in mining output and emerging world central banks still keen to use gold to diversify reserves away from the US dollar, the longer-term picture for gold prices remains bright.

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