May 2023

MONTHLY HOUSE VIEWS

GROUNDHOG DEBT

Macro

Citi's index of global economic surprises has turned decisively lower in recent weeks and is now barely in positive territory. Nonetheless, consensus forecasts for global GDP growth this year continue to be revised higher, from 2.1% in January to 2.6%, driven by a generally strong outlook for consumer spending. JPMorgan's global purchasing manager index (PMI) for manufacturing is still in contraction whereas the sister index for services indicates the strongest expansion since November 2021. Consumer confidence is buoyed by generally robust labour markets – unemployment in the US is the lowest since 1953 and at all-time lows in the Eurozone. Despite some disappointing data, economists continue to ratchet 2023 growth forecasts for China higher, from 4.8% in January to 5.7%.

Central Banks

Central bankers in the US and Europe continue to send hawkish messages despite the -21.5% drop in oil prices compared to last April. Their worries centre on measures of underlying inflationary pressures – such as wage gains or ex-food and energy prices – which show no signs of reverting to pre-pandemic levels. Eurozone core inflation in April at 5.6% year-on-year was only 0.1pp below March's all-time high while core price rises in the US were still 5.5%. Although the Federal Reserve signalled in early May that it might pause rate hikes, that does not mean that easing is imminent – policymakers still expect no cuts this year, despite bets to the contrary by traders. And the European Central Bank remains committed to at least two more 25bp hikes.

Markets

Equity markets gains year-to-date are in high single digits, but this masks deep discrepancies. Growth stocks are up almost 20% while Value stocks are by and large unchanged. Despite eye-watering gains for US megacaps, the US market has only matched the MSCI World's price returns while large-cap Eurozone stocks have almost doubled the returns from global equities. With MSCI World earnings set to fall -1.2% this year, it is clear that all the index's returns have come from rising valuations. Bond markets on the other hand have only recovered a small portion of last year's -16.2% losses as investors fret about sticky inflation. Commodities have given back all their 2022 gains, with the bulk of the losses coming from energy, last year's big winner.

Bottom Line

We have brought equity exposure to Neutral while adjusting away from China and Europe towards the US. This helps achieve a better balance between Growth stocks and Value. Market consensus that economic weakness will force an imminent Fed pivot to easy money will play in favour of high-quality Growth companies, which dominate the US stock market. Within fixed income, we continue to like short-dated bonds, which offer relatively attractive yields and low sensitivity to swings in key rates, and high-quality credit. Among currencies, the receding threat of energy shortages and the improving interest rate differential should continue to boost the euro against the US dollar. Finally, 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.

Summary House Views

OUR ASSET ALLOCATION

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

Equities	We have raised 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. However, after eight months of outperformance, we suggest taking some profits	↘	=
UK	The negotiation of a revised Northern Ireland protocol 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 some buying 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.		Overweight
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.		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.	Downgrade	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	The banking crisis failed to generate any safe-haven flows into the US currency and the strong dollar trend of the last decade has turned downwards.	
EUR/USD	Now that the Fed has signalled a pause, traders have pivoted towards currencies like the euro where the central bank has stepped up its hawkish rhetoric.	Overweight
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.	Neutral
EUR/GBP	Both currencies face strikes and political challenges, but the Eurozone's budget discipline should help the euro continue to strengthen against sterling.	Overweight
USD/JPY	The negative cost of carry on long Japanese yen positions will continue to act as a drag for the foreseeable future.	Neutral
EUR/CHF	The Swiss National Bank matched the ECB's recent rate hike – CHF strength remains key to the SNB's strategy to keep inflation under control.	Neutral
Emerging	EM currencies have begun to recover from their multi-decade low against the dollar. However, they remain vulnerable to any switch back to risk-off sentiment.	Neutral

↗ Upgrade ↘ Downgrade ⊕ Overweight ⊜ Neutral ⊖ Underweight

Economic Outlook

GROUNDHOG DEBT

In 1993's **Groundhog Day**, Bill Murray plays a television weatherman who is trapped in a time loop, endlessly reliving the same day. Investors may feel the same way about the US debt ceiling crisis which seems to recur as regularly as clockwork. Can this time be ignored safely given that such crises have always been resolved in the past?

In recent decades, US federal debt has risen inexorably, from 53.1% of GDP at the turn of the century to 108.7% in 2019, just before the pandemic hit, according to the International Monetary Fund (IMF). Deficit spending to cushion the pandemic's impact pushed the debt/GDP ratio up to 133.5% in 2020 and it is projected to still be at 122.2% at the end of this year and back to 136.2% by 2028.

In their seminal 2009 book **This Time is Different**, ex-IMF economists Carmen Reinhart and Kenneth Rogoff argued that economic growth potential might be impaired at debt/GDP ratios above 90%. This assertion is hotly contested by economists – why 90% and not 60% like the Maastricht threshold, or 120%? – but the basic premise that money used to service debt is not available for more productive uses appears to hold water. The level of debt may not be so much of an issue when ten-year Treasury yields average 2.4% like they did in the 2010s – let alone break below 1.0% as they did for much of 2020 – but it becomes a pressing problem now that yields are back at 3.5%.

Concerns about sovereign debt are not unique to the US, but it is the only major country – apart from Denmark – to have self-imposed a debt ceiling. Importantly, the US limit is set as a dollar amount, meaning that the nominal growth in spending over time will push debt levels ever closer to the ceiling resulting in frequent breaches of the limit – Congress has had to increase the ceiling 78 times since 1960, on average more than once per year. In contrast, since Denmark introduced its ceiling in 1993, it has never been breached.

The problems with the US ceiling are manifold. First, the limit is typically set very close to prevailing debt levels, leaving little room for manoeuvre as spending increases. Second, it takes no account of growth in the economy over time. Third, it has singularly failed to rein in federal spending. And finally, it has become a political football which has encouraged grandstanding by politicians on both sides of the aisle. The latter aspect has been exacerbated in recent years by increased polarisation across the political spectrum. This has been aggravated this year in the aftermath of last November's mid-term elections. Congress is split – the Republicans regained the House while the Democrats retained the Senate – as are the parties. It took the Republicans 15 votes, the most since 1860, to elect Kevin McCarthy as House Speaker after stiff opposition from the right-wing Freedom Caucus.

Yet again, US debt has bumped up against its ceiling and Treasury Secretary Janet Yellen fears that the country will run out of money and risk default as soon as June 1 (the X-date). Yet again, extremists in Congress – this time the Freedom Caucus and progressives among Democrats – are refusing to compromise. And yet again, market tensions are rising – on Friday May 12th, the cost of insuring against US default over the next year rose to its highest level on record. One-year US credit default swaps, which traded at 8 points twelve months ago, hit 178 points. For context, one-year Greek and Italian CDS have averaged 48 and 42 points respectively over the past twelve months.

In addition, the near-term Treasury bill market has been thrown into disarray as the X-date has loomed ever closer. After a brief wobble in mid-March, three-month (3m) bill yields have recovered to trade around 5.2%, bang in the middle of the 5.0-5.25% target range for Fed funds rates. On the other hand, 1m yields plummeted to 3.23% in April before soaring to 5.6% in recent days. This abnormal volatility at the near end of the yield curve has apparently been driven by money-market funds rotating into longer-dated securities to avoid turbulence around the X-date. This in turn has forced the Treasury to offer much higher yields to roll over 1m funding to keep day-to-day operations funded.

However, the proximity to the debt ceiling has slowed new issuance of longer-dated debt, which has forced the Treasury to run down its liquidity on its Treasury General Account (TGA) with the Federal Reserve, from $1 trillion twelve months ago to $116bn at present. Once the debt ceiling crisis is resolved, the Treasury is likely to resume bond issuance and rebuild reserves in the TGA, which will probably suck liquidity away from the financial system.

Bottom Line

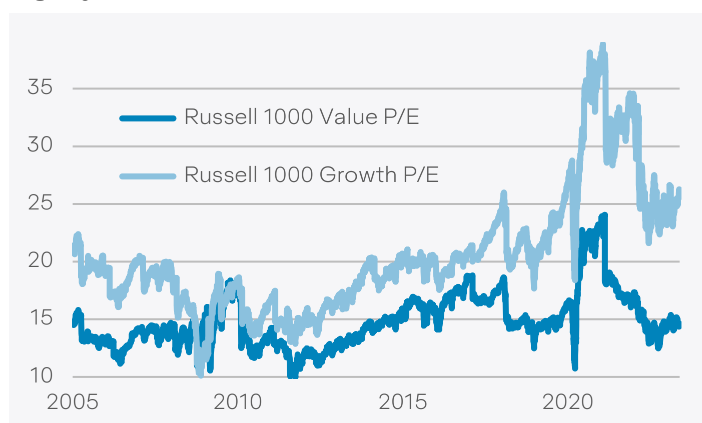
The overwhelming majority of market participants expect a last-minute solution to the debt ceiling crisis but the motivation to compromise may only come if politicians see significant market turbulence. It then remains to be seen whether the solution would mark the end of turbulence or whether the expansion of the TGA might trigger some further volatility.

But the histrionics surrounding the debt ceiling should not distract investors from the real problem which is the unsustainable trajectory of US public finances. The Congressional Budget Office estimates that the deficit will hit -5.8% of GDP next year, of which almost half will be taken up by the cost of servicing the debt burden. While times of emergency – like World War II or the Covid-19 pandemic – are legitimate reasons to run large deficits, such borrowing levels should be the exception rather than the rule. However, the political will or consensus to make the requisite structural adjustments look sadly lacking today.

EQUITIES

Global equities built on March's 2.7% advance with the MSCI World index gaining 1.6% in April, but emerging markets failed to follow suit, dipping -1.3%. European equities resumed their recent run of outperformance versus the US, thanks largely to a 1.7% rally in the euro against the dollar.

US . April saw a shift away from megacap Growth stocks – as epitomised by the NYSE FANG+ index which shed -1.1% over the month – back towards large-cap Value. The Russell 1000 Value index gained 1.4% – led by sectors like consumer staples, energy, health care and financials – versus 0.9% for Growth. The valuation differential remains extremely large – the Russell Value index trades at 14.5x forward earnings according to Bloomberg against 25.8x for the Growth index, while earnings revisions over the past four weeks have been slightly better (+1.7%) for Value than for Growth (+1.6%).



Source:Bloomberg

Looking at the broader market, valuations remain rather demanding – the S&P500 index trades at a trailing 18.7x price/earnings ratio (PER), well above levels in Europe and Asia. Moreover, earnings are expected to decline this year in the US by -1.1% versus increases in other regions. Interestingly, small cap stocks are expected to show decent earnings growth this year – the Bloomberg consensus estimate for the Russell 2000 index is +7.2% – although their performance has lagged the large-cap indices so far this year. Nonetheless, hopes of a Fed pivot combined with solid long-term EPS forecasts have encouraged us to strike a balance in portfolios between large-cap Growth and Value.

Europe . After March's underperformance, European equity markets resumed their outperformance over US and global equities in April. The EuroSTOXX index (which covers the Eurozone) and the STOXX600 (which also includes non-euro markets like the UK and Switzerland) gained 0.9% and 1.9% respectively versus 0.1% for the MSCI World expressed in euros. Despite regular outperformance since last October, Europe's equity markets remain unloved. According to EPFR, investors have redeemed a total of -$12bn from European equity funds this year, after last year's enormous -$106bn outflow.

To be sure, there are black clouds hovering over the continent – the war in Ukraine shows no sign of resolution, inflation remains a thorn in households' sides and strikes and civil unrest bedevil countries like the UK and France – but none of these factors are particularly new. Moreover, these headwinds are already reflected in valuations – the EuroSTOXX trades at 13.4x trailing earnings and the STOXX600 at 13.3x, substantial discounts to the US, and both will pay estimated dividend yields of 3.6% this year, over twice the 1.7% yield on offer in the US. We continue to favour stocks which should benefit from the revival in Chinese demand as well as the smaller market capitalisation segment, which contains many under-researched gems and where expected earnings growth for next year at 15.6% is over double the STOXX600's expected 5.6%.

Asia . Emerging Asian equities underperformed other regions in April, dropping -3.9% versus 0.1% for Latin America and a standout 9.9% jump in Eastern Europe (all figures in euro terms). Nevertheless, the region still looks attractively positioned as it will be the prime beneficiary of China reopening. China itself looks particularly interesting. The Bloomberg consensus expects 19.5% EPS growth over the next twelve months for Hong Kong-listed stocks in the MSCI China index and 19.9% for the onshore CSI300 index, well above the 2.4% and 4.9% expected in the US and the Eurozone respectively. The MSCI China index trades at a trailing PER of 12.0x and offers an estimated 2.7% dividend yield. However, recent underwhelming macro data from China have dampened investor enthusiasm and we have scaled back our exposure.

Factors . So far this year, Quality and Growth factors have dominated returns across global equities. April did see some modest underperformance from Growth – the MSCI World Growth index gained 1.5% versus 1.7% for Value. However, this is likely to be short-lived as 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. For example, Nvidia and Microsoft have soared 89.9% and 24.0% respectively year-to-date. However, the valuation differential is rather extreme – Growth trades at 28.5x trailing earnings versus 11.5x for Value – and we recommend to balance positions across factors.

Bottom Line

We maintain equity allocations at Neutral. Given recent strong performance from European equities, we suggest taking some profits and adding to positions in the US. We have also reduced exposure to China as we await some more encouraging macro data. Across markets, we recommend investors strike a balance between Value and Growth.

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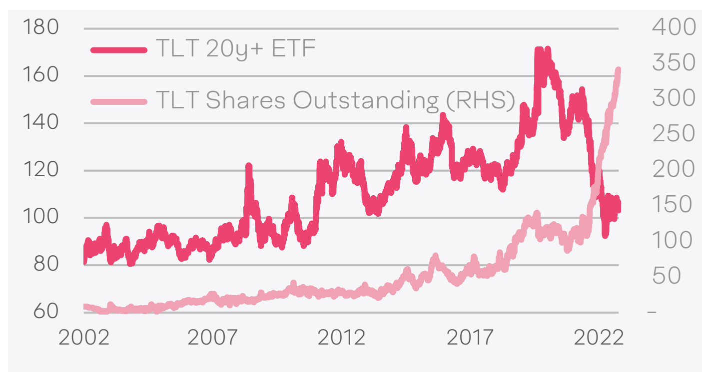
FIXED INCOME

Our core view remains that investors should avoid taking duration risk in the medium term. This is driven by the fact that it is the public sector which has taken on the most leverage in recent years in developed markets.

US . For the time being, we remain cautious given that investor positioning is deeply divided.

On one hand, large speculators or hedge funds – as measured by net open positions on ten-year (10y) Treasuries with the Chicago Board of Trade – are as short duration as they have ever been.

On the other, investors in exchange-traded funds – who may be less sophisticated than the hedge funds – have piled into the TLT ETF of 20+ year Treasuries to lengthen duration in their portfolios. Despite a -32.8% drawdown last year and only a modest 1.4% recovery year-to-date, the number of outstanding shares has kept increasing as investors have added duration.

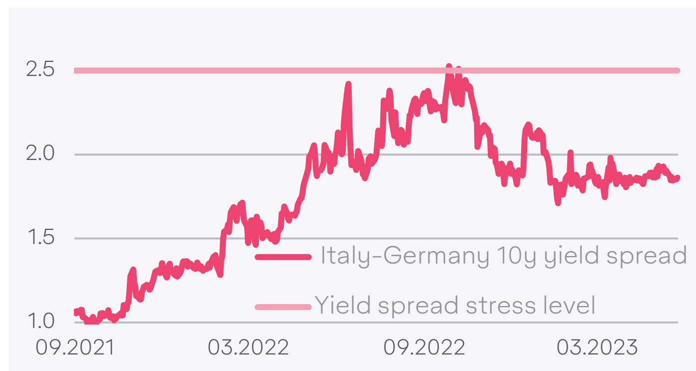


Source: Bloomberg

This divergence in current positioning is likely to create volatility as it is gradually resolved, in one direction or the other. In our view, this normalisation may mean higher yields given that we anticipate a dearth of buyers of Treasuries. The Fed is unlikely to start buying again given persistent inflation and the bloated size of their balance sheet. Moreover, recent failures of regional banks which were hit by losses on long duration bonds mean that institutional investors like banks and insurance companies might be loath to add to duration.

Europe . The German yield curve should continue to shift higher as the ECB restated in early May that they are not finished hiking rates. At yields around 2.4%, the risk on 10y German Bunds is highly asymmetric. We think that higher short-term rates in the Eurozone and – possibly – higher yields in the US will start putting pressure on Bund prices.

In Italy, despite the budget announcement in April that the deficit will be slightly larger than anticipated, we think that inflation could ease the country's fiscal burden. The projected deficit of 4.5% remains well below recent levels of 7% nominal growth, thanks to sticky inflationary pressures. However, it is important to remain nimble in any case as any flight to quality could push the spreads very rapidly wider.



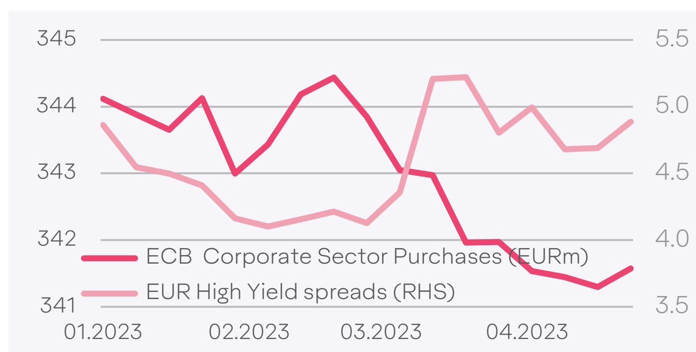
Source: Bloomberg

Credit . There is a lot of talk of credit tightening following the bank failures in March. However, the bond market remains very stable and, while bond issuance has declined in the first four months of the year, it is not much lower than in 2022.

USD denominated bonds remain unattractive – credit spreads are relatively tight, and the yield curve is significantly inverted making risk-free investment in short-dated Treasuries the best place to get some income. As mentioned in previous reports, a significant decline in long-term yields would only be triggered by the sort of event which would push credit spreads wider – not a great risk/reward trade-off for long duration credit.

In Europe, the reward for taking on credit risk is more attractive. However, with interest rates rising and credit conditions tightening, we remain cautious with a highly selective focus on those borrowers which will be fine in an economic downturn.

Overall, the reduction of the ECB's corporate bond holdings which started in March seems to have been well digested by the market. Credit spreads did widen in March, but this also coincided with the collapse of Silicon Valley Bank and Credit Suisse. Since then, spreads have trended slightly lower. The pace of ECB sales is due to accelerate in June and we will monitor the situation closely.



Source: Bloomberg

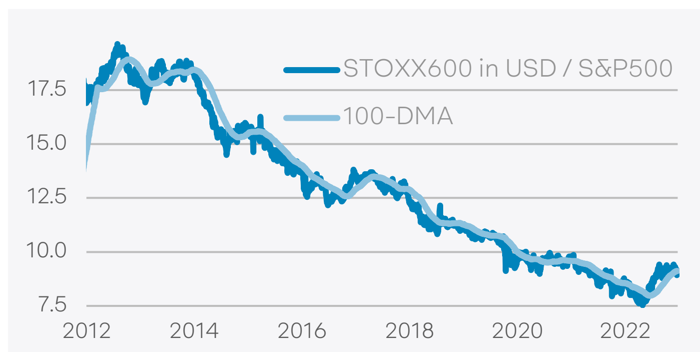
Bottom Line

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

CURRENCIES

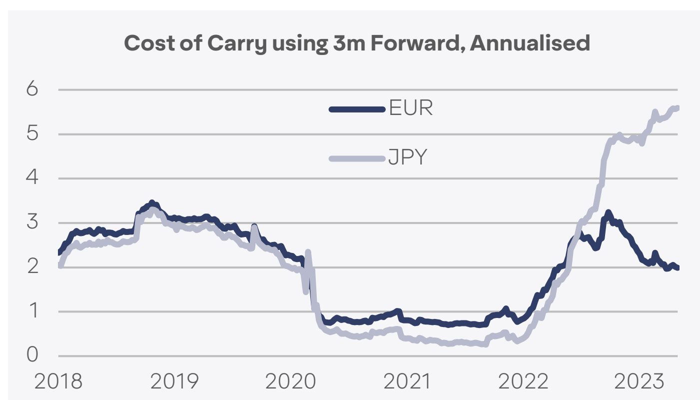
Last year's strong dollar uptrend peaked last autumn when headline inflation began to undershoot forecasts.

EUR . We see signs that the strong dollar trend of the last decade has turned, at least against the euro. First, as we have explained in previous reports, the net international investment position of Eurozone members has become very positive in recent years. This makes sense as prevailing negative rates forced euro-based investors to look abroad for positive yields. Now that the negative interest rate era is over, we think some of these flows will return to Europe. Moreover, European stocks have underperformed the US for more than a decade, culminating in a lurch lower during the pandemic. Since then, the tide appears to have turned despite the serious doubts about European growth cast by the Russia-Ukraine conflict.



Source: Bloomberg

JPY . In Japan, the situation is very different, and we do not see the currency appreciating any time soon. For that to happen, monetary policy would have to change, which looks unlikely. At his first meeting as central bank governor, Kazuo Ueda declared that he is not ready to change the ultra-accommodative stance and went on to say he stood ready to ease policy without hesitation if needed. With Japan set to remain the only advanced economy not hiking rates, the cost of carry of long Japanese yen positions will become ever more negative. This should continue to act as a drag on the yen for the foreseeable future, even as the dollar loses value against other currencies.



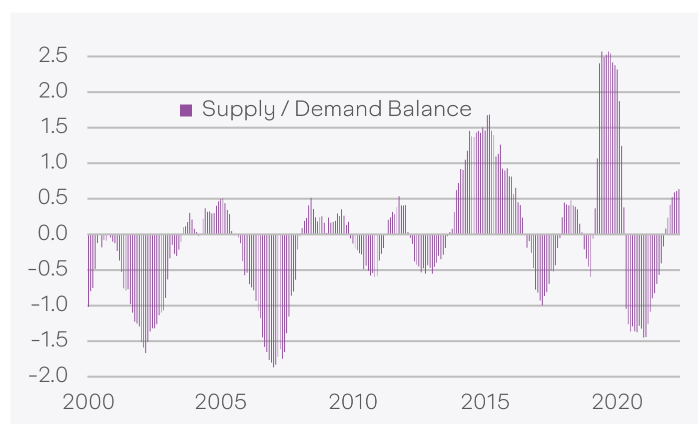
Source: Bloomberg

COMMODITIES

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

Energy . After rallying sharply in early April on the announcement that Saudi Arabia and its OPEC+ partners would cut output target cuts by a total 1.6 million barrels per day (mb/d) until the end of the year, Brent crude prices sold off again dipping below their recent $77 to $87/b trading range by early May. As highlighted last month, these cuts are designed to act as an insurance policy against any recession-induced slowdown in global demand and we believe that further price weakness could trigger even deeper cuts in output to shore up prices.

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.



Source: Bloomberg

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, Washington recently announced plans to recommence rebuilding its strategic petroleum reserve, which currently stands at a 40-year low. In addition, oil majors' preference for returning capital to shareholders over capital spending on 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.

Gold . According to the World Gold Council, gold buying by central banks continued in Q1, with a net 228 tonnes (t) added to their reserves, the strongest first quarter on record. However, this did mark a slowdown from the frenetic pace in Q3 and Q4 2022 when central banks added 459t and 379t to reserves respectively. There was also a year-on-year bounce in demand for gold bars and coins, up from 288t to 302t but jewellery demand did slip lower, from 516t to 509t.

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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