May 2024

MONTHLY HOUSE VIEWS

A PAUSE IN THE BULL MARKET

Macro

Last month, the International Monetary Fund updated its economic projections, accompanied by a warning that global growth five years from now – at 3.1% – would be the "lowest in decades". Moreover, its projection for 2024 is only slightly higher at 3.2%. This year's growth picture is mixed with continued upgrades to consensus expectations for the US (now at 2.4%, up from 0.6% last August) while the Eurozone forecast has been downgraded from 1.0% to 0.6% over the same period. However, recent trends in data suggest a shift may be coming. In the US, Citi's economic surprise index has tumbled, April's flash purchasing manager index (PMI) surveys came in well below expectations while the first estimate for annualised Q1 GDP growth hit 1.6%, well below Q4's 3.4%. In the Eurozone on the other hand, economic surprises remain positive, April's PMIs accelerated, and Q1 GDP hit an annualised 1.2%, the fastest pace since Q3 2022.

Central Banks

The year started with high conviction among traders that a slowing economy and falling inflation would see the Federal Reserve (Fed) and European Central Bank (ECB) make up to seven -25bp rate cuts in 2024. Economic resilience, especially in the US, and sticky inflation have put paid to those expectations. In the US, the annualised rate of the last three months of core inflation is 4.9%, up from 3.2% in Q4 and 2.8% in Q3 and well above the Fed's target. No surprise therefore that traders have slashed their projections for rate cuts – at the end of April, the consensus forecast according to Bloomberg was just over one cut from the Fed this year and less than three from the ECB. The only major central bank which does not face an inflation problem is the People's Bank of China – the consumer price index is up only 0.1% over the past year.

Markets

After rallying 24.2% with barely a pause over the previous five months, the MSCI World index of global equities dropped -3.9% in April. One bright spot was in emerging market equities, a laggard in the recent rally, which rose 0.3% last month. There was little divergence between style factors with MSCI's World Value index dropping -3.6% while Growth fell -4.1%. Among sectors, only utilities and energy managed to make modest gains, but the other nine world equity sectors fell last month, the weakest being the -7.3% drop in real estate. Bloomberg's Global Aggregate bond index fell -2.5% in April, the third drop so far this year. Commodities provided another bright spot – prices rose 0.6%, led by jumps in industrial and precious metals.

Bottom Line

Our Investment Committee has decided to keep equity allocations unchanged for now at modestly Overweight. Our geographic picks also remain unchanged, with the US preferred to Europe and Europe to Asia. We continue to call for a balanced exposure across factors to avoid too much concentration in areas like Technology where valuations remain somewhat demanding. 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. Investors should remain very selective 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

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.	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 4.8% 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	The growth outlook has begun to improve despite the UK's structural weaknesses, but election uncertainty could weaken sterling in the near term.	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

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Economic Outlook

CYCLICAL UPSWING, STRUCTURAL WEAKNESS

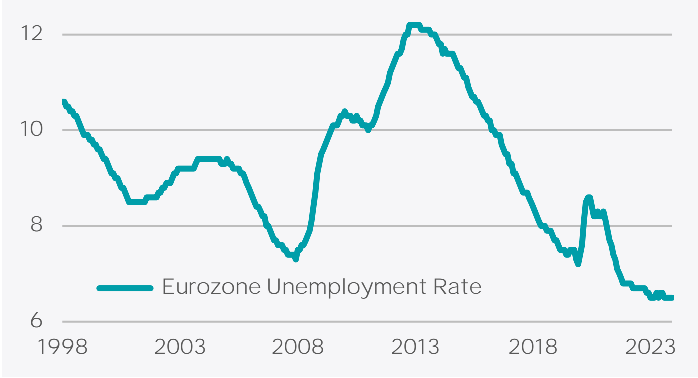
After focusing on the United States and China in recent months, let's turn to the growth prospects of the Eurozone, which is often viewed as a perpetual laggard among the major economic blocs. Is this reputation justified?

Business surveys like S&P Global's monthly purchasing managers index (PMI) are widely used as leading indicators, in that they regularly improve before output data begin to show signs of life. So, it is encouraging that April's PMI poll for the Eurozone continued March's turn higher. The improvement was concentrated in services, however, with the manufacturing index lower at 45.7, well below the 50-point level which marks the threshold between expansion and contraction of activity. The services index on the other hand hit 52.9 points, well above forecasts, helped by the fastest growth in new orders since last May. Given that services represent 73% of EU gross value added according to Eurostat, it is no surprise that the composite PMI hit 51.4, the second straight month above 50 and the highest level since May 2023.

At the country level, Germany, the largest economy in the Eurozone, has struggled in recent quarters so it is encouraging to see some signs of improvement. The IFO business confidence survey for April showed improvement in both the current situation and in expectations. Sentiment was less negative on manufacturing and turned positive on services. Moreover, the ZEW survey of market economists also jumped in April, well above expectations and hitting the highest level since February 2022. In addition, the GFK consumer confidence index reached the highest level since last summer.

Citi, the US bank, publishes a daily index of economic surprises for the major economies. It compares macro data with consensus expectations to measure the balance between positive and negative surprises. After an extended run of disappointing data releases, Citi's index for the Eurozone has turned positive over the past 13 weeks as business confidence and activity measures have turned higher. Fiscal policy remains mildly expansionary, despite the gradual removal of pandemic-era stimulus measures. The Eurozone's aggregate budget deficit should hit 3.0% this year and 2.6% next, down from 3.4% in 2023. At these levels, the underlying primary balance is likely to add around 0.3pp to GDP growth this year. Moreover, the Q1 GDP report heralded a welcome return to growth after the technical recession in H2 2023 – the 0.3% increase was the best result since Q3 2022. And in turn, this has encouraged economists to start to revise 2024 growth forecasts higher, up 0.1pp to 0.6%.

One area which remained resilient throughout last year's recession was the job market. The unemployment rate has fallen from 6.7% – at the time, the lowest level since the single currency's launch – to 6.5%. Recruitment difficulties are making employers reluctant to lay staff off, a phenomenon dubbed "job hoarding", but deeper forces may be at play. Weak demographic trends mean a shrinking population – the European Union's fertility rate is 1.46 live births per woman, well below the 2.1 births generally considered necessary to keep a population stable. And a shrinking population means sluggish economic growth – economists at Société Générale suggest that the Eurozone's potential long-term growth rate may be in the 0.5-1.0% range.



Source: Bloomberg

Inflation remains a thorn in the European Central Bank's side. In April, year-on-year headline and core inflation hit 2.4% and 2.7% respectively, within striking distance of the bank's 2.0% target. However, the last three months have seen a worrying trend – the month-on-month changes in headline inflation were 0.6%, 0.8% and 0.6%, which is an 8.3% annualised rate. Moreover, unit labour costs continue to grow too fast – growth hit 5.8% YoY in Q4 2023, well above the 3.0% ceiling which would allow domestic inflation to return durably to 2.0%. Nonetheless, the ECB seems determined to start to cut rates in June, as intimated by President Christine Lagarde, and traders agree – according to Bloomberg's calculator, there is an 85% probability of a -25bp rate cut on June 6th.

Bottom Line

The outlook for the Eurozone is mixed. Structural factors like demographics will constrain potential GDP growth in the long run but they also mean a resilient labour market. Despite the prudent pruning of the budget deficit, fiscal policy remains modestly supportive. And, with a debt to GDP ratio of 90.4% this year, the Eurozone has more fiscal flexibility than the US where the ratio is on track to hit 126.2%. Inflation may be stickier than hoped by the ECB, but the central bank seems determined to push ahead with policy easing which should be growth-supportive. All in all, we would not be surprised to see further modest upgrades to Eurozone growth forecasts for this year. However, real GDP growth will remain below the levels we expect in the US and China.

EQUITIES

The second quarter got off to a poor start with a -3.9% drop in the MSCI World index of global equities, its first decline in six months. After underperforming in March, the Magnificent Seven group of stocks proved somewhat resilient last month, shedding only -2.3%, while the pan-European STOXX600 index outperformed the US S&P500 index for the second time running, down -2.6% versus -4.2% respectively. Emerging market stocks outperformed global equities for the second time in three months with a 0.3% advance (all data in dollar terms).

US . Participation in the rally remains elevated despite a reduction in the proportion of stocks trading above their 200-day moving average (DMA) from 86% at end March, the highest level since mid-2021, to 72% at end April. Last month's weakness in prices was spread across equity factors – MSCI's US factor indices for Value, Growth, Momentum and Quality all fell by between 4% and 5%. At the sector level, only utilities managed to gain ground, rising 1.8% – the sector is considered defensive and tends to rally in market turbulence, but in addition investor interest has been bolstered by the increase in energy demand triggered by the data farms required to run artificial intelligence models. Small and medium-sized stocks underperformed in April for the second time in three months with the Russell 2000 small-cap index tumbling -7.1%.

The pullback in prices in April pushed S&P 500 valuations down from 23.5x trailing earnings to 22.6x, but this remains well above end October's 19.1x, just before the stock rally commenced. However, the initial earnings reports for Q1 have been encouraging – at end April earnings reports were in aggregate 9.1% above expectations with all eleven sectors beating consensus estimates, according to Bloomberg. The trailing valuation premium over European stocks eased lower from 9.8 points to 9.0 but remains 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 9.4%, well below consumer discretionary and financial stocks, which are 114.3% and 95.3% more expensive respectively. The same holds true for factor indices - according to MSCI, US Growth stocks trade at a 54.2% premium to Europe and US Value 74.0% 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 seems to have turned 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 continue to disrupt supply chains, adding to inflationary pressures. However, the macro backdrop may be improving. Since the start of February, there have been more positive than negative surprises among economic reports according to Citi's Economic Surprise Index and economists have begun to revise their forecasts for 2024 's real GDP growth higher. Moreover, there are early signs of a turn higher in business confidence – the Eurozone's composite PMI survey strengthened further in April after returning to expansion territory in March for the first time since May last year. This is also beginning to feed through to earnings – according to Bloomberg, analysts have cut their forecast decline in 2024 MSCI Europe earnings from -3.0% to -1.9% over the past month. In addition, investors have begun to return to European equity funds recently – the last week in April saw only the second inflow to European equities in the last 13 months. Finally, Eurozone equity markets continue to perform satisfactorily – since bottoming at the end of September 2022, the STOXX 600 index has provided a 35.6% net total return versus 31.1% 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 13.8x trailing earnings versus 22.8x for its US counterpart. Moreover, European stocks are expected to pay investors a handsome 3.5% dividend yield in 2024, more than twice the forecast 1.5% yield on the MSCI US index.

Emerging Markets . Stocks in emerging Europe and Asia both edged higher in April, by 0.9% and 1.1% respectively, while Latin America lagged with a -4.0% tumble. This big outlier in LatAm was again Argentina – stocks jumped 6.7% in April taking year-to-date returns to 31.3%, easily the strongest returns among all the markets we follow. In Asia, regional heavyweight China returned to the fore with an 8.0% jump in the Hang Seng China Enterprises index (HSCEI) after many months of disappointing performance (all data in dollar terms).

Q1 growth in China surprised on the upside. GDP grew by 5.3% year-on-year, well above the 4.8% expected and the government's new 5.0% target for 2024. Moreover, the authorities have taken a number of steps to shore up equity markets which were trading close to the lowest levels in 18 years in January. Since then, the HSCEI has bounced 32.0% but still remains -67.6% below its 2007 all-time highs. Although earnings growth forecasts are modest at 6.9% over the next twelve months, valuations at 8.0x forward earnings are extremely attractive.

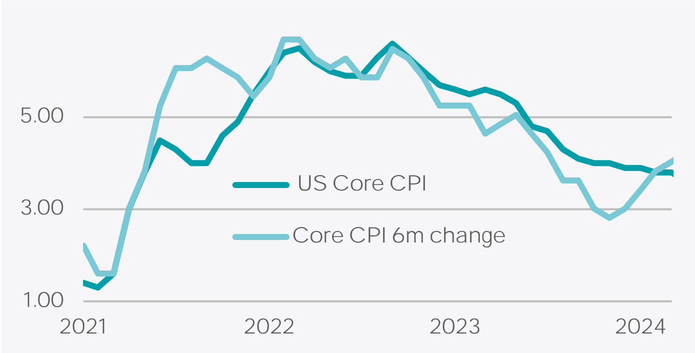
Bottom Line

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.

FIXED INCOME

Bloomberg's Global Aggregate bond index dropped -2.5% in April taking year-to-date losses to -4.6%. This comes after last year's 5.7% rally and sets the bond market on track for an unprecedented third decline in four years.

US . Consumer price inflation (CPI) and core CPI – which strips out volatile food and energy prices – surprised the market negatively last month with year-on-year increases of 3.5% and 3.8% respectively. This should not come as a surprise as the annualised rates of core CPI over the past three and six months have been trending higher.



Source: Bloomberg

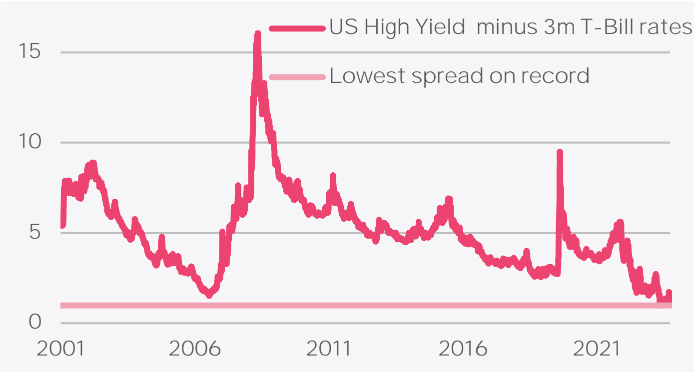
Money supply, which seems to have been leading inflation since the large increase in 2020, has also been trending higher since late last year, which does not bode well for the near term. The consensus view is still that the Fed has managed to bring inflation down with higher rates, but the reality is that the financial conditions remain loose, as shown by the Goldman Sachs Financial Conditions index which has been in accommodative territory since last November. While banks' senior loan officers continue to tighten lending conditions and we are starting to see some stress in specific sectors, risk appetite for corporate credit remains high, keeping spreads very tight for most borrowers. It is by no means certain that the Fed will need to cut rates this year.

Ten-year Treasury yields surged 48bp in April following the hotter-than-expected inflation report. This move may have been too much, too fast and we would expect now to see a retracement. However, we would caution that supply and demand remain in imbalance and believe that risks remain tilted toward higher yields. The US federal deficit is now at 6% of GDP and the economy is growing nicely which means borrowing needs will continue to expand. Moreover, while the Fed did announce that it will slow the pace at which it is shrinking its asset holdings, it is still a net seller of $25 billion worth of Treasuries each month.

Foreigners, traditionally large buyers of Treasuries, are slowing their purchases. For many, gold is a more attractive asset to hold following the freezing by the G7 of the Russian central bank's assets in early 2022. While it is true that Japan – historically, one of the largest buyers – has resumed purchases recently, we do not believe this will last. First, dollar yields are less attractive than Japanese government bonds currently when hedged back into yen and, second, the official sector has recently started to buy yen to defend the currency – this does not bode well for purchases of Treasuries for reserve purposes. This leaves us with households. For the moment, they are increasing their holdings but mostly in short-dated notes, which matches the Treasury department's issuance programme. However, another bout of inflation could curb their appetite, and they could demand higher yields to absorb the coming supply.

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.

Credit . Credit spreads – the difference in yield between sovereign and corporate bonds – have compressed significantly over the last two years and are now near historical lows. This has encouraged a large run of new issues which was easily absorbed by the market.



Source: Bloomberg

Credit quality remains solid. There have been several isolated cases of bankruptcies among companies which had taken on too much debt at low rates, but this is not the case for the majority of borrowers. Indeed, many companies we follow have been deleveraging and remain prudent with debt. Moreover, inflationary pressures and sizeable fiscal spending are likely to push turnover and nominal GDP higher, thereby reducing the companies' real debt burden in aggregate. Careful credit analysis is more important than ever given the idiosyncratic risks and tight credit spreads, but we do not envisage a lasting downturn in corporate bond markets.

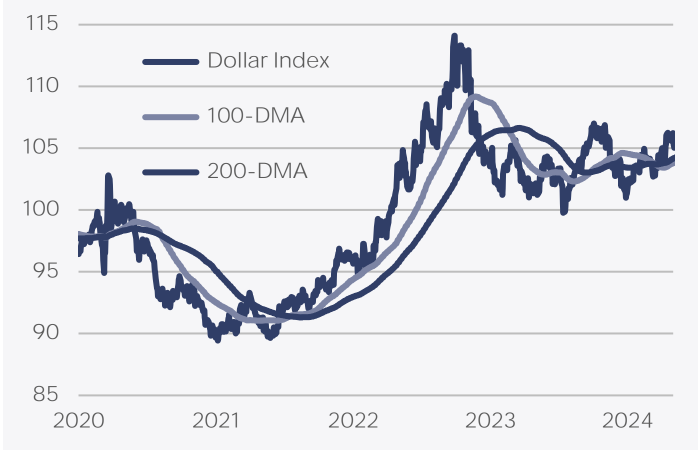
Bottom Line

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

CURRENCIES

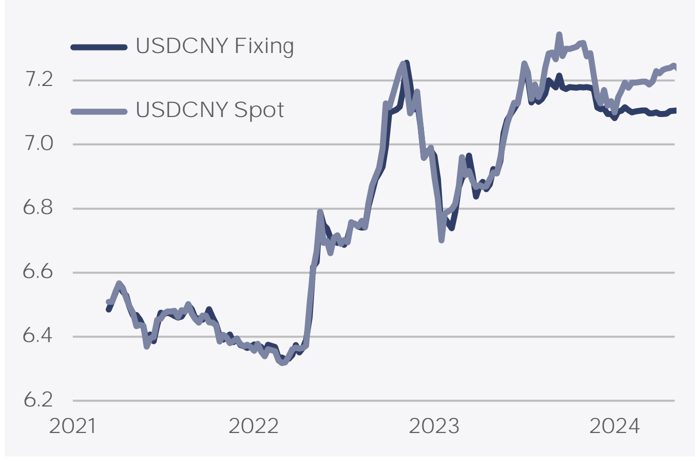
Over the past 18 months, the dollar index has been stuck in wide range. The 4.8% rally this year is a recovery from oversold levels at the end of 2023.

USD . The US economy remains strong and there is a clear case that interest rates will not be cut as fast as in Europe, which could support the currency. The main driver so far this year has been the differential in real rates (i.e., after deducting domestic inflation), and continued widening could support the USD further against its G10 peers.



Source: Bloomberg

CNY . The renminbi remains the currency to watch given the importance of China in global trade. As noted in previous reports, the market rate is weaker than 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. The sustained divergence from the fixing could spark market intervention by the government, a move that could potentially impact many currency cross rates.



Source: Bloomberg

COMMODITIES

Global spot commodity prices rose a further 0.6% in March, driven by strong advances in industrial and precious metals.

Energy . After a sharp 4.6% rally in March, Brent crude prices inched 0.4% higher last month, taking year-to-date (YTD) performance to 14.0%. The other main benchmark for crude oil, the US West Texas Intermediate contract, dipped -1.5% in April, as traders fretted that weaker macro data might reduce oil demand, but remains up 14.3% YTD. This rally has been driven by a number of factors, most notably rising geopolitical tensions in the Middle East – the Israeli/Hamas conflict has already led to tit for tat strikes between Israel and Iran, while Houthi rebels continue to disrupt shipping traffic around the Red Sea. Moreover, the OPEC+ cartel has prolonged its late-November decision to add 2.2m barrels per day (mb/d) in voluntary cuts to the previous output curbs of 3.6mb/d until the cartel's next meeting on June 2nd.

These cuts were designed initially to keep supply tight in light of fears of economic weakness leading to lower energy demand. Until recently, however, economic data has mostly surprised on the upside, helping bolster this year's rally in crude prices, but momentum has begun to slow. According to the International Energy Agency (IEA) April report, global oil demand growth in Q1 was estimated at 1.6mb/d, roughly 120kb/d below their precious forecast. For 2024 as a whole, however, demand growth is projected to slow further to 1.2mb/d this year from 2.3mb/d last year, taking this year's forecast demand to 102.9mb/d, and then to 1.1mb/d in 2025. On the other hand, the IEA has kept its estimate for 2024 world oil supply at 102.9mb/d, leaving the market very close to equilibrium. All in all, crude prices should continue to trade in a wide band this year.

Gold . Gold prices gained a further 2.5% in April to $2,286 per ounce, after reaching a new all-time high at $2,392 mid-month. As noted last month, gold has now clearly broken above its previous peaks above $2,000 – in August 2020, August 2022 and March 2023 – despite dollar strength and rising bond yields. The dollar index has risen 4.8% since the start of the year while 10y Treasury yields have jumped 80bp. 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 – at the end of April, investors had made redemptions equivalent to 146 tonnes so far this year, after eleven consecutive months 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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