March 2023

MONTHLY HOUSE VIEWS

NO LANDING? REALLY?

Macro

February's purchasing manager surveys showed improved confidence, especially in services. In the US and Europe, the final composite indices – which cover all sectors – bounced solidly into expansion territory for the first time since last June. Moreover, job markets remain extremely strong, with the unemployment rate at 55-year lows in the US and just above all-time lows in the Eurozone. As a result, estimates for US and Eurozone 2023 GDP growth have inched higher year-to-date, albeit still well below 1.0%. In contrast, as China emerges from zero-Covid hibernation, estimates for its growth have shot up from 4.8% to 5.3%, while India is expected to register 7.0% this year. Despite resilience in Europe and US, the principal global growth engines are clearly in Asia.

Central Banks

Inflation reports for January failed to reassure investors that disinflation was on track. The headline price index for US personal consumption expenditures (PCE) ticked higher as did the core PCE, the Federal Reserve's preferred metric, which strips out volatile items like food and energy. And the core consumer price index (CPI) for the eurozone continued its surge higher in February reaching 5.6% year-on-year (YoY), a new record high. As a result, investors have begun to take central banks' hawkish rhetoric more seriously. The ultimate high point in Fed funds – known as the "terminal" rate – jumped 50bp in February and continues to rise, while European Central Bank (ECB) officials have been vocal in their insistence that March will see the sixth outsized rate hike in a row.

Markets

We wrote last month that January's rapid gains in bond and equity markets looked vulnerable and so it proved. Negative inflation news and hawkish central bankers pushed bond markets into negative territory year-to-date, meaning higher yields which in turn put downward pressure on equity valuations. On the earnings front, analysts only expect 0.9% growth in US profits over the next twelve months and 1.1% in the Eurozone. The negative sentiment swirling around bond and equity markets prompted a revival in interest in safe havens, which helped the dollar index jump 2.7% in February, its first monthly gain in five. Despite the brighter business confidence data, commodity traders remained prudent – the GSCI Spot index of raw material prices dropped -4.0% last month.

Bottom Line

We have decided to take advantage of the pull-back in equity prices to increase our allocation to the lower end of the Neutral band, by adding to exposure in the US, Europe and China. Despite the negative news on corporate earnings, discount rates, geopolitical tensions and the sluggish economy, markets have remained remarkably resilient as investors try to focus on the ensuing recovery. Of course, we stand ready to dial back positions should their optimism prove short-lived. Within fixed income allocations, we continue to like short-dated bonds, which offer relatively attractive yields and low sensitivity to swings in key rates. Finally, the prospect of a pick-up in raw material demand from China encourages us to remain Overweight in commodities.

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Summary House Views

OUR ASSET ALLOCATION

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

Equities	We have decided to take advantage of the pull-back in equity prices to increase our allocation to the lower end of the Neutral band, by adding to exposure in the US, Europe and China.	↗	⊜
United States	Although megacap US stocks still trade at lofty ratings, mid and small-sized companies now offer more attractive valuations.	↗	⊜
Eurozone	Eurozone equity markets are cheap, under-owned and home to many undervalued defensive stocks which should provide a measure of downside protection.	↗	⊜
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 will probably move away from his predecessor's ultra-accommodative monetary policy which could penalise exporters via upward pressure on the yen.		⊖
Emerging (EM)	The reopening of the Chinese economy after shelving its zero-Covid restrictions should boost economic activity and appetite for Asian equity markets, most notably China and India,	↗	⊕

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 yields 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 could push longer-dated yields higher still.	⊖
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 yields 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. Opportunities have emerged in subordinated financials.	⊖
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 in Brazil demands careful monitoring.	⊜

↗ Upgrade ↘ Downgrade ⊕ Overweight ⊜ Neutral ⊖ Underweight

Commodities	With reopening in China likely to boost demand for raw materials, we maintain our modestly Overweight allocation to commodities.	Overweight
Energy	With Russia 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.	Overweight
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 dollar index is no longer oversold but still continues to consolidate as traders await policy moves from advanced economy central banks.	
EUR/USD	Hopes that lower inflation readings might prompt a pivot to easier policy by the Fed have fostered interest in currencies like the euro where the central bank has stepped up its hawkish rhetoric.	Overweight
GBP/USD	Sterling experienced a relief rally after Sunak's arrival in power. However, the growth outlook looks bleak, and the UK's structural weaknesses offer little prospect of any long-term strength.	Neutral
EUR/GBP	Both currencies face energy and political challenges but the Eurozone's budget discipline should help the euro continue to strengthen against sterling.	Overweight
USD/JPY	Hopes of change in the Bank of Japan's monetary policy stance provided some support to the beleaguered yen, which remains extremely undervalued.	Neutral
EUR/CHF	The ECB has turned more hawkish than the Swiss National Bank, which has boosted the single currency. However, CHF strength remains key to SNB strategy to keep inflation under control.	Neutral
Emerging	EM currencies have begun to recover from their multi-decade low against the dollar. However, a switch back to risk-off sentiment could see further weakness.	Neutral

↗ Upgrade ↘ Downgrade ⊕ Overweight ⊜ Neutral ⊖ Underweight

Economic Outlook

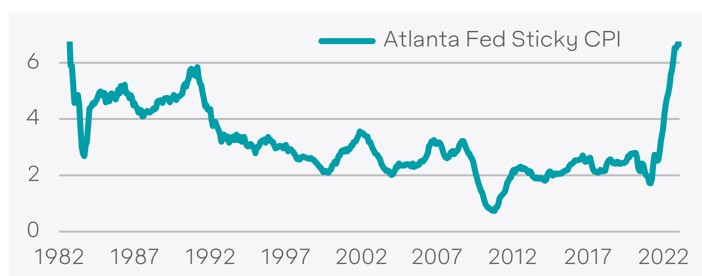
NO LANDING? REALLY?

In recent weeks, a third economic scenario – in addition to a hard or soft landing – has gained traction among US market participants. But what does "no landing" actually mean? And is it a realistic outcome.

A hard landing is almost self-explanatory. A severe downturn in activity which pushes unemployment higher, which in turn weakens household and corporate confidence and demand and forces the Federal Reserve (Fed) to ease policy in an attempt to stave off the inevitable recession, which finally pushes inflation back towards the Fed's 2% target range. In a soft landing, activity slows modestly, confidence and demand remain elevated, inflation dissipates, and the Fed is able to pivot to modestly easier policy settings.

So where did "no landing" come from? It emerged after a period when imminent recession had become the consensus expectation – last November, 77% of respondents to Bank of America's monthly survey of global fund managers expected one. Then we hit a run of positive economic surprises – in January, the US reported a mammoth 517 000 new jobs created, almost triple the consensus forecasts, retail sales jumped 3% and manufacturing production rose 1%. With the purchasing manager index (PMI) for services back in expansion territory in February, it's no surprise that the Atlanta Fed's GDPNow gauge of Q1 GDP growth is currently running at a robust annualised 2.3%, up from 0.7% at the end of January. And in BoA's latest poll, less than a quarter of respondents now expect a recession this year.

At the same time, inflation readings have been sending mixed signals. Headline consumer price inflation (CPI) readings have tumbled from last June's 40-year high of 9.1% to 6.4% in January. However, the fall in the Fed's preferred inflation gauge – core personal consumption expenditure prices, or core PCE – has been less spectacular, from a high of 5.4% last winter to 4.7% in January. And other indicators tell a similar story – the Cleveland Fed's median CPI measure hit its all-time high at 7.1% in January while the Atlanta Fed's sticky CPI (which tracks those prices which change least frequently) is still at 6.7%, again a 40-year high.



Source : Bloomberg

So, from the Fed's perspective "no landing" sounds like a bit of a nightmare, with resilient activity fuelling labour shortages contributing to demands for wage increases and keeping inflation uncomfortably high.

However, January may prove to have been an outlier. First of all, the Bureau of Labor Statistics makes annual adjustments to its methodology every January, which often leads to erratic readings. Second, the BoA survey targets fund managers, whose confidence levels tend to fluctuate with stock prices – January's 7.0% jump in the MSCI World index may have tinted their lenses a nice rose colour. And third, January saw unseasonably warm weather across much of the US, with New York City remaining snow free for the first time since 1973 – this enabled a 1.4% increase in hours worked and a 7.2% jump in food service sales over December. We would not be surprised if January proves to have been a false dawn.

Moreover, a "no landing" scenario is more of a staging post than an arrival point. Given that it would likely force the Fed's hand to tighten more aggressively than expected by investors, we would likely find ourselves debating again in due course whether the landing will be hard or soft.

So, which will it be? Soft landings are actually pretty rare. Arguably, the only one in recent decades was in 1994-95, when the Greenspan Fed hiked rates from 3.0% to 6.0% without sparking a recession. However, there are a couple of key differences with today. First, there have already been a cumulative 450bp in rate hikes so far this cycle, with more promised by Fed chair Powell. Second, and more importantly, inflationary pressures are much stronger now than in 1994-95, when US headline CPI rose from a low of 2.3% to a high of only 3.2%.

Moreover, in addition to historical precedent, a number of leading indicators point towards a hard landing. For example, ten-year bond yields have dipped below three-month rates, thereby inverting the yield curve, which normally slopes upwards. As shown on the chart below, recessions have always been preceded by inverted yield curves. In addition, the Conference Board's Leading Economic Index has been in slowdown or recession territory since last July. This is only the fifth warning signal from the LEI since 1990 and each of the previous alerts was followed by a recession.

Bottom Line

In summary, we do not believe that "no landing" represents a viable alternative scenario, and the ultimate outcome for the US economy will either be a soft or a hard landing. And given some resilient activity readings and generally persistent underlying inflationary pressures, the Fed is likely to maintain its higher-for-longer mantra well beyond what is expected by markets, which argues for the latter. For now however, traders are convinced that the landing will be soft and equity markets look set to resume their rally – investors should stand ready to adjust their exposure rapidly should hard landing fears resurface.

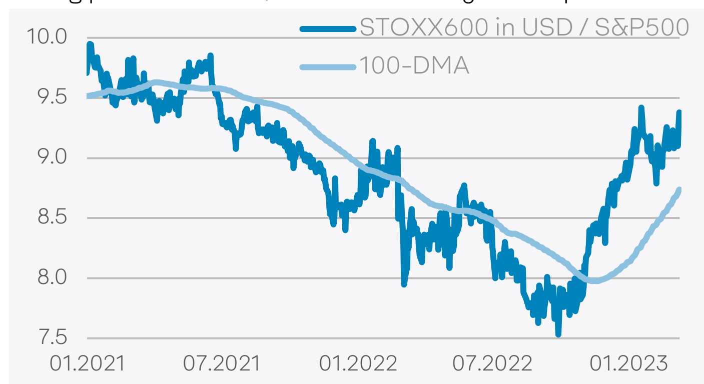
EQUITIES

Global equities corrected in February with the MSCI World index shedding 2.5% after soaring 7.0% in January. The weakness was broad-based with emerging markets tumbling -6.5%. Although many European bourses rose in local currency terms, the -2.6% slump in the euro against the dollar meant that international investors in the STOXX600 index lost -0.7% over the month.

US . US equities continued last year's underperformance versus the global average in February, despite the resilience of the information technology sector – home to mega-caps like Microsoft, Nvidia and Apple – which eased 0.4% higher. The weakest sectors were energy – which led the way last year – and defensive areas like utilities and health care, down -6.4% and -4.7% respectively. However, the -2.6% decline could have been worse given the negative news-flow and remarkably rapid rise in peak Fed funds projections.

US valuations remain rather demanding – the S&P500 index trades at a trailing 18.2x price/earnings ratio (PER), well above levels in Europe and Asia. However, it should be noted that the index valuation is skewed upwards by its very largest members – for example, Apple represents 6.8% of the index and trades at a PER of 25.6x. Nonetheless, the outlook for 2023 is subdued – according to Bloomberg, S&P500 earnings per share (EPS) are set to fall -1.2% compared to last year. Given this unpromising combination of weaker earnings and demanding valuations, we continue to focus on more defensive Value segments, for example among small and medium-sized companies or in the energy sector.

Europe . Since last autumn, European equity markets have steadily outperformed the US, surprisingly in many ways given the war on its doorstep, widespread strike action and the heated talk about energy crisis this winter. In part, this outperformance reflects cheap valuations, in part it is acknowledgement that many European exporters have much to gain from China reopening and in part a contrarian bet by investors. According to EPFR, European equity funds saw aggregate outflows of -$106bn last year – with so many investors already underweight, markets can rally when the selling pressure eases, as it has recently in Europe.



Source: Bloomberg

European equities remain attractively valued – the Eurozone trades at 13.0x trailing earnings, a -21.0% discount to the US, and will pay an estimated 3.5% dividend yield this year, double the pay-out for the S&P500 index. Moreover, the Eurozone's earnings yield – calculated by dividing trailing earnings by the price of the index – looks competitive at 7.7% versus 2.7% for three-month (3m) German Bunds. In contrast, the earnings yield for the S&P500 is 5.5% versus 4.8% for 3m Treasuries. 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 is around double estimates for the STOXX 600 index.

Asia . In sympathy with their Western European neighbours, eastern European emerging markets outperformed the other regions last month, gaining 0.9% while emerging Asia shed -4.6% and Latin America -4.1%. However, we still expect Asia to outperform this year – expected earnings growth is currently 8.9% for 2023 and valuations remain cheap at 12.2x trailing EPS. Our preferred pick is China – the consensus expects 24.5% EPS growth for the members of the MSCI China index over the next twelve months, much higher than the low single digits expected in the US and the Eurozone. We have decided to increase exposure to China further to take advantage of the reopening dynamic.

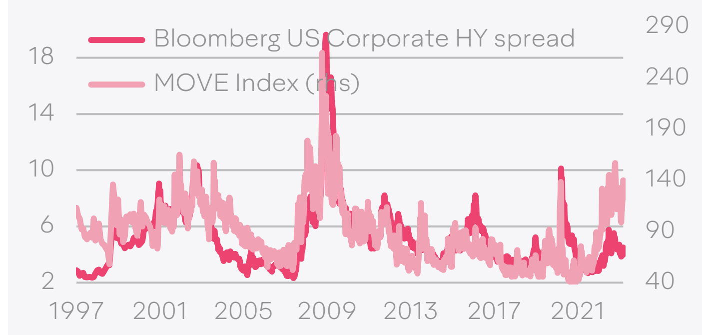
Factors . After 2022's trend reversal away from Growth stocks in favour of Value, the first two months of the year have marked swing back towards the winners of the last decade. The NYSE FANG+ index – named after Facebook, Amazon, Netflix and Google – was up 23.2% by end-February. With long-dated yields – which are used to discount high growth hopes – under upward pressure if inflation proves as sticky as we fear, we still expect Value to outperform this year.

Bottom Line

We have decided to take advantage of the recent pull-back in equity prices to increase our allocation to the lower end of the Neutral band, by adding to exposure in the US, Europe and China. Of course, we stand ready to dial back positions should investor optimism prove short-lived.

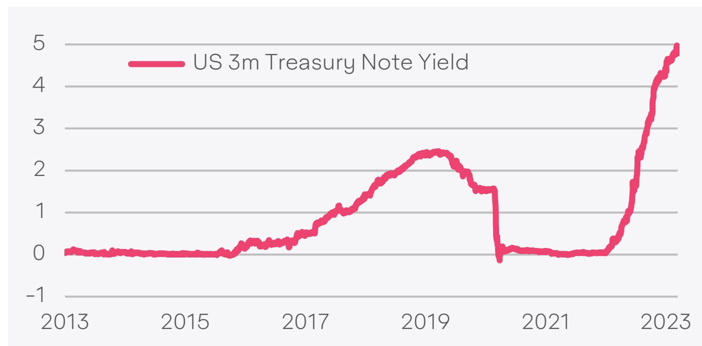
FIXED INCOME

US . Long-term interest rates seemed to have resumed their march higher in February with US ten-year (10y) yields breaking back above 4% in early March. This was driven by resilient activity data and stickier-than-expected headline and core inflation. There seems to be still plentiful liquidity in the system despite the quantitative tightening – i.e., sales to reduce holdings of Treasury and mortgage-backed bonds – by the Federal Reserve (Fed). We believe that as long as the withdrawal of liquidity injected following the pandemic persists, GDP growth, inflation and, as a result, key rates and long-term yields will continue to trend higher. This means 10y yields will make new cycle highs. The MOVE index, which measures the implied volatility of US Treasuries, could also



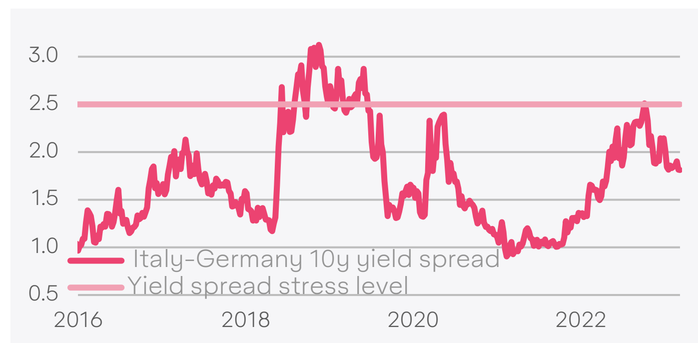
Source: Bloomberg

spike higher, which would widen credit spreads – the difference in yields between sovereign and corporate bonds – given that macro uncertainty and higher refinancing costs increase credit risk. All in all, the risk/reward ratio is skewed against long-dated bonds and credit at present. This makes short-dated Treasury bonds very attractive – they have negligible sensitivity to changes in interest rates, no credit risk and offer yields around 5.0%.



Source: Bloomberg

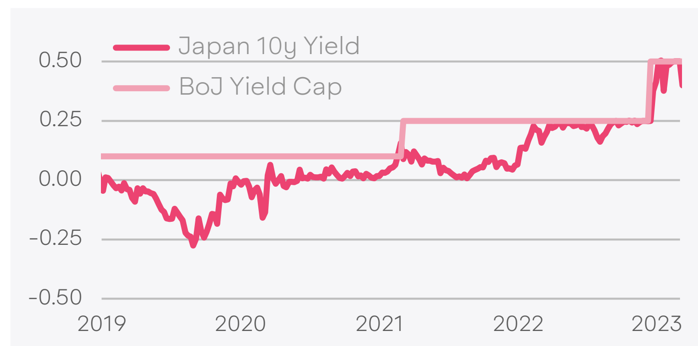
Europe . With headline inflation stuck above 8% and core inflation at record highs, European Central Bank (ECB) policy rates should continue to rise. We also see upward pressure on longer-dated yields – they started to rise from a very low base and still remain deeply negative after inflation. For example, German 10y yields recently made new cycle highs and the trend remains up. On balance, inflation should actually benefit highly-leveraged European countries – it means their nominal GDP can grow faster than their debt. The spread between yields on 10y German Bunds and Italian BTPs – which is often used as the canary in the Eurozone coal mine – is currently at 181bp, well below the 250bp which would signal danger ahead.



Source: Bloomberg

European credit is not as overvalued as in the US when compared to money market yields. It is by no means cheap, but the yield advantage of short-dated sovereigns is not as clearcut as in the US.

Asia . The Bank of Japan had to intervene in record size in January to protect its cap on 10-year yields (a policy known as "yield curve control"), which meant a massive injection of liquidity which buoyed global asset markets. With inflation in Japan currently running at twice the BoJ's target, it will be interesting to see what the incoming governor does about yield curve control. As we saw in Switzerland in 2015, abandoning a cap can unleash enormous volatility. However, the Japanese have been attempting to spur inflation for many years without success – they may not want to quash it too fast, meaning that easy BoJ policy might last longer than the market expects.



Source: Bloomberg

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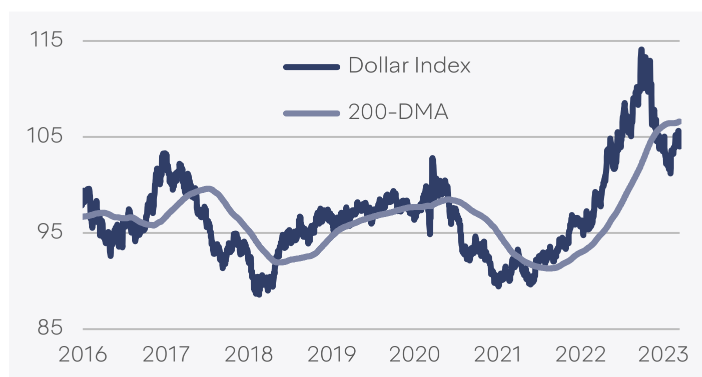
CURRENCIES

Last year's strong uptrend in the US dollar seems to have peaked last autumn when headline inflation began to undershoot forecasts.

From its peak last September, the dollar index – which measures its value against its main advanced economy trading partners – corrected sharply before regaining around 2.7% in February. With inflation running higher than expected in the US, one might think that the negative cost of shorting the Euro – the largest weight in the index – has increased, but that is not the case. Although interest-rate differentials have driven the EUR/USD cross rate for much of the time since mid-2021, that relationship appears to have broken down. The ECB also faces higher inflation than expected, its recent rate hikes have been larger than the Fed's and its members remain rather hawkish in their communication.



Source: Bloomberg

Asian currencies were among the weakest performers against the dollar over the last month. Inflation levels are generally low, as are central bank policy rates, meaning that the upward readjustment in US rate expectations driven by sticky inflation has aggravated interest rate differentials. Moreover, capital flows into China could be slowed by geopolitical tensions which have made many investors more reluctant to invest in the country, a trend which could be exacerbated by reshoring plans to invest more in Europe and the US than in Asia.

COMMODITIES

With reopening in China likely to boost demand for raw materials, we maintain our Overweight allocation to commodities.

Energy . Brent crude oil prices have traded sideways between $77 and $87 per barrel (/b) since December, well below last March's multi-year high at $128/b. This reflects the fact that the Biden administration plans to resume sales from the US Strategic Petroleum Reserve next month, that global economic growth is expected to be sluggish and that China's oil consumption still remains 500 000 barrels per day (b/d) below its December 2021 all-time high. Moreover, G7 sanctions on Russian crude exports have simply succeeded in redirecting those flows towards China and India and at discounted prices dictated by the EU-imposed $60/b cap, which has helped depress prices on global oil markets.

As we highlighted last month, we remain convinced that this setback for crude prices will prove transitory. Chinese demand will surely recover to new highs now that the economy is reopening – unlike recessions, when demand for oil stagnates but doesn't collapse, lockdowns create a bust then boom cycle. Moreover, OPEC and its allies have refused to bow to US pressure and have kept output targets low to prop up prices – Russia recently announced a 500 000/b reduction in March output to Washington's fury. In addition, 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.

Although average temperatures in Europe have fallen since January's unseasonably warm spell, the EU's natural gas storage remains plentiful, thanks to energy-saving measures by households and switching by some industrial users to alternative inputs. Storage currently stands at 57.5% of capacity, well above the 30-35% norm for this time of year. Accordingly, futures prices have collapsed and currently sit below pre-Ukraine invasion levels.

Gold . According to the World Gold Council, gold buying by central banks continued in January, with a net 31 tonnes (t) added to foreign exchange reserves. As in recent years, purchases were led by emerging economies, notably Turkey and China which purchased 23t and 15t respectively. The only prominent seller was Uzbekistan which reduced holdings by -12t. However, the rise in US bond yields and resulting dollar rally put pressure on non-interest-bearing, dollar-denominated assets like gold in February. The decline in prices in turn generated selling by holders of gold via exchange-traded funds (ETFs) – February saw sales totalling -$1.7bn, the equivalent of around -34t.

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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