WOOD MAN.

February 2024

MONTHLY HOUSE VIEWS

STRONG START

Macro

2024 got off to a strong start, in particular for the US economy. Consumer confidence surveys have shot higher, manufacturing confidence is back in expansion territory and January's jobs data suggested the labour market remains extremely resilient. The Q4 GDP report showed much stronger than expected growth and the Atlanta Federal Reserve's GDPNow tracker estimates that Q1 growth is currently running at an annualised 3.5% pace. The Eurozone economy remains sluggish – Q4 GDP was flat quarter-on-quarter – but here too there are signs of improvement. Although still in contraction territory, purchasing manager confidence in manufacturing has been improving steadily since last July while Citi's economic surprise index is back in positive territory for the first time since May 2023. The Chinese authorities have announced a number of stimulus measures in recent months but, so far, the post-lockdown recovery has proved underwhelming.

Central Banks

As highlighted last month, traders' expectations that the Federal Reserve (Fed) might cut its key rates by up to seven times this year seemed rather excessive, and a more considered assessment has emerged over the last few weeks. This has been driven by a run of strongly positive economic surprises and by insistence from Fed policy-makers that they would stick to December's projection of only three cuts – nonetheless, with six cuts still pencilled in, further downward adjustments are likely. In the Eurozone, European Central Bank (ECB) president Christine Lagarde suggested in Davos that rate cuts were possible from this summer onwards, and traders now expect six before year-end. Rate cuts are also possible in China given the country's deflationary headwinds – already, the reserve requirement ratio has been cut to free up additional bank capital for lending. The only major central bank which may tighten policy this year is the Bank of Japan (BoJ) where inflation has been above target since April 2022.

Markets

After soaring 9.2% and 4.8% in November and December, the MSCI World index of global equities recorded a more modest 1.1% gain in January with Growth stocks continuing to outperform Value. After two strong months to close the year, the Bloomberg Global Aggregate bond index shed -1.4% in January as strong economic reports led investors to reassess the likelihood of lower rates, which pushed long-dated bond yields higher. The better economic data also helped commodities to a 3.6% advance, their first in four months, thanks mainly to a 6.1% surge in Brent crude oil prices. This backdrop also helped spark a 1.9% rally in the dollar index, its first monthly advance since October.

Bottom Line

We decided to keep our overall asset allocation unchanged again this month with equity allocations towards the top of the neutral band. We expect some further upside in equities over the next few months before investors begin to fret about recession risks. Our favourite region remains the US which we prefer over Europe, which we prefer in turn over Asia. As highlighted last month, the adjustment in traders' over-optimistic rate-cut forecasts helped spark a rise in long-dated yields, which enabled us to bring our allocation to US duration (i.e., sensitivity to changes in rates) to Neutral.

Summary House Views

OUR ASSET ALLOCATION

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

Equities	We maintain equity allocations towards the upper end of the Neutral band and continue to recommend investors strike a balance between Value and Growth. We prefer the US to Europe, and Europe to Asia.	⊜
United States	We have adjusted our US allocation to achieve a better balance between Growth and Value. Quality and Growth stocks have dominated recent market performance, but their valuations are getting stretched.	⊕
Eurozone	The bear story for Eurozone equity markets is well-known. However, the markets are still cheap, still under-owned and still in an uptrend.	⊜
UK	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 Tokyo Stock Exchange's efforts to improve corporate governance and the focus on shareholders' returns combined with cheap valuations have fostered a bull run in Japanese stocks.	⊜
Emerging (EM)	The Chinese authorities have taken some measures to shore up domestic equity markets and Chinese stocks look cheap in light of expected earnings growth.	⊜

Fixed Income	Today's environment of sticky inflation, elevated policy rates, quantitative tightening and inverted yield curves will continue to prove challenging for fixed income investors.	⊖
Sovereigns	The sharp rise in policy rates and inverted yield curve have created attractive opportunities in short-dated bonds. Nonetheless, the risk of a downturn justified our decision to rebuild exposure to duration.	⊖
Duration	We have now rebuilt a Neutral allocation in duration which has both reduced our underweight compared to the market and provided a hedge against macro weakness and a Fed pivot.	↗ ⊜
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	Credit spreads have tightened to unattractive levels, especially if growth weakens which could penalise 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 and oil majors reluctant to invest in new production capacity, crude oil supply is constrained. However, fears of economic slowdown in the west keep prices rangebound.	=
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	After weakening in Q4, the rangebound dollar index rose 1.9% in January, as traders turned less optimistic on Fed rate cuts in 2024.	
EUR/USD	The conviction that the European Central Bank has finished its rate hike cycle may remove one of the single currency's supports.	=
GBP/USD	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, and the advantage conferred by the Eurozone's better budget discipline is offset by sterling's higher rates.	=
USD/JPY	The shift in official statements about yen weakness suggests that the authorities may intervene to prevent further dollar strength at some point.	=
EUR/CHF	The Swiss National Bank will keep a close eye on ECB rate hike plans – CHF strength has been to the SNB's strategy to keep inflation under control, which appears to have worked for now.	=
Emerging	EM currencies hit a new multi-decade low against the US dollar in early October and have since attempted to begin to build a base.	−

↗ Upgrade ↘ Downgrade + Overweight = Neutral − Underweight

Economic Outlook

IS IT DIFFERENT THIS TIME?

According to cynics, the most dangerous words in economics and finance are "This Time it's Different". Like much market lore, there is a kernel of truth in the saying. Economies tend to follow a regular cycle of recovery, expansion, slowdown and downturn, followed by the next recovery. But on occasion, these patterns are disrupted by a Black Swan event – one that comes as complete surprise to virtually all observers and which has an extreme impact. By that definition, the Covid-19 pandemic and the ensuing lockdowns will most probably be viewed by historians as a classic Black Swan.

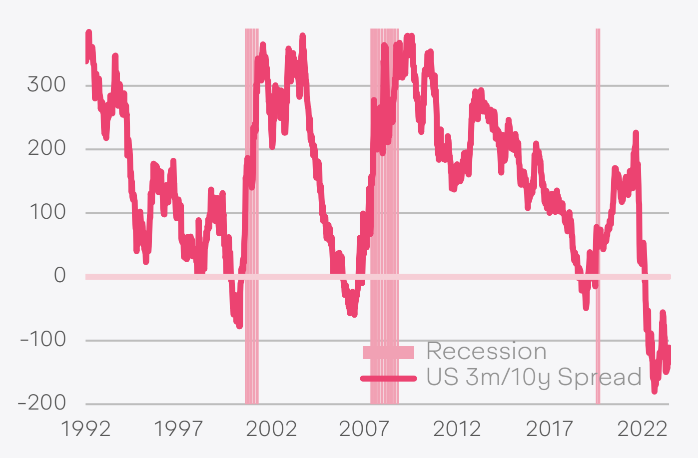
The lockdowns certainly created the most unusual recession on record, as billions of workers worldwide were forced to stay at home. Certain jobs, particularly those involving close physical proximity with colleagues or customers, became temporarily redundant overnight. Governments reached deep into their pockets to support companies and households and central banks bought vast quantities of sovereign bonds to shore up financial markets. In the US, the Government Accountability Office estimates that total Federal support amounted to $4.6 trillion (tn) (21% of the US's pre-pandemic GDP). At the same time, the Federal Reserve (Fed) accelerated its quantitative easing asset purchases, boosting its balance sheet from $4.2tn in early 2020 to a $9.0tn peak in Spring 2022.

The stimulus cheques and unemployment benefits meant that US households saw a massive surge in their liquidity. According to the Fed, their checkable bank deposits rose from less than $1.0tn in late 2029 to $4.5tn in Q3 2022. However, lockdowns meant that consumers mostly turned to consumer goods, often bought online. But the pandemic had also disrupted global supply chains leading to shortages, which encouraged wholesalers and retailers to boost their orders to suppliers.

This cocktail of excess demand, constrained supply and profligate fiscal and monetary policies ensured that 2020's recession was the shortest on record. However, demand for goods quickly waned. Purchasing managers had overordered, and consumers began to switch their spending to services as lockdowns eased. This led in turn to a collapse in business confidence among manufacturers – the Institute of Supply Management's (ISM) monthly survey has been in contraction territory since November 2022.

ISM data are a key component of a number of leading indicators of activity such as the Conference Board's Leading Economic Index, which has been in negative territory since July 2022. Other historically reliable indicators of recession have been sending similarly negative messages. For example, the yield curve has inverted ahead of all eight US recessions since the 1960s. Most recently, the US yield curve has been inverted since November 2022.

However, the economy remains robust – the Atlanta Fed's GDPNow forecasting model for Q1 suggests that growth will hit an annualised rate of 3.4%, while January's surprise 353,000 surge in new jobs shows that the job market remains extremely strong. Does this mean that the yield curve has given a false signal? Not necessarily.



Source: Bloomberg

First of all, the yield curve has provided an average 13 months of advance warning ahead of the last four recessions – the current inversion has lasted 15 months so far, still quite close to the average – and in each case, the yield curve has normalised before the recession commenced. Second, households began to draw down their excess savings in 2023. It is estimated that the bulk of the excess will have been withdrawn by Q3 this year. Third, repayments on student loans have been reinstated for 43.2 million Americans since last October, adding to the negative outlook for consumption. Fourth, outstanding credit card debt has surged by 24.7% over the past two years to an all-time high, defaults are rising and 22.9% of loan officers reported in January they are tightening standards on credit card loans.

Bottom Line

Although this cycle may have started very differently from previous examples, the excesses are working their way through the system. Meanwhile, the outlook for consumption has clouded while the ISM manufacturing survey still points to sluggish activity ahead. These notes of caution stand in sharp contrast to the optimism among market participants. With stock analysts expecting S&P 500 earnings per share to grow 9.1% this year and the index trading at 22.6x trailing earnings, markets are priced for perfection and investors do not seem prepared for any H2 slackening in economic momentum.

EQUITIES

The upward momentum in global equity markets continued to slow in January – the MSCI World index of global equities gained 1.1% after 4.8% and 9.2% in December and November respectively, leaving the index just 1.3% shy of its January 2022 all-time high. US equities outperformed Europe for the first time in three months – Europe's STOXX600 index shed -0.6%, pulled lower by a -2.0% fall in the euro against the dollar, while the US S&P500 index gained 1.6%. Both indices outperformed emerging markets which dropped -4.7% overall last month (all data in dollar terms).

US . Participation in the rally remained broad-based – the proportion of stocks trading above their 200-day moving average (DMA) remained above 70.0% at end January, close to the highest level since mid-2021. There was more dispersion between factors than in December – MSCI's US factor index for Momentum led the way with a 5.6% jump while Value, which had outperformed in December, gained only 0.4%. Five out of the eleven sectors lost ground in January, led by rate-sensitive real estate – December's big winner – which dropped -4.8% and materials which lost -3.8%. The big gains were in Quality Growth sectors like communication services, home to Meta and Alphabet, which jumped 4.5% and information technology which added 3.8%. After a strong December, small and medium-sized stocks struggled in January – the Russell 2000 small cap index dropped -3.9%.

The recent surge in prices has pushed S&P 500 valuations considerably higher, from 19.1x trailing earnings at end October to 22.6x at present. The 15.5% pace of the advance in prices since end-October has not been matched by upward revisions in forward earnings expectations, which have only risen 2.5% since then, according to Bloomberg. Moreover, the trailing valuation premium over European stocks rose sharply over the period, from 8.0 to 9.3 points. And as illustrated in our December House Views, this premium has little to do with the market-dominant positions of the Magnificent Seven stocks – US financials and utilities, for example, trade at premia of 103.3% and 77.6% respectively while US information technology stocks are at a premium of only 33.5% over their European brethren. The same holds true for factor indices - according to MSCI, US Growth stocks trade at a 41.5% premium to Europe and US Value 81.1% higher.

Europe . The bear case for European equities is well known. Economic growth is sluggish at best – real GDP only advanced by a tiny 0.1% last year compared to 2022 and the composite PMI business confidence surveys have been stuck in contraction territory since last May. As a result, corporate earnings have disappointed – according to Bloomberg, earnings for the MSCI Europe index fell -3.9% last year and are now expected to fall -1.3% in 2024. Moreover, investors have been steady sellers of European equity funds in recent quarters – apart from modest inflows to European equity funds right at the end of 2023, there have been 48 weeks of steady outflows in the past 49 according to EPFR. And finally, the geopolitical backdrop remains worrisome – the war in Ukraine has reached stalemate while the conflict in the near east looks like spilling over to the broader region with knock-on effects to supply chains and inflation from Houthi attacks on cargo ships in the Red Sea. And yet, Eurozone equity markets continue to perform satisfactorily – since bottoming in late September 2022, the STOXX 600 index has provided a 29.1% net total return versus 23.8% 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 12.9x trailing earnings versus 22.2x for its US counterpart. Moreover, European stocks are likely to pay investors a handsome 3.6% dividend yield in 2024, well above the current 3.3% yield on euro investment grade corporate bonds and the expected 1.5% yield on the MSCI US index.

Asia . Within emerging markets, Eastern Europe outperformed in January, shedding only -2.7% while Latin America slightly underperformed with a -4.8% decline. After plunging -49.0% in December after new president Javier Millei devalued the peso by -57.1% against the US dollar, Argentinian equities clawed back some of their losses with a 32.7% leap. Asia continued to lag with a -5.3% drop, dragged lower by a -10.6% nosedive in Chinese stocks, which are the largest weight in the index. The other Asian heavyweight, India, compensated somewhat edging 0.2% higher last month, the strongest return among regional markets.

Chinese authorities have taken steps in recent days to shore up the market, including replacing the stock market regulator and instructing state-controlled investors to buy up equities. It remains to be seen what effect this will have, but Chinese stocks certainly look cheap – the MSCI China index trades at 8.2x forward earnings which are expected to grow 15.3%, versus 17.8x and 6.9% for the MSCI World index.

Factors . January started with another month of strong outperformance by Growth stocks over Value, the ninth since December 2022 according to MSCI's factor indices. As is to be expected, earnings forecasts are optimistic – the consensus expects 20.2% growth this year versus a -1.6% decline for Value. But this is reflected in valuations – global Growth stocks trade at 31.1x trailing earnings versus 13.2x for Value. We continue to call for a balance between factors in portfolios.

Bottom Line

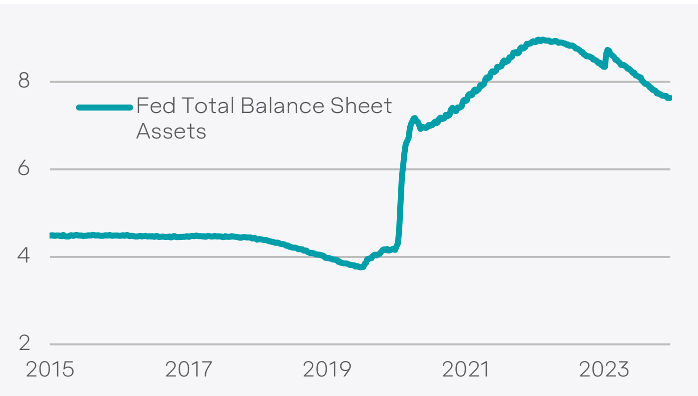
We have decided again to keep our overall equity allocation unchanged at the upper end of the Neutral band. Within that allocation, we prefer US equities to Europe, and Europe to Asia. If we are right in expecting a slowdown in H2, investors should expect more volatility later this year after what we expect to be a decent Q1.

FIXED INCOME

After gaining 5.7% last year, its first positive year in three, Bloomberg's Global Aggregate bond index was down -1.4% in January. The decline was driven by a combination of higher sovereign yields and some spread widening. As highlighted in January's House Views, the rally late last year was driven by a combination of declines in long-dated bond yields (as investors bet on economic weakness and falling inflation pushing central banks to pivot to policy easing) and of tightening credit spreads (as investors bet that economic strength would allow credit quality to improve), which we felt was not sustainable. Given the economy's strong start to the year (see page 4) and some stickiness in inflation, some further upside in yields could be on the cards.

US. After their strong year-end rally, US ten-year (10y) bond prices edged lower in January as investors began to reassess the likelihood and number of Fed rate cuts this year. In the wake of the Fed's dovish pivot at its mid-December policy meeting, investors pushed their expectations for 2024 rate cuts to between six and seven -25bp reductions by early-January, which stood in sharp contrast to the Fed's own projections of only three cuts this year. As highlighted on page 4, macro data releases have been generally positive since the start of the year, which suggests less need for rate cuts. Moreover, the communication from the Fed at its end-January meeting was clear – no rate cuts are planned for the March meeting, and any cuts are likely to come in the second half.

The US Treasury yield curve remains inverted (this is when 10y bonds yield less than 3m bills, an exception to the normal relationship between the two). After tightening from -190bp in May to -50bp in mid-October, the yield spread has now widened again to -145bp. However, bond traders may have pushed prices too far too fast. First, the market still expects six -25bp rate cuts this year, despite the Fed's protestations. Second, inflation may prove stickier than has been widely assumed – the decline in month-on-month core inflation readings has reversed since last June. Third, despite shrinking its asset holdings by -$95bn per month since late 2022, the Fed's balance sheet is still $3.4 trillion (tn) larger

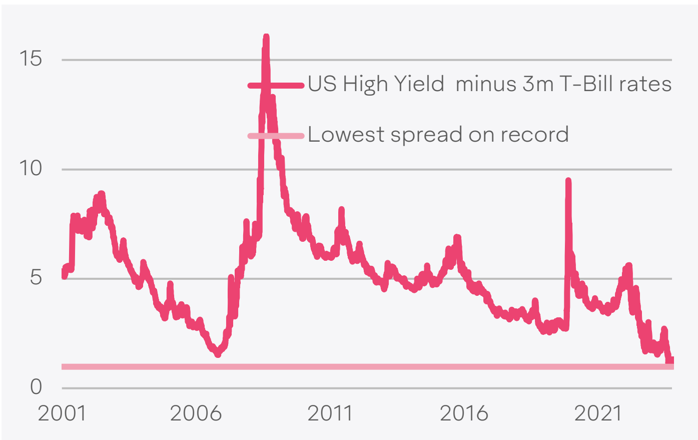


Source: Bloomberg

than before the pandemic, which suggests more selling to come. Finally, money market funds' reverse repurchase agreements with the Fed have shrunk by over -$1.7tn since last May as fund managers have switched towards Treasury bills to capture the attractive yields on offer, which has absorbed much of the massive increase in Treasury issuance. However, this process will be largely complete by mid-2024 at which point the shrinking liquidity driven by the Fed's "quantitative tightening" could start put to downward pressure on bond prices given the need to finance the administration's massive deficits.

Europe. German 10y Bund yields followed the same path as in the US, collapsing from almost 3.0% to under 2.0% over Q4. This accentuated the inversion of the 3m10y yield curve which reached -171bp in late December, the steepest level on record, before tightening modestly to -155bp at the end of January. Like the Fed, the ECB has cautioned traders about expecting too much in the way of rate cuts this year – there was no discussion of cuts at the January 25th meeting, and none are likely before the summer according to President Lagarde. Moreover, the governing council decided to wind down the reinvestment of maturing bonds in its pandemic emergency purchase programme from June onwards, which will reduce demand for eurozone sovereign bonds. Nonetheless, traders still expect around six -25bp rate cuts by year-end. Any unwinding of these bets would surely put some upward pressure on 10y yields.

Credit. As highlighted last month, the "everything rally" in November and December pulled credit spreads (the difference in yields between corporate and sovereign bonds) extremely tight across the board. However, the risk-on sentiment in markets pushed investment grade spreads down by -2bp in USD and -7bp n EUR. There was more dispersion in high yield where spreads tightened by -18bp in euros (where we identified some value last month) and widened by 21bp in dollars. Nonetheless, any second-half economic slowdown is likely to put some upward pressure on corporate spreads.



Source: Bloomberg

Bottom Line

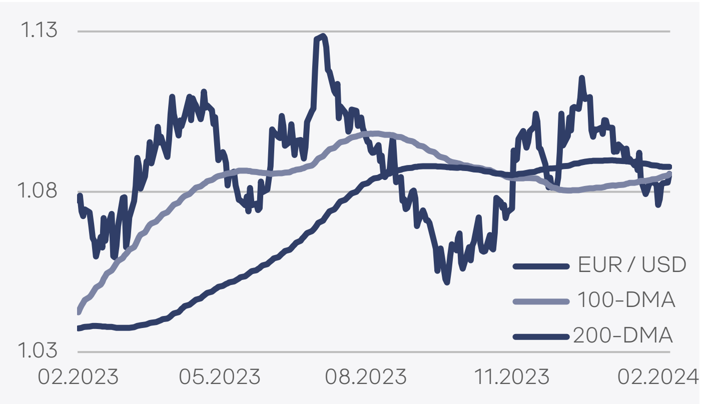
Although we remain defensive overall in our fixed income allocations, with a clear focus on high quality credit, we have now rebuilt a Neutral allocation in duration given the likelihood of some economic weakness later this year.

CURRENCIES

The rangebound dollar index rose 1.9% in January, as traders turned less optimistic on Fed rate cuts in 2024.

USD . As we suggested last month, the more hawkish noises emerging from the Fed helped the dollar index (which measures its value against its main trading partners among advanced economies) rally 1.9% in January, recovering some of the ground lost on November and December. If, as we expect, traders continue to adjust rate cut expectations lower in the weeks to come, the index could continue its rally. However, the offset between relatively high interest rates in dollars and the worsening twin deficits in the US could keep the dollar index rangebound for some time to come.

EUR . After adding 4.4% against the dollar in Q4, the euro started 2024 by shedding -2.0% in January. With the Eurozone economy showing some signs of life and traders adjusting lower the number of rate cuts they expect from both the ECB and the Fed, the euro is likely to remain rangebound against the dollar.



Source: Bloomberg

JPY . So far, the Bank of Japan (BoJ) has stuck to its negative interest rate policy, the last major central bank to do so, which has kept the currency weak against the dollar. Indeed, after shedding -7.0% last year, its third consecutive large annual fall against the greenback, the yen shed another -4.0% in January. Looking ahead, the BoJ may be emboldened to normalise policy now that inflation has been above its 2.0% target for 21 consecutive months. A shift to positive rates should strengthen the yen, especially if it coincides with Fed rate cuts.

CNY . Unlike Japan, China is battling with a bout of deflation – consumer prices fell -0.3% YoY in December – and the People's Bank of China (PBoC) has been engaged in very gradual policy easing. In late January for example, the PBoC cut major banks' reserve requirement ratio from 10.5% to 10.0%, to stimulate bank lending. However, given the sluggishness of the recovery from the zero-Covid lockdowns and the overhang of bad real estate loans, further easing is likely. Looking ahead, the CNY is unlikely to stage a rally until the economy is on a sounder footing.

COMMODITIES

Global spot commodity prices jumped 3.6% higher in December, boosted by a recovery in energy prices.

Energy . After a 32.7% surge from their mid-June low to the late-September high for the year, Brent crude prices corrected sharply by -19.2% over the fourth quarter before rallying 6.1% in January. This choppy trading has been driven by a number of factors, most notably rising geopolitical tensions in the Middle East – the retaliatory strikes by the US and the UK on Houthi rebels have raised concerns that the flow of oil from the Persian Gulf could be disrupted. Moreover, the OPEC+ cartel's decision in late November to extend and increase output cuts was designed to keep supply tight in light of fears of economic weakness leading to lower energy demand.

The rebound in economic optimism since late December combined with these output cuts to spark January's rally in crude prices. However, the outlook for oil remains uncertain. According to the International Energy Agency (IEA) January report, global oil demand growth slowed to only 1.7 million barrels per day (mb/d) year-on-year in Q4, down from 3.2mb/d in Q2 and Q3, and is projected to slow further to 1.2mb/d this year. Moreover, world oil supply is forecast to rise to a new high of 103.5mb/d in 2024, thanks to surging output from the US, Brazil, Guyana and Canada – in contrast, the IEA expects no increase in OPEC+ production this year. All in all, crude prices should continue to trade in a wide band this year.

Gold . Gold prices shed -1.1% in January after a stellar 13.1% gain in 2023. Since late November, gold has generally traded above $2,000 per ounce, and indeed hit an all-time high at $2,077 per ounce in late December. The previous peaks above $2,000 – in August 2020, August 2022 and March 2023 – were all short-lived, but gold's resilience in this latest break-out attempt looks encouraging. In addition, it comes against a backdrop of dollar strength and rising bond yields – gold is 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 not attracted buyers of gold-backed ETFs – January saw redemptions equivalent to 51 tonnes, the eighth consecutive month 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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