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October 2024

MONTHLY HOUSE VIEWS

CHINA EASES ITS POLICY MIX

Macro

Although Citi's global economic surprise index dipped in late September, it remains well above the 42-month low reached in mid-August. And the pick-up in macro surprises has prompted further improvements to consensus GDP growth forecasts – after 2025 was upgraded earlier this summer, the 2024 forecast was revised to 3.1% in September, up from 2.6% at the start of the year. Nonetheless, economic data remain mixed. JPMorgan's global purchasing manager index for manufacturing moved further into contraction territory while its sister survey for services has been stuck in expansion territory since January 2023. The US remains the strongest region while Europe continues to be held back by the recession in German industry. China's sluggish economy and depressed property market finally pushed the authorities to unveil a broad support package in late September.

Central Banks

The US Federal Reserve's (Fed) mid-September policy meeting was the monetary policy highlight last month. In the event, the central bank cut rates for the first time since 2020, by -50bp rather than the -25bp move which had been expected up until Fed chair Powell's speech at the Jackson Hole symposium in late August. Policymakers justified this move by a shift in the Fed's priorities, away from its recent focus on inflation to focus on fighting weakness in the job market. The Fed was not alone among advanced economy central banks – the Eurozone, Sweden, Switzerland and Canada all cut rates by -25bp last month, and further reductions are expected before year-end. And as part of its support measures, the People's Bank of China cut most of its key rates and also slashed the reserve requirement ratio to free up bank lending capacity.

Markets

The MSCI World index of global equities hit another all-time high at end-September after gaining 1.7% last month, its tenth increase in the last eleven months. Yet again, the rally was broad-based with only two out of eleven sectors (energy and healthcare) posting negative returns. Among factors, Quality lagged with a 0.4% gain while Growth, Value, Momentum and High Dividend Yield all added between 1.5% and 1.9% over the month. Central bank rate cuts in the wake of weak US job data for August helped bonds continue their rally with Bloomberg's Global Aggregate bond index up 1.7%, its fifth straight monthly gain. In currency markets, the greenback continued to lose ground – the dollar index shed -0.9% last month, its fourth drop in five months.

Bottom Line

Our recommended equity allocations remain unchanged at modestly Overweight. We maintain our strategy of balancing exposure to the major US technology and internet platform stocks with positions in mid-cap equities. The Chinese equity market shot higher on news of the stimulus package, and we suggest waiting for a pullback before committing new capital to the market. For now, we continue to favour US stocks. Our allocation to US duration (i.e., sensitivity to changes in rates) remains at Neutral, while credit spreads (the difference in yield between corporate and sovereign bonds) tightened further – we suggest bond investors should remain very selective.

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 Overweight territory. We 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 this year's 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	Recent macro data in the UK has shown some improvement, and the equity market has begun to catch up with its neighbours.	=
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	Recent strength in the yen against the US dollar could encourage investors to reassess the outlook for Japanese stocks which could in turn interrupt their bull run for now.	=
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	Lower inflation readings, interest rate cuts and some worries about economic growth have helped bonds rally into positive territory for the year to date. However, we continue to prefer equities.	−
Sovereigns	As bonds have rallied, the yield curve normalised, and 10-year yields have moved back above 2-year rates. Any signs of sticky inflation combined with weak macro could accelerate this move.	−
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.	=
Inflation-linked	Inflation-protected securities tend to have very high duration, making then extremely sensitive to small shifts in inflation expectations.	=
Investment Grade	Elevated policy rates and inverted yield curve have created some buying opportunities in short-dated high-quality corporate bonds. We remain Underweight nonetheless.	−
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.	−
Emerging debt (in € and $)	In recent months, we have warned that political risk in Latin America required careful monitoring. The reaction to June's presidential elections in Mexico underlined this point.	=

↗ Upgrade ↘ Downgrade + Overweight = Neutral − Underweight

Commodities	Although the long-awaited recovery in China will eventually boost demand for raw materials, worries about a slowdown in advanced economies in H2 lead us to keep allocations to commodities at 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 once the economy finally picks up. We also continue to highlight the attractions of transition metals like copper.	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 dollar index remains stuck in the wide trading range which has been in place since late 2022. After falling -0.9% in August, the index is now down -0.5% since the start of 2024.	
EUR/USD	The euro's rally from its April lows against the dollar appears to have stalled now that the Federal Reserve has commenced its rate cut cycle.	Overweight
GBP/USD	The UK's growth outlook has begun to improve despite its structural weaknesses, and the strong majority won by Labour means the country faces little political uncertainty over the next few years.	Overweight
EUR/GBP	Both currencies face numerous challenges, but the lack of political uncertainty in the UK and the country's improved economic performance have pushed sterling higher.	Neutral
USD/JPY	Global investors began to unwind some of their "yen carry trades" (constructed by borrowing in yen to invest in higher-yielding assets in foreign currencies), which could mean further upside for the yen.	Underweight
EUR/CHF	After weakening sharply from January to late May, the Swiss Franc commenced a rally which has taken it back to January's levels, despite the likelihood of further SNB rate cuts.	Neutral
Emerging	EM currencies have tracked generally sideways against the US dollar in recent months and could begin to build a base for recovery from their recent all-time lows.	Neutral

↗ Upgrade ↘ Downgrade ⊕ Overweight ⊜ Neutral ⊖ Underweight

Economic Outlook

CHINA'S "WHATEVER IT TAKES" MOMENT

In our editorials in May and July, we highlighted just how sluggish Chinese growth had become and how unlikely it was that China would resume its position as the main contributor to global growth given the authorities' focus on stabilisation rather than stimulus. Starting in late September, the government and central bank have announced a series of policy initiatives. Will they succeed or are further measures required? And what does this mean for financial markets?

The first flurry of measures was announced in late September. The People's Bank of China (PBoC) cut its key short-term reverse repo rates by between -10bp and -20bp, in order to guide the medium-term lending facility and loan prime rates lower by between -20bp to -30bp. Unusually, the central bank simultaneously cut the reserve requirement ratio (RRR, the amount of reserves banks must hold against loans) by -50bp, which freed up around CNY 1 trillion ($140bn) for new lending. Significantly, the PBoC also signalled that further RRR cuts of between -25BP and -50bp were in the pipeline.

Regarding the property market, the central bank will push commercial banks to cut the rates on existing mortgages by around -50bp on average, which should provide some relief to heavily indebted households. Furthermore, the authorities will lower the minimum down-payment for second-home buyers from 25% to 15% in the hope that this may help clear part of the backlog of unsold homes. A further support measure will come via state-owned firms which have been instructed to buy up unsold flats to turn them into affordable housing, helped by more generous financing terms from commercial banks. And finally, certain approved companies will get attractive funding to acquire land from developers, providing them with a much-needed cash inflow.

There were also specific measures to support stock prices. The securities regulator will provide support to the Central Huijin Investment state fund to expand the scope of its stock purchases. In addition, rules will be changed to encourage the launch of new equity ETFs to channel new investment into the market. And China will take a leaf out of Japan's playbook, with measures to promote corporate restructuring and M&A. Moreover, the PBoC wants to get in on the act – it will provide up to CNY 300bn ($42bn) in cheap loans to help fund stock buybacks as well as CNY 500bn ($70bn) of swaps to help finance stock-buying by brokers, funds and insurance companies.

The initial market reaction to the authorities' support measures was enthusiastic – in the two weeks following the first stimulus announcements, domestic Chinese stocks shot up by over 32.0% while the renminbi jumped to a 17-month high against the dollar. Investors had clearly been waiting for a signal from the authorities before piling back into the market. According to EPFR, investors poured $39bn into Chinese equity funds in the first week of October, accounting for almost all of that week's record $41bn inflows into all emerging market funds.

However, the measures announced so far to support the property market look designed to achieve stabilisation, not to relaunch property speculation or massive new developments. China faces a two-stage overhang of supply – first, already built homes for which buyers must be found, and second, new projects for which developers are unable to get the finance to start construction. Bloomberg estimated in May that this overhang represents a total of 60 million homes, which could take over four years to sell. Last month's measures should help move some of this inventory but are unlikely to encourage cash-strapped developers to launch new projects. This should come as no surprise – as we argued in our previous articles, the authorities want to avoid repeating the errors of the past. President Xi's mantra remains "common prosperity" backed by strong industrial output.

In addition, the economy still suffers a severe drag from deflation – recent GDP data showed that prices fell again in Q3, for the sixth consecutive quarter, the longest deflationary streak since 1999. It is no surprise therefore that consumer spending is so weak – cumulative retail sales since the start of this year are up only 3.3% year-on-year, less than half the 6.8% growth recorded at the same point last year.

Nonetheless, the last month's support measures look likely to have a lasting impact on investor sentiment. First, they should reduce the risk of another downward spiral in the property market by setting in place the mechanisms to gradually absorb the overhang of unsold or unbuilt houses. Second, authorities have given a strong hint that they did not want equity prices to fall below mid-September's five-year low, which suggests that further weakness in equity markets could be met with further support measures.

Finally, even after the recent rally, Chinese equities do not look overpriced. The CSI300 index of onshore stocks currently trades at 13.4x forecast earnings versus 21.6x and 28.7x for the S&P500 and Nasdaq Composite respectively. And Chinese earnings growth expectations at 21.1% compare favourably with 14.4% and 20.9% for the two US indices (all data from Bloomberg).

Bottom Line

China policy support does not represent a shift in strategy but rather the recognition that further economic weakness could imperil President Xi's long-term plan to rebalance the economy away from over-reliance on debt-fuelled property speculation. The support measures should bolster investor sentiment, helped by the fact that Chinese equities look attractive compared to other international markets.

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EQUITIES

The MSCI World index of global equities ended last month at another new all-time high, up 1.7% to take year-to-date returns to 17.5%. The rally was broad-based across factors – Growth, Value, High Dividend Yield and Momentum all gained between 1.5% and 1.9% while Quality lagged, adding only 0.4%. After underperforming in July and August, the very largest global companies bounced back to the top of the leaderboard – the Magnificent Seven index of the biggest US tech and internet platform companies jumped 6.4% in September. However, smaller companies also performed well – the MSCI World Small Cap index gained 1.6% last month. At the regional level, Europe underperformed the US (-0.5% versus 2.0% on the MSCI indices) while emerging markets soared 6.4% higher over the month (all data in dollar terms).

US . Participation in the rally in US equities continued to broaden in September after an initial dip, with the proportion of stocks trading above their 50-day moving average (DMA) hitting 85% at month-end, the highest level since early January. In terms of factors, Momentum and Growth led the way with gains of 3.0% and 2.5% respectively while Quality brought up the rear with a 0.9% gain. Despite the weakness in the Magnificent Seven, technology managed a 1.3% gain. At the sector level, only energy, healthcare and financials fell on the month, down -2.8%, -1.8% and -0.4% respectively. The equal-weighted version of the S&P500 index slightly out-performed its market-cap-weighted sibling in September, up 2.2% versus 2.0%. However, smaller companies underperformed again – the S&P Small Cap 600 index gained only 0.7% last month.

The rally in stock since last October has pushed S&P 500 valuations up from 19.1x trailing earnings to 24.7x. At these levels, hopes are high that analysts' optimism will prove well-founded – currently, they expect S&P500 index earnings to grow by 14.4% over the next twelve months according to Bloomberg, just ahead of the start of the Q3 earnings season. This has pushed the trailing valuation premium over European stocks to 10.3 points on MSCI data, 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 20.9%, well below consumer discretionary and financial stocks, which are 111.4% and 79.3% more expensive respectively. The same holds true for factor indices – according to MSCI, US Growth stocks trade at a 48.7% premium to Europe and US Value 82.6% higher. We continue to call for a blend of Growth and Value stocks in portfolios.

Europe . In recent years, it has been easy to be bearish on European equity markets. The macro backdrop is worrisome – business confidence in manufacturing has been stuck in contraction territory since July 2022 and the economy has only grown at an annualised 0.3% rate over the past seven quarters. The geopolitical backdrop also remains problematic – the war in Ukraine continues to drag, which has fragilized Europe's energy supplies, the deepening conflict between Israel and Iran's proxies in Gaza and Lebanon will exacerbate Europe's refugee crisis, while Houthi attacks on cargo ships in the Red Sea continue to disrupt supply chains, adding to inflationary pressures on the key Asia-Europe freight route. In addition, investors continue to shy away from European equity funds – according to EPFR, redemptions since the start of this year now total -$42.1bn. Moreover, after a run of positive macro surprises, Citi's Economic Surprise Index plunged back to its twelve-month lows when the September purchasing manager index reports were released, the third time in four months that the PMIs have disappointed. Nonetheless, European equity markets continue to perform satisfactorily – over the past two years, the STOXX 600 index has provided a net total return of 42.1% versus 44.3% for the S&P 500 in euros.

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 14.7x trailing earnings versus 25.0x for its US counterpart. Moreover, European stocks are expected to pay investors a handsome 3.3% dividend yield in 2024, more than twice the forecast 1.3% yield on the MSCI US index.

Emerging Markets . There was massive divergence among the main emerging regions last month – Latin America and Eastern Europe both fell back, by -0.1% and -2.1% respectively, while Asian markets soared 7.8%. Asia's out-performance was concentrated in the last part of September as investors reacted to China's support measures (see page 4 for further details). The CSI300 index of onshore equities skyrocketed 22.2% higher for the month, taking its performance back into positive territory for the year-to-date. However, the euphoria did not spill over to the broader region – Taiwan edged 0.7% higher while South Korea fell -1.3% (all data in dollar terms).

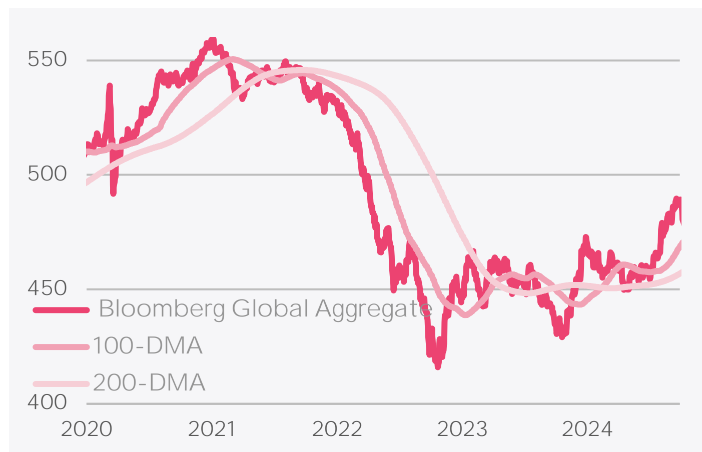
Factors . Growth stocks outperformed Value for the first time in three months according to MSCI's factor indices. As is to be expected, earnings forecasts for Value are modest – the consensus expects only 8.2% growth over the next twelve months versus 23.6% for Growth. But this is reflected in valuations – global Value stocks trade at 15.7x trailing earnings versus 33.4x for Growth.

Bottom Line

Our Investment Committee has decided to keep equity allocations unchanged for now, at modestly Overweight. Our geographic preferences remain unchanged, with the US preferred to Europe and Europe to Asia. The discrepancy between Value and Growth has become extreme and we reaffirm our suggestion to take some profits in megacap technology stocks and to add to holdings in small and mid-caps.

FIXED INCOME

Bloomberg's Global Aggregate bond index rose 1.7% in September, its fifth consecutive monthly advance, ending the month up 3.6% and just below its high for the year. As illustrated on the chart below, the index has commenced a pattern of higher highs and higher lows since its -25.7% swoon between January 2021 and October 2022.



Source: Bloomberg

US . The turning point for US financial markets came on September 11th when the inflation report for August indicated that inflationary pressures were coming under control. Coming on the back of some sluggish job market data, this left the path open for the Federal Reserve to cut rates more aggressively than had been expected, which they duly did at their monetary policy meeting the following week.

Although leading indicators like the PMI manufacturing confidence surveys are still in contraction territory, macro surprises have improved steadily since late August – Citi's economic surprise index ended last month just below zero, having been in sharply negative territory throughout July and August. US GDP is expected to grow by 2.6% in 2024 and the risks are to the upside – after 1.6% and 3.0% annualised in the first and second quarters, the Atlanta Fed's GDP Now model suggests that Q3 could see further acceleration. There are pockets of weakness – retail sales at hard discounters (known as "dollar stores") have disappointed, suggesting that lower-income households are suffering, while the unemployment rate continues to trend higher. However, liquidity remains abundant, central banks are cutting rates from multi-year highs and governments are increasing fiscal stimulus.

This environment could be bullish for rates in the medium term. The short end of the yield curve is anticipating more rate cuts from the Fed – the two-year rate touched 3.5% during September, down from 5% in May. Longer-dated yields have also fallen but not as fast – ten-year yields now sit at 3.8%, meaning that the 2y10y curve has turned positive for the first time since 2022. The return from an inversion to a positively sloping yield curve has historically been a sign of an upcoming recession. Given that inflation is back under control for the moment and that returns on cash are coming down, long term bonds offer an attractive risk-reward payoff on the short-term. However, the longer-term picture looks less interesting – federal deficits are high and rising, which will dramatically increase supply of bonds, and neither presidential candidate shows any inclination to rein in the deficit in the medium term.

Europe . In Europe, rates remain much lower and the risk-reward prospects for longer-dated bonds are less attractive. Moreover, unlike the United States, we have seen markets punish fiscally profligate countries. In 2022, the Bank of England was forced to intervene when Liz Truss's short-lived government attempted to push through unfunded tax cuts. More recently, France, which is experiencing a toxic combination of political uncertainty and out-of-control government spending, has seen borrowing costs rise above those of Spain.

China . As detailed on page 4, the month's main news came from China. The authorities have concocted a generous package, in an effort to stabilise the economy which has been suffering from the after-effects of the property crisis in recent years. Mortgage rates have been cut, the minimum down payment on second home purchases has been lowered as have banks' reserve requirement ratios. Moreover, the Ministry of Finance is planning to issue CNY 2 trillion ($280 billion) of special sovereign bonds this year. The funding should be used to stimulate consumption as well as addressing local government debt issues. The government also announced handouts and subsidies for the poorest without disclosing the total amounts.

Credit . The outlook remains positive for corporate bonds (credit), but we remain cautious on special situations where some companies took on too much leverage during the period of low interest rates and now face punishingly high borrowing costs. Many of these issuers fall into the CCC category of bonds, which is where the most of troubled credits are to be found and where spreads over Treasuries are at the widest. Nonetheless, the situation of the large number of companies which took advantage of abundant liquidity to extend debt maturities and decrease leverage is much healthier. Moreover, high nominal growth has helped reduce these companies' debt burden, which leaves them in a strong position, especially in a context of falling rates. We remain constructive but selective.

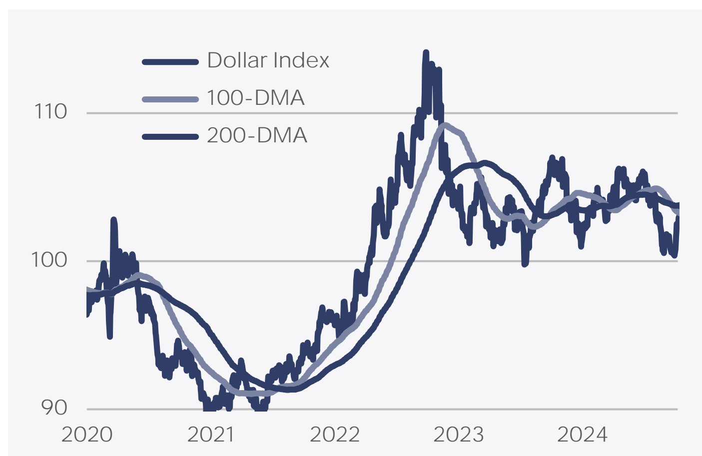
Bottom Line

Although we remain defensive overall in fixed income allocations, with a clear focus on high quality credit, we maintain a Neutral allocation in duration given the possibility of economic weakness in coming months.

CURRENCIES

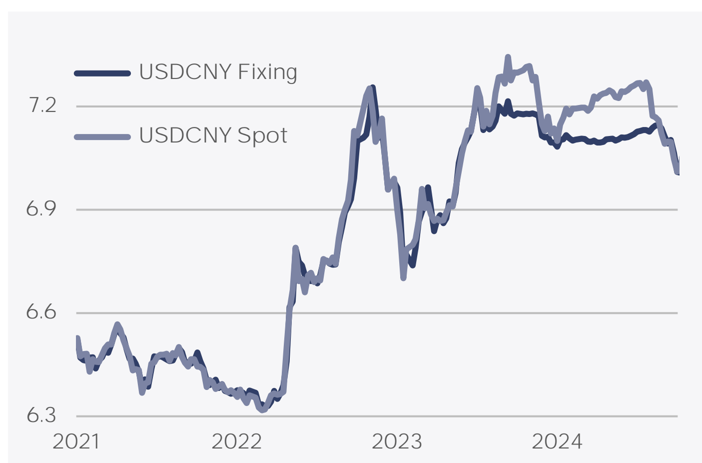
Since late 2022, the dollar index has been stuck in wide trading range between 100 and 107 points. After falling another -0.9% in September, the index has shed -0.5% this year and sits at the bottom of its range.

USD . Divergences in central bank policy put the dollar under pressure last month. The Fed cut rates by -50bp while the European Central Bank and Swiss National Bank both reduced rates by -25bp, which lowered the interest rate differential in favour of the dollar. Moreover, the Bank of Japan (which mentioned it could raise rates again in December) and the Bank of England both kept key rates unchanged. This meant that the cost of hedging dollar positions for international investors fell across the board in September.



Source: Bloomberg

CNY . Although the People's Bank of China also cut rates and looks likely to ease policy further, the CNY gained 1.0% against the dollar last month as traders expect China's wide-ranging support measures to attract investment and portfolio flows to the country.



Source: Bloomberg

COMMODITIES

Global spot commodity prices fell -0.7% in September, their fourth decline in the last five months, pulled lower by further sharp weakness in energy prices while both precious and industrial metals rose by mid-single digits.

Energy . After jumping 14.0% in the first four months of the year, Brent crude oil has tumbled, including a -8.9% drop in September which left prices down -6.8% for the year. This has taken Brent to the lower end of the broad trading range between $70 and $90 per barrel (/b) which has been in place since Q4 2022. This weakness reflects fear about Chinese demand (at least until Beijing's latest support package, see page 4) and OPEC+'s decision to allow members to gradually increase output. Moreover, the Financial Times reported in late September that Saudi Arabia was planning to drop its unofficial $100 per barrel (/b) price target and to focus policy on regaining market share.

In its September report, the International Energy Agency (IEA) highlighted the impact of China on oil demand – consumption there contracted year-on-year for the fourth straight month in July. Overall, global demand will only grow by 0.9 million barrels per day (mb/d) this year, down from 2.1mb/d in 2023 and the 0.95mb/d increase forecast for next year suggests no significant pick-up in sight. On the supply side, non-OPEC producers continue to ramp up production – Guyana and Brazil both increased output while US production averaged 13.3mb/d in September, just below August's all-time high. Overall, the IEA expects output to increase by 0.66mb/d this year before jumping 2.1mb/d in 2025, which would push the market towards oversupply and lower prices.

Gold . Gold prices jumped 5.2% in September, after hitting another new all-time high at $2'672 per ounce just before month-end, taking year-to-date performance to 27.7%. Central banks, notably in developing markets, have emerged as a significant source of demand as they seek to diversify their foreign exchange reserves away from G7 currencies. August saw a pause in buying – only 8 tonnes were added to reserves, the slowest month since March – but year-to date purchases have now reached 228t, led by Turkey, India, Poland and China which have each bought more than 30t so far this year.

At long last, retail and institutional investors have begun to participate in the bull market, as witnessed by flows in gold exchange-traded funds (ETFs). The last five months have seen uninterrupted inflows to gold ETFs totalling 120.3t, which has reduced total outflows since the start of the year to -25.5t. However, the strong rally in gold prices means that assets under management in gold ETFs ended September at an all-time high of $270.9bn, up over 25% year-to-date.

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