November 2023

MONTHLY HOUSE VIEWS

YEAR END RALLY?

Macro

Macro divergence between the US, Europe and China continued in Q3. In annualised quarter-on-quarter terms, the US recorded its best quarter since 2021 with a growth rate of 4.9% while the Eurozone declined by -0.4% and China saw year-on-year growth slip from 6.3% to 4.9%. However, leading indicators – like the shape of yield curves, tightening bank lending standards or business confidence surveys – tell us that trouble may lie ahead. These headwinds have been mitigated in part by budgetary policy, which remains broadly expansionary in advanced economies, and by healthy household cash balances. However, rising debt service costs will squeeze countries' fiscal flexibility while many US families have spent almost all their accumulated pandemic stimulus cheques.

Central Banks

Central banks' monetary policy meetings in late October and early November triggered a massive reassessment of the outlook for short-term rates, the second in as many months. Between September and October, the consensus switched from expecting a total -100bp in rate cuts from the US Federal Reserve (Fed) next year to only -50bp, and their forecast is now -100bp again. Despite Fed chair Jerome Powell sticking to his "higher-for-longer" mantra, his assertion that recent rises in Treasury yields had tightened financial conditions served to convince traders that a cut might come as early as next May. However, inflation expectations are proving sticky – swaps on where investors expect five-year average inflation to be in five years' time have ticked up from 2.5% on average in January this year to 2.8% in early November, well above the Fed's 2.0% target.

Markets

The MSCI World index of global equities dropped -3.0% in October, its third monthly decline in a row. There was little respite from other asset classes, with the Bloomberg Global Aggregate bond index down -1.2% for the month and the GSCI Spot commodity index tumbling -5.4%. The only commodities to gain ground were precious metals, led by gold which bounced 7.3%. According to Bloomberg, equity analysts expect MSCI USA earnings to grow by 9.0% over the next twelve months while MSCI Emerging Markets earnings are set to jump by 16.4%. The valuation discrepancy remains wide, with the US trading at 18.3x forward earnings versus 11.5x for emerging markets. Finally, as noted last month, global bonds, down -3.4% year-to-date, are on track to record an unprecedented third consecutive yearly decline.

Bottom Line

We decided to keep our overall asset allocation unchanged this month with equity allocations towards the top of the neutral band. Although the Q3 earnings season failed to spark the rally we expected, steady upgrades to earnings expectations for 2024 should help equity markets recover into the end of the year. Our favourite region is the US which we prefer over Europe, which we prefer in turn over Asia. At the same time, we continue to build a position in US duration (i.e., sensitivity to changes in rates) via an ETF of 7-10 year maturity Treasuries. This both reduces our underweight compared to the benchmark and hedges against a weaker economy possibly triggering a pivot in monetary policy.

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.		Neutral
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.	Upgrade	Overweight
Eurozone	The bear story for Eurozone equity markets is well-known. However, the markets are still cheap and still under-owned.		Neutral
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.		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 new central bank governor has finally commenced some modest policy tightening aimed at stabilising the yen, which could underline the attractiveness of Japanese equities.		Neutral
Emerging (EM)	The reopening of the Chinese economy has underwhelmed investors. For now, advanced economy equities in the US and Europe have more upside potential.	Downgrade	Neutral

Fixed Income	Today's environment of high 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 inverted yield curve have created attractive opportunities in short-dated Treasuries. Nonetheless, the risk of economic downturn justifies continuing to rebuild exposure to duration.	Underweight
Duration	With real yields finally back in positive territory., we have started to rebuild duration. This both reduces our underweight compared to the market and provides a hedge against macro weakness and a Fed pivot.	Underweight
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	The macro backdrop will blow headwinds against risk assets like high yield bonds, 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   Downgrade   Overweight   Neutral   Underweight

WOOD
MAN.

Commodities	With reopening in China likely to gradually boost demand for raw materials, we maintain our modestly Overweight allocation to commodities.	Overweight
Energy	With OPEC+ cutting output, China reopening and oil majors reluctant to invest in new production capacity, crude oil supply is constrained. However, fears of economic slowdown in the west keep prices rangebound.	Overweight
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 a bullish surge from July to September, the dollar index has begun to consolidate around its highs for this year.	
EUR/USD	The conviction that the European Central Bank has finished its rate hike cycle may remove one of the single currency's supports.	Neutral
GBP/USD	Although the growth outlook still looks bleak given the UK's structural weaknesses, sterling remains heavily under-valued.	Neutral
EUR/GBP	Both currencies face strikes and political challenges, 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.	Neutral
EUR/CHF	The Swiss National Bank will keep a close eye on ECB rate hike plans – CHF strength remains key to the SNB's strategy to keep inflation under control.	Neutral
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.	Underweight

Upgrade Downgrade Overweight Neutral Underweight

Economic Outlook

CHINA'S NOMINAL REALITY

In the last few weeks, the world's major economies have published their initial estimates for Q3 GDP growth, the first indication of how economies performed in aggregate last quarter. The first to report, as always, was China and, at first glance, its statistics made for encouraging reading.

September industrial production came in ahead of forecasts at a 4.5% year-on-year (YoY) growth rate versus expectations of 4.4%. Retail sales also beat consensus projections with a 5.5% increase YoY versus forecasts for 4.9%. And China's real GDP registered 4.9% growth in Q3, much better than the expected 4.5%. Quarter-on-quarter (QoQ) growth also outperformed expectations, rising 1.3% after a downwardly revised 0.5% QoQ in Q2. This good news means that China is on track to meet its 5.0% GDP growth target for this year after 4.5% and 6.3% YoY in the first and second quarters respectively. This also means however that the authorities are less likely to push ahead with big-bang stimulus measures for now.

Among the major contributors to Q3's GDP performance, consumption growth has rallied to converge with the 2017-2019 trend. Moreover, retail sales of services rose 18.9% YoY in Q3, well ahead of the 5.5% rise in sales of goods. Looking at September's data in more detail, manufacturing output grew by 5.0% YoY, outperforming both mining and utilities which recorded growth of 1.5% and 3.5% respectively. Within manufacturing, growth in vehicle and electronic production was solid – autos advanced 9.0% YoY thanks to stimulus measures, notably for electric vehicles, while electronics grew by 4.5% on the back of the roll-out of Huawei's new smartphone models. Within retail sales, there was a surge in spending on food and beverages, and better momentum in clothing and leisure goods. This came against a backdrop of falling unemployment (5.0% in September, down from 5.2% in August) and lower household savings (the savings rate reached 30% in Q3 versus 32% on average in the four years before the pandemic).

However, the picture is not quite as rosy as the headlines might suggest.

The property market remained under pressure in September. Housing sales have fallen -12.0% YoY and -9.1% year-to-date while housing starts are down -17.0% YoY. Moreover, property investment was down -11.2% YoY versus -10.9% in August. The government did announce major policy relaxation in late August which should begin to help the property market, but property developers have been severely weakened by the crisis, with some leading companies close to default on their debt obligations.

Moreover, the jobs component of the National Bureau of Statistics' recent purchasing manager index (PMI) survey of companies shows employment contracting in both manufacturing and, in particular, in services where the index hit 46.8 in September, down from 50.1 in February (PMI results are calibrated so that 50 points mark the frontier between expansion and contraction).

Another worry for China's leaders is deflationary pressure. China's September inflation data showed that (rather than edging higher to 0.2% YoY) headline CPI was unchanged last month pushing the country close to deflationary territory again. In addition, producer prices remain mired in recession (the PPI fell -2.5% YoY in September) which doesn't augur well for Chinese corporate margins. These trends were confirmed by the GDP deflator, which measures the difference between nominal and real GDP. In Q3, the data show that prices fell -1.4% YoY. The last time the deflator reached such deflationary extremes was during the Great Financial Crisis in 2008.

This means therefore that **nominal** GDP growth was lower than **real** growth (which is the measure targeted by the Chinese Communist Party). At only 3.5% YoY, nominal growth in Q3 is well below pre-Covid standards, which casts a very different light on the encouraging real growth figure. This also means that Chinese nominal growth is underperforming many advanced economies – YoY nominal GDP growth in Q3 reached 6.3% in the US, 6.4% in Japan and 6.1% in the Eurozone.

Bottom Line

Although most economists focus on real growth, which strips out the impact of changes in prices to measure underlying levels of activity, companies and households live in a world on nominal growth. And on that measure, China has fallen behind some of its direct competitors, at least for now.

From Deng Xiaoping to Hu Jintao, China's leaders were focused on economic development as a means to pull the population out of poverty and subsistence farming and into a more affluent urban lifestyle. Under Xi Jinping, the focus has shifted in favour of stability, with crackdowns on some wealthy business leaders and their companies and a refusal to over-extend leverage to stimulate the economy. With vast numbers of unemployed youths (21.3% of 16-24 year olds before statistics were suspended in June this year) and such low levels of nominal GDP growth, the key question for China is how long the pursuit of stability will be preferred to the pursuit of growth and employment.

EQUITIES

Global equities have now fallen for three straight months with the MSCI World index down -3.0% in October. European equities underperformed the US for the fifth time in six months with the STOXX 600 index dropping -3.7% while the S&P500 shed -2.2%. Emerging market equities also underperformed, with a -3.9% decline, which took the MSCI Emerging Markets index further into negative territory for the year so far with a -4.3% drop (all data in dollar terms).

US . Between and May and late July, the proportion of S&P500 index members above their 200-day moving average (DMA) rose from 41% to 76% as participation in the rally broadened. Since then, however, the proportion has tumbled to 32% as increasing numbers of stocks display deteriorating momentum. Just like in September, there were few places to hide last month – MSCI's US factor indices all lost ground, with Quality down -1.6%, Growth -1.8% and Value -3.0%, while the only sector to gain ground in October was utilities. As we have often highlighted in recent months, the overall market had become overly reliant on a very small number of mega-cap stocks, known as the "magnificent seven" (Meta, Amazon, Apple, Microsoft, Alphabet, Tesla and Nvidia). However, these stocks have now lost ground over each of the last three months, including October's -3.0% drop. At the other end of the market capitalisation scale, the Russell 2000 small-cap index plunged -6.9% last month, taking it into negative territory for the year to date (YTD) at end-October.

In general, US valuations continue to look rather demanding, especially considering that stock prices fell in October. Moreover, the sharp rise in bond yields continues to put downward pressure on valuations – Treasury yields are often used as the risk-free rate to discount future earnings, which means that higher yields beget lower valuations. On Bloomberg's data, the S&P500 index is currently trading at 20.0x trailing earnings, up from 19.5x a month ago and still well above the low-teens levels we see in Europe and Asia-Pacific. Overall valuations are skewed higher by the mega-cap growth stocks – for example, the Magnificent Seven index trades at 37.4x trailing earnings versus 13.5x for the Russell 2000 small-cap index. At the sector level, the only one trading at a single-digit multiple is energy which is at 8.9x trailing earnings whereas information technology and consumer discretionary (which include five of the magnificent seven) trade at 28.6x and 28.0x trailing earnings respectively. We continue to call for a blend of Growth and Value stocks in portfolios.

Europe . From last September until April, the STOXX600 index of pan-European large caps outperformed the S&P500 in euro terms seven months out of nine, but since May the roles have been reversed with the US index outperforming six times out of seven. This period has coincided with sustained redemptions from European funds by global investors – according to EPFR, Europe has seen 35 straight weeks of outflows, which has taken year-to-date redemptions to -$61.1bn, while the US has witnessed 34 consecutive weeks of inflows.

Negative macro news flow in recent months has combined with geopolitical uncertainties, investor selling and weak expected corporate results to put a cap on European equity markets. However, the bear case for Europe in well-known, investor sentiment is extremely depressed and expectations are uniformly low, meaning that it would take only a marginal improvement in data to wrong-foot traders. Moreover, these factors have depressed valuations to rather attractive levels – the EuroSTOXX and the STOXX600 both trade at 11.9x trailing earnings, versus 20.0x for the S&P500, and both will pay estimated dividend yields of 4.0% this year, over twice the 1.7% yield on offer in the US.

Asia . Among emerging markets, Eastern Europe stood out with a 11.2% jump last month – this was driven by the regional heavyweight, Poland, which soared after a pro-European coalition came first in the parliamentary elections. On the other hand, both Latin America and Asia lost ground, shedding -4.9% and -4.0% respectively. Within Asia, the only emerging bourses still in positive territory for the year are tech-heavy Taiwan and India, up 8.7% and 6.0% respectively (all data in dollar terms).

Much of India's outperformance is due to its growth advantage. It has a young population (median age, 28.2 years versus 39.0 for China), the world's largest population and competitive labour costs (average salaries are almost five times lower than in China according to the Reshoring Institute). The consensus among economists expects 6.2% growth next year versus 4.5% in China and forward earnings growth for the MSCI India index is set at 26.8%, slightly faster than MSCI China's 22.1%. However, this is amply reflected in valuations – India trades at 20.3x forward earnings versus 9.5x for China – and investors should ensure they are well diversified across the region.

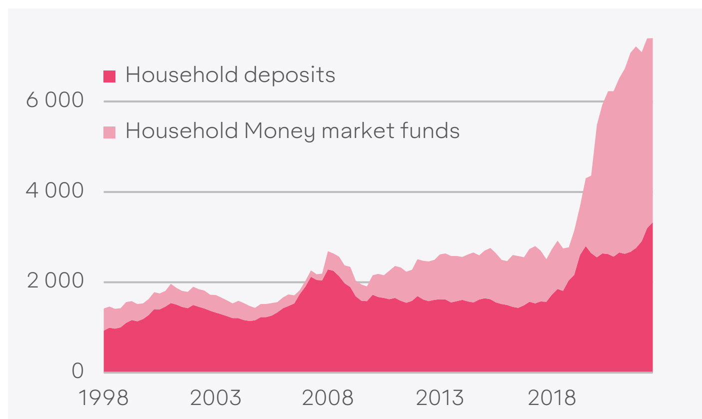
Factors . Despite outperforming Value stocks in October by -2.4% to -3.5%, global Growth stocks have underperformed since the start of the second half after dominating returns over the first six months of 2023. However, this still leaves Growth well ahead for the year so far, to the tune of 17.2% versus -3.6%. Even after the recent underperformance, the valuation discrepancy in favour of Growth still looks extreme. The MSCI World Growth index is trading at 25.4x forward earnings versus 12.5x for Value. We continue to call for a balance between factors in portfolios.

Bottom Line

As we head into the closing weeks of 2023, we have decided 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.

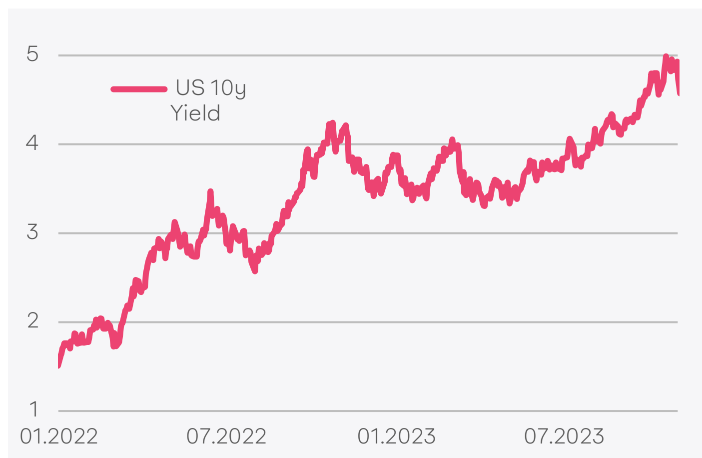
FIXED INCOME

US . The US economy surprised to the upside again last month – Q3 GDP growth was strong and leading indicators stabilised. This led to sharp increases in Treasury yields but then early November's disappointing job numbers partially reversed that trend, at least for now. Households still have substantial levels of liquidity compared to pre-pandemic levels, which should support demand for financial assets. However, estimates from JP Morgan show that this extra liquidity is now concentrated in the top 20% of households, the remainder having already depleted much of their excess savings. This helps explain why credit card delinquency is picking up progressively.



Source: Bloomberg

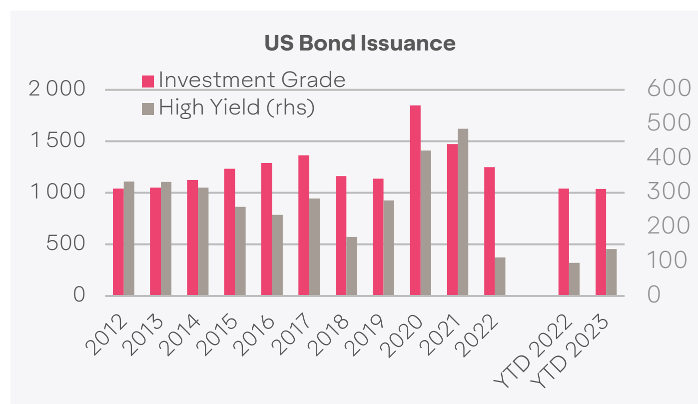
After hitting 5%, ten-year (10y) Treasury yields retraced much of their recent advance and some high-profile bond bears (who had bet that yields would rise) announced they were closing or even reversing their short positions. Given current risks to the economy such as tighter monetary policy and financial conditions, it is difficult to argue that this should be a risk-on environment. However, the bullish mindset of many investors, notably for tech stocks, suggests that policy might not yet be as restrictive as a comparison with recent history would suggest.



Source: Bloomberg

Looking at supply and demand, it is now widely recognised that the huge US fiscal deficit is set to generate a large supply of bonds. So far, the Treasury department has opted to issue mainly short term bills, which have been bought by households and money market funds. However, the additional supply in the pipeline and the steady depletion of households' cash buffers mean that the Treasury may have to seek different buyers at different maturities in coming quarters.

Credit . In the corporate bond market, we continue to find some attractive opportunities. However, we prefer to focus on shorter maturities, at least for the more speculative names, as lower government yields are likely to put some upward pressure on credit spreads. In addition, long duration high yield could have a difficult time if tighter policy pushes the economy closer to recession. On a more positive note, issuance of high yield bonds in the US has been moderate again in 2023. Moreover, we have noticed many issuers moving to reduce their leverage as higher rates make borrowing less attractive. In addition, higher nominal growth certainly helps borrowers given that, in aggregate, their EBITDA should be rising faster than the cost of servicing their fixed-rate debt.



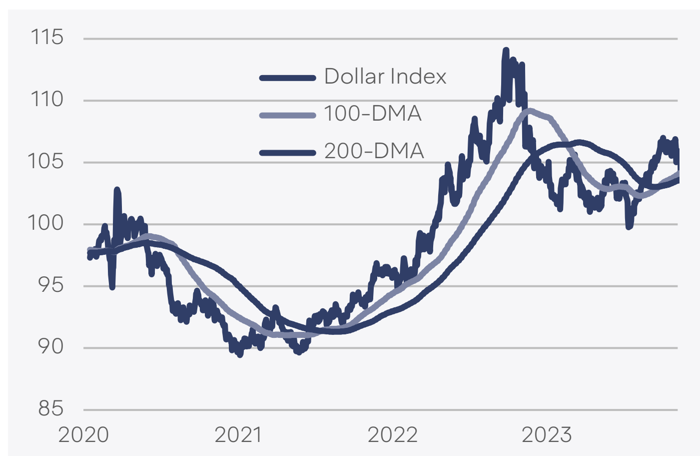
Source: Bloomberg

Bottom Line

Although we remain defensive overall in our fixed income allocations, with a clear focus on high quality credit, we have decided to continue to reduce our massive underweight in rate-sensitive bonds.

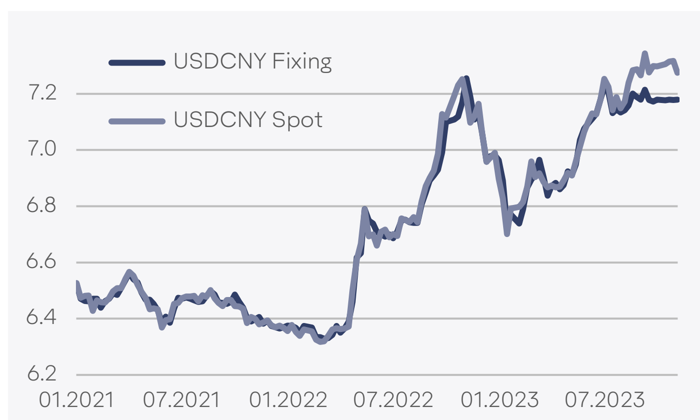
CURRENCIES

As market hopes that other central banks will pause rate hikes, the dollar index has staged a rally.



Source: Bloomberg

USD . Real rate differentials have been the major driver of currency performance so far this year. With the US economy set to remain more robust than peers, rate differentials should continue to support the dollar. However, dollar strength is a consensus trade, and the trend is getting long in the tooth, which argues for caution. For example, the Renminbi has been trading below the fixing published by the China Foreign Exchange Trading System (CFETS) since late summer. A move by the People's Bank of China to strengthen the currency would have impact on all major cross-rates given China's importance in global trade flows.



Source: Bloomberg

COMMODITIES

October saw a sharp reversal of the previous month's trend, with precious metals regaining their place as the best-performing category for the year to date.

Energy . As we noted last month, Brent crude prices were left vulnerable to a bout of consolidation after the summer surge and so the ongoing correction should have come as no surprise. After jumping 9.7% in September, Brent dropped -8.3% last month as worries about weak demand returned.

On the demand side, the International Energy Agency (IEA) highlighted in its November report that demand gains from the OECD group of advanced economies had been "slim" this year and that next year might see a contraction. However, this is not the whole picture. The IEA actually expects 2023 global demand to hit 102.0 million barrels per day (mb/d) – the highest level ever recorded – thanks to strong growth in China. Chinese demand hit 17.1mb/d in September and the country will account for fully three quarters of the forecast 2.4mb/d increase in this year's global demand.

Global supply on the other hand is set to increase by 1.7mb/d, taking this year's output to a record 101.8mb/d, which will leave the world market in slight undersupply. The growth in output – up 0.3mb/d in September – is coming mainly from the United States and Brazil. US weekly production hit a new all-time high of 13.2mb/d at the start of October and has remained there ever since. This came as something of a surprise to traders given that the rig count – the number of active drilling rigs, which acts as a leading indicator for output – has been trending lower, from a recent high of 627 last November to 494 at present. Moreover, it would appear that oil majors are keener to invest in M&A deals than in exploring and developing new oil fields – in October, ExxonMobil agreed to buy Pioneer for $60bn and Chevron announced it would acquire Hess for $53bn, two of the biggest deals in the oil patch in recent years

Gold . The quarterly data from the World Gold Council showed that central banks continue to have a "voracious" appetite for gold bullion. Q3 was the third strongest quarter on record with 337 tonnes (t) in net buying by central banks, taking year-to-date buying to 800t, a record amount for nine months. In addition, Q3 investment demand at 157t was up 56% year-on-year while jewellery demand softened -2% to 516t, bar and coin investment dropped -14% to 296t and investors redeemed -139t from gold ETFs. All in all, total quarterly gold demand reached 1147t, 8% above the five-year average. The scale and persistence of demand appear to have encouraged gold miners to ramp up production – global output rose 2% to 971t in Q3, a new record.

Gold has proved extremely resilient in the face of rising nominal and real yields – prices rose 6.4% in October despite a massive 46bp jump in 10y Treasury yields. Moreover, emerging world central banks are still keen to use gold to diversify reserves away from the US dollar, helping keep the longer-term outlook for gold prices bright.

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