January 2023

MONTHLY HOUSE VIEWS

DON'T FIGHT THE CENTRAL BANKS

Macro

Recent economic data releases have generally been much better than expected in the Eurozone. In large part, this reflects the uniformly negative sentiment surrounding Europe's Russian-energy-dependency, which has begun to look over-pessimistic with European natural gas prices now lower than before Russia's invasion of Ukraine. China's recent cancellation of its zero-Covid restrictions creates near-term uncertainties but should then usher in a period of catch-up consumption. Moreover, job markets remain robust – in the US, there are more jobs on offer than jobseekers while Eurozone unemployment is the lowest on record. Nonetheless, the International Monetary Fund has sounded a cautionary note for 2023 – it sees the US, the EU and China slowing simultaneously this year.

Central Banks

The decline in energy prices has enabled a flurry of positive headline inflation surprises in recent weeks. However, core inflation – which strips out food and energy – is still uncomfortably high at 5.2% year-on-year in the Eurozone, the highest level ever recorded. Moreover, the Atlanta Federal Reserve's (Fed) "sticky" inflation gauge – which measures those prices which are slowest to change – hit a new 40-year high in November. Against this backdrop, both the Fed and the European Central Bank (ECB) were crystal-clear in their year-end meetings. Fed policymakers think rates will remain higher for longer than markets expect, while the ECB plans "significant" rate hikes at a steady pace and a steady shrinking of its bloated bond portfolio, starting in March. Now that the Bank of Japan has inched towards tightening, the People's Bank of China is the only major central bank still easing policy.

Markets

Global stocks and bonds fell heavily last year – the MSCI World index tumbled -19.5% while the Bloomberg Global Aggregate bond index fell -16.2%, the most ever in a single calendar year. The principal culprit was inflation – 8.0% on average over the past 12 months in the US and 7.8% in the Eurozone – which forced central banks to tighten policy. This pushed bond prices lower, meaning higher yields which – when used to discount the present value of future cash flows – in turn pulled equity valuations lower. Investors seem oblivious to central banks' warnings of still higher rates, which we believe should be taken seriously. And with economists pencilling in 2023 recessions in Europe and the US, the near-term outlook does not look promising.

Bottom Line

Our overall asset allocation stance remains defensive at the start of 2023, with underweight positions in both stocks and bonds. Among equity regions, we prefer Europe to the US – valuations are cheaper and investors are generally underweight, meaning selling pressure lies behind us, not ahead. And we prefer Value stocks to Growth, especially among small and medium-sized companies. Within fixed income allocations, we continue to like short-dated bonds, which offer relatively attractive yields and reduced sensitivity to swings in key rates. After two strong years, we expect the US dollar might weaken this year against European currencies and suggest hedging exposures. Finally, the supply/demand imbalance for many commodities looks supportive, but we await price confirmation before increasing allocations.

Summary House Views

OUR ASSET ALLOCATION

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

Equities	Our overall stance remains defensive, in terms of overall allocation, geographic exposure, sector weightings and factors given the risk of downward revisions to over-optimistic 2023 earnings estimates.		⊖
United States	US equities have lagged in recent months, no doubt held back by downward revisions to earnings forecasts and still-high valuations.		⊖
Eurozone	Eurozone equity markets are cheap, under-owned and home to many undervalued defensive stocks which should provide a level of downside protection.	↗	⊜
UK	The nomination of a more conventional premier has calmed market concerns about UK debt sustainability, but the switch to austerity will do 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 central bank's switch to slightly more restrictive monetary policy has put upward pressure on the yen, which could penalise exporters.	↘	⊖
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	We recommend Neutral exposure to Commodities in light of the impending economic slowdown. Longer term, we remain constructive on crude oil and energy-transition metals.		⊜
Energy	With OPEC+ deciding to reduce its output targets and the US starting to rebuild its Strategic Petroleum Reserve, we believe that crude oil prices may be finding a floor.		⊜
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	The shift to risk-on sentiment has sparked a shift away from safe-haven currencies like the US dollar, despite its wide yield advantage.		
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.	↗	⊕
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.		⊜
EUR/GBP	Both currencies face energy and political challenges but the Eurozone's budget discipline should help the euro continue to strengthen against sterling.		⊕
USD/JPY	The recent change in Bank of Japan monetary policy stance provides some support to the beleaguered yen, which remains extremely undervalued.	↘	⊜
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.		⊜
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.	↗	⊜

↗ Upgrade ↘ Downgrade ⊕ Overweight ⊜ Neutral ⊖ Underweight

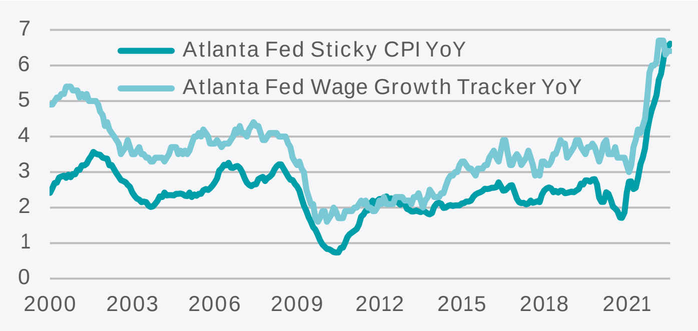
Economic Outlook

READ OUR LIPS

When investors talk about consumer price inflation (CPI) expectations, they often refer to market observations which are linked to inflation trends. For example, by subtracting the yield on Treasury Inflation-Protected Securities (TIPS) from fixed-rate Treasuries of the same maturity, we obtain the "breakeven" rate which approximates to the expected US CPI over the life of the bonds. Conversely, other investors look to inflation-linked swaps, which are derivative contracts to exchange a fixed rate for the realised inflation over the life of the contract – in the case of five-year / five-year contracts (5y5y), the average inflation rate over a five-year period starting in five years' time.

Ever since the US headline inflation rate broke above the Fed's 2% target in March 2021, there has been a marked divergence between breakevens and realised inflation. CPI hit a 40-year high in June 2022 at 9.1% whereas the high for the 10y breakeven was 3.0% and it currently trades around 2.3%. This discrepancy is generated in part by the difference in time-horizon (rolling 12-month historic inflation versus average future inflation over ten years) and in part by the fact that the bond market is subject to external influences (such as the Fed's quantitative easing and tightening) which pay little heed to inflation trends. Turning to 5y5y swaps, there has been surprisingly little pickup in inflation expectations – contracts have averaged 2.5% since March 2021 versus 2.4% over the preceding decade.

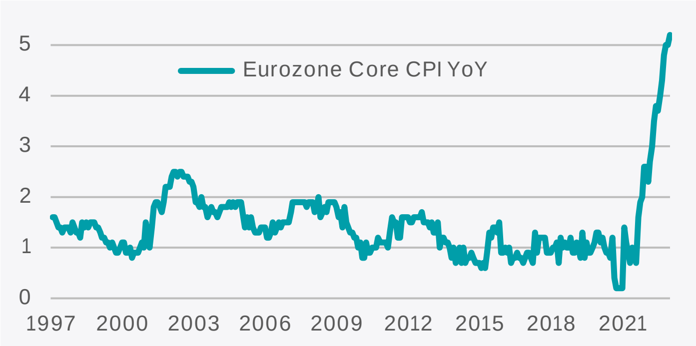
This is why we believe it is preferable to look at other measures. For example, the University of Michigan's survey of consumer expectations for one year ahead inflation has come closer to the mark, having hit its high at 5.4% in March 2022. Investors should also look at long-term drivers of CPI, such as energy prices or wages. As we argue in our report on commodities on page 7, the recent declines in crude oil and natural gas prices are unlikely to last, given China's coming emergence from its zero-Covid hibernation. And the Atlanta Fed's wage growth tracker remains uncomfortably high at 6.4% year-on-year (YoY), just below June's 6.7% all-time high – with 10.5 million jobs on offer and only 6.0m registered unemployed, companies are likely to continue to sanction higher salaries to attract and to keep staff, which they will seek to pass on to consumers via higher prices.



Source: Bloomberg

The Fed is focused on these dynamics. Chair Jerome Powell has repeatedly referred to what happened under the Volcker Fed in the early 1980s – rates were cut after the first spike in inflation began to subside, only to be yanked even higher when prices began to surge again. He does not want to repeat the mistake. Powell is also concerned by the divergence between market expectations for cuts in key rates to 4.5% by end-2023 and his own colleagues' projections of further increases to around 5.25%. He fears this has created an "unwarranted" easing in financial conditions, which might force the Fed the hike even more than currently planned.

The message from the ECB is similarly hawkish, and similarly ignored by traders. At its mid-December meeting, ECB president Christine Lagarde promised that "significant" rate hikes will continue at a steady pace, which we interpret as meaning further 50bp hikes at the ECB's next few meetings, taking deposit rates close to 4.0% by June next year. She justified this outlook by pointing to the upward revision in the ECB's inflation projections – worryingly, the first projections for 2025 show inflation still stuck above the ECB's 2.0% target. However, traders do not seem convinced – Bloomberg's probability calculator shows ECB deposit rates peaking at 3.25% next summer. Moreover, nine-month German government bills currently yield only 2.55%, which must be ringing alarm bells in Frankfurt, especially with December core inflation – which excludes volatile food and energy prices – hitting 5.2% YoY, a new all-time high.



Source: Bloomberg

Bottom Line

Most investors and traders have only experienced conditions where central banks have tended to ease policy in reaction to crises in markets, a policy known as the "Fed put". After all, the first time the put was exercised was 24 years' ago, when the Greenspan Fed cut rates by 75bp to shore up financial markets in the face of the Long Term Capital Management hedge fund implosion. However, the policy was made possible by dormant inflationary pressures – headline CPI averaged 2.1% between 1998 and 2021. Today's situation, we believe, is radically different. Investors would be well-advised to take central bankers at their word.

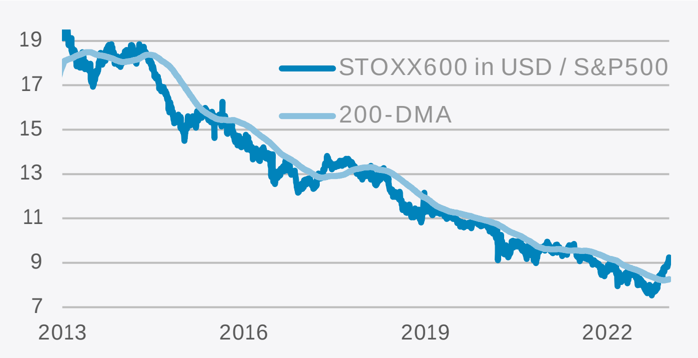
EQUITIES

The rally which took the MSCI World index briefly above its 200-day moving average ((DMA) in early December fizzled out and global equities ended up shedding -4.3% over the month and 19.5% for the year.

US . For once, the US – by far the largest global market with some 60% of total market capitalisation at end-2022 – failed to outperform the global average. As highlighted on page 1, the principal culprit was last year's nasty inflation surprise. Higher prices meant higher rates which in turn meant lower valuations. As the highest-valued among major global markets, the US is particularly vulnerable to swings in the discount rate – typically Treasury yields – used to value long-term cash-flow projections. The -20.7% fall in US equity prices last year was driven far more by the fall in the trailing price/earnings ratio (PER) – from 24.7x to 18.6x – than by the -6.9% shortfall in earnings compared to expectations.

Moreover, current valuations can hardly be described as a bargain. The trailing PERs for Europe and China are 14.9x and 11.9x respectively and both markets will pay higher dividend yields (4.4% and 3.6%) than the 1.9% on offer in the US. In addition, when we look at trend earnings over the last ten years compared to today's prices – a calculation known as the cyclically-adjusted PER – the US trades at a 61.2% premium to its historical average. Within the US market, we continue to shy away from expensively-valued tech stocks and to focus on more defensive Value segments, for example among small and medium-sized companies or in the Energy complex.

Europe . In contrast to the US – which saw $156bn of inflows into equity funds – international investors redeemed a total of -$106bn out of European equity funds last year. The pessimism is unsurprising given Europe's decade-long underperformance versus the US and widespread fears of an energy crisis after Russia's invasion of Ukraine. Paradoxically perhaps, investors can actually draw some comfort from these outflows – markets can often stage a recovery once such sustained selling pressure has dried up. Indeed, this is what seems to be happening – since reaching a low point last October, European equities have registered steady outperformance over the US (see chart). In addition, China's gradual exit from its zero-Covid policies will be a boon for many European exporters.



Source: Bloomberg

As mentioned above, European equities remain attractively valued – they currently trade at a -20.0% discount to their average forward PER over the past decade. Moreover, today's macro backdrop should favour some sectors which are particularly well represented in European indices. For example, luxury goods stocks should be prime beneficiaries of the China reopening theme, as should export-oriented Industrials. We also favour the lower market capitalisation segment which contains many under-researched gems and where expected earnings growth for 2023 is around double estimates for the STOXX 600 index.

Asia . Emerging market equities generally underperformed the major western markets last year, dragged lower by China's zero-Covid policies and the fallout from the war in Ukraine. December did see the beginnings of a reversal in trend, which could continue as Chinese reopening begins to exert its influence on demand and commerce. Moreover, Asian emerging markets – where China dominates with a 41.3% weighting – have begun to outperform the broader emerging market benchmark for the first time in many quarters. In addition, India, which represents 18.4% of MSCI's Emerging Asia index, looks appealing – the consensus expects 23.1% growth in earnings per share this year.

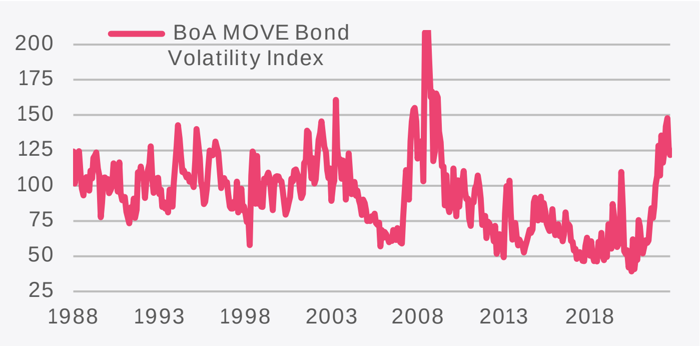
Factors . We continue to highlight the attractions of Value stocks. In times of rising yields, valuation multiples tend to come under pressure as higher discount rates on long-term Growth cash flows translate into lower estimates of present value. After a decade when Growth outperformed Value almost without interruption, 2022 saw a reversal in trend, which we expect to continue this year.

Bottom Line

Although we did increase exposure to equities last autumn, we remain defensively positioned, in terms of overall allocation, geographic exposure, sector weightings and factors. Given the macro challenges faced by companies across the globe, we believe there is a risk of downward revisions to over-optimistic 2023 earnings estimates.

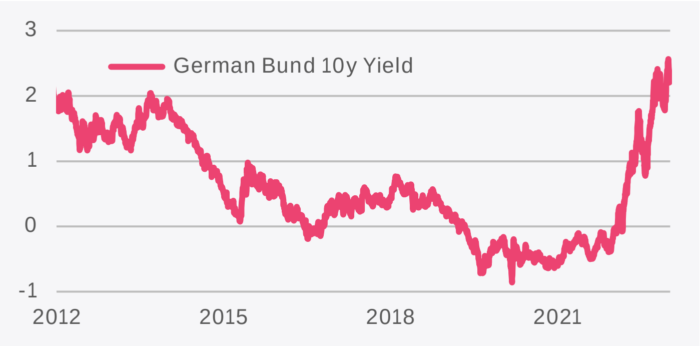
FIXED INCOME

US . Ten-year (10y) Treasury yields rose in the second half of December but still remain below the October highs. This means that the yield curve – which is obtained by subtracting 10y yields from three-month bill rates – remains deeply inverted. Although yield inversions have historically been precursors to recession – and the current inversion is the deepest since the early 1980s – economic indicators are still supportive. In any case, the Fed is not ready to stop tightening financial conditions – it needs to make sure that inflation is brought under control – which should push the whole yield curve higher. The extraordinary liquidity conditions created by the pandemic response are still with us and should continue to foster high bond volatility. The market seems to agree with us – the Move index, which measures the implied volatility on US Treasuries, remains close to its highest level since 2008's financial crisis.



Source: Bloomberg

Europe . In Europe, rates remain relatively high despite consensus forecasts of recession and signs that we might have seen the peak in inflation. This is hardly surprising given how low rates remain compared to inflation. The ECB lagged the Fed in tightening financial conditions and is now playing catch-up, with further rate increases planned in the medium term. In addition, from March onwards, they will stop reinvesting 100% of the proceeds from maturing securities they hold. This means that their balance sheet will shrink by around €15bn on average each month until June, after which reinvestments will likely shrink further.



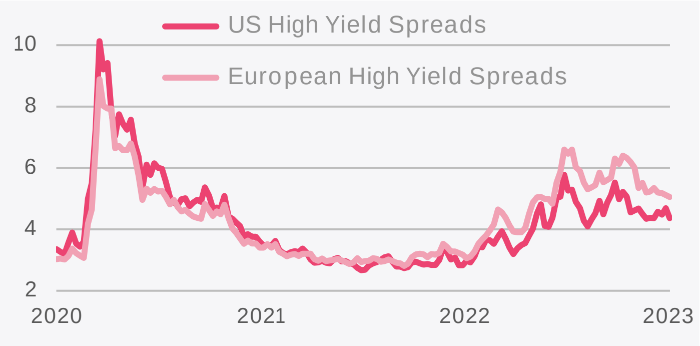
Source: Bloomberg

Asia . Both inflation and rates in China have remained low so far, but there are signs this could change. The worst for the economy looks like it's behind us – China has completely shelved its zero-Covid policy, and re-opening is likely to generate higher growth and higher inflation. Of course, in China, government interference in the economy will remain an important driver of returns – in early January, we learned that the government is planning to soften the so-called "three red lines" policy, which limits the leverage real estate companies can take on. We see such measures as supportive for the Chinese economy and, ultimately, bonds.

In December's House Views, we mentioned that the Bank of Japan (BoJ) could find its yield curve control policy untenable if inflation continued to rise, and so it proved. This policy – which limited the band within which 10y yields could fluctuate to +/-25bp around zero – was ditched in late December in favour of +/-50bp. The BoJ insists this was not a pivot from its dovish stance, but traders disagree. 30y yields – which the BoJ does not target – continued to march higher, closing the year at 1.61%, up from 0.69% at end 2021.

Credit markets . Most credit spreads – the difference in yield between corporate and sovereign bonds – continued to narrow in December, with demand boosted by a period of low issuance. Leverage for corporate issuers is also coming down thanks to strong nominal growth. According to Goldman Sachs, median leverage in the US high yield market is the lowest since 2008's financial crisis.

We continue to favour short duration bonds where we have good visibility on cash flows, as well as reduced sensitivity to higher government yields. Increases in government rates could easily offset any decrease in credit spreads. Conversely, a big move lower in long term yields would probably be triggered by recession, which would clearly be negative for credit spreads.

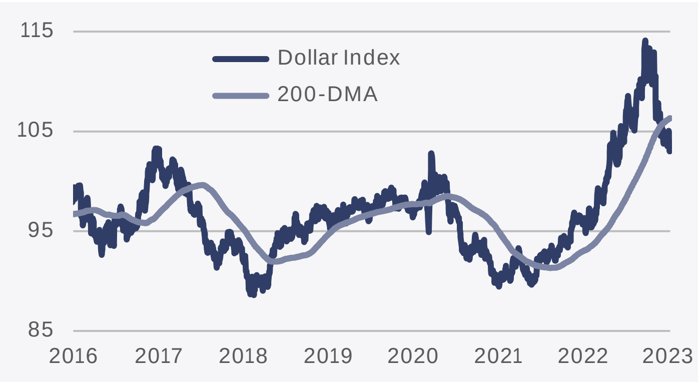


Source: Bloomberg

CURRENCIES

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

With inflation peaking, traders are betting that the Fed might be able to slow the tightening of financial conditions at a time when other central banks are having to play catch-up. The resulting narrowing in interest rate differentials would mean less support for the greenback. Valuations are also supportive – the dollar's real effective exchange rate was getting close to levels last seen just before the Plaza accords of 1985.



Source: Bloomberg

A flight to safety, which could be triggered by a global recession, would certainly push the dollar higher again. However, in the meantime, we see more downside. Trader positioning was probably skewed heavily towards the dollar in October when pessimism on Asia and Europe reached extremes. Since then, the news has improved – China is set to re-open while the worst fears about a European energy crisis have abated due to unseasonably high temperatures – which will certainly help these economies in the medium term.

Nevertheless, hedging dollar exposure remains expensive, as it still has the highest interest rates among major currencies. However, interest rate differentials with the euro are set to narrow as the ECB has turned more hawkish. Moreover, the BoJ has widened the trading band for 10y sovereign yields which marks a shift towards a more restrictive stance.

Latin America is one region where we start to see some light at the end of the tunnel. Brazil and Mexico hiked aggressively early on and now have positive real short-term rates. The region's currencies could present very attractive opportunities, but the risks warrant close monitoring, as was underlined with the riots in Brazil by supporters of former president Jair Bolsonaro.

COMMODITIES

We have kept exposure to commodities at Neutral in light of the economic slowdown. However, reopening in China is likely to boost demand for raw materials.

Energy . Since reaching their March high, Brent crude oil prices have trended steadily lower, shedding -37.5% by early January. The weakness was sparked by a number of factors. The Biden administration spent much of the year selling a substantial part of its Strategic Petroleum Reserve in order to bring prices lower. Moreover, various leading indicators like the Purchasing Manager Indices (PMI) have pointed to an economic downturn, which has persuaded traders that demand in the US and Europe is set to collapse. In addition, the G7's sanctions on Russian crude exports have proved ineffectual so far. Finally, in December's House Views, we highlighted that China's zero-Covid policy had reduced its crude oil demand by –1.3 million barrels per day, around 1.5% of global demand. Since then, the Chinese authorities have moved precipitately to remove all restrictions, sparking a surge in infections which will no doubt disrupt activity and supply chains in the near term.

We remain convinced that this setback for crude prices will prove transitory. Chinese demand will surely recover to new highs once the economy has fully reopened. Moreover, OPEC and its allies have refused to bow to US pressure and have kept output targets low to prop up prices. In addition, Russian production is unlikely to return to pre-2020 levels given Western restrictions on exports of oil field equipment. All in all, we see a lasting supply/demand imbalance which should underpin higher prices in due course.

The unseasonably warm weather which followed December's cold snap has combined with industrial shutdowns to lower European demand for natural gas. The EU's storage is currently at 83.5% of capacity, well above the 70-75% 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, last year saw the biggest purchases by central banks since 1967, some 673 tonnes. Back then, it was European central bank buying which depleted the US's reserves, which duly led to the demise of the Bretton Woods system in 1971. This time round, it is emerging markets which are leading the way, notably China and Russia as they seek to diversify their reserves away from the US dollar. According to Julius Baer research, Russian holdings of US Treasuries have fallen from $150bn in 2012 to only $2bn while its gold holdings have increased from $52bn to $132bn.

With little growth forecast in mining output and the Dollar index trending lower, solid demand could continue to push gold prices higher.

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