January 23, 2023

THIS WEEK

This Year's Big Macro Event

Recent news reports have been full of stories of waning in China, many prompted by demographic decline. Last year, China's population fell for the first time since 1961, during Mao's "Great Leap Forward" famine. Demographic trends play out over the long-term – this decline was set in motion in 1980 when China's one-child policy was introduced – but they have profound implications. After all, GDP is often defined as workforce growth multiplied by productivity.

But the sheer predictability of demographic trends has enabled China to plan for this moment, by focusing on improving productivity. According to World Bank data, 81% of China's population lived in rural areas in 1981, where subsistence farming severely limits worker productivity. By 2022, that proportion had fallen to 37%. And China has the potential to do much more – only 17% of Americans live outside urban areas. However, the incremental gains from further urbanisation will not turbo-charge growth to the same extent as in recent decades – China will have to get used to real GDP growth growing at less than 5.0% rather than the 9.1% average since 1980.

2023 is likely to prove the exception to that rule. Last year saw growth slip to only 3.0%, the worst outcome since 1976, save for the pandemic lockdowns in 2020, as China's zero-Covid policies shut down entire cities for months on end. This year – with lockdowns now in the rear mirror – will see a snap-back analogous to 2021's 8.4% spurt in GDP growth.

In part, this will be due to a base effect. 2022 ended with retail sales down -9.0% year-on-year (YoY) in December, property investment down -10.5% and industrial production up only 0.1%. But in part, it will come from stimulus measures such as the recent easing of the "three red lines" curbs on lending to property developers.

Bottom Line

China's post-zero-Covid reopening is likely to be the biggest single macro event this year. We expect the economy to follow the playbook from post-lockdown western economies – a surge in demand combined with lingering infections could create supply chain disruptions and spark inflationary pressures, notably in industrial metal and energy prices.

Equities	Last	%5D	%1M	%YTD
MSCI World	2 725.40	-0.4	5.1	4.7
S&P 500	3 972.61	-0.7	4.0	3.5
Nasdaq Composite	11 140.43	0.6	5.6	6.4
Russell 2000	1 867.34	-1.0	6.8	6.0
STOXX 600	452.12	-0.1	6.6	6.4
Euro STOXX 50	4 119.90	-0.7	8.3	8.6
SMI	11 295.02	0.0	6.0	5.3
Topix	1 926.87	1.3	1.1	1.9
MSCI EM	1 036.24	0.6	9.0	8.4
China CSI 300	4 181.53	2.6	9.2	8.0
VIX	19.85	8.2	-7.6	-8.4
V2X	18.68	7.7	-9.7	-10.5

Fixed Income	Last	5Dbp	1Mbp	YTDbp
US 2Y	4.17	-6	-8	-26
US 10Y	3.48	-2	-20	-40
German 2Y	2.58	-2	6	-19
German 10Y	2.18	1	-13	-39
Swiss 2Y	1.03	-1	-9	-19
Swiss 10Y	1.16	7	-24	-43
USD IG Spread	134	0	-13	-9
EUR IG Spread	129	-6	-15	-11
USD HY Spread	424	17	-34	-45
EUR HY Spread	468	-5	-58	-44
EM Sovereign Spread	392	-12	-10	-2

Currencies	Last	%5D	%1M	%YTD
Dollar index	102.01	-0.2	-1.9	-1.5
EURUSD	1.086	0.2	2.2	1.4
GBPUSD	1.240	1.4	1.8	2.6
USDJPY	129.6	1.4	-1.6	-1.2
EURCHF	0.999	-0.5	1.5	0.9
JPM EM FX Spot	51.09	-0.4	2.8	2.4
USDCNY	6.785	1.2	-2.5	-1.7

Commodities	Last	%5D	%1M	%YTD
GSCI Spot	616.16	1.7	4.7	1.0
Brent Crude Oil	87.63	2.8	9.6	2.0
Gold	1 926.08	0.3	5.9	5.6
Copper	9 324.00	1.5	11.6	11.4
Bitcoin	22 318.24	12.6	32.2	34.9

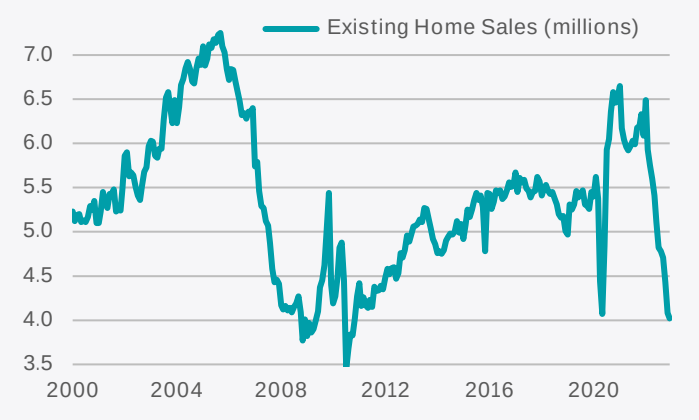
Source: Bloomberg, 20.01.2023

EQUITIES

Global . The MSCI World global equity index eased -0.4% lower last week in choppy trading, with three consecutive daily moves of +/- 1.0% or more to end the week. As we highlighted last Monday, the technical picture has improved further with the 50-day moving average (DMA) moving above the 200. The next hurdles will be for the 200-DMA to stop declining and the 100 to break higher.

US . US stocks underperformed the global average last week with the bellwether S&P500 index trading -0.7% lower. Last week's laggard sectors included Industrials, Utilities and Consumer Staples – all down around -3.0% – while Communication Services rallied 2.9% and Information Technology rose 0.8%. So it was no surprise that the NYSE FANG+ index – named after Facebook, Amazon, Netflix and Google – jumped 2.7%. On the other hand, the Russell 2000 smaller company index – home to many undervalued plays – dipped -1.0%.

US macro data continues to be mixed. For example, initial claims for unemployment benefits fell to a 17-week low – a sign of labour market resilience – while the Atlanta Federal Reserve (Fed) GDPNow model currently estimates 3.5% annualised growth in Q4. Other readings suggest less resilient activity – December's retail sales and industrial production both fell more month-on-month than expected, while existing home sales fell for the 11th consecutive month.



Source: Bloomberg

Another area of concern is the government's $31.4tn debt ceiling, which was breached last week, meaning in theory that the US will no longer be able to finance spending by issuing bonds. This is unfortunately a regular occurrence, but likely to be worsened this year by the obdurate Freedom Caucus who so delayed Republican Kevin McCarthy's recent nomination as Speaker of the House of Representatives. The Treasury will be able to use its "extraordinary measures" capabilities to give lawmakers time to strike a deal. But if none is forthcoming by early June, the risk of a technical default on Treasury securities will be on the world's front pages. And the mere fact that such standoffs have always been resolved in the past is unlikely to be of much comfort to traders.

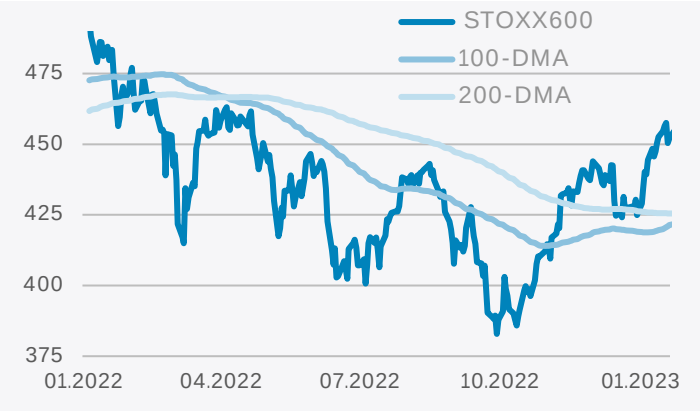
The S&P500 index finished the week 0.1% above the 200-DMA, which continues its steady decline. The 50-DMA has traded below the 200 since last March but is now rising to meet it – a breach would be a positive technical signal, although the fundamental picture looks dim. Q4 earnings-per-share growth is currently at -4.5%, which should begin to prompt downgrades to 2023 estimates.

Implied volatility. With prices falling back last week, the major implied volatility indices – the US VIX and the European V2X – both bounced higher last week. The VIX jumped 8.2% to 19.9 but remains well below the 25.7 average of the past twelve months. Low implied volatility reflects investor optimism that they don't need to pay up for option protection, and suggests a degree of complacency at these levels.

Europe . European equities outperformed again last week. The Euro STOXX 50, which covers the largest companies in the Eurozone, fell -0.7% while the STOXX600, which includes the UK and other non-euro markets, eased -0.1% lower. Moreover, the euro's 0.2% gain against the US dollar brought further comfort to international investors. Within the region, strong currencies helped the UK and Switzerland to outperform – both rose 0.4% in euro terms – while the laggards included the Netherlands and Finland, down -1.3% and -1.1% respectively.

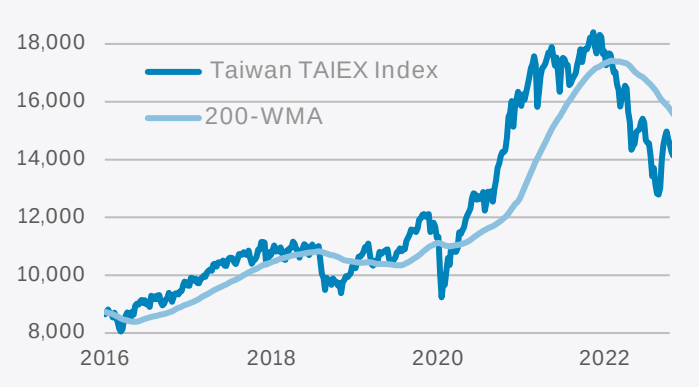
The Eurozone's recent run of positive macro surprises continues. The final consumer price inflation figure for December came in below consensus – -0.4% month-on-month against -0.3% expected – and Germany's ZEW survey of market economists bounced back into positive territory for the first time since last February. It's no surprise that Citi's index of economic surprises hit its highest level since July 2021.

In our comment on the technical picture last week, we suggested that a period of consolidation might be in order after the STOXX600's 18.1% rally from its late-September low. This may have commenced last week. If the rally is to continue, an uptick in the 200-DMA would be encouraging, as would a break above it by the 100.



Source: Bloomberg

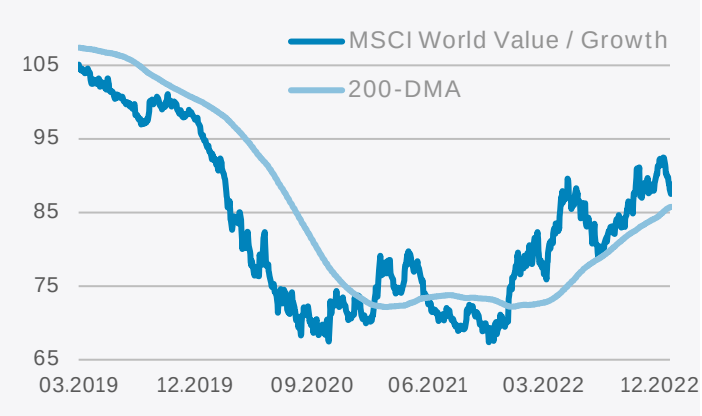
Asia . As highlighted on page 1, China's last hard data before the Lunar New Year hiatus made depressing reading. But that's all in the rear-view mirror now that zero-Covid is behind us. Indeed, mobility measures suggest the recovery has already started – passenger volumes using road transport during the Lunar New Year migration are up 65.3% YoY, air passengers up 38.1% and rail up 27.6%.



Source: Bloomberg

Asia outperformed other emerging regions last week – up 0.8% versus -0.9% in both Latin America and eastern Europe. Indonesia led the way, jumping 3.8%. Elsewhere in Asia, Australia, China Taiwan outperformed, rising 1.4%, 1.2% and 1.1% respectively, while Singapore and Thailand struggled, registering -0.2% and 0.0% (all figures in euro terms).

Style factors . Value stocks underperformed last week. The MSCI World Value index fell -0.3% while Growth stocks rose 0.6%, continuing their year-to-date (YTD) outperformance. All other factors lost ground last week High Dividend shed -1.4% while Momentum slipped -0.8% and Quality -0.3%. With bond yields tumbling sharply YTD, traders are betting on a Fed pivot to easier monetary policy and switching into the last decade's winners.



Source: Bloomberg

Bottom Line

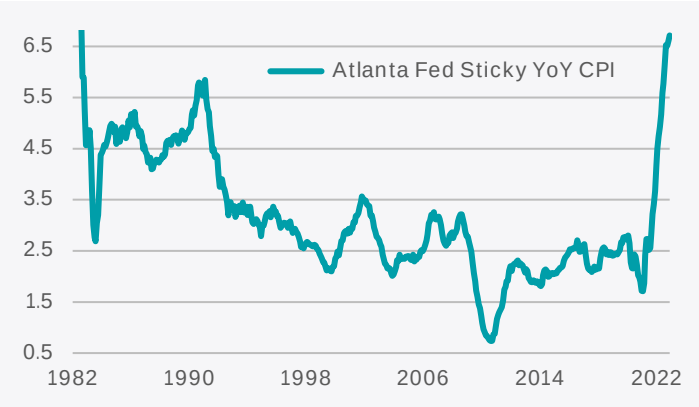
We remain relatively defensive in our allocations. We continue to believe that risks to the downside remain, given the macro challenges faced by companies across the globe, and the risk of downward revisions in 2023 earnings estimates.

FIXED INCOME

Last week saw the Bloomberg Global Aggregate Index – a proxy for diversified high quality bonds – track sideways. Nonetheless, the index has already gained 3.3% since the start of the year. Traders appear to be betting on a "Goldilocks" macro backdrop – not too hot, which might stoke wage and price pressures, and not too cold, which might mean a deep recession. We find it difficult to be so sanguine about the outlook.

US . US ten-year (10y) yields fell another -2bp last week, taking the YTD decline to -40bp. Statements from Fed policymakers fell broadly into two camps. On one side, the Fed governor Christopher Waller and Philadelphia's Patrick Harper both endorsed a downshift to 25bp hikes from February onwards. On the other, the St Louis Fed president Jim Bullard expressed a preference for 50bp to get rates above 5.0% as quickly as possible. What unites them all however is the belief that rates need to continue to rise beyond the next meeting and to stay there through to early 2024 at least. The contrast is stark with the current market consensus – according to Bloomberg's calculator, traders expect less than 50 bp in further hikes, followed by cuts in the second half.

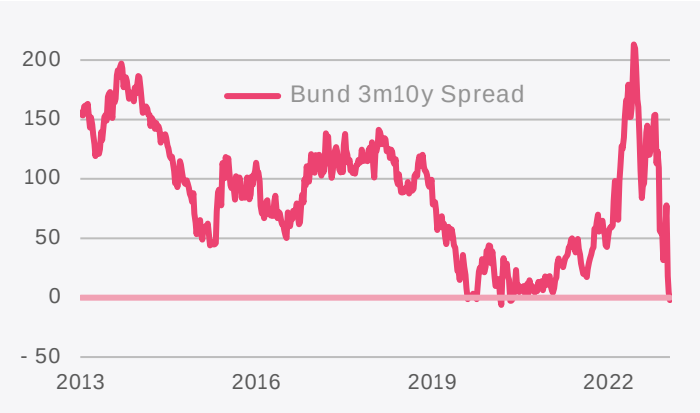
3m yields, on the other hand, rose 6bp over the week, taking the YTD increase to 29bp. As a result, the 3m10y curve accentuated its inversion by a further -8bp, taking the spread to -120bp, the lowest level since Bloomberg's records started in 1992. Inverted yield curves – when long-dated yields are lower than shorter maturities – are generally a good early-warning for recessions. However, the sharp declines in 10y Treasury yields in recent months may not be sustainable – the Atlanta Fed's sticky inflation gauge hit 6.7% in December, the highest since 1982, suggesting that inflation may not subside as far or as quickly as traders hope.



Source: Bloomberg

Europe . Talk from the European Central Bank (ECB) was similarly hawkish last week. Chief economist Philip Lane stressed in an interview with the Financial Times that the ECB now needs to bring rates into restrictive territory, implying several more hikes from today's 2.0% target rate. And ECB president Christine Lagarde was just as clear in Davos last week. She stated that inflation "by all accounts is way too high" and warned traders not to place too much hope in the ECB pivoting to slower hikes than the recent 50bp per meeting – "I would invite [markets] to revise their position, they would be well advised to do so".

The ECB comments pushed German 10y Bund yields 1bp higher last week while 3m yields gained 7bp to 2.15%. This means that the 3m10y curve is very close to inversion at only 3bp, the lowest level since the March 2020 pandemic panic. However, with the ECB set to hike by 50bp at its next meeting on February 2, there is more upside for 3m yields. And Lagarde's comments on inflation lead us to expect that 10y yields will also have to rise – Eurozone core inflation, which strips out energy and food prices, hit 5.2% in December, a new all-time high for the single currency and more than double the 2.18% available on 10y Bunds.



Source: Bloomberg

As has been the case in recent weeks, the tilt towards "risk-on" strategies has favoured Italian debt. The yield on 10y BTPs dipped below 4.0% last week, taking the BTP/Bund spread to 182bp, well below the 250bp level beyond which alarm bells begin to ring on traders' desks.

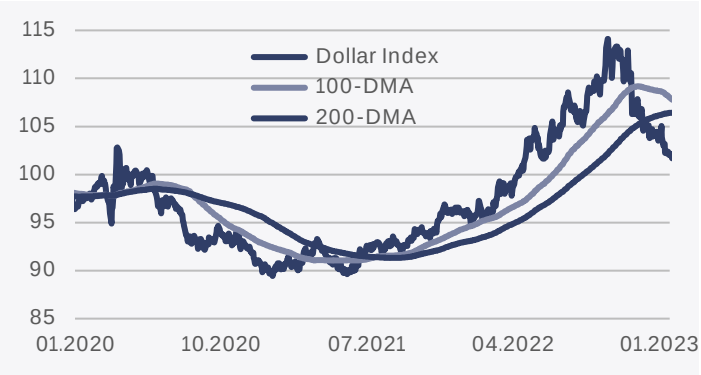
Credit markets . Last week, credit spreads – the difference in yields between corporate and sovereign bonds – generally widened in dollars and tightened in euros. The spread on USD investment grade bonds was flat at 134bp while EUR IG spreads tightened to 129bp, a new eight-month low. In the high yield segment, dollar spreads widened by 17bp, but euro spreads narrowed by -5bp. The relative resilience of EUR credit last week was no doubt helped by generally positive economic surprises.

Bottom Line

Overall, we remain defensive in our fixed income allocations. However, some value has been restored in short-dated bonds and niches such as subordinated financials.

CURRENCIES

The dollar index – which measures its value against its major trading partners among advanced economies – slipped -0.2% lower last week to its lowest level since early June 2022. This was the fifth dollar decline in the past six weeks and, for now, there is little sign of a period of consolidation. In coming weeks, the 100-DMA is likely to break below the 200, thereby accentuating the bearish technical configuration.



Source: Bloomberg

EUR . The euro gained 0.2% against the dollar last week, its eighth advance in the last nine weeks. The 200-DMA has now flattened for the first time since the dollar bull market commenced in Q2 2021, and the 100-DMA is poised to break above it in the coming weeks. The strength of the recent rally means the euro now looks somewhat overbought, which argues for a period of consolidation although the ECB's new-found hawkishness – see page 5 – is supportive of further euro strength.

GBP . Sterling jumped 1.4% last week against the dollar, its fourth consecutive weekly advance. This gain took the cross rate above the trend line from the February and December highs and has pulled the 50-DMA above the 200, which continues to trend lower for now. With the Bank of England already split on whether to continue to hike, given the stagflationary winds blowing in the UK, we would expect sterling to underperform the euro from here.

CNY . The renminbi slid 1.3% lower against the dollar, its first decline in four weeks. This comes ahead of a week-long halt in official CNY trading as China celebrates the Lunar New Year holiday. The 50-DMA has now crossed above the 100 and we would expect it to break through the 200 by mid-February, which could signal a continuation of the rally from the late-October lows.

JPY . Last week, the Bank of Japan dashed hopes that it would further widen the trading band for 10y sovereign yields (it increased the range from +/-25bp to +/-50bp at its December meeting). This means that large-scale bond purchases will continue for now, keeping policy much easier than in the US. However, the nomination of a new BoJ governor this spring is likely to mark a further hawkish shift in policy, which should limit any downside in the yen.

COMMODITIES

GSCI . With the exception of agriculture, commodity prices were generally stronger last week, driven by a bounce in energy. The GSCI spot commodity index gained 1.70% over the week, its second consecutive strong gain, taking it above the 50-DMA. However, the 100 and 200-DMAs continue to trend lower and should offer stiff resistance to further rally attempts.

Energy . Brent crude prices completed their recovery from the 8.5% slide in the first week of January to end last week up 2.0% YTD at $87.6 per barrel. Brent has now broken above the 50-DMA and now lies just below the 100. Further rally attempts will meet resistance around $97-98/b, where the October and November highs meet the 200-DMA.

The principal driving factor behind recent strength has been optimism about increased demand from China as it sheds its zero-Covid shackles. The International Energy Agency's monthly report estimated that China will account for one half of an estimated 1.9 million barrels per day (mb/d) increase in global oil demand to a new all-time high of 101.7mb/d. Moreover, there has been some easing of recession fears in the US and Europe in recent weeks.

The supply picture looks constrained this year. OPEC+ has ignored US calls for increased output to push prices lower and has stuck with the production cuts decided last year. Moreover, a combination of environmental pressures and capital-discipline constraints have encouraged major oil groups to prefer share buybacks and dividend distribution to capital expenditure in new capacity, which suggests long-term constraints on output. And finally, the US halted sales from its Strategic Petroleum Reserve just before Christmas – after reducing its size by 221mb last year – and plans to start restocking it from next month.

With the return of winter temperatures in western Europe, natural gas prices rallied 3.2% on the Dutch futures exchange last week. However, they remain down -12.3% YTD and -80.3% lower than last August's peak. Storage is at above-average levels for this time of year and massive investment in new liquid petroleum gas terminals – notably in Germany – means that the absence of imports from Russia is progressively less problematic for European consumers.

Metals . Industrial metal prices were broadly higher last week – up 1.5% on the GSCI spot index – thanks to hopes of revived Chinese demand. However, it should be noted that actual buying in volume will only start in earnest after this week's holiday. After its recent price weakness, nickel rebounded last week by 7.4%, followed by zinc and copper, which rose 2.9% and 1.5% respectively. On the other hand, iron ore prices fell -4.9% last week – after a 46.2% rally from last October's lows, a pause seems in order.

Bottom Line

The outlook for commodities looks brighter and we await an opportunity to add to positions.

AGENDA

Monday January 23rd . US December Leading Economic Index. Eurozone consumer confidence. China markets closed all week for Lunar New Year holiday.

Tuesday January 24th . Flash Purchasing Manager Indices Manufacturing, Services and Composite for US, Eurozone, UK, Germany, France and Japan.

Wednesday January 25th . US December Chicago Fed national activity index. UK December producer price inflation (PPI).

Thursday January 26th . US Q4 GDP advance estimate, personal consumption and core personal consumption expenditures (core PCE) inflation. .

Friday January 27th . Eurozone December M3 money supply data. US December personal income and spending, and core PCE, January University of Michigan consumer sentiment survey. Japan January Tokyo consumer price inflation (CPI).

Sunday January 22nd . China Lunar New Year, start of the Year of the Rabbit and week-long public holiday.