HOUSE VIEWS

JULY 2023

WAITING FOR THE PAUSE

Economic activity data has slightly disappointed, without calling into question our scenario of moderate growth this year. Recent data show a slightly less positive trend in economic activity in the United States, the Euro area, and also in China, whose post-Covid recovery remains modest. Only the United Kingdom is outperforming expectations. That said, the figures remain broadly consistent with our scenario of continued modest growth. Developed economies will continue to be underpinned by healthy labour markets and still plentiful household and corporate savings, which will continue to mitigate the impacts of inflation and monetary clampdown.

Markets are now pricing in a pause by central banks. Inflation has continued to come down rapidly, in line with producer prices, but underlying inflation is proving more stubborn against a backdrop of still-solid labour markets. Central bank policy tightening now seems to be nearing its end. Banks look ready to pause but will keep policy rates high until they see clear evidence underlying inflation is easing.

Balancing equities and fixed income to play the favourable momentum of equity markets. Our highly diverse global positioning has let us play the rally in equities since the start of the year, while retaining some protection against any fresh turbulence. Within our equity exposure, we still like European stocks, which are still riding a stronger earnings trend and trading on cheaper multiples. We also retain our Overweight to US sovereign and top-rated corporate debt because of the attractive returns being paid on both these asset classes.

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Unless specified, all figures and statistics in this report are from Bloomberg and Macrobond on 16/06/2023, publication completion date

OUR STRONGEST CONVICTIONS

We still expect a scenario of modest growth for the rest of the year

Recent indicators confirm the resilience of activity, notably in the service sectors. Higher prices and central bank tightenning will continue to weigh on developed economies. However, the continuing support provided by the labour market and Covid savings moderates these effects and reduces the risk of a sharper slowdown.

Central banks near peak but not yet pivoting

Inflation should fall substantially in coming months due to flattering energy base effects. Underlying inflation, though, will take time to come down, mainly because pressures continue to ripple out through the economy. Central banks look set to stand firm against inflation while keeping a weather eye on risks of financial instability.

Diversification plays

We remain confident in our central scenario, but risks of fresh turbulence continue to run high against the backdrop of interest rate hikes and increased geopolitical pressures. These risks argue for broad diversification, with bonds once again playing a protective role in case equity markets fall.

Preference for European and - to a lesser extent - US market equities

The European equity market continues to be more attractive, both in terms of valuation and earnings prospects. The US market would continue to benefit from a favourable momentum due to the resilience of the economy, enthusiasm for the artificial intelligence sector and the imminent end of the rate hike cycle. On the emerging equity markets, China's reopening appears to be more gradual than expected and less favourable to the markets.

The rise in interest rates makes some classes of fixed income attractive

Bond markets now seem to have priced in most of central banks' policy tightening and yields are attractive, even in real terms. We are therefore Overweight the best-rated corporate debt and US Treasury bonds.

OUR ASSET ALLOCATION

The table below presents the latest conclusions of our Global Investment Committee (GIC)

			Summary house views					
			UW	Slight UW	N	Slight OW	OW	Variation since last GIC
EQUITY		GLOBAL EQUITY			■			=
		United States			■			=
		Euro area				■		=
		United Kingdom				■		=
		Japan		■				=
		Emerging		■				=
FIXED INCOME	SOVEREIGN	GLOBAL RATES			■			=
		U.S. Treasuries				■		=
		Bunds			■			=
		Gilts			■			=
		EM Govies ($)		■				=
	CORPORATE	U.S. IG				■		=
		U.S HY		■				=
		EMU IG				■		=
		EMU HY		■				=
		U.K. IG				■		=
FOREX		EURUSD				■		=
		USDJPY				■		=
		GBPUSD				■		=
		EURCHF		■				=
ALT.		Commodities			■			=
		Gold			■			=
		Hedge funds		■				=

ECONOMIC OUTLOOK

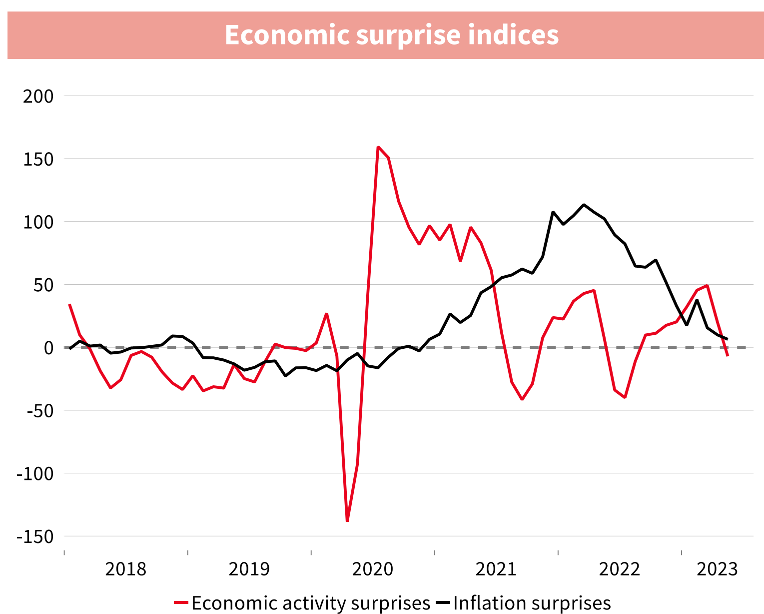
The end is near for rate hikes

Latest economic data show growth cooling off and headline inflation now clearly on the way down. So we can expect central banks to end their rate rises soon. After that, however, given our scenario of continued modest growth and underlying inflationary pressures, central banks will likely keep rates on a high plateau for several months.

We see modest growth for the rest of this year. The economic picture has been somewhat less rosy of late. China is still only managing a fragile recovery and is not driving the world economy forward as it was expected in the beginning of the year. In the United States, latest business surveys show a slowing services sector and industrial activity still bumping along the bottom. In the Euro area, revised German data shows the region fell into technical recession between Q4 2022 and Q1 2023 following last autumn's gas squeeze. While inflation and monetary tightening will continue to suppress demand in developed economies, a number of support factors remain. Improving labour markets and falling inflation are helping boost incomes, while household and business savings are mitigating the tight financial environment.

Central banks will remain watchful. Headline inflation continues to fall in the United States and Euro area, to 4% and 6.1% respectively in May. The downtrend could gather pace in coming months as production prices ease, particularly energy prices. However, underlying inflation – at 5.3% in the US and the same in the Euro area– will take time to get back to levels central banks feel happy with. The United Kingdom is a standout here, with headline and underlying inflation still running high at 8.7% and 6.8% respectively in May. Buoyant labour markets are driving wage hikes despite only small productivity gains and this is sending inflationary waves rippling through the economy. Widening company margins are another potential source of pressure on selling prices. In this environment, central banks seem to be nearing the end of their cycle of policy tightening. The Fed has already hiked rates by 500 bp, the ECB by 375 bp and the Bank of England will soon have done 450 bp. They will then adopt a wait-and-see stance until underlying inflation is clearly on the way down.

Economic surprise indices



Sources: SGPB, Macrobond, Citi 05/2023

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EQUITIES

Favorable Momentum

The world's leading equity indices continue to rally, boosted most recently by great hopes for AI. We are sticking by our Neutral position in equity markets, with a European Overweight, to keep cashing in on this favourable momentum.

Style preferences		
	Growth	**Value**
US	■	
EA		■
UK		■

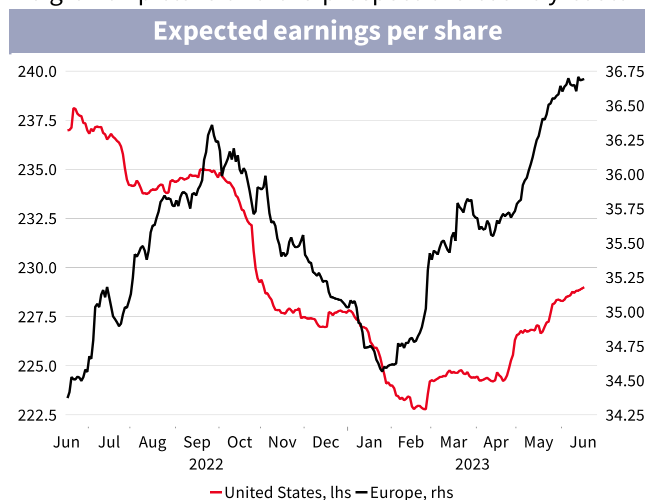
United States. United States equity markets have been booming in recent months. The S&P500 is up by more than 5% on the month and the Nasdaq 100 by 11%. These rallies largely reflect investors' enthusiasm for artificial intelligence and tech sector large caps. Outside the tech sector, market gains have been less impressive. Hopes for AI have also led analysts to upgrade their revenue forecasts. However, the market rally is out of kilter with the latest economic figures, which point to modest growth. Also, at the last meeting of the Fed's open markets committee, Chair Jerome Powell confirmed the Bank would be keeping rates high for the next few quarters. We are therefore holding at Neutral on US equities, with a preference for Growth stocks.

Euro area. Euro area equity markets continued to do well. The equity index is up 2.5% on the month, driven by Growth sectors, the AI rush and China's post-Covid reopening, which has been good news for the luxury sector. The revenue outlook continues to look healthy, helped by still substantial nominal growth in the economy. Finally, despite recent gains, stock prices remain attractive. The Price to Earnings ratio is in line with the historical average. We therefore remain Overweight Euro area equities, preferring Value stocks.

United Kingdom. Unlike other developed equity markets, the FTSE 100 fell back nearly 2%. The underperformance is explained by its heavy exposure to the energy sector, hard hit by falling commodity prices in recent months. However, we remain Overweight the British Market. It is still trading on attractive multiples. In fact, it is the cheapest developed market on earnings estimates. And strong nominal growth should be good news for those UK equities focused on the domestic market.

Japan. Japan has been the top performing developed market year to date, up 23% in local currency (14% in euros). Its rally is grounded in a "more balanced" economic growth picture and the prospect the country could effectively escape the deflation trend. Nevertheless we remain at Underweight on Japanese equities. Several indicators, including salary trends, suggest it will be some time before we can call the end of deflation, which in turn pushes back the exit from the yield curve control policy. Given the foreign exchange risk, we remain Underweight the Japanese market.

Emerging markets. We remain Underweight emerging market equities. The disappointing trend in Chinese growth since the economy reopened and major geopolitical risks continue to weigh on emerging market equities.



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FIXED INCOME

Pending the end of the tightening cycle

Central banks are nearing the end of their policy tightening cycle and likely heading for a pause. We remain Neutral on Fixed Income, but Yields remain attractive, particularly on well-rated corporate debt and US Treasuries.

Rates

Duration preferences

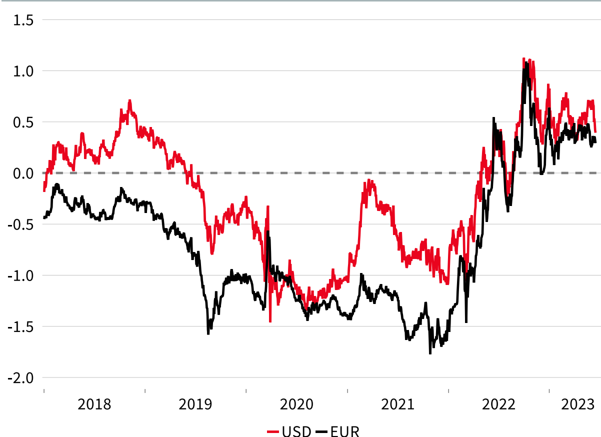
	Short term	Medium Term	Long Term
US			
EA			
UK			

United States. US Treasuries have been broadly stable all year despite spasms of volatility during the banking wobble and debt ceiling negotiations. 10-year yields are now close to 3.8% and 2-year bills are paying over 4.5%. May inflation figures confirm price rises are slowing. Headline inflation was 4% in May, its lowest since March 2021, and the underlying figure was 5.3%. The path down for inflation continues to be muddied by the ongoing resilience of the United States jobs market. New job creations remain solid, unemployment is low and wage rises have only eased slightly. Given this context, Fed committee members kept rates on hold at their June meeting. We are clearly getting near the peak of the tightening cycle, but the Fed will want to be sure underlying inflation is coming down before committing to a pause. Recessionary fears have receded of late and markets have readjusted their expectations to match, falling into line with our scenario, and now expect rates to plateau at the end of the year (vs. July previously). We remain Overweight Treasuries on grounds of their attractive real yields.

Euro area. Yields on Euro area sovereign debt have been broadly stable all year. The Bund is paying close to 2.4% and OAT yields are nearing 3%. June figures confirmed inflation is falling rapidly, thanks to better base effects and a fallback in energy prices. Inflation was 6.1% against 6.3% expected, a sharp drop from the peak seen late last year and from the prior month. Underlying inflation is running at 5.3%, still too high but showing signs of slowing down. Labour markets in the zone are still holding up. At its last monetary policy meeting the ECB hiked rates by 25 bp to 3.50-4.00%. We expect another quarter-point rise before it calls a prolonged halt. Meanwhile headline inflation is likely to continue falling steeply over coming months. Overall, we remain Neutral on Euro area sovereign debt.

United Kingdom. Gilt yields have been on the up all year, topping 4.75% at 10 years and 4.25% at 2 years. Inflation is proving stickier than in other developed economies. The headline figure is still too high, at 8.7% in April. Underlying inflation meanwhile is bowling along, increasing to 6.8% in April compared to 6.2% previously. Salary pressures remain strong, with private sector wages up nearly 8% in April and labour shortages have exacerbated these pressures since Brexit. Persistently high inflation and labour market pressures should persuade the Bank of England to continue its monetary policy tightening. In this environment, markets have upgraded their expectations for policy tightening, triggering a general rise in interest rates. Overall, we remain Neutral on Gilts.

Real rates (Interest rate swap – Inflation swap)



Sources: SGPB, Macrobond, 16/06/2023

Credit

U.S and Euro area credit. We remain Overweight investment grade corporate credits which are still paying good returns. We remain Underweight high-yield which looks risky in a higher interest rate environment.

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CURRENCIES

Closing spreads sustaining EUR and GBP

We remain Overweight the euro and sterling versus the dollar as the transatlantic monetary policy gap continues to narrow and Europe's balance of payments improves.

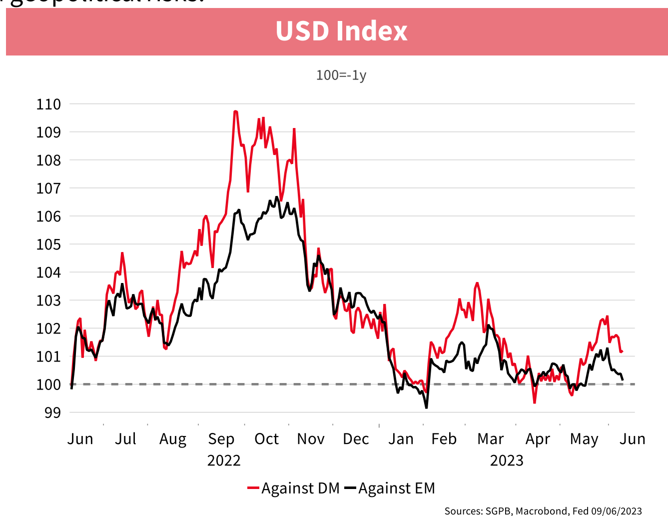
Dollar index. The dollar held broadly stable against leading developed and emerging market currencies last month. While the dollar made initial gains against major developed currencies, particularly the yen, the hawkish tone struck by central banks helped European currencies regain ground. On the emerging market exchanges, Latin American currencies continue to climb against the greenback, with the MXN and BRL up 1.5% in the past 4 weeks. But Asian currencies continue to lose ground. The CNY fell back 2.6% in an environment where Asian policy rates are lower than at the Fed and ECB.

EUR/USD. The EUR traded broadly flat against the dollar last month. The ECB is expected to keep tightening rates for some months yet, taking the deposit rate to at least 3.75% while the Fed is likely to hold steady at 5-5.25%. Rate spreads between the two currencies should therefore continue to narrow, supporting the European currency. The euro area balance of payments is also continuing to improve, with the current account back in the black and likely to stay there thanks to easing energy prices and healthy exports. We remain Overweight the EUR/USD.

GBP/USD. We remain Overweight sterling against the dollar too. The GBP rallied 1.4% against the dollar last month as the cable rate spread narrowed. The BoE should continue to raise its base rate, currently 4.5%, as headline and underlying inflation continue to trend well above target. Also, as in the Euro area, the trade balance has improved since the beginning of the year which should be good for sterling.

EUR/JPY. We remain Overweight on the EUR/JPY. The yen continues to fall against the euro as the rate gap between the two currencies has widened. Japan is, for now, sticking by its yield curve control system, in which the Bank of Japan caps the 10-year JGB yield at 0.5%. Markets expect a gradual exit from the YCC system because Japanese underlying inflation hit 4.1% in April, nominal wages are starting to rise faster than 2% and the system obliges the BoJ to keep buying sovereign bonds even though it already holds over 40% of the total outstanding.

EUR/CHF. We remain Underweight the EUR/CHF. Inflation in Switzerland remains well below that elsewhere in Europe – underlying Swiss inflation was 2%, compared to Europe's 5.3% – and this is buoying the Swiss franc. Also, the Swiss National Bank continues to tighten policy – toward a forecast terminal rate of 2% in 2023 (against 1.5% currently) – and is reducing its foreign currency reserves. In any case, the CHF retains its role as a safe haven in a context of still high financial and geopolitical risks.



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ALTERNATIVES

Low attractiveness

The high interest rate environment makes diversification into alternative classes less attractive. We have stay Neutral on Gold, and on industrial commodities, which remain strongly linked to economic growth prospects. Although hedge funds remain a valuable diversification tool, they are less attractive than fixed income products.

Commodities and Gold

Commodities. We remain Neutral on industrial commodities. Prices of industrial commodities have been declining sharply for weeks now, reflecting the disappointing signals from economic and inflation data. Crude is sliding especially fast, despite Saudi steps to prop up prices by curbing its output.

Gold. We remain Neutral on gold. Gold is currently trading at around USD 1,940/oz. Having previously taken profits on our Overweight we are staying at Neutral.

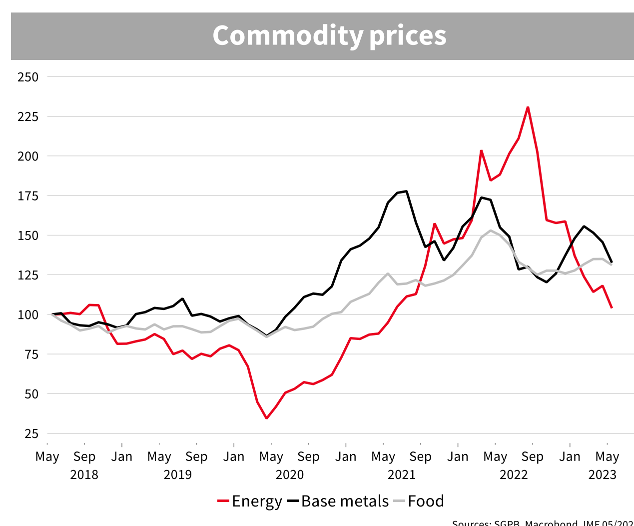
Hedge Funds

Long/Short Equity. Higher volatility and dispersions, coupled with the cycle nearing its end, should offer rich pickings for Long/Short Equity plays, at least those that follow non-directional strategies.

Event Driven. Rising interest rates are bad for M&A and make this fund category less appealing.

Fixed Income Arbitrage. With rates on the rise, there are opportunities for funds playing sovereign debt. We retain our relative interest in funds positioned in the credits segment.

Global Macro / CTA. Commodity Trading Advisers (CTAs) are still doing well out of their traditional protection against market volatility, but the current period does not seem to offer the best entry point.



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