CURMI & PARTNERS

November 17th, 2022

Monthly Strategy Update

The month in summary:

Financial markets recovered during October, offsetting some of the losses incurred in the previous month. Global equities delivered a solid 7.2% total return during the month, whilst European High Yield (+2.0%) and US High Yield (+2.6%) also registered decent returns, despite higher US bond yields. As for currencies, the Euro benefited from the more risk-on sentiment during October, whilst the British Pound recovered some of the steep losses incurred following the surprising mini-budget announcement at the end of September.

The economic backdrop weakened further in October with several data points missing economist expectations. The Global Composite Purchasing Manager Indices ("PMI") fell deeper into contraction territory, with both the manufacturing and services sector (which was previously still expanding) contracting. On balance, although the economic weakening implies a higher risk of recession, we believe that several mitigating factors could support the global economy in the coming months. This includes the resilient US labour market, which could support consumer spending. In Europe, the government support measures could help shield the customer from energy inflation, though uncertainty remains very high.

Monetary policy remained top of mind for investors, and we believe this led to the rally in risky assets in October. Central bankers insisted during September that they would do whatever it takes to tame inflation. Yet, the communication and action taken in October hinted to a possible slowdown in the tightening cycle. The Bank of Canada ("BoC") hiked rates by 50bp against market pricing of 67bp. The European Central Bank ("ECB") delivered a dovish 75bp hike, with President Lagarde noting that substantial progress in withdrawing monetary policy accommodation has been made, increasing the odds of a slow-down in the hiking pace. The Bank of England also hiked by 75bp but noted that market pricing is too hawkish. Finally, last week the Federal Reserve ("FED") hiked rates by 75bp, hinting to a possible slower pace of hikes but with a higher terminal rate peak.

Another positive during October was the weakness seen in gas prices, down c.6% month-on-month. The supply-side issues (mainly caused by low flows from Russia) has led to a surge in energy prices, a key risk for Euro-area growth in Q4 and 2023. Having said that, we do not believe that the weakness seen in October is the start of a downward trend.

Sovereign		
	MoM bp	YTD bp
US 10-year yield	22	254
DE 10-year yield	3	232
UK 10-year yield	-58	255
Credit		
Total return	MoM %	YTD %
EUR IG	0.1%	-14.5%
EUR HY	2.0%	-13.4%
USD IG	-1.0%	-19.6%
USD HY	2.6%	-12.5%
GBP IG	4.4%	-21.2%
GBP HY	2.3%	-13.7%
Equities		
LCL Total returns	MoM %	YTD %
S&P 500	8.1%	-17.7%
Nasdaq 100	3.9%	-29.3%
STOXX 600	6.3%	-13.5%
DAX	9.4%	-16.6%
CAC	8.8%	-9.9%
FTSE 100	3.0%	-0.9%
Emerging markets	-3.1%	-29.2%
EM ASIA	-6.1%	-32.1%
EM LATAM	9.7%	13.0%
EM EMEA	4.3%	-29.1%
Currencies		
Total return	MoM %	YTD %
EURUSD	0.8%	-13.1%
EURCHF	2.3%	-4.6%
GBPEUR	1.8%	-2.5%
GBPUSD	2.6%	-15.3%
Commodities		
Total return	MoM %	YTD %
Oil WTI	8.6%	21.5%
Oil Brent	9.7%	25.0%
Natural Gas	-6.1%	70.4%
Gold	-1.5%	-10.6%
Copper	-1.5%	-23.4%
Iron Ore	-15.3%	-4.6%
Lumber	9.3%	-59.8%

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Macro-economic views

The macro-economic backdrop has unsurprisingly deteriorated further in October due to a combination of additional monetary policy tightening and higher prices weighing on consumer confidence. The Global Composite PMI moved into contraction territory in August, and by October had fallen to its lowest level (49) since June 2020. The Global Manufacturing PMI has deteriorated for the past six consecutive months and has been in contraction territory since September. From the countries we follow (US, EU and UK) and China (a significant manufacturing country), the US is the only country with a manufacturing sector that is currently not contracting. It is even worse within the services sector as all countries we follow are in contraction territory. This does not bode well for economic growth over the near term.

Inflation has remained well above target for developed economies for far longer than initially expected by economists. Central banks have adopted a relatively aggressive stance to tame inflation, with FED officials lifting rates by 375bp since March. Kansas FED President George noted that with interest rate hikes there is usually a lag effect on prices that can take between six to twelve months. Therefore, since the first rate hike by the FED was just seven months ago, it is possible that the full impact of the FED's tightening policy is yet to be felt on economic activity.

In summary, the economic developments seen over the past month were generally negative in nature and risks of an economic slowdown are rising. Goldman Sachs expect the global economy to grow by 2.4% in 2023, with the Euro-area (-0.4%) and UK (-1.4%) both going into a recession. Barclays expect global growth to hit 2.1% in 2023, with the US (-0.1%), Euro-area (-1.1%) and UK (-0.3%) experiencing a slowdown.

Exhibit 1 – Consensus real GDP growth and inflation expectations

Expectations for developed economies have been revised lower over the past month, with growth of just 0.6% expected in FY23

	Consensus Forecast, % QoQ						Consensus Forecast, % YoY			Revisions since last meeting							
Real GDP, %	*3Q22F*	*4Q22F*	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F (New)*	*FY22F*	*FY23F*	*FY24F*	*3Q22F*	*4Q22F*	*1Q23F*	*2Q23F*	*3Q23F*	*FY22F*	*FY23F*	*FY24F*
United States*	2.6	0.6	-0.1	0.2	0.8	1.2	1.7	0.4	1.4	1.2	-0.4	-0.9	-0.7	-0.4	0.1	-0.4	-0.2
Japan*	1.4	1.9	0.8	0.4	-0.5	1.1	1.6	1.4	1.1	0.0	0.0	-0.4	-0.8	-1.6	0.0	-0.1	-0.1
Germany	0.7	0.2	-1.0	-0.9	-0.6	0.5	1.5	-0.6	1.6	0.0	0.0	-0.1	-0.2	-0.3	0.0	-0.4	-0.3
France	1.0	0.4	0.4	0.2	0.3	0.8	2.5	0.4	1.6	0.0	0.0	-0.2	0.0	-0.3	0.0	-0.1	-0.1
Italy	1.9	0.8	0.4	-0.5	-0.1	0.7	3.3	0.0	1.3	0.1	0.1	-0.1	-0.2	-0.2	0.0	-0.4	-0.2
Spain	3.8	1.5	1.5	0.6	1.3	1.6	4.5	1.0	2.0	-0.1	0.0	0.0	-0.6	-0.3	0.0	-0.6	-0.2
Eurozone	1.9	0.9	0.0	-0.7	-0.2	0.7	3.0	-0.1	1.5	0.1	0.0	-0.2	-0.4	-0.2	0.1	-0.3	-0.4
UK	2.2	0.3	-0.5	-0.9	-0.5	0.1	4.2	-0.4	1.2	0.0	-0.1	0.0	-0.5	-0.3	0.7	-0.2	-0.3
Developed Economies	2.0	0.9	0.3	0.2	0.7	1.2	2.5	0.6	1.6	0.2	-0.2	-0.4	-0.5	-0.3	0.1	-0.3	-0.2
China	3.9	3.8	3.5	6.7	4.7	4.4	3.3	5.0	4.9	1.3	2.7	2.9	5.9	2.9	0.0	-0.1	-0.1
Emerging Economies	3.4	2.8	2.7	5.0	4.1	4.1	3.0	4.2	4.4	0.1	0.1	-0.7	-0.6	-0.4	-0.1	-0.1	0.0
Global							2.9	2.3	2.9						0.0	-0.2	-0.1

	Bloomberg consensus forecasts								Revisions since last meeting						
Consumer prices, YoY %	*4Q22F*	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*FY22F*	*FY23F*	*FY24F*	*4Q22F*	*1Q23F*	*2Q23F*	*3Q23F*	*FY22F*	*FY23F*	*FY24F*
United States	7.3	5.9	4.2	3.6	3.0	8.0	4.1	2.5	0.1	0.1	0.2	0.4	0.0	0.3	0.1
Japan	3.0	2.4	1.7	1.2	0.8	2.3	1.5	0.8	0.1	0.0	0.0	0.0	0.1	0.1	0.0
Germany	10.5	9.0	7.2	5.8	3.6	8.4	6.2	2.4	0.4	0.4	0.5	0.1	0.2	0.7	0.2
France	6.6	6.1	4.9	4.0	3.1	5.8	4.5	2.1	0.1	0.2	0.1	0.1	0.0	0.3	0.1
Italy	9.5	7.8	6.4	4.5	2.9	7.9	5.3	1.9	0.0	0.2	0.1	0.1	0.2	0.6	0.1
Spain	8.6	6.9	5.2	3.6	3.2	8.9	4.5	2.2	0.0	0.0	-0.1	0.0	0.1	0.3	0.2
Eurozone	9.6	8.1	6.4	5.0	3.4	8.3	5.5	2.1	0.1	0.4	0.2	0.3	0.1	0.4	0.0
UK	10.3	9.7	6.4	5.2	3.5	9.0	6.3	2.6	-0.2	-0.1	0.0	0.0	0.0	-0.2	0.3
Developed Economies	8.8	7.2	5.3	4.5	3.5	8.4	4.9	2.7	0.1	0.1	0.2	0.3	0.3	0.4	0.2
China	2.7	2.8	2.4	2.3	2.0	2.2	2.4	2.2	0.0	0.0	0.2	0.1	-0.1	0.1	0.1
Emerging Economies	6.9	6.2	5.4	5.1	4.9	6.3	5.4	4.2	0.0	-0.2	0.2	0.2	0.2	0.5	0.3
Global						7.4	4.8	3.3					0.2	0.2	0.0

Source: Bloomberg (Note: QoQ figures for the US and Japan are QoQ SAAR; 3Q22 numbers for China, France, Spain and the US are actuals

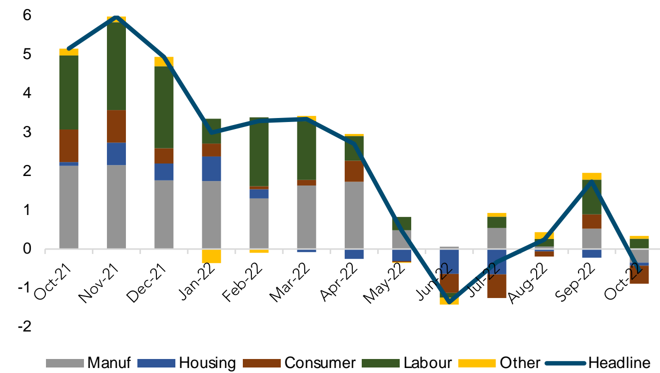
United States

Growth: The US economy expanded 2.6% during 3Q22, exceeding economist expectations and marking the first quarter of positive GDP growth in 2022. This improvement in economic activity can also be seen in GS's Current Activity Indicator ("CAI"), which showed month-on-month ("MoM") improvements through 3Q22 (Exhibit 2). Yet, activity in October seems to have somewhat stalled as headline CAI fell into negative territory, primarily as a result of weakness seen in manufacturing, consumer and labour CAI. The services PMI remained in contraction territory during October (fourth consecutive month) whilst the manufacturing sector was still expanding (Exhibit 3).

Inflation: Expectations for Inflation in the US have been revised higher during October. Economists now expect inflation to close 2023 at 4.1% (+30bp) and 2024 at 2.5%. Therefore, inflation is expected to remain above target at least until 2025, which reduces the possibility of a FED pivot over the near term unless something breaks. CPi seems to have peaked in June, but Core PCE has increased for the past 3 consecutive months (Exhibit 4). The job-workers gap (which provides some insight on demand/supply dynamics in the labour market), peaked in March at 5.9 million and has since fallen to 4.6 million (Exhibit 5). Goldman Sachs note that the job opening gap needs to fall to around 2 million for wage growth to fall to a rate compatible with the FED's inflation target.

Exhibit 2 – US Current Activity Indicator

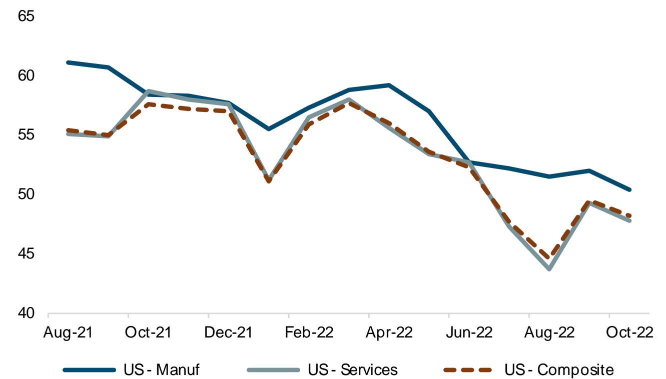
The recovery in 3Q22 was short-lived with CAI turning negative again in October…



Source: Goldman Sachs

Exhibit 3 – US PMIs

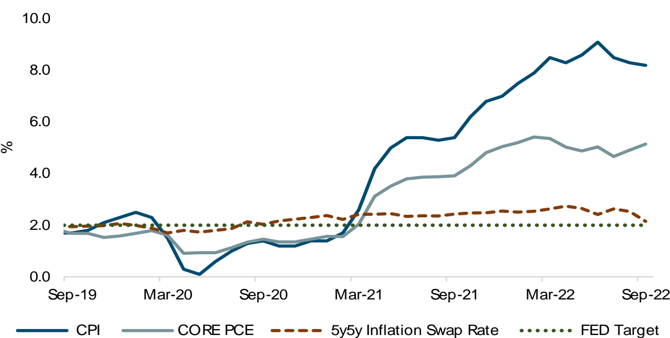
…with the economic weakness also seen in both manufacturing and services PMI



Source: Bloomberg

Exhibit 4 – US Inflation rate

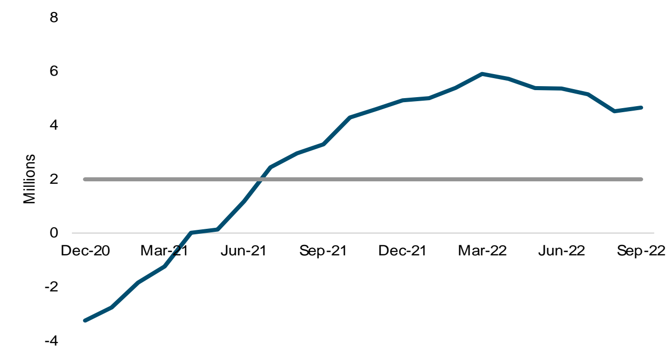
Inflation remains well above target despite aggressive tightening seen so far this year…



Source: Bloomberg

Exhibit 5 – Job-workers gap

…but the job-workers gap widened slightly in September, possibly due to seasonal factors



Source: FRED

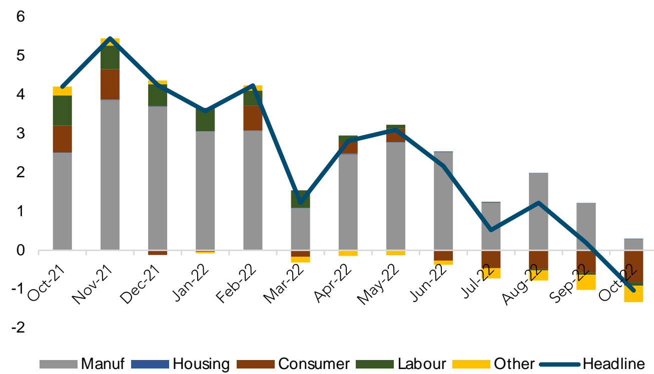
Europe

Growth: Economists expect the Euro-area to grow 1.9% (10bp upward revision) in 3Q22**.** Despite this, economic activity has clearly continued to slow down in October, as headline CAI fell from 2.2 in July to 0.2 by the end of September, with activity only increasing during August, which is traditionally peak tourism season (Exhibit 6). The main driver of the decline in activity seems to be related to the manufacturing sector, which is being severely impacted by the energy crisis. Both Manufacturing and Services PMI are below 50, which is indicative of a contraction in economic activity (Exhibit 7). The Euro-area flash PMI fell to 47.1 in October, well below consensus expectations, with the decline more pronounced in manufacturing (especially in Germany) and the forward-looking components have deteriorated further. The government measures being announced to shield the consumers from the surge in energy prices should support demand over the short-term, though there is a limit to fiscal support that can be permitted given current debt at country level.

Inflation: Core CPI in Europe came in at 6.4% in September, the seventh consecutive month of rising core inflation (Exhibit 8) while headline inflation increased to 10.7%, up from 9.9% in the previous month. Inflation has not yet peaked in Europe, though the deterioration seen in the macro-economic backdrop could lead to a weakening in the demand environment, whilst gas shortages could also have an impact.

Exhibit 6 – EU Current Activity Indicator

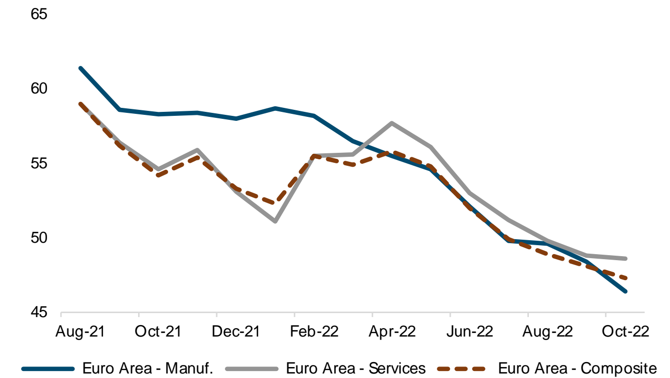
Similar to the US, economic activity turned negative during October…



Source: Goldman Sachs

Exhibit 7 – EU PMIs

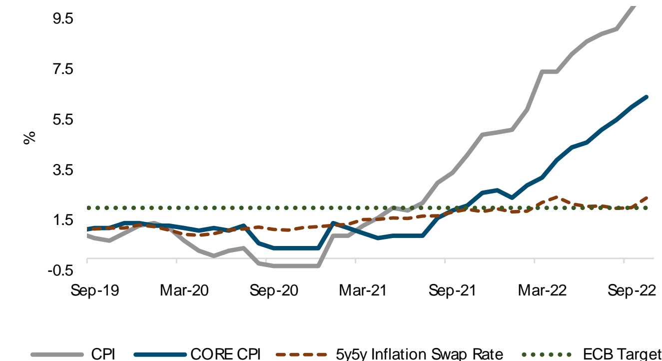
…as PMIs remain well into contraction territory



Source: Bloomberg

Exhibit 8 – EU Inflation rate

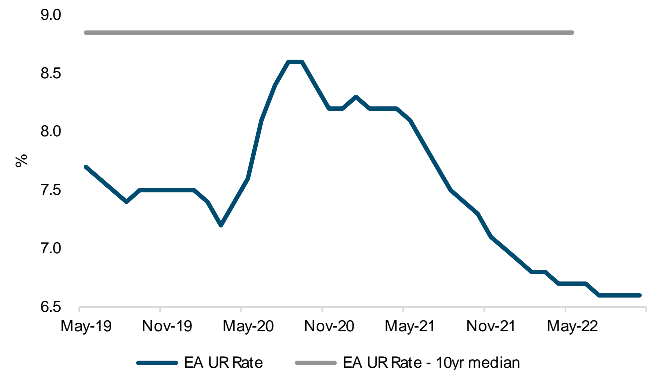
Inflation continued to accelerate during October…



Source: Bloomberg

Exhibit 9 – Euro-area unemployment rate

…with unemployment well below 10-year median



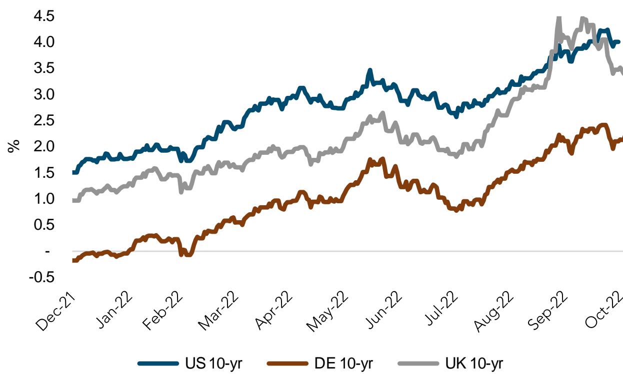
Source: Bloomberg

Rates

The rate hike cycle that started earlier this year continued during October, with the FED (75bp), BoE (75bp), ECB (75bp) and BoC (50bp) all hiking rates. Yet, even though hiking pace was fairy similar to September, the rise in yields was much less pronounced. The US 10-year yield rose 22bp in October (vs 64bp in September) whilst the German 10-year rose just 3 bp (vs 57bp in September). Moreover, the 10-year Gilt yield fell 58bp during October following the reversal of the mini-budget measures announced at the end of September which had led to a surge in UK yields (Exhibit 10).

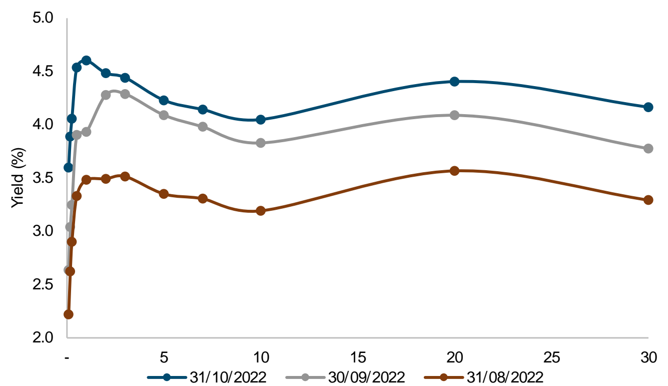
The narrative has now switched to cycle extension, which implies a slower rate hike cycle which lasts longer. GS note that G10 hiking cycles have historically lasted for 15 months on average and tend to be longer in the US and shorter in the UK, Canada and Australia. On average, policy rates have increased by 400bp during hiking cycles, versus current projection of 475bp rate increases in the US and 325bp in Europe.

Exhibit 10 - 10-year nominal bond yield for the US, Germany and UK
Upward pressures on yields was less pronounced during October as investors increased probability of a slowdown in the hiking pace



Source: Bloomberg

Exhibit 11 – US Yield Curve
The US Yield curve inverted in July, with upward pressure on the short-end of the curve from FED policy



Source: Bloomberg

United States

The FOMC pointed to a slower pace of hiking but a higher peak funds rate during the November meeting. Chair Powell said that slowing down the pace of tightening was not contingent on softer inflation data but is likely to be appropriate in view of the level of funds rate is now much higher, tightening to date has been substantial and the magnitude and the timing of its impact of the economy are uncertain. Following the meeting, markets priced a higher probability of a 50bp rate hike in December (down from 75bp previously), with more tightening expected in 2023.

The rising hope for a FED pivot during October weighed on the short-end of the curve (Exhibit 11). The 10s30s inversion retraced during October, with the spread rising from -5 in September to +11 by the end of October, and to +4 after the FOMC meeting. The 2s10s (which is more closely followed by the market) fell deeper in inverted territory to -58 after the FOMC meeting as the UST2YR moved up to 4.71% (from 4.48%) whilst the UST10YR moved up to 4.14% (from 4.05%).

Europe

President Lagarde said the ECB had made substantial progress in withdrawing monetary policy accommodation on 27/10. The ECB noted that future decisions will be based on three factors: (1) Inflation outlook and the rising risk of recession; (2) Tightening measures already taken; and (3) Lag of monetary decisions taken to impact inflation. Although the ECB has communicated that hiking pace is data dependent, and inflation is still at record levels (10.7% in October), the odds of a slow-down in the hiking pace increased following the meeting, with a 50bp rate hike being expected at the next meeting in December.

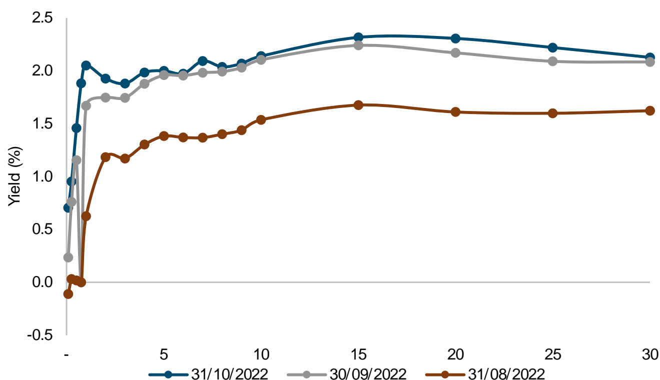
The moves along the curve in October were mainly concentrated at the short-end (Exhibit 12). The higher-than-expected inflation data implies that inflation in the Bloc is still not under control and more tightening will be required, and this was confirmed by President Lagarde during the October meeting (*"The risks to the inflation outlook are primarily on the upside"*). This was the main driver of the move seen at the short-end of the curve. However, the rising recession risk weighed on the long-end of the curve. Economic data continued to deteriorate over October, and the ECB expects further weakening to year-end (*"we expect a further weakening in the remainder of this year and the beginning of next year").*

October in the UK was characterized by high political turmoil and rates volatility. On the political front, Lizz Truss's tenure came to abrupt end after 44 days following the mini-budget announcement that spooked markets. PM Sunak has been more vocal on what the budget will look like, preparing the market for higher taxes and spending cuts. The fear is that Sunak will go too far on the other side with austerity hampering growth.

The more conservative fiscal outlook has led to a flattening in the curve in October (Exhibit 13). Pressures on the UK Gilt market subsided with yields well below the end of September highs across the curve, with the move much more pronounced at the short-end owing to the rate hikes that were priced-in following the mini-budget announcement as fiscal policy is generally inflationary. PM Sunak's budget will be announced on 17/11 and will likely see tax increases and spending cuts up to £50 billion.

Exhibit 12 – German 10-year yield curve

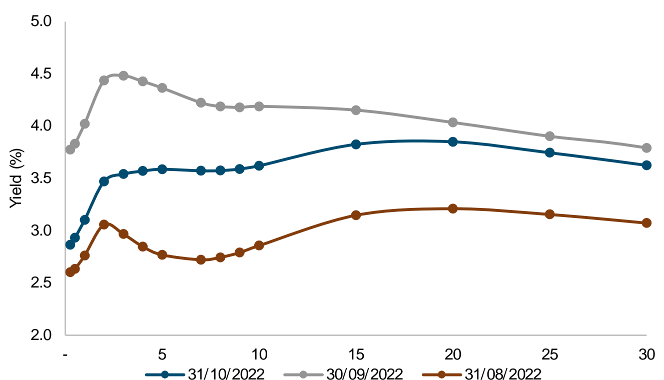
Yields have remained relatively unchanged over the month of October despite the record inflation print for the Bloc



Source: Bloomberg

Exhibit 13 – UK 10-year yield curve

Yield curve has flattened in October following the mini-budget shock in September



Source: Bloomberg

Credit

October was a better month for bondholders as markets provided some respite to investors, with the UK serving as the notable outperformer. Better than expected labour market data and an upside surprise in inflation out of the US reinforced a hawkish response by the Fed in October, which drove some weakness in the treasury market, impacting the IG space. In the UK, political events continued to dominate the headlines, with the introduction of Rishi Sunak as the new prime minister and a fiscal U-turn bringing some stability to the market as the BOE ended its Gilt purchase programme. In Europe, the ECB raised rates by an expected 75bp toward the back end of the month, however the communication was interpreted as predominantly dovish in nature, as Ms Lagarde noted increasing concerns over the region's growth outlook, in part due to ongoing weak activity data across the region, with manufacturing PMIs now deep into contractionary territory whilst inflation breaches new all-time highs year over year. Although US and European government bond yields were marginally higher over the month, the ensuing tightening of credit spreads drove excess returns during the month, whilst UK credit also enjoyed the tailwinds provided by a shift lower in the Gilt curve.

Financial markets have now started running with the narrative that central banks are beginning to pivot away from aggressive rate hikes, an argument which began gathering steam at the ECB meeting toward the end of October and was boosted in early November following dovish interpretations out of the BOE, and commentary out of the Fed which has hinted at a slowdown in the pace of rate hikes. The challenge facing the ECB in terms of policy trade-off was evident in the October flash PMI data, with the composite Euro area reading falling by 0.9pts to 47.1 - more than expected - with weakness broad-based across sectors and regions. This is seen as clear indication that the Euro area has entered a period of decline in economic activity. The outlook bias, an indicator of future rating actions, dropped deeper into negative territory across each region, and the weakest link ratio rose, signalling that lower ratings are under increasing pressure.

Exhibit 14 – Spread movements and total returns for Investment Grade and High Yield credit
A stronger month from credit, with Sterling outperforming following the fiscal policy U-turn

	31/10/2022	30/09/2022	31/12/2021	MoM Δ	YTD Δ
Total Returns (%)					
EUR IG	225.44	225.2	263.64	0.10%	-14.50%
EUR HY	379.23	371.68	437.87	2.00%	-13.40%
USD IG	2,834.50	2,864.12	3,523.57	-1.00%	-19.60%
USD HY	2,153.03	2,098.50	2,461.43	2.60%	-12.50%
GBP IG	244.06	233.86	309.61	4.40%	-21.20%
GBP HY	768.27	750.67	890.43	2.30%	-13.70%
	31/10/2022	**30/09/2022**	**31/12/2021**	**MoM Δ**	**YTD Δ**
Spread Movements (bps)					
EUR IG	220.93	225.25	94.99	-4.33	125.94
EUR HY	605.09	630.98	318.01	-25.88	287.09
USD IG	158.49	158.98	92.37	-0.49	66.12
USD HY	464.14	552.22	282.98	-88.08	181.16
GBP IG	228.62	234.02	113.77	-5.4	114.85
GBP HY	747.45	702.13	375.68	45.32	371.76

Source: Bloomberg

For these reasons, our preference remains to position portfolios defensively, with a move up in credit quality by advocating a reduction in the current overweight positioning to Euro High Yield, with proceeds being redistributed to Investment Grade credit. With this defensive bias in mind, we caveat that we may be forced to revisit this view sooner than might be expected depending on how the macro environment progresses. For now, it would appear that the macro situation will continue to worsen near-term, including a recession in Europe starting this quarter and lasting until roughly 2Q of next year.

We continue to favour Euro IG credit over USD and GBP, as the spread pickup provided, particularly around the 3-5 year maturity bucket, is close to the wides reached at the height of the European debt crisis in 2012. Similarly, relative spread within this maturity bucket relative to the rest of the Euro curve remains at multi-year wides. There remains a long list of challenges facing the Euro area, chief amongst which is the length and severity of the recession. That said, a number of key hurdles have been cleared, which should limit the risk of further material widening in the spread pickup offered by the Euro market. Quantitative tightening is now well-anticipated, even though the details of the implementation have yet to be provided. Further, with the latest 75bp rate hike now behind us, policy rates have gotten much closer to most estimates of the neutral rate, which should pave the way for a slowdown in the pace of hikes going forward. Finally, policy risk in Italy has abated to a degree, and the prospect of a deteriorating growth backdrop and the ensuing reduction in the fiscal space will likely push the new government to postpone the myriad fiscal proposals put forward during the electoral campaign.

With respect to sector preferences, we note the underperformance during October for European Senior Financial paper relative to subordinated notes. The subordinated premium has contracted to 41bp over Euro swaps compared to 83bp at the end of September, creating a potential opportunity to rotate existing financials subordinated exposure into senior portions of the capital structure at attractive rates. Outside of financials, we continue to see spreads within the utilities and the relatively defensive TMT space as attractive.

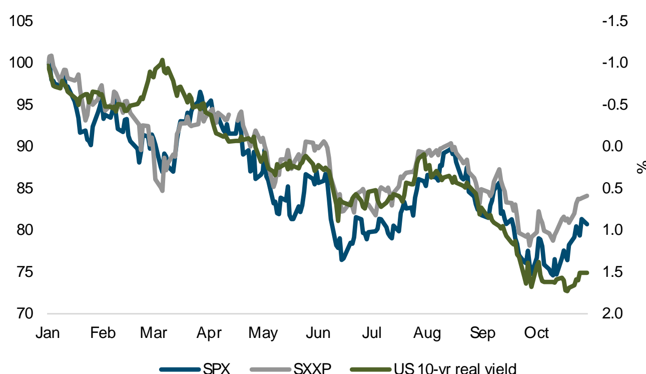
Upcoming quantitative tightening from the ECB remains an overhang for the asset class, and one which we will receive further information on in December. Though, assuming the ECB follows a passive run-off approach under QT, around €200bn worth of corporate bonds will likely remain on the portfolio by the end of 2027, from €388bn currently. From a market standpoint, quantitative tightening may drive some IG/HY spread decompression, though this may be offset to a degree depending on the pace of new issuance in early 2023. For the time being, forecasts on both gross and net IG issuance going into 2023 remain varied. On the one hand, difficult conditions in capital markets given tepid risk appetite and elevated funding costs could keep issuers at bay. Euro IG supply has this year persisted at a relatively normal pace, implying that the near term refinancings needs have essentially stayed flat, and may drive a decline for issuance going into 2023. On the other hand, should spreads peak in 2023, the subsequent rally will likely be met with a plethora of supply which may drive overall higher issuance for the full year. In the case of the Euro HY market, given the rock bottom levels of issuance that have taken place this year, issuers now face a steeper maturity wall that will have to be addressed, leading to a general forecast consensus for an uptick in both gross and net supply for 2023. Ultimately, with this wide range of projections for 2023 issuance, much will likely come down to the course of inflation, recession, and central banks' monetary policies in reaction.

Equity

Equities recovered some of the losses incurred since the summer rally on hopes that central banks will slow down the hiking pace. Global equities generated a total return of +7.2% (US$) during the month, after losing -16.1% over a two month period that started in mid-August. Central bank policy continued to dominate sentiment, as investors attributed a higher probability of a slower hiking pace. This expectation of a slower rate hike cycle led to a 20bp retraction in the US 10-year real yield which is generally positive for risky assets (Exhibit 15).

Exhibit 15 – S&P 500, STOXX 600 and US Real yield (RHS)

There is a clear negative correlation between real yields and equity market performance

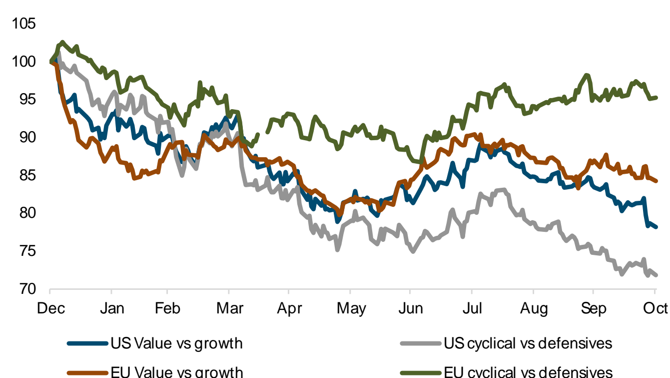


Source: Bloomberg

Performance rebased from 31 December 2021

Exhibit 16 – EU and US performance by strategy

Value strategies outperformed growth during October, a common trend so far in 2022



Source: Bloomberg

Performance rebased from 31 December 2021

Third quarter earnings season was in full swing during October, with Goldman Sachs noting that from the companies they follow (c. 60% of SXXP), more than 23% had reported by month end. Out of the companies that had reported, earnings came in 1% higher than expectations whilst revenue surprised 3% to the upside (helped by high inflation and the weaker Euro). Yet there are signs that inflation is starting to bite on margins, as 80% of companies beat on sales but only 55% beat on EPS, which implies margins have surprised to the downside. GS's revenue sentiment indicator remains in positive territory with more top-line upgrades than downgrades. Yet, their net margin sentiment indicator remains under pressure, and we expect the high inflation will continue to weigh on margin sentiment.

Barclays's analysis of earnings call transcripts reveals that wage inflation is a bigger concern for a larger subset of firms than before. Meanwhile, high energy costs issues still persist, though other supply side issues have eased compared to previous quarters. The difference in PMI points between "new orders" and "current output" indicates that inflation will have a larger impact on margins in Q4 compared to Q3. Therefore, it seems likely that wage inflation and energy costs will weigh on margins over the coming quarters.

The rising rates narrative has weighed on long-duration equities (growth stocks) so far in 2022. However, the underperformance of growth stocks during October was more a function of a poor earnings season. A number of mega-cap growth stocks like Amazon, Microsoft and Meta disappointed analyst expectations when reporting earnings which led to a steep sell-off post-results.

The rally seen in equity markets during October led to higher valuations compared to September (Exhibit 17). Although there was no significant change in fundamentals, valuations of the countries we follow expanded by c. 10% on average, as the rally in prices was not matched by an upward revision in earnings growth estimates. When compared to the end of 2021, valuations are roughly 26% cheaper primarily due to the aggressive rate hike cycle. In our opinion the attractiveness of the asset class relative to bonds has decreased as yields offered in fixed income markets are significantly higher now compared to the start of the year. Assuming there is no pick-up in the macro-economic backdrop, and the probability of a recession rises whilst inflation starts to normalise, we could see investor flows away from equities into fixed income instruments.

Emerging market equities were hit by a combination of rising political risk in China and FED policy during October. Despite the improved sentiment seen in developed market equities, EM equities lost 4.1% (€ terms) during October, mainly as a result of weakness in Asia (-7.0% in €) offset by strength in LATAM (+8.6% in €). China's 20th Party Congress came to an end on 22/10 and the 20th Politburo Standing Committee ("PSC") was unveiled on 23/10 with four new appointments. The Congress did not bring material changes to housing and fiscal policies. Furthermore, there was no update on whether the country will abandon its zero-COVID policy in 2023, which has put the economy under severe strain. We note that China is one of the few countries not to experience a second COVID-19 wave, and it is therefore very likely that cases would surge if a decision is taken to abandon the zero-COVID policy.

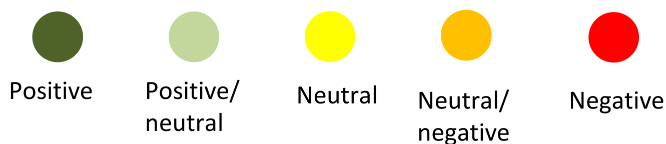
Exhibit 17 – Valuations – Developed markets

Valuations have come down significantly since the start of the year

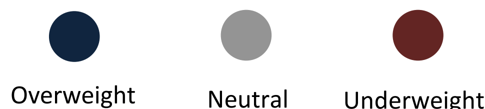
Historical Data	SPX	SXXP	SX5E	DAX	CAC	FTSE100	FTSE250
Current Forward PE ratio (FPE)	16.3x	11.2x	10.6x	10.3x	10.4x	9.1x	9.7x
Forward PE ratio (31/12/2021)	21.1x	15.7x	15.3x	13.2x	14.6x	12.1x	14.8x
10 Year data							
Highest	22.1x	17.5x	18.0x	15.7x	18.2x	15.4x	17.9x
Highest (date)	31/12/2020	29/12/2020	29/12/2020	28/12/2020	04/12/2020	02/12/2015	29/12/2020
Lowest	11.8x	10.0x	9.0x	8.4x	9.1x	8.4x	8.3x
Lowest (date)	08/01/2013	18/03/2020	18/03/2020	18/03/2020	18/03/2020	03/10/2022	23/03/2020
Median	15.9x	13.7x	12.8x	12.1x	13.3x	12.8x	13.7x
95th percentile	20.4x	16.0x	16.3x	14.4x	15.9x	14.9x	15.3x
5th percentile	13.0x	11.2x	10.3x	10.3x	10.5x	10.3x	11.1x
Historical rank (since 2006)							
Percentile	77.0%	29.3%	31.0%	26.3%	24.1%	8.8%	12.8%
Current FPE, % above/ (below) 10-YR median	2.5%	-18.1%	-17.0%	-14.9%	-21.9%	-29.1%	-29.5%
Current FPE, % above/ (below) Dec 21	-22.6%	-28.7%	-30.9%	-21.8%	-28.6%	-25.2%	-34.6%

Source: Bloomberg

Key – Our view



Key – Allocation



Asset Class	Positioning
Developed Market Sovereign Bonds	Our negative view on Government bonds remains unchanged given inflation pressures on central bank's commitment to fight inflation. We continue to see upside risks to terminal rates as inflation pressures remain elevated. We also continue to see little scope for shift in policy given sticky inflation which means that central banks are less likely to tolerate easier financial conditions any time soon, unless the risk of a deep recession increases significantly.
Investment Grade Corporate Bonds	Investment grade returns will continue to depend on movements in benchmark rates and corporate spreads, though following the material widening since the onset of the Ukraine conflict, the asset class has begun providing reasonable opportunities to add risk on a selective basis. At current levels, the asset class offers a significantly better cushion against adverse movements in benchmark bond yields than we have seen for a number of years. The default and rating environment for global credit is beginning to show signs of weakness, reinforcing our preference to move further up in credit quality where possible. Whilst we acknowledge the risks for benchmark rates to move higher, we prefer to increase our exposure to IG corporate bonds, though maintain a preference for a low-to-neutral duration stance versus the broader corporate market.
High Yield Corporate Bonds	The elevated uncertainty on the growth outlook and higher inflationary forces as a result of the war in Ukraine has led to a substantial widening in credit spreads. We continue to like the asset class at current valuations, though as we begin to see signs of weakness in the outlook for global credit quality, we are becoming all the more selective in the names we choose to hold on portfolios. The focus remains on identifying positions on a name-by-name basis, screening for issuers based on resilience of cash flow and strength of balance sheets that should see limited drag on operational performance as finance costs and input costs increase in the face of slowing growth. We place additional focus on names and sectors less exposed to a potential slowdown and on issuers at the upper end of the HY rating scale to avoid downgrades into distressed territory.
Developed Market Equities	Equity markets have been hit by a combination of rate volatility and economic growth concerns so far this year. While equity valuations in most regions we follow have normalised, bonds have re-priced lower too. The equity risk premium for equities is at the lowest it has been over the past decade. Therefore, fixed income instruments are now offering a viable alternative to equities. Furthermore, the total return of bonds and equities on a YTD basis is fairly similar, which is unusual when considering the rising recession risk. Normally, as economic activity slows, bonds tend to outperform equities as investors look to cut their exposure to the riskier asset classes. Equities have probably held up better this year due to their status as an inflation hedge. However, once inflation peaks there will be less scope for bond sell-off and the market narrative will shift to recession concerns, which could provide more downside.
Emerging Market Equities	We have downgraded Emerging market equities to underweight as we believe that the strengthening of the US Dollar and the deterioration in the global macro economic prospects will likely weigh on the asset class. There has been a significant outperformance in LATAM (where we were o/w until recently) relative to Asia and EMEA, which is mostly explained by the rally in commodity prices. We think that this performance could reverse the closer we get to an inflation peak in developed economies, and we get a better understanding of that damage suffered by the global economy.

Disclaimer

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