CURMI & PARTNERS

February 16th, 2023

Monthly Strategy Update

The month in summary:

There has been a clear shift in sentiment over the past few months as news flow has turned more positive. Going into 2023 investors feared that economic growth could slow significantly, but three main developments have led to a pick-up in risk sentiment in the opening month of the year: First is China's rapid re-opening which surprised markets and has boosted its domestic growth outlook. We view this as a positive not only for China's growth but also for its important trading partners (Europe). Secondly, warmer than expected weather in Europe has sharply reduced its recession risk. Finally, inflation in most developed economies has been falling which could indicate that we have seen the worst in terms of tightening of monetary policy, reducing the risk of a hard landing. These developments led to a pickup in risk sentiment, as evidenced by Goldman Sachs' Risk Appetite Indicator ("RAI"). After spending most of last year in negative territory, GS's RAI has turned markedly to around 0.5 and Risk Appetite Momentum is at +0.3.

Financial markets understandably reacted positively to these developments, but it seems investor focus remained fixed on central bank policy. We can summarize January as a month were rates fell, returns of credit and equities were positively correlated and the Dollar weakened. In short, a typical goldilocks trade. Rates fell by over 30bp in January, whilst all credit markets delivered a positive total return. Within equities, the Nasdaq (a long-duration index) was the best performer of the indices we follow whilst the US Dollar and commodities weakened.

The macro-economic backdrop is brighter today compared to the end of 2022, but in our opinion, we are not out of the woods yet. The increase in economic activity from the China re-opening, resilient US labour market and warmer than expected weather in Europe which should boost consumer spending could have implications for inflation. We think this is important given the investor attention central bank policy is receiving and the easing in financial conditions seen lately, though the situation could change swifty. China could experience a surge in COVID-19 cases forcing fresh lockdowns, temperatures in Europe might drop later than expected and stay cold for longer and the US economy might suffer a lagged impact from the aggressive hiking cycle of 2022. In summary, despite the buoyant mood, risks to the outlook remain.

Sovereign		
	MoM bp	YTD bp
US 10-year yield	-37	-37
DE 10-year yield	-29	-29
UK 10-year yield	-34	-34
Credit		
LCL Total returns	MoM %	YTD %
EUR IG	2.2%	2.2%
EUR HY	3.2%	3.2%
USD IG	4.0%	4.0%
USD HY	3.8%	3.8%
GBP IG	4.1%	4.1%
GBP HY	3.3%	3.3%
Equities		
LCL Total returns	MoM %	YTD %
Global	7.1%	7.1%
S&P 500	6.3%	6.3%
Nasdaq 100	10.7%	10.7%
STOXX 600	6.7%	6.7%
DAX	8.7%	8.7%
CAC	9.6%	9.6%
FTSE 100	4.3%	4.3%
Emerging markets	7.9%	7.9%
EM ASIA	8.2%	8.2%
EM LATAM	9.9%	9.9%
EM EMEA	2.3%	2.3%
Currencies		
Total return	MoM %	YTD %
EURUSD	1.5%	1.5%
EURCHF	0.6%	0.6%
GBPEUR	0.4%	0.4%
GBPUSD	2.0%	2.0%
Commodities		
Total return	MoM %	YTD %
Oil WTI	-2.0%	-2.0%
Oil Brent	-0.2%	-0.2%
Natural Gas	-40.0%	-40.0%
Gold	5.7%	5.7%
Copper	10.2%	10.2%
Iron Ore	2.1%	2.1%
Lumber	40.2%	40.2%

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Macro-economic views

The outlook for the global economy has improved notably over the past months with risks of a recession receding. The faster than expected re-opening in China, the warmer than expected weather in Europe and the more supportive inflation data should be supportive for economic growth in 2023. Also, we expect the drag from tighter financial conditions to be lower compared to the previous year. Consensus forecast for global growth was unchanged, though developed economies are now expected to grow at 0.5% (up from 0.4%) in 2023, whilst forecasts for emerging economies have been revised upwards 0.2% to 4.1% (Exhibit 1). We believe that risks are skewed to the upside if the global economy remains resilient.

China's re-opening should provide a sizeable boost to its local economy, and signs of an acceleration are already there. The January composite PMI jumped into expansionary territory at 52.9 in January, from 42.6 in December. Industrial production has picked-up, growing 1.3% year-on-year in January after two consecutive months of contraction. We expect consensus economic forecasts for China to be revised higher if February and March show additional gains. Growth outside of China is also likely to benefit, especially in commodity exporting countries as well as Asian economies which are popular with Chinese tourists.

Inflation expectations have remained broadly unchanged despite the improvement seen in the macro backdrop. Recent inflation data has confirmed that we have probably seen the peak and inflation data has been falling for several months. However, we see a rising risk of an upside surprise in inflation, primarily in view of the uptick in economic activity seen recently. Consensus expects global headline inflation of 5.2% (unchanged) in 2023, with inflation for developed market economies at 5.2% (-0.1% revision) and emerging market economies at 5.8% (unchanged).

Exhibit 1 – Consensus real GDP growth and inflation expectations

Developed economies economic growth for 2023 has been revised higher over the past month but inflation expectations remain unchanged

	Consensus Forecast, % QoQ							Consensus Forecast, % YoY			Revisions since last meeting								
Real GDP, YoY%	4Q22F	1Q23F	2Q23F	3Q23F	4Q23F	1Q24F (New)		FY22F	FY23F	FY24F	3Q22A	4Q22F	1Q23F	2Q23F	3Q23F	4Q23F	FY22F	FY23F	FY24F
United States*	2.9	0.1	-0.6	-0.2	0.7	1.5	1.8	2.1	0.5	1.2	0.3	1.8	0.0	0.0	-0.2	-0.2	0.2	0.2	-0.1
Japan*	3.0	0.9	1.0	0.9	1.1	1.0	1.2	1.3	1.3	1.0	-2.6	0.1	0.2	0.1	0.0	-0.1	-0.1	0.1	0.0
Germany	1.1	-0.4	-0.5	-0.6	0.1	1.0	1.3	1.9	-0.4	1.3	0.6	0.5	0.4	0.3	0.3	0.0	0.2	0.2	0.1
France	0.5	0.4	-0.1	-0.1	0.3	0.8	1.2	2.5	0.3	1.2	0.0	0.3	0.1	0.0	0.0	-0.2	0.0	0.1	0.1
Italy	1.3	0.8	-0.3	-0.5	0.0	0.7	1.0	3.8	0.1	1.0	0.7	0.0	0.1	0.1	0.1	0.1	0.0	0.1	0.0
Spain	2.7	1.7	0.4	0.6	1.1	1.6	1.9	5.5	1.0	1.9	0.0	1.3	0.3	0.1	0.0	-0.2	1.0	0.0	0.0
Eurozone	1.9	0.4	-0.2	-0.3	0.4	1.0	1.3	3.3	0.0	1.3	0.2	0.6	0.1	0.3	0.1	0.1	0.1	0.1	-0.1
UK	0.3	-0.7	-1.2	-1.2	-0.9	-0.1	0.8	4.1	-0.9	0.9	0.2	-0.1	0.0	0.1	0.0	0.0	-0.3	0.1	0.0
Developed Economies	1.9	0.4	-0.2	0.0	0.7	1.3	1.6	2.7	0.5	1.4	0.4	0.6	0.1	0.1	-0.1	-0.1	0.1	0.1	0.0
China	2.9	2.6	6.9	4.8	5.9	5.4	5.1	3.0	5.1	5.0	0.0	0.0	-0.5	0.2	0.4	0.9	0.0	0.3	0.0
Emerging Economies	2.6	2.2	5.1	4.0	4.9	4.6	4.5	3.1	4.1	4.4	0.5	0.1	-0.3	0.1	0.2	0.6	0.0	0.2	0.0
Global								3.4	2.1	2.9							0.2	0.0	0.0

	Consensus Forecast, % QoQ							Consensus Forecast, % YoY			Revisions since last meeting							
Consumer prices, YoY %	4Q22F	1Q23F	2Q23F	3Q23F	4Q23F	1Q24F	2Q24F (New)	FY22F	FY23F	FY24F	4Q22F	1Q23F	2Q23F	3Q23F	4Q23F	FY22F	FY23F	FY24F
United States	7.1	5.6	3.8	3.1	2.9	2.7	2.5	8.0	3.8	2.5	-0.2	-0.3	-0.2	-0.2	-0.1	0.0	-0.2	0.0
Japan	3.8	2.9	2.4	1.7	1.2	1.1	1.1	2.5	2.0	1.1	0.0	0.3	0.1	0.0	0.0	0.1	0.2	0.1
Germany	10.8	9.4	7.5	6.1	3.9	3.1	3.0	8.6	6.6	2.9	-0.6	-0.3	0.0	0.0	0.5	-0.2	0.1	0.3
France	7.0	6.7	5.5	4.8	3.6	2.6	1.9	5.9	5.1	2.3	-0.2	-0.3	0.0	0.0	0.1	-0.1	0.0	0.0
Italy	12.5	10.1	8.4	6.9	2.7	2.3	2.0	8.7	6.5	2.0	0.5	1.2	0.7	1.1	0.1	0.1	-0.1	0.0
Spain	6.5	5.0	4.1	3.3	3.6	3.4	2.8	8.3	4.2	2.5	-1.0	-0.9	-0.8	-0.2	0.0	-0.2	-0.3	0.2
Eurozone	10.0	8.4	6.6	4.9	3.4	2.9	2.8	8.4	5.9	2.3	-0.3	-0.3	-0.2	-0.5	-0.1	-0.1	-0.2	0.1
UK	10.8	10.1	8.0	6.5	4.2	3.6	2.4	9.1	7.0	2.5	0.0	-0.1	0.1	-0.1	-0.2	0.0	-0.2	0.0
Developed Economies	8.6	7.3	5.5	4.6	3.7	3.4	3.0	8.5	5.2	2.9	-0.6	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	0.1
China	1.8	2.3	2.2	2.2	2.5	2.4	2.2	2.0	2.3	2.2	-0.4	-0.3	0.0	0.0	0.3	-0.1	0.0	0.0
Emerging Economies	4.8	6.3	5.4	5.2	5.2	4.9	4.3	5.1	5.8	4.3	-1.9	-0.2	0.0	0.1	0.2	-1.3	0.0	0.1
Global								8.8	5.2	3.5						0.0	0.0	0.2

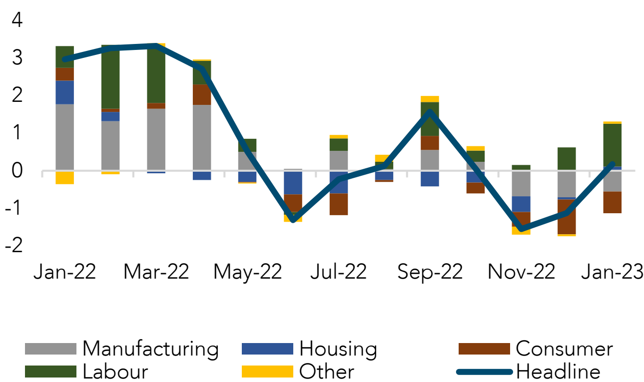
Source: Bloomberg (Note: QoQ figures for the US and Japan are QoQ SAAR, Shaded areas indicate Actuals)

United States

Growth: Economic activity in the US has picked up strongly since the November lows, as evidenced by the Goldman Sachs Current Activity Indicator ("CAI") improving to +0.2 in January from -1.6 in November (Exhibit 2). This improvement was primarily driven by resilience shown in the labour market and a recovery in the housing market. The upbeat data has also been reflected in the Atlanta FED GDP estimate, which has been revised from +0.7% at the end of January to +2.2% (Exhibit 3). There has been a clear disconnect between soft and hard data in the US, with the former pointing to a weakening but the latter remaining resilient. In truth, soft data tends to understate growth during periods of heightened fear of a recession. A survey of economists conducted by the Wall Street Journal in mid-January showed that 61% expect a recession in 2023, which was 2% lower than the October survey but still historically high.

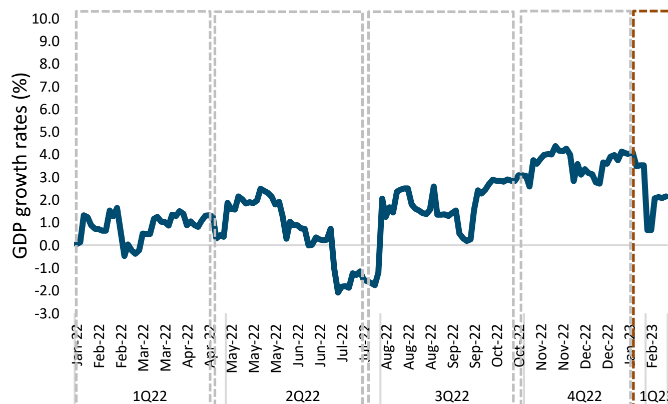
Inflation: Headline inflation was roughly unchanged in January at 6.4%, but came in ahead of economist expectations (6.2%). More importantly, core CPI came in at 5.6%, which represented a slowdown from the 5.7% reported in December but slightly above median economist expectations of 5.5%. Used car prices and airfares declined by more than expected, but with used car auctions and jet fuel moving higher this year, this weakness will likely reverse over the course of the year. The January inflation number is considered to be particularly important because many prices and supplier contracts are reset or renegotiated in that month.

Exhibit 2 – US Current Activity Indicator
January Headline CAI improved to 0.2, mainly as a result of improvements in the Labour and Housing CAI



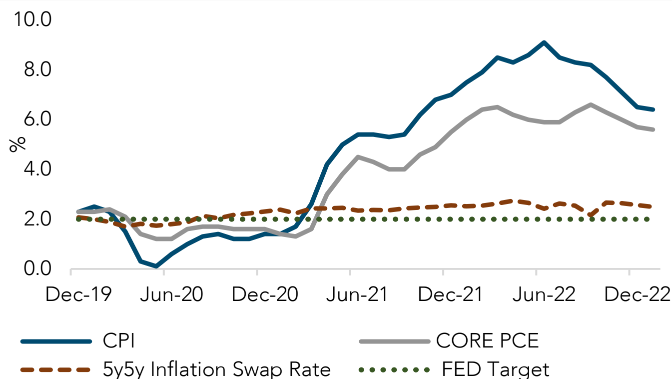
Source: Goldman Sachs

Exhibit 3 – Atlanta FED GDP estimate
The Atlanta FED growth forecast for 1Q23 has improved from +0.7% on the 27th of January to +2.2% on the 8th of February



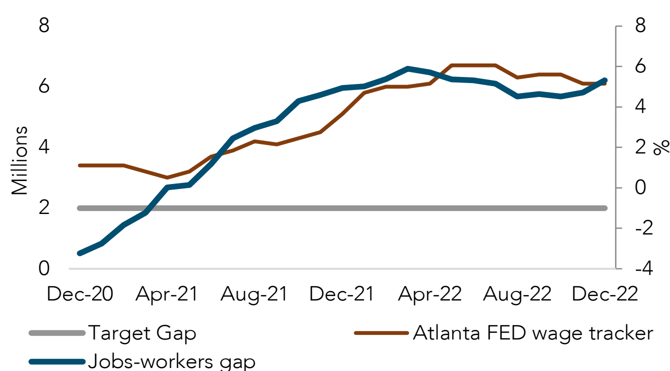
Source: Atlanta FED

Exhibit 4 – US Inflation rate
Core inflation has been on a downward trend for the past 3 months starting in September



Source: Bloomberg

Exhibit 5 – Job-workers gap (LHS) and Atlanta FED wage tracker (RHS)
The jobs-workers gap climbed slightly in December as the number of unemployed (-278k) fell by more than job openings (54k)



Source: FRED, Atlanta FED

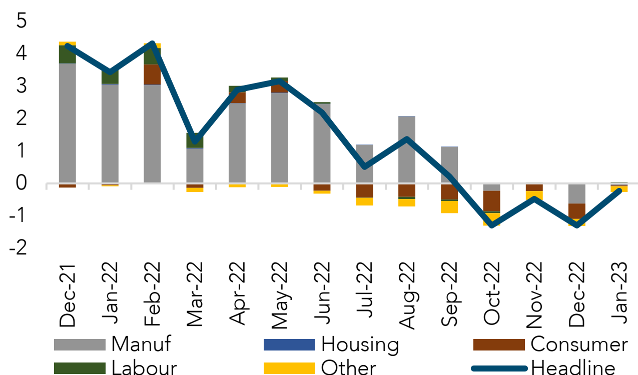
Europe

Growth: Europe's economic activity has been boosted by warmer than expected weather so far in winter as shown by Goldman Sachs' CAI (Exhibit 6). Manufacturing and consumer CAI improved significantly during the month, possibly as a result of the improvement in sentiment, in view of the expected positive impact of lower energy bills on disposable income. This improvement was also seen in the composite PMI, which moved back to expansionary territory for the first time since June 2022. The recovery was primarily driven by a recovery in services (to 50.8 from 49.8 in December), whilst manufacturing remains in contraction territory (48.8), but momentum has been positive since October (Exhibit 7). Despite the positive developments, we note that Europe is not out of the woods yet. The energy crisis remains a concern especially as we approach the re-fill season in the summer. China is back in growth mode which implies that demand/supply dynamics could be unhelpful for Europe.

Inflation: Headline inflation in Europe fell to 8.5% in January, down from 9.2% in December. Lower energy prices no doubt played a part in the lower headline number, though it should be noted that Germany had a data processing problem and the number used was an estimate, meaning that it could be unreliable. Core inflation remained unchanged at 5.2%, which is still well above target (Exhibit 9).

Exhibit 6 – EU Current Activity Indicator

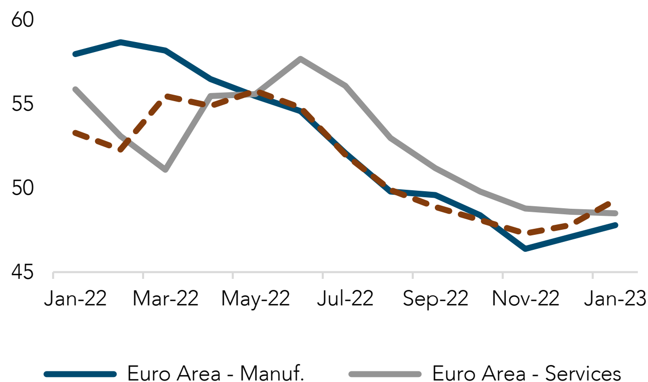
Economic activity picked-up during January boosted by a resilient labour market and a significant improvement in manufacturing



Source: Goldman Sachs

Exhibit 7 – EU PMIs

…which was also evidenced in PMIs, where the composite reading came in ahead of expectations



Source: Bloomberg

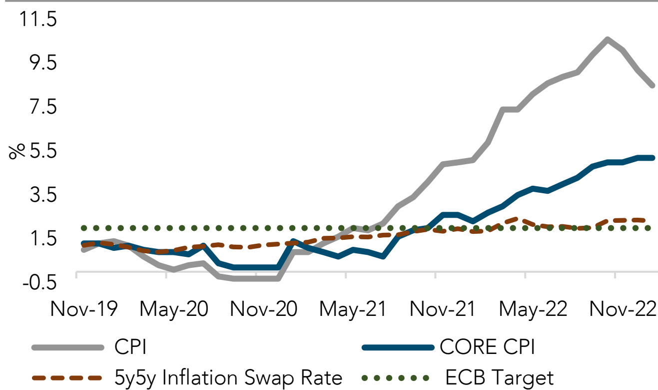
Exhibit 8 – EU Industrial Production

The fall in industrial production was primarily driven by energy-intensive industries like chemicals, base metals and paper

Source: Bloomberg

Exhibit 9 – EU Inflation rate

Headline inflation has been on a downward trend since October 2022 but Core inflation remained unchanged

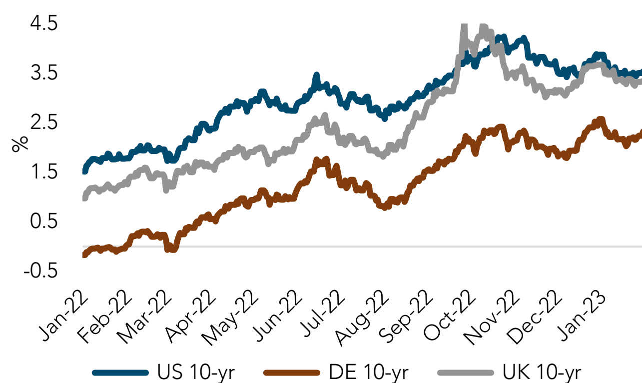


Source: Bloomberg

Rates

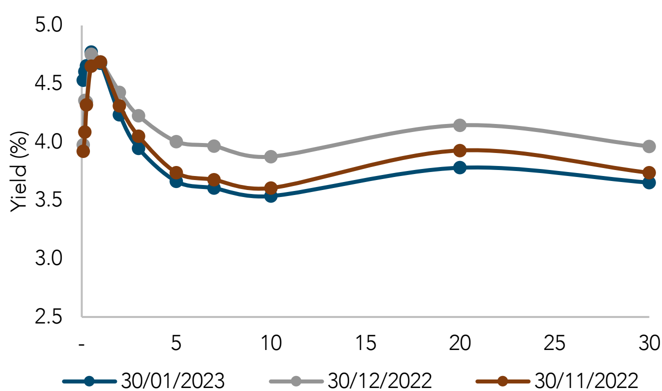
January was a quiet month in terms of central bank action as none of the major central banks, barring the BoJ, held any meetings. However, policy makers did provide pointers as to their preferred path on monetary policy with economic data also providing further insight as to the direction of the global economy. Sovereign yields declined across the board during the month with curves inverting further. Yields fell by 33bp on average in the three markets we follow, despite the improving macro-economic backdrop (Exhibit 10). Despite the moderation in prices seen recently, core CPI prints across developed economies remain above target, which supports our view that rates will remain higher for longer.

Exhibit 10 - 10-year nominal bond yield for the US, Germany and UK
The positive developments in the macro-economic backdrop still led to lower yields across the markets we follow



Source: Bloomberg

Exhibit 11 – US Yield Curve
The U.S. sovereign yield curve continued to invert during January to levels not seen since the 1980s



Source: Bloomberg

United States

During the month of January, the yield on the U.S. Treasury declined by circa 37bp to close the month at a yield of 3.5%. The U.S. sovereign curve inverted further as the spread between the 2s10s contracted by circa 14bp. The main drivers of the movements seen in January were (a) expectations that the Federal Reserve will slow down its hiking pace to 25bp at its February meeting and (b) the historically high market implied probability of a recession in the US. Yet, as we noted earlier, several positive developments have led to an improvement in the macro-economic backdrop.

The probability of a recession in the US remains historically high, though we believe that the continued strength shown in the labour market and pick-up in economic activity make us believe that the risk of a recession today is much lower than it was a month ago. Along with the improvement in the global macro backdrop, we see the moderation in inflation as supporting the view of recession risks receding.

The market is currently pricing-in around 200bp of rate cuts from peak rate. Yet, we think that the probability of a rate cut is low when considering that core inflation is well above target and the economy is still growing. We could therefore see a re-pricing higher at the long-end of the curve as expectations for a rate cut fade.

Europe

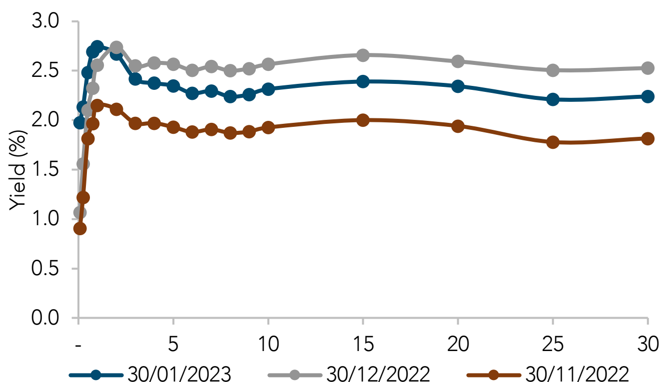
German ten-year yields declined in January despite ECB's forward guidance at the December meeting. The yield on the German ten-year declined by 29bp in January closing at the 2.3% level while the German sovereign curve flattened further during the month as the spread differential between the two-year and the ten-year compressed by 17bp (Exhibit 12). The lower yields came about despite the high inflation numbers released and the hawkish messaging coming from ECB members. Inflation declined to 9.2% in December, the lowest in four months and below forecasts of 9.7% and the prior month's 10.1% mainly driven by the slower rate of increase in energy prices.

The yield on the German Bund reached an intra-month low of 2.0% before the risk sentiment improved which led to a sell-off in the Bund. The improvement in risk sentiment occurred as there seems to be growing market expectation that inflation has peaked. The ECB hiked 50bp at its February meeting, as expected, and stated that it intends to deliver another 50bp rate hike in March. The Governing Council indicated after the March meeting that it will then evaluate the subsequent path of its monetary policy. President Lagarde indicated during the press conference that there would likely be "more ground to cover" but rate decisions beyond March will continue to be data-dependent and follow a meeting-by-meeting approach.

The yield of the UK Gilt declined by 34bp to 3.3% while the U.K. sovereign curve flattened as the spread differential between the 2s10s contracted by 23bp (Exhibit 13). The lower Gilt yield was driven by expectations that the Bank of England may adopt a more dovish stance in the face of weak activity data, as PMIs surprised to the downside again, in contrast to the improvement seen in the Euro Area. Taken together with the lower gas prices and the impact on inflation, the Bank of England is expected to adopt a softer stance. While the BoE hiked rates by 50bp, there seems to be a higher risk of a dovish surprise when compared to other major central banks. Expectations are for the UK economy to enter a recession in 2023. The only risk to this view, according to economists, is the fact that the U.K. labour market remains very tight with the unemployment rate remaining at 3.7% while wage growth accelerated to 6.4% in December on a YoY basis compared to 6.1% in October.

Exhibit 12 – German 10-year yield curve

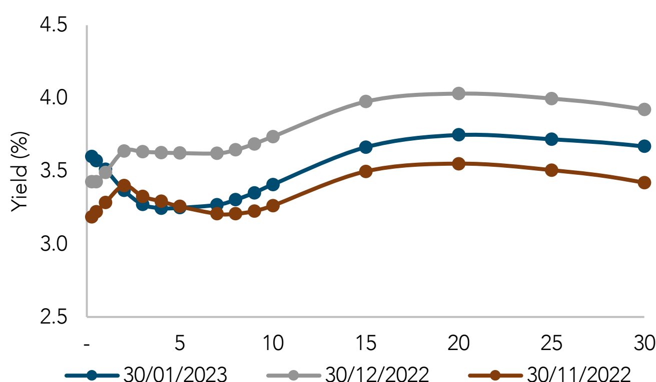
German 10-year yields fell 29bp during January as investors interpreted the ECB meeting to be more dovish than expected



Source: Bloomberg

Exhibit 13 – UK 10-year yield curve

Yields continued to fall after the September shock brought about by the budget announcement



Source: Bloomberg

Credit

The rally seen in the corporate bonds market in January was driven by lower implied risk coming from inflation across both sides of the Atlantic. The moderation in inflation, although still well above central bank targets, led to expectations that central banks may adopt a more dovish stance over the near term, which was confirmed in part by slow down the pace of rate hikes. In fact, spreads tightened across both the investment grade and non-investment grade segments of the markets with U.K. spreads tightening by the largest degree during the first month of the 2023.

We believe that the current scenario of low rates and tight spreads is unsustainable. Since the late 1980s the correlation between rates and spreads was negative. However, last year the correlation between the two turned positive, with the positive relationship continuing in January. It is unlikely that this relationship will continue to remain positive as the lower rates and spreads seen in the last few months reflect the growing confidence of a Goldilocks scenario which includes a rapid decline in inflation, moderate growth and a less restrictive monetary policy. The drag from last year's tightening in financial conditions by the Federal Reserve should reverse the rally in rates with spreads expected to trade sides to lower.

In Europe, S&P's base case projects the default rate is set to rise towards the long-term average of 3.3% by September 2023 compared to 1.6% in November 2022. During the fourth quarter of 2022, European risky credits increased by 13% to 54 which is 1.5x more than the pre-pandemic level. Consumer products, media and entertainment account for 47% of all risk credits. Inflation, slower growth, tighter financing conditions and geopolitical tensions are baked into forecasts. In the U.S., S&P projects that the default rate is set to reach 3.75% by September 2023 up from 1.6% a year earlier but below the long-term average of 4.1%. More than half of U.S. CCC rated bonds operate in consumer reliant sectors such as media and entertainment, retail/restaurants and consumer products.

Exhibit 14 – Spread movements and total returns for Investment Grade and High Yield credit

Total Returns indices	MoM Δ	YTD Δ
USD IG	4.0%	4.0%
USD HY	3.8%	3.8%
AAA	4.7%	4.7%
AA	3.8%	3.8%
A	3.8%	3.8%
BBB	4.2%	4.2%
BB	3.3%	3.3%
B	3.8%	3.8%
CCC	6.1%	6.1%

Total Returns indices	MoM Δ	YTD Δ
EUR IG	2.2%	2.2%
EUR HY	3.2%	3.2%
AAA	1.4%	1.4%
AA	1.5%	1.5%
A	2.0%	2.0%
BBB	2.5%	2.5%
BB	2.7%	2.7%
B	3.5%	3.5%
CCC	5.4%	5.4%

Total Returns indices	MoM Δ	YTD Δ
GBP IG	4.1%	4.1%
GBP HY	3.3%	3.3%
AAA	2.9%	2.9%
AA	3.4%	3.4%
A	4.0%	4.0%
BBB	4.2%	4.2%
BB	N/a	N/a
B	N/a	N/a
CCC	N/a	N/a

Spread Movements	MoM Δ	YTD Δ
USD IG	-12.71	-12.71
USD HY	-49.12	-49.12
AAA	-3.00	-3.00
AA	-4.13	-4.13
A	-11.74	-11.74
BBB	-14.83	-14.83
BB	-28.32	-28.32
B	-55.24	-55.24
CCC	-115.41	-115.41

Spread Movements	MoM Δ	YTD Δ
EUR IG	-15.29	-15.29
EUR HY	-52.22	-52.22
AAA	15.74	15.74
AA	-1.71	-1.71
A	-8.73	-8.73
BBB	-22.22	-22.22
BB	-40.34	-40.34
B	-61.33	-61.33
CCC	-115.52	-115.52

Spread Movements	MoM Δ	YTD Δ
GBP IG	-26.97	-26.97
GBP HY	-57.87	-57.87
AAA	-8.75	-8.75
AA	-10.56	-10.56
A	-23.00	-23.00
BBB	-31.17	-31.17
BB	N/a	N/a
B	N/a	N/a
CCC	N/a	N/a

Source: Bloomberg

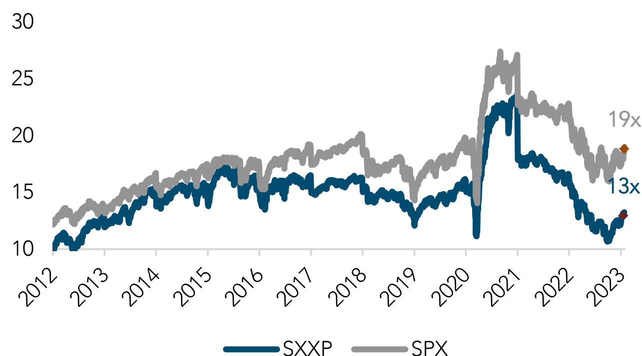
Equity

There has been a clear shift in sentiment over the past few months as news flow has turned more positive. Going into 2023 investors feared that economic growth could slow significantly, but three main developments have led to a spike in risk sentiment in the opening month of the year. Firstly, China's rapid re-opening surprised investors and has boosted its domestic growth outlook. We view this as a positive not only for China's domestic growth but also for its important trading partners (Europe) and commodity exporting regions (Latin America). Secondly, warmer than expected weather in Europe has sharply reduced the recession risk for the region. Finally, inflation in most developed economies has been falling which could indicate that we have seen the worst in terms of tightening of monetary policy, reducing the risk of a hard landing.

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 – 12-month forward PE for US and EU stocks
The US is trading on a forward PE of around 19x forward consensus earnings while Europe trades at around 13x



Source: Bloomberg

Understandably, investors started to price-in the more positive economic outlook which led to a sharp rally in global equities. On closer inspection however, the returns seen in January were consistent with the typical goldilocks trade that we have become accustomed to the majority of the pre-GFC period. During January rates fell, returns for credit and equities were positively correlated, commodities fell and the Dollar weakened. Yet, in our opinion the improving economic backdrop should have led to a re-pricing higher in yields, a negative correlation between credit and equities, with value strategies outperforming growth, and higher commodity prices.

We expected the narrative to shift away from rates to a focus on economic growth. However, we suspect that investor focus remains firmly on future rate expectations. The rally in equities during January seems to be consistent (amongst other things) with the view that the FED will cut rates in 2023, with the market implied rate cut expectations at roughly 200bp from peak rate. We continue to believe that a rate cut is unlikely in a period characterised by high inflation, combined with positive economic growth. Therefore, we see risks to the downside for equities due to their negative correlation with real rates (Exhibit 15), but we see a higher risk of a pullback for long-duration equities over the short-term.

Apart from the investor expectations around rates, the rally in equity markets that started in October has been primarily driven by short covering. This is clearly visible in Europe, where short interest on the STOXX 600 has halved from a recent high. Short positions had increased significantly through 2022, but as the market rallied in the fourth quarter, many investors chose not to roll forward futures in the December expiry, letting them expire.

In terms of our preferences with the equity market, we continue to prefer European equities over US equities. In our opinion, European stocks offer a better risk/return trade-off with lower valuations (in Europe) no longer supported by a significant difference in EPS growth expectations. Despite this, the US equity market is still trading on a premium of around 31%, well above median levels of around 15.4% since 2012. We note that the period 2012 to 2021 was a period characterised by strong top line growth for US equities during periods of lacklustre economic growth. Hence, the premium attached to US stocks was significantly higher during that period than it is today. Also, US markets have less to gain if the US avoids a recession. US equities are much more duration sensitive than non-US, and could underperform should US rates rise. On the other hand, European equities have a higher economic beta and should therefore benefit from an improved macro-economic outlook.

As for Value over Growth, Growth stocks outperformed value stocks in the US (+10.3% vs +3.2%), less so in Europe (+7.0% vs +6.7%). However, we believe that the improvement in the macro backdrop is more favourable for value over growth stocks. After years of underperformance we could see typical value sectors like Banks and Energy companies outperform. Banks have stronger balance sheets and adequate capital levels, and when combined with the positive impact from higher interest rates, we expect increased returns to shareholders in the short-term. As for Energy, low oil prices over the past decade led to a period of under investment by the industry which led to a demand/supply imbalance at the start of 2022. The invasion of Ukraine in 2022 reduced supply further, leading to higher energy prices for much of 2022. Although demand for energy fell late in 2022 and early in 2023, we believe that demand will rise at a faster rate than supply which should support prices. We expect the Energy sector to increase shareholder returns, either through dividends, share buy backs or a combination of both.

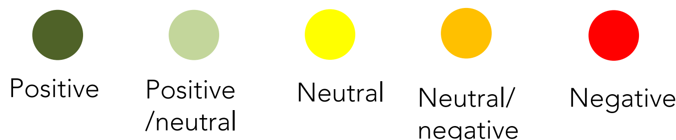
Exhibit 17 – Valuations – Developed markets

Valuations have come down significantly since the start of the year

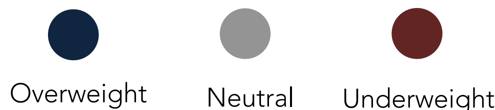
Historical Data	SPX	SXXP	SX5E	DAX	CAC	FTSE100	FTSE250
Current Forward PE ratio (FPE)	18.3x	12.9x	12.9x	12.3x	12.5x	10.6x	11.1x
Forward PE ratio (31/12/2022)	16.8x	12.0x	11.6x	11.1x	11.2x	10.0x	11.0x
10 Year data							
Highest	22.1x	17.5x	18.0x	15.7x	18.2x	15.4x	17.9x
Highest (date)	31/12/2020	29/12/2020	29/12/2020	28/12/2020	04/12/2020	02/12/2015	29/12/2020
Lowest	12.0x	10.0x	9.0x	8.4x	9.1x	8.4x	8.3x
Lowest (date)	25/02/2013	18/03/2020	18/03/2020	18/03/2020	18/03/2020	03/10/2022	23/03/2020
Median	16.0x	13.7x	12.8x	12.2x	13.3x	12.8x	13.8x
95th percentile	20.4x	16.0x	16.3x	14.5x	15.9x	14.9x	15.2x
5th percentile	13.4x	11.4x	10.7x	10.5x	10.7x	10.0x	10.9x
Historical rank (since 2006)							
Percentile	89.8%	56.2%	73.1%	67.0%	50.0%	30.3%	30.2%
Current FPE, % above/ (below) 10-YR median	14.2%	-5.5%	0.7%	0.7%	-6.4%	-17.1%	-19.6%
Current FPE, % above/ (below) Dec 22	8.6%	8.1%	11.0%	10.0%	11.1%	5.9%	0.8%

Source: Bloomberg

Key – Our view



Key – Allocation



Asset Class	Positioning
Developed Market Sovereign Bonds	We remain cautious on Government bonds as in our opinion the moderation seen in headline inflation over the past months is more than offset by core inflation remaining well above central bank targets. We also believe that the declining probability of a recession makes rate cuts unlikely over the short-term. Despite this, the market is pricing-in around 200bps of rate cuts from peak terminal rate which is expected to be reached around mid-2023. Finally, in our opinion the stronger macro-economic backdrop increases the risk of a higher terminal rate than is currently being priced-in by the market.
Investment Grade Corporate Bonds	Investment grade returns will continue to depend on movements in benchmark rates and corporate spreads. The asset class continues to provide reasonable opportunities to add risk on a selective basis. At current levels, the spread differential between EUR IG and 10-year BTP bonds has dramatically compressed, reverting to post-COVID levels. We believe that spreads could compress further from here. We also see room for the recession risk premium that built up over the past months in EUR IG spreads to compress further. Given our expectation for rates volatility we remain marginally more comfortable with our short duration positioning, though we see scope to extend further out the curve to be closer to the benchmark as we approach mid-2023. In the meantime, we see short-duration IG as a quasi-cash alternative with attractive yields.
High Yield Corporate Bonds	High Yield spreads have contracted during January as investors started to price-in the possibility of rate cuts in 2H23. Also, the improving macro-economic backdrop led to a compression in the recession risk premium that had built up in 2022. We continue to like the asset class as we think that HY is more insulated from rates anxiety, should they arise. We continue to prefer issuers that generate high cash flows combined with a strong balance sheet as we believe their earnings will be less susceptible to higher finance and input costs. Also, S&P see default rates rising towards the long-term average of 3.3% by September 2023 compared to 1.6% in November 2022, which makes credit quality more relevant in the screening process.
Developed Market Equities	We remain underweight developed market equities despite the strong rally YTD, which we believe was primarily motivated by rate cut expectations and short covering. Although we acknowledge the improvement in the macro-economic backdrop and the outlook for monetary policy is also more supportive, we believe that bullish positioning exposes investors to near-term risks. The current bullish sentiment requires growth momentum to pick up from current levels. We also note that "good news" might become "bad news" if inflation surprise to the upside again. For most of 2022, any good economic news was interpreted by the market as more inflation pressure and led to weakness in equities. This has not been the case so far this year, and we believe equity investors will struggle to digest further economic strength especially in the labour market. Finally, we expect equities to underperform should bond yields reprice higher. On balance, we believe that risks for equity investors remain tilted to the downside over the next 3-months, which supports our underweight rating.
Emerging Market Equities	In our opinion Emerging market equities performance could be boosted by China's commitment to re-open its economy at a faster rate than previously expected at the start of the year. China has underperformed for the last two years, on the back of higher political risk and a slowing economy that was impacted negatively by lockdowns and a weakening property market. There are already signs that the re-opening has led to a rapid acceleration in growth, and if February and March see additional gains, then we would expect upgrades to consensus forecasts. We think that China growth should also be beneficial for commodity exporting regions like Latin America.

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