CURMI & PARTNERS

May 24th, 2023

Monthly Strategy Update

The month in summary:

April was another month of positive performance for risky assets, across the geographies we follow. The Federal Reserve ("FED") is expected to pause monetary policy action in the coming months after aggressively hiking interest rates by 500bp since March 2022. Despite the resilient US labour market, there have been indications that wage growth is moderating which bodes well for inflation. However, the European Central Bank ("ECB") has more work to do, with economists expecting at least two more rate hikes over the next two meetings. Both the FED and ECB delivered 25bp rate hikes in their latest meetings.

Economic data released during the past month suggests risks to the growth outlook. Last month, we highlighted China's economic expansion as being supportive of global growth. Yet, most of the China economic data released over the past weeks has surprised to the downside, which could indicate that growth momentum is slowing earlier than previously expected. Although the slowdown in China has not reached alarming levels, we note that globally, the manufacturing sector has remained weak, with economies supported by the services sector. Any further deterioration in China could have repercussions for the manufacturing sector, and economies that rely heavily on the sector like Germany. Finally, the risks of the US debt ceiling being breached by June remains.

On balance, price action in the asset classes we follow suggests that investors have opted to look through the risks. Yields on the sovereign 10-year paper were largely unchanged following the drop seen in March as markets reacted to the US banking crisis. The 10-year UK Gilt rose 23bp during the month following resilient economic data and inflation surprising to the upside. All credit markets we follow, in terms of both geographies and investment rating grades, generated positive returns in April as spreads tightened following a volatile March. Developed market equities outperformed emerging markets amid renewed US/China tensions. These mainly related to Taiwan, as well as potential new restrictions from the US administration on foreign direct investment into China. Developed market equities performed strongly over the past weeks, with the growth parts of the market benefiting from growing interest in Artificial Intelligence. Also, investors are hoping that central banks will move to ease monetary policy in 2H23.

Sovereign		
	MoM bp	YTD bp
US 10-year yield	-5	-45
DE 10-year yield	2	-26
UK 10-year yield	23	5
Credit		
LCL Total returns	MoM %	YTD %
EUR IG	0.7%	2.5%
EUR HY	0.5%	3.4%
USD IG	0.8%	4.3%
USD HY	1.0%	4.6%
GBP IG	0.3%	2.8%
GBP HY	0.4%	4.1%
Equities		
LCL Total returns	MoM %	YTD %
Global	1.8%	9.8%
S&P 500	1.6%	9.2%
Nasdaq 100	0.1%	17.1%
STOXX 600	2.4%	11.0%
DAX	1.9%	14.4%
CAC	3.0%	16.8%
FTSE 100	3.4%	7.1%
Emerging markets	-1.1%	2.8%
EM ASIA	-2.1%	2.2%
EM LATAM	2.7%	6.7%
EM EMEA	4.1%	3.0%
Currencies		
Total return	MoM %	YTD %
EURUSD	1.7%	2.9%
EURCHF	-0.7%	-0.4%
GBPEUR	0.3%	1.0%
GBPUSD	1.9%	4.0%
Commodities		
Total return	MoM %	YTD %
Oil WTI	1.3%	-4.6%
Oil Brent	0.8%	-5.2%
Natural Gas	8.8%	-46.1%
Gold	1.1%	9.1%
Copper	-4.4%	2.7%
Iron Ore	-14.0%	-13.9%
Lumber	-5.3%	-5.9%

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Macro-economic views

The divergence in economic performance widened over the past weeks with recent data published by China showing signs of weakening, Europe's performance remained reliant on services and the US showing signs of resilience though impacted by US debt ceiling negotiations. Overall, we believe that the economic backdrop has weakened recently due to a combination of tightening financial conditions, rising cost of living and an uncertain demand outlook leading to firms preferring to keep low inventory levels.

The Global Manufacturing PMI remained unchanged at 49.5 (any figure below 50 implies contraction) in April. Notwithstanding, the Global Services PMI improved further to 55.4 in April (from 54.4 in March) leading to an improvement in the Composite PMI to 54.2 (from 53.4). Yet, China's April activity data disappointed market expectations by a large margin against a low base created by the lockdown last year. Overall, the main takeaway from the weaker data release is that, unless this is a one-off, the China impulse could be lower than economists currently expect, weighing on global growth expectations for 2023. The People's Bank of China is likely to react and loosen monetary policy, though how much of an impact these actions will have is debatable.

The European Commission revised growth for the region upwards to 1.1% in 2023 (from 0.9%) and 1.6% in 2024 (from 1.5%), but noted that downside risks to the economy have increased. These risks include persistently high core inflation and the impact this could have on purchasing power of households and monetary policy. Also, we believe that a deterioration in China's growth could also have implications for growth in the Bloc, especially the manufacturing industry which is important for core economies.

We note that lending standards in both the US and Europe have tightened in the first quarter of 2023, and are expected to tighten further in the second quarter. This is likely to have tightened financial conditions further, which could weigh on economic growth.

Exhibit 1 – Consensus real GDP growth and inflation expectations

Global economic growth expectations for FY23 are largely unchanged from last month

	Consensus Forecast, % QoQ							Cons. Forecast, % YoY		
Real GDP, YoY%	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F*	*FY23F*	*FY24F*	*FY25F*
United States*	1.1	0.1	-0.9	-0.3	1.0	1.6	1.9	1.1	0.8	2.0
Japan*	1.3	1.4	1.1	1.0	0.9	1.1	1.0	1.0	1.1	1.0
Germany	-0.1	0.1	-0.2	0.5	0.9	1.1	1.3	0.0	1.1	1.6
France	0.8	0.4	0.5	0.6	0.8	0.9	1.2	0.6	1.0	1.6
Italy	1.8	0.4	0.2	0.5	0.7	0.8	1.0	0.6	0.9	1.1
Spain	3.8	0.8	1.0	1.2	1.3	1.4	1.9	1.4	1.5	1.8
Eurozone	1.3	0.5	0.3	0.5	0.8	0.9	1.2	0.6	1.0	1.6
UK	0.0	-0.2	-0.1	-0.1	0.2	0.7	1.0	-0.2	0.9	1.5
DM Economies	1.4	0.4	-0.1	0.3	1.0	1.5	1.7	0.9	1.2	1.9
China	4.5	8.0	5.3	5.8	4.9	4.9	5.0	5.6	5.0	4.8
EM Economies	3.1	5.7	4.2	4.7	4.3	4.4	4.5	4.2	4.3	4.3
Global								2.5	2.8	3.3

	Revisions since last meeting									
Real GDP, YoY%	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F*	*FY23F*	*FY24F*	*FY25F*
United States*	-0.2	-0.1	-0.4	-0.6	0.0	0.0	0.1	0.1	-0.2	0.0
Japan*	-0.1	0.1	0.0	0.0	-0.2	-0.1	-0.2	-0.1	-0.1	0.0
Germany	0.0	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
France	0.1	0.1	0.1	0.2	-0.1	-0.1	0.0	0.1	0.0	0.2
Italy	0.7	0.2	0.2	0.1	-0.1	-0.2	0.0	0.1	0.0	-0.2
Spain	1.3	0.2	0.1	0.2	0.0	-0.3	0.0	0.1	0.0	-0.3
Eurozone	0.2	0.1	0.0	-0.1	-0.1	-0.3	-0.1	0.1	-0.2	0.0
UK	0.2	0.4	0.4	0.2	0.1	0.1	0.1	0.2	0.1	-0.2
DM Economies	0.2	0.1	-0.1	-0.2	-0.1	0.0	0.0	0.1	-0.1	0.0
China	1.1	0.7	0.4	0.0	-0.3	-0.1	0.1	0.3	0.0	0.1
EM Economies	0.4	0.3	0.2	0.0	-0.2	-0.1	0.0	0.0	-0.1	0.0
Global								0.1	0.0	0.0

* - QoQ SAAR
- The highlighted fields in the consensus forecast table refer to actual figures for the period.

	Consensus Forecast, % QoQ							Cons. Forecast, % YoY		
Consumer prices, YoY %	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F*	*FY23F*	*FY24F*	*FY25F*
United States	5.8	4.2	3.6	3.2	2.8	2.6	2.5	4.2	2.5	2.4
Japan	3.6	2.8	2.2	1.6	1.5	1.6	1.4	2.4	1.4	1.3
Germany	8.8	7.0	5.7	3.5	3.2	2.7	2.7	6.2	2.8	2.2
France	7.0	6.1	5.3	4.2	3.3	2.8	2.2	5.5	2.6	1.9
Italy	9.5	8.1	6.4	2.2	2.3	2.4	2.2	6.5	2.4	2.0
Spain	5.0	3.7	2.8	3.9	3.0	2.5	2.3	4.1	2.6	1.9
Eurozone	8.0	6.4	4.9	3.3	2.9	2.6	2.4	5.6	2.5	2.2
UK	10.2	7.2	5.5	3.4	2.9	2.2	2.4	6.6	2.5	2.0
DM Economies	7.1	5.8	4.9	4.1	3.6	3.3	3.0	5.5	3.0	2.5
China	1.3	1.4	1.9	2.4	2.6	2.6	2.2	2.1	2.3	2.2
EM Economies	6.3	5.4	5.4	5.6	5.3	5.0	4.4	6.2	4.8	3.7
Global								5.5	3.5	3.3

	Revisions since last meeting									
Consumer prices, YoY %	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F*	*FY23F*	*FY24F*	*FY25F*
United States	-0.1	-0.1	-0.2	-0.2	-0.2	-0.1	0.0	-0.1	-0.1	0.0
Japan	0.2	0.1	0.1	-0.1	0.0	0.4	0.1	0.1	0.2	0.2
Germany	0.0	0.3	0.1	-0.1	0.2	0.1	0.3	0.0	0.2	0.1
France	0.0	0.4	0.2	0.3	0.7	0.7	0.2	0.1	0.0	-0.1
Italy	-0.1	-0.3	-0.1	-0.1	-0.1	0.0	-0.1	0.0	0.0	0.1
Spain	0.0	-0.1	-0.3	0.2	-0.1	-0.5	0.3	0.0	0.0	-0.1
Eurozone	0.0	0.2	0.2	0.2	0.1	0.1	0.1	0.0	0.1	0.0
UK	0.4	0.0	0.1	-0.2	-0.2	0.1	0.2	0.1	0.1	-0.1
DM Economies	-0.7	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.0
China	0.0	-0.6	-0.3	-0.3	-0.1	0.3	0.2	-0.2	0.0	-0.1
EM Economies	0.5	0.2	0.2	0.2	0.1	0.4	0.3	0.3	0.2	0.0
Global								-0.1	-0.1	0.0

- The highlighted columns in the consensus forecast table refer to actual figures for the period.

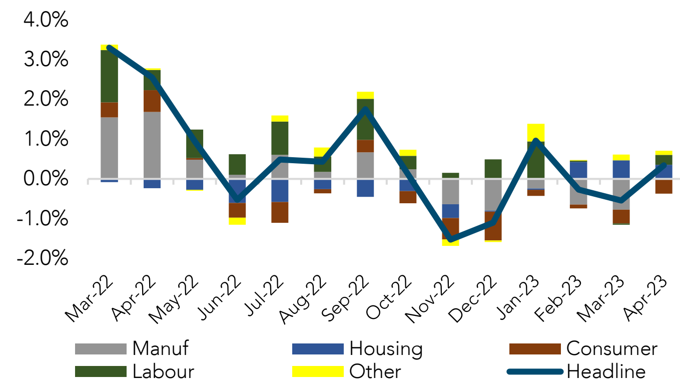
Source: Bloomberg (Note: QoQ figures for the US and Japan are QoQ SAAR, Shaded areas indicate Actuals)

United States

Growth: Goldman Sachs' Current Activity Indicator ("CAI") was once again in positive territory in April following two consecutive months of being in the negative (Exhibit 2). The Headline April CAI was reported at +0.3% following the prior figure of -0.5% (revised downward from the -0.4% reported in our previous monthly strategy report). The improvement was primarily driven by Manufacturing and Labour CAI. In line with the CAI monthly movements, the 1Q23 Atlanta FED GDP estimate was revised downward to +1.1% on 26/04 (the last estimate for Q1) from +2.5% on 18/04, while the latest estimate for 2Q23 reached +2.9% on 17/05 from +1.7% on 28/04 (Exhibit 3). The slower growth expected in 1Q23 by the Atlanta FED was primarily the result of lower consumer spending and investment growth expectations.

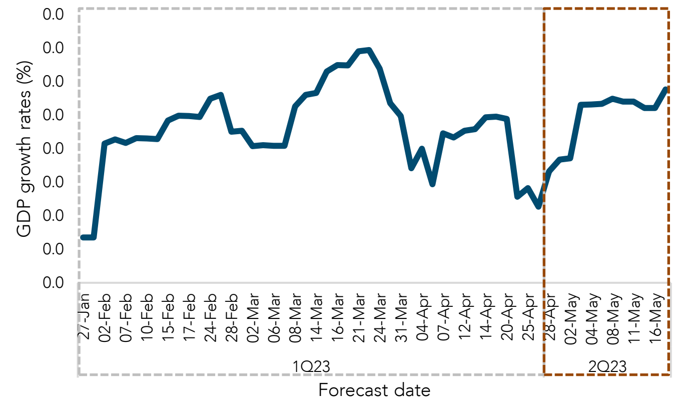
Inflation: The Core PCE decreased to 4.6% year-on-year in March from the prior 4.7%, above expectations of 4.5% (Exhibit 4). The rate remains elevated due to the tight labour market conditions especially in the services sector. However, based on the recent downward trend in both the job-workers gap and the Atlanta Fed wage tracker (Exhibit 4), the labour sensitive PCE core services inflation is likely to slow down during the coming months.

Exhibit 2 – US Current Activity Indicator
April headline CAI returned to positive territory following two consecutive months of deterioration.



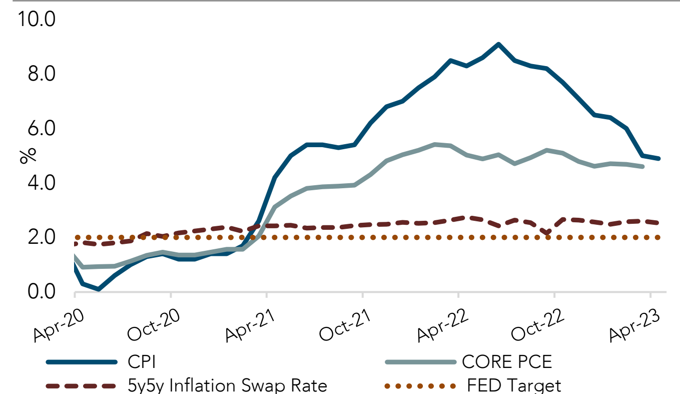
Source: Goldman Sachs

Exhibit 3 – Atlanta FED GDP estimate
The last growth estimate for 1Q23 fell to +1.1% on 26/04 from the peak of 3.5% on 23/03.



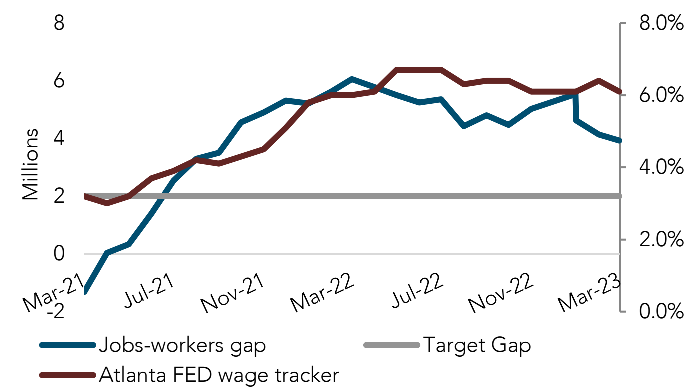
Source: Atlanta FED

Exhibit 4 – US Inflation rate
Core PCE increased to 4.6% y/y in March, above the expectations of 4.5% but below the prior 4.7%.



Source: Bloomberg

Exhibit 5 – Job-workers gap (LHS) and Atlanta FED wage tracker (RHS)
The job-workers gap has dropped below 4mn during March, while the Atlanta Fed wage tracker fell once again to 6.1% from 6.4%.



Source: FRED, Atlanta FED

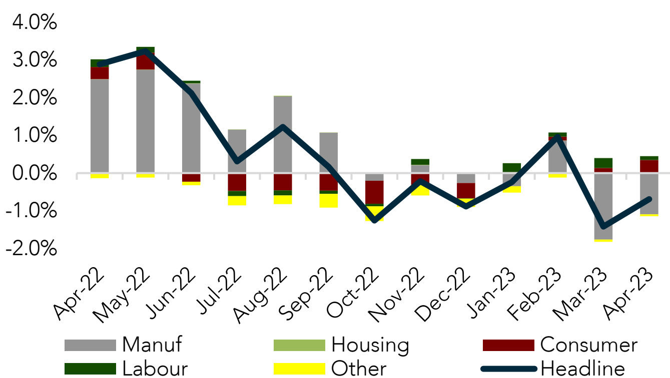
Europe

Growth: The Euro Area Headline CAI for April improved but remained in negative territory at -0.7% compared to the prior -1.4% (Exhibit 6). The improvement was driven by positive moves in the Manufacturing (+0.7%) and Consumer CAI (+0.2%). The pickup in activity was also noted in the PMI release for April, where the strong services sector continued to offset the weak manufacturing sector. Yet, the Euro Area Composite PMI for May fell slightly to 53.3 from the prior 54.1 (Exhibit 7), supported once again by the services sector. The manufacturing sector appears to be contracting at an accelerating pace, as new orders and the backlog of work both declined sharply, suggesting that the post-pandemic surge in activity has now ended. Also, Industrial production fell sharply in March after recovering in February (Exhibit 8). Despite the decline in Composite PMI, this reading is still consistent with the economy expanding in Q2, which is in line with the ZEW current conditions index data for May which edged up.

Inflation: Headline inflation for April edged up to 7.0% from the prior 6.9% with the increase reflecting a rise in energy inflation and a fall in food inflation. On the other hand, core inflation edged down to 5.6% from the prior 5.7% reflecting that core goods inflation has come down further from its February peak (Exhibit 9). Inflation for goods affected by supply bottlenecks fell again in April and the rate of inflation for items within that category (such as motor cars and household furnishing) is easing.

Exhibit 6 – EU Current Activity Indicator

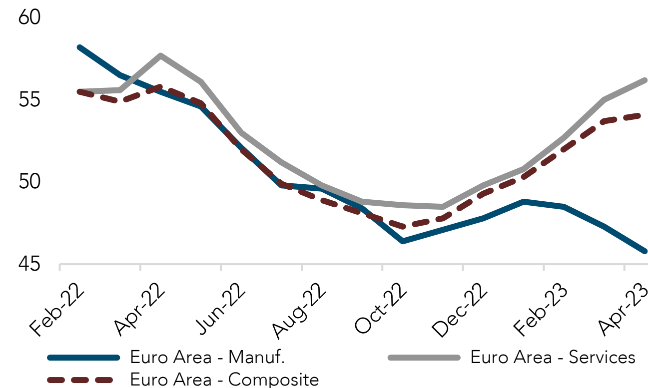
Headline CAI improved 0.72% to -0.7% during April, aided by Manufacturing and Labour CAI.



Source: Goldman Sachs

Exhibit 7 – EU PMIs

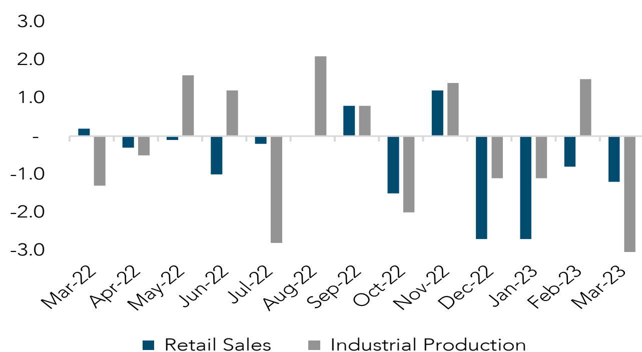
The April Composite PMI rose to 54.1 from 53.7, supported by services as manufacturing continued to contract.



Source: Bloomberg

Exhibit 8 – EU Industrial Production

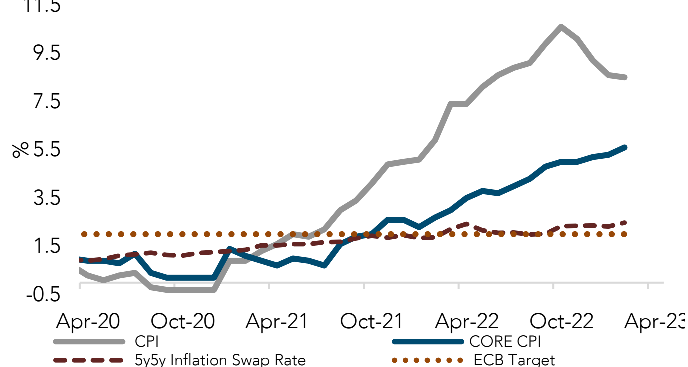
IP declined 4.1% m/m, driven by a sharp decrease in capital goods production. Retail sales fell 1.2% m/m as high prices weighed on consumers' affordability.



Source: Bloomberg

Exhibit 9 – EU Inflation rate

The April inflation print was in line with expectations of 7%, above the prior 6.9%. The core inflation print on the other hand edged down to 5.6% from the prior 5.7%.

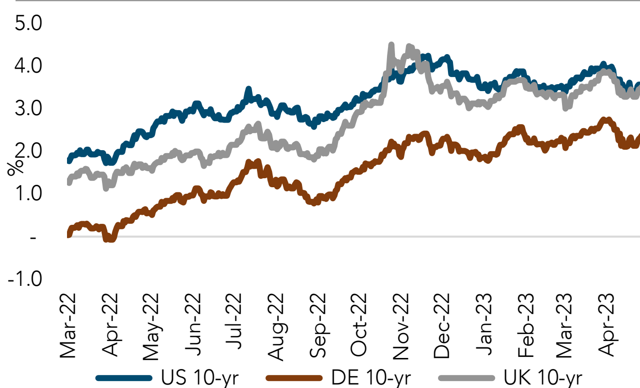


Source: Bloomberg

Rates

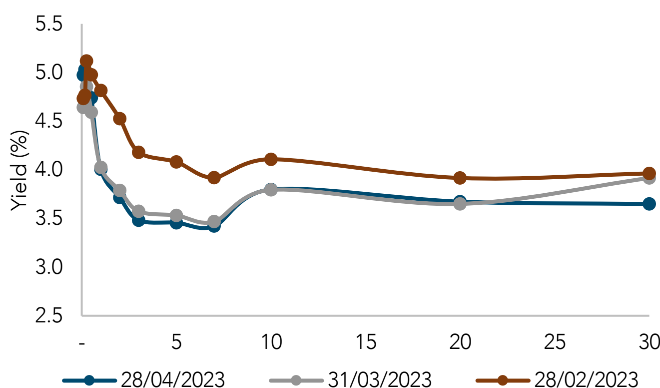
Sovereign yields were mixed during the month of April. The yield on the U.S. 10-year Treasury declined slightly during the month while the opposite was true for both the Bund and the Gilt. However, the move in the UK 10-year Gilt was more pronounced, as the yield rose c. 23bp to 3.7%. The month of April was charaterised by a somewhat dovish rate hike by the FED as the central bank increased rates by 25bp, whilst the ECB reduced the pace of hiking from 50bp to 25bp. However, while inflation remained on the forefront of investor concerns, attention shifted to the debt ceiling negotiations in the US. Both sides of the negotiation seem unwilling to make concessions to get the debt ceiling limit lifted, increasing the risk of a breach over the coming weeks.

Exhibit 10 - 10-year nominal bond yield for the US, Germany and UK
The higher yields in the EA and UK were inflation and rate hike driven. The Fed's dovish hike and banking crisis drove the UST lower.



Source: Bloomberg

Exhibit 11 – US Yield Curve
The U.S. sovereign yield curve inverted further in April, particularly at the front and long-end with the 2s10s spread widening by c. 3bp.



Source: Bloomberg

United States

U.S. rates are expected to remain range-bound given the expectations around economic data and the ongoing talks around the debt ceiling limit. The debt ceiling limit was the main topic of interest towards the end of April. While the probability of the U.S. defaulting on its debt are low, U.S. rates markets are expected to trade in a volatile fashion around any news that may emanate from the negotiations. Treasury Secretary Janet Yellen informed Congress that the Treasury is expected to run out of funds as early as 1st June but *"potentially a number of weeks later"*. Legislatively speaking, the timeline around reaching an agreement on the debt limit is tight as there are only two weeks when both chambers are in session before early June as each chamber begins their respective recess period shortly after.

On the monetary policy front, the FED is expected to pause its rate hikes at the June meeting after raising rates by 25bp in May to bring the Federal Fund Rate to 5.00% - 5.25%. FED Chair Powell did not explicitly state that the central bank will be pausing rate hikes, however, the language used during the press conference did allude to this being the case. This view is supported by the recent release of the Senior Loan Officer Opinion Survey, which showed a tightening in lending standards by banks in the US. As previously stated by FED officials, tighter lending standards could in essence replace rate hikes. Notwithstanding, any future monetary policy action will be dictated by economic data released.

Europe

While the ECB's Governing Council did not meet in April, at its May meeting it slowed down the pace of hikes to 25bp. The Governing Council did note that past rate increases are now being transmitted into financing conditions although it did also note that risks to inflation remain skewed to the upside. Importantly, the ECB's Governing Council announced that it plans to discontinue all APP investments from July which implies a run-off of about EUR 25.0 billion on average per month. Going forward, the market expects the ECB to hike rates by 25bp at both its June and July meeting to bring its terminal rate to 3.75%. The expectations of higher rates are due to the resilient economic growth, strong wages and sticky core inflation.

Following the May meeting, Governing Council members have turned more hawkish. While the path for monetary policy in the Euro Area will remain dependent on activity and price data, Governing Council members are discussing the possibility of hiking rates beyond the July meeting. With respect to European sovereign spreads, the APP run-off is expected to lead to wider spreads.

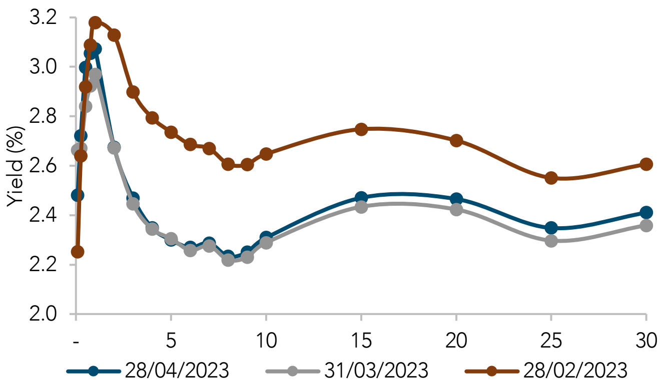
The Euro-area bank lending survey showed a deterioration in the credit demand and supply during the first quarter of 2023. The survey noted that demand for loans *"decreased strongly, mainly by rising interest rates"* whilst banks *"reported a further substantial tightening in their approval criteria for loans to firms and loans for house purchase"*. If this tightening persists, could eventually replace future rate hikes by the ECB, in-line with comments from the FED in the past months.

In the U.K., the Bank of England's ("BoE") Monetary Policy Committee hiked rates by a further 25bp in May to 4.5%. While the BoE warned that its inflation target will not be met before 2025, it did upgrade its growth and inflation projections. Inflation is expected to fall from its current 10.1% to 5.1% by the last quarter of 2023. Furthermore, the BoE now expects that the U.K. economy will avoid a recession relatively comfortably. Going forward, the market expects the BoE to hike rates two more times by 25bp to bring the terminal rate to 5.0% even though Governor Bailey did not provide any forward guidance.

Exhibit 12 – German 10-year yield curve

German 10-year yields rose 2bp during April despite rate hike expectations. On a YTD basis, the Bund yield has risen 26bp.

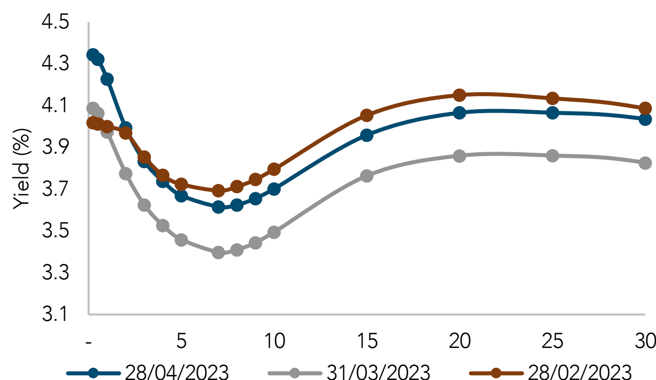
did not meet in April, at its May meeting it decided to hike rates



Source: Bloomberg

Exhibit 13 – UK 10-year yield curve

The 10-year Gilt yield rose by c.23bp during April with the yield curve inverting by the largest degree compared to the EA and U.S.



Source: Bloomberg

Credit

The pressure on US regional banks continued following below-consensus earnings from First Republic Bank, which was later acquired by JP Morgan. In credit markets, contagion risk remains largely in check, with the post-Silicon Valley Bank ("SVB") bifurcations between regional and money centre banks still intact. This divergence is expected to continue as the headwinds from lower market capitalisations, deposit outflows, elevated funding costs, and downside risk for earnings will likely continue to pressure the balance sheets of small banks. However, when considering the low share of regional banks in the USD IG market (1.6% of the broader USD IG market) and the strong capital and liquidity positions of money centre banks, the risk of spill over remains low. When comparing bank spreads versus non-financial bank spreads, this suggests that the quasi entirety of the excess premium that built up post-SVB failure has remained stubbornly in place, both in the USD and EUR markets. Most analysts have viewed this repricing as evidence of a modest funding shock for banks.

Valuation constraints in the USD IG market have turned dramatically more severe this month, this being a by-product of a more inverted Treasury yield curve and generally tighter spreads. The share of the IG index that yields less than the 3-month Treasury bills has jumped to a new record-high level of 54%. We believe that the surge in yields seen in shorter-dated paper is a result of rising anxiety relating to the US debt ceiling negotiations as theoretically, the risk of default for debt maturing in the coming months is higher. Not surprisingly, the higher the rating, the higher this share: 95% of AA-rated bonds yield less than the 3-month Treasury bills versus 65% and 37% of A and BBB-rated bonds, respectively.

Cumulative flows in IG funds have risen again to around €10.0bn on a YTD basis, while during the same period HY fund flows also rose (albeit not at the same level), though remaining below the €2.0bn mark. When compared to the prior year, both IG and HY funds have shown an improvement in cumulative flows.

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

Total Returns indices	MoM Δ	YTD Δ
USD IG	0.8%	4.3%
USD HY	1.0%	4.6%
AAA	0.8%	5.8%
AA	0.7%	4.7%
A	0.8%	4.1%
BBB	0.8%	4.4%
BB	0.7%	4.2%
B	1.0%	4.5%
CCC	2.3%	7.4%

Total Returns indices	MoM Δ	YTD Δ
EUR IG	0.7%	2.5%
EUR HY	0.5%	3.4%
AAA	1.2%	1.2%
AA	0.5%	1.8%
A	0.6%	2.2%
BBB	0.8%	2.8%
BB	0.7%	3.1%
B	0.5%	4.0%
CCC	-0.6%	1.1%

Total Returns indices	MoM Δ	YTD Δ
GBP IG	0.3%	2.8%
GBP HY	0.4%	4.1%
AAA	-0.8%	0.2%
AA	-0.5%	1.2%
A	0.2%	2.7%
BBB	0.5%	3.1%
BB	N/a	N/a
B	N/a	N/a
CCC	N/a	N/a

Spread Movements	MoM Δ	YTD Δ
USD IG	-2.25	5.87
USD HY	-3.05	-16.83
AAA	-0.57	-2.15
AA	-0.30	0.42
A	-2.00	7.18
BBB	-1.86	6.49
BB	3.38	-8.89
B	-7.66	-32.20
CCC	-41.07	-75.49

Spread Movements	MoM Δ	YTD Δ
EUR IG	-7.12	-5.01
EUR HY	6.97	-8.28
AAA	-15.74	30.91
AA	-2.93	8.60
A	-6.41	-0.15
BBB	-7.28	-9.15
BB	5.66	5.36
B	11.74	-35.38
CCC	79.27	189.70

Spread Movements	MoM Δ	YTD Δ
GBP IG	-18.80	-21.79
GBP HY	-7.16	-57.23
AAA	-9.00	0.13
AA	-11.78	-2.81
A	-19.77	-22.28
BBB	-19.05	-23.30
BB	N/a	N/a
B	N/a	N/a
CCC	N/a	N/a

Source: Bloomberg

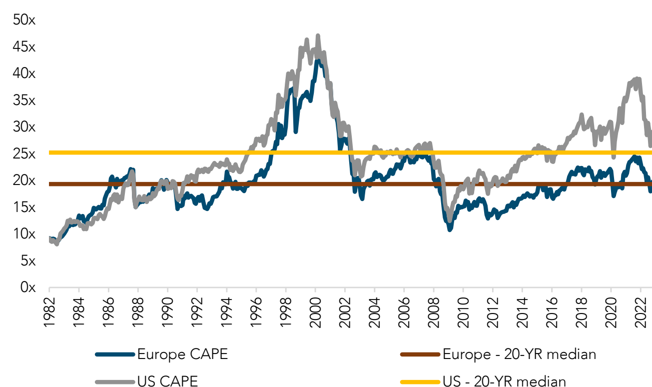
Equity

Global equities continued to rally during April despite no significant improvement in the macro-economic backdrop. Global equities delivered a total return of +1.8% (US$) during the month, boosted by strong performance in UK equities (+3.4%), Japan (+2.9%) and Europe (+2.6%). Real yields rose 10bp during April, which could explain the underperformance of US equities relative to their European counterparts, as well as the underperformance of Growth areas of the market relative to Value. That said, real yields are 32bp lower compared to the start of the year, coinciding with a strong performance for Growth strategies (Global Growth +17.1% vs +3.2% for Value YTD).

Exhibit 15 – S&P 500, STOXX 600 and US Real yield (RHS)
Real yields rose 10bp during April to c. 1.3% as Value strategies outperformed Growth and Europe outperformed the US

Source: Bloomberg
Performance rebased from 31 December 2021

Exhibit 16 – Europe and US CAPE
The divergence between the valuation of Europe and US stocks has grown over the past 10 years



Source: Barclays

The Nasdaq (a Growth strategy proxy) has generated a total return of 17.1% (US$) YTD, the best performing developed market index we follow. We believe that investor preference for long-duration equities is driven by the market's perception that the FED will cut rates aggressively in 2H23. Currently, market-implied pricing suggests 100bp to January 2024, an increase from the 50bp expected at the start of the year . Yet, inflation is still relatively high and well above FED target. There is a clear disconnect between what rates markets and equity markets seem to be pricing-in. The expectation of interest rate cuts starting in 2H23, coupled with the shape of the yield curve, the 2s10s curve and the 2yr vs 5yr rate are all consistent with a recession starting in the next 12 months. Also, the recession probability remains at 65%, above the median calculated since 2008 .

Current pricing suggests equity investors expect inflation moderation to continue, interest rates to fall and no recession materialising. Confidence that we might have seen the worst in terms of inflation continues to grow, with data released during the month suggesting labour market conditions to be moderating. Yet, we doubt whether inflation can slow at a fast enough pace without a recession, and without a recession we believe that the probability of the FED cutting rates to be fairly low.

In our opinion this is a typical late cycle dilemma where different markets point to significantly different outcomes. The Rates market are pointing to a recession over the next 12-months, whilst equities are not. Generally, equities tended to trade in a range for this period, until the first rate cut is announced.

There was renewed pressure on US regional banks during May, driven by the closure and subsequent takeover of First Republic bank on 01/05, which led to a steep sell-off in the shares of PacWest, Western Alliance and First Horizon. PacWest and Western Alliance sold-off following news that they were exploring strategic options, including a sale whilst First Horizon fell in response to Toronto-Dominion calling off its merger. The failure of First Republic bank brings the total assets of failed US commercial banks to over $500 billion this year, a little over 2% of total bank assets.

Equity valuations remain high and whilst we believe that the market focus will remain fixed on the inflation/growth dynamics, another constraint for equities is the high starting valuation. Also, the high interest rates are also attracting investors back to lower risk asset classes. At 17.2x forward PE, the US market trades c.6% above its 10-year median. When looking at the CAPE, US equities are currently trading at a premium of 16.4% to the 20-year median (For most of the past 20 years interest rates have been low and consequentially, valuations have been high) (Exhibit 16). Valuations outside the US are generally cheaper, with European equities trading on a premium of just 8.4% relative to the 20-year CAPE. This supports our preference for Europe relative to the US. Furthermore, valuations are close to average, implying little scope for re-rating without lower interest rates.

High cash returns mean that there are no reasonable alternatives to equities. Lower risk asset classes like Sovereign are much more attractive today compared to recent history, which implies less demand for equities. Equity Risk Premiums (“ERP”) have fallen sharply over the past year, implying relatively low prospective returns compared with risk-free assets. The yield gap has compressed (and in some cases turned negative) following the monetary policy tightening and a less positive yield gap can point to either strong expected economic growth, which is unlikely or a lower equity risk premium. Unless this can be achieved equities would have to de-rate vs bonds. Therefore, since ERP is already at very low levels, we see scope of the dividend yields to increase (which would improve the yield gap).

The VIX volatility index fell to 17.0, having peaked at 27 in March following the bank sector crisis. Since then, despite the collapse of other banks, as well as the risk of breaching the debt ceiling by June, volatility has remained low which could imply a reasonable degree of complacency. We see risk of an uptick in volatility should the risk of recession increase over the near term which would weigh on the asset class’s performance.

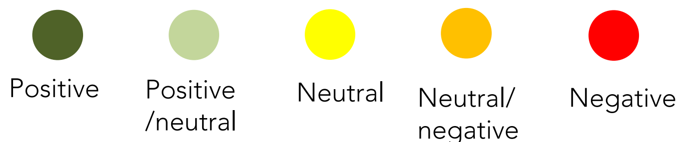
Exhibit 17 – Valuations – Developed markets

Valuations have expanded since the end of February despite the uptick in banking sector stress

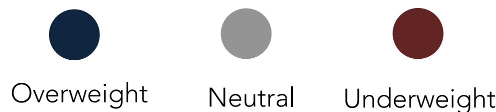
Historical Data	SPX	SXXP	SX5E	DAX	CAC	FTSE100	FTSE250
Current Forward PE ratio (FPE)	17.2x	12.4x	11.9x	10.5x	12.4x	10.6x	8.4x
Forward PE ratio (31/12/2022)	16.8x	11.9x	11.3x	10.5x	11.3x	10.0x	11.1x
10 Year data							
Highest	22.1x	17.5x	18.0x	15.7x	18.2x	15.4x	17.9x
Highest (date)	31/12/2020	29/12/2020	29/12/2020	28/12/2020	04/12/2020	02/12/2015	29/12/2020
Lowest	12.2x	10.0x	9.0x	8.4x	9.1x	8.4x	8.3x
Lowest (date)	23/03/2020	18/03/2020	18/03/2020	18/03/2020	18/03/2020	03/10/2022	23/03/2020
Median	16.1x	13.7x	12.8x	12.2x	13.3x	12.8x	13.7x
95th percentile	20.4x	16.0x	16.3x	14.5x	15.9x	14.9x	15.2x
5th percentile	13.8x	11.6x	11.1x	10.8x	11.0x	9.9x	10.7x
Historical rank (since 2006)							
Percentile	84.2%	45.9%	48.4%	28.9%	47.7%	29.8%	3.9%
Current FPE, % above/ (below) 10-YR median	6.8%	-9.2%	-7.4%	-13.6%	-7.1%	-17.4%	-38.7%
Current FPE, % above/ (below) Dec 22	2.0%	4.8%	5.3%	0.6%	9.4%	5.6%	-24.4%

Source: Bloomberg

Key – Our view



Key – Allocation



Asset Class			Positioning
Developed Market Sovereign Bonds			We prefer to remain on the sidelines for the time being given the current elevated volatility within the rates market. Rates have come down significantly over the past months as investors are pricing-in rate cuts in the second half of the year. However, we believe that central banks are unlikely to cut rates given where inflation is at. Core inflation is moderating in the US and Europe, but remains well above the FED's and ECB's target. We would expect rates to rise slightly and hover around current high levels assuming the base case scenario of a soft landing materialises. We would re-assess our position if the macro-economic outlook deteriorates meaningfully.
Investment Grade Corporate Bonds			We expect spreads to contract further in the coming months driven by outflows out of riskier asset classes into IG. We note that certain pockets within the IG space are offering attractive yields to investors following the aggressive tightening by central banks over the past months. This should provide investors with a more compelling argument to reduce their risk exposure, especially when considering the high uncertainty around the macro-economic backdrop. Cumulative flows in IG funds have been positive on a YTD basis and we expect this to persist over the coming months. Also, when taking into consideration our view on DM Sovereign bonds, we prefer to have a slightly shorter-duration compared to the benchmark.
High Yield Corporate Bonds			We downgraded our allocation on HY to Neutral from Overweight during March given the macro-economic outlook. Similar to the IG space, the asset class is providing investors with much higher yields to compensate for the higher risk. Yet, given the uncertainty around economic growth we opted to reduce exposure to the sector. Our view is supported by the rising default rate which we expect will get worse if the base case (soft landing) materialises. Also, we believe that the combination of higher funding costs (as a result of the higher interest rates) and tighter lending conditions could result in liquidity issues for companies that are under stress. Within the sector 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. Similar to IG, we prefer to have slightly shorter-duration compared to the benchmark.
Developed Market Equities			Despite the rising uncertainty, equity markets have generated double-digit returns on a YTD basis. Although we acknowledge that developments early in the year were positive for the global macro-economic outlook, we note that the US bank stress and the recent deterioration in economic data released by China could reverse some of the optimism. Also, the persisting downward trend in the equity risk premium despite the rising risk environment suggests a certain degree of complacency. We believe that equity investors are currently pricing-in continued moderation in inflation, lower interest rates and no recession. However, we believe that central banks will not cut rates unless something breaks, which implies rates will have to increase weighing on valuations. The other scenario would see a recession materialising, which could result in downwards revisions to corporate earnings growth forecasts.
Emerging Market Equities			Emerging market equities generally outperform developed market equities during periods of strong economic expansion. Although this was never likely to materialise in 2023, we expected the faster China re-opening to boost the asset class, especially when considering the underperformance of Chinese equities over the past years. Our view on Chinese equities has not changed, and we would only revise our view if the Chinese economy deteriorates significantly. The uncertainty over global macro-economic growth has weighed on commodities, hitting the LATAM region. The demand/supply dynamics within the oil industry are expected to be more supportive in the summer.

Disclaimer

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