CURMI & PARTNERS

June 16th, 2023

Monthly Strategy Update

The month in summary:

Economic data published lately has been mixed, providing little clarity on the general strength of the global economy. The divergence between manufacturing and services sectors within developed economies continued to widen. The US S&P Services PMI rose to a 13-month high of 54.9, and both the EU and UK services PMI remained above 55 (any number above 50 indicates expansion). In contrast, the slowdown in manufacturing has become more evident. The euro-area manufacturing PMI fell further in contraction territory at 44.8 in May, its lowest level since May 2020. Furthermore, the US and UK manufacturing PMI readings were also in contraction territory (below 50).

The US labour market data released last week was also mixed, with the stronger non-farm payrolls (also called establishment data) contrasting with the increase in the unemployment rate (household data). We note that the initial response rate for the establishment data was unusually low at 54.7%, down from over 70% in the prior two months, suggesting that revisions may be announced in upcoming reports. This low response rate is also evident in the JOLTS job openings data release. On balance, we think that low response rate reduces reliability.

Economic data released in Europe does not provide much better visibility. Headline inflation moderated more than expected but core inflation remained elevated with one-off technical factors suggesting a re-acceleration in June. Also, we are concerned with the slowdown in China, which could suggest that the economy is losing momentum after a strong start to 2023. We believe that this could have implications for the Euro-area, though we note this week, China announced stimulus measures to boost economic growth.

May was a difficult month for risky assets, with most equity benchmarks generating negative returns. The exception was the US, where the enthusiasm around Artificial Intelligence (AI) boosted technology stocks. Government bond yields edged higher as the market revised terminal rate expectations higher. Performance within credit markets diverged between countries and rating. US credit generated negative returns in May both in the investment grade ("IG") and high yield ("HY") space, whilst EU credit generated positive returns. Finally, commodity markets experienced some weakness, with Oil closing the month around 40% lower than last year.

Sovereign		
	MoM bp	YTD bp
US 10-year yield	22	-23
DE 10-year yield	-3	-29
UK 10-year yield	46	51
Credit		
LCL Total returns	MoM %	YTD %
EUR IG	0.2%	2.6%
EUR HY	0.9%	4.3%
USD IG	-1.4%	2.8%
USD HY	-0.9%	3.6%
GBP IG	-2.5%	0.2%
GBP HY	0.3%	4.5%
Equities		
LCL Total returns	MoM %	YTD %
Global	-0.9%	8.8%
S&P 500	0.4%	9.6%
Nasdaq 100	5.9%	24.1%
STOXX 600	-2.5%	8.2%
DAX	-1.6%	12.5%
CAC	-3.9%	12.3%
FTSE 100	-5.0%	1.7%
Emerging markets	-1.7%	1.1%
EM ASIA	-1.8%	0.4%
EM LATAM	-0.9%	5.8%
EM EMEA	-6.0%	-3.1%
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	-11.1%	-14.7%
Oil Brent	-9.2%	-13.2%
Natural Gas	-6.0%	-49.4%
Gold	-1.4%	7.6%
Copper	-5.9%	-3.4%
Iron Ore	-1.7%	-15.4%
Lumber	-2.2%	-12.8%

Robert Ducker, CFA
+356 23426112

Simon Gauci Borda
+356 23426132

Nicole Busuttil
+356 23426126

Macro-economic views

Economic data published lately has generally been mixed and difficult to interpret for investors. There are signs that China's economy is starting to lose steam following a strong 1Q23 that was positively impacted by the re-opening. China is the second largest economy globally and a slowdown will have implications for global growth in general, though countries with strong ties to the country, like Europe and Australia are likely to be impacted more. However, we note that the People's Bank of China ("PBOC") cut the open market operations ("OMO") rate by 10bp, from 2.0% to 1.9%. This could suggest the start of additional monetary policy easing over the near term to help boost domestic demand.

Global Manufacturing PMI was unchanged in May, slightly in contraction territory for the ninth consecutive month (at 49.6). Growth in manufacturing production accelerated to an 11-month high (though still relatively subdued), boosted by strength in Asia which offset weakness in the US and Europe. Output growth recovered to an 11-month high in China, Japan saw expansion following ten months of contraction, while India and Thailand grew strongly. On the flipside, growth slowed in the US, whilst Greece was the only country within the EU that registered expansion. The UK, Australia and Brazil all saw production decline. Finally, new orders fell for the eleventh consecutive month driven by weakness in the US, the EU, the UK and Brazil, whilst new orders in China, Japan and India rose.

Global Composite index rose slightly to 54.4 (from 54.2), marking the fourth consecutive month of a reading above 50 (expansionary territory). This was primarily driven by strength in the services sector, with activity accelerating to levels not seen since November 2021. Output increased in all national economies covered by the survey (especially in the US, China, Japan and Germany) whilst growth in new business was the strongest since July 2021.

Exhibit 1 – Consensus real GDP growth and inflation expectations

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

	Consensus Forecast, % QoQ							Consensus Forecast, % YoY			Revisions since last meeting								
Real GDP, YoY%	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F*	*FY22F*	*FY23F*	*FY24F*	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*FY22F*	*FY23F*	*FY24F*
United States*	1.3	0.6	-0.5	-0.4	0.8	1.6	1.9	1.1	0.8	2.0	0.2	0.5	0.4	-0.1	-0.2	0.0	0.0	0.0	0.0
Japan*	1.6	1.4	1.0	0.9	1.0	1.2	1.2	1.0	1.1	1.1	0.3	0.0	-0.1	-0.1	0.1	0.1	0.0	0.0	0.1
Germany	-0.5	0.1	-0.2	0.5	0.7	1.0	1.2	0.0	1.1	1.6	-0.4	0.0	0.0	0.0	-0.2	-0.1	0.0	0.0	0.0
France	0.9	0.5	0.4	0.6	0.7	0.8	1.2	0.6	1.0	1.5	0.1	0.1	-0.1	0.0	-0.1	-0.1	0.0	0.0	-0.1
Italy	1.9	0.9	0.6	0.9	0.6	0.8	1.0	1.0	0.9	1.3	0.1	0.5	0.4	0.4	-0.1	0.0	0.4	0.0	0.2
Spain	3.8	1.4	1.2	1.1	1.2	1.3	1.7	1.8	1.4	2.0	0.0	0.6	0.2	-0.1	-0.1	-0.1	0.4	-0.1	0.2
Eurozone	1.3	0.5	0.3	0.5	0.7	1.0	1.0	0.6	1.0	1.7	0.0	0.0	0.0	0.0	-0.1	0.1	0.0	0.0	0.1
UK	0.2	0.1	0.3	0.2	0.3	0.7	1.0	0.2	0.9	1.7	0.2	0.3	0.4	0.3	0.1	0.0	0.4	0.0	0.2
Developed Economies	1.4	0.7	0.1	0.2	0.9	1.5	1.7	1.0	1.1	1.9	0.0	0.3	0.2	-0.1	-0.1	0.0	0.1	-0.1	0.0
China	4.5	7.7	5.0	5.4	4.7	4.7	4.7	5.5	4.9	4.7	0.0	-0.3	-0.3	-0.4	-0.2	-0.2	-0.1	-0.1	-0.1
Emerging Economies	3.9	5.6	4.1	4.5	4.2	4.2	4.3	4.2	4.3	4.2	0.8	-0.1	-0.1	-0.2	-0.1	-0.2	0.0	0.0	-0.1
Global								2.6	2.7	3.2							0.1	-0.1	-0.1

	Consensus Forecast, % QoQ							Consensus Forecast, % YoY			Revisions since last meeting							
Consumer prices, YoY %	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F (New)*	*FY22F*	*FY23F*	*FY24F*	*4Q22F*	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*FY22F*	*FY23F*	*FY24F*
United States	5.8	4.2	3.5	3.2	2.8	2.7	2.5	4.1	2.5	2.4	0.0	0.0	0.0	-0.1	0.0	-0.1	0.0	0.0
Japan	3.6	3.2	2.6	2.0	1.8	1.8	1.5	2.7	1.5	1.3	0.0	0.0	0.4	0.4	0.4	0.3	0.1	0.0
Germany	8.8	7.1	5.8	3.8	3.2	2.6	2.4	6.1	2.8	2.1	0.0	0.0	0.1	0.1	0.3	-0.1	0.0	-0.1
France	7.0	6.1	5.3	4.2	3.3	2.6	2.2	5.5	2.5	2.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.1
Italy	9.5	7.8	5.7	1.5	2.0	2.5	2.2	6.3	2.4	2.0	0.0	0.0	-0.3	-0.7	-0.7	-0.2	0.0	0.0
Spain	5.0	3.9	2.9	4.0	3.2	2.7	2.2	3.9	2.6	1.8	0.0	0.0	0.2	0.1	0.1	-0.2	0.0	-0.1
Eurozone	8.0	6.3	4.9	3.0	2.8	2.5	2.3	5.5	2.5	2.0	0.0	0.0	-0.1	0.0	-0.3	-0.1	0.0	-0.2
UK	10.2	7.7	5.9	3.9	3.2	2.3	2.4	6.9	2.6	2.0	0.0	0.0	0.5	0.4	0.5	0.3	0.1	0.0
Developed Economies	7.1	5.8	4.8	4.1	3.6	3.3	3.0	5.5	3.1	2.5	0.0	0.0	0.0	-0.1	0.0	0.0	0.1	0.0
China	1.3	0.6	1.1	2.1	2.5	2.5	2.0	1.6	2.3	2.2	0.0	0.0	-0.8	-0.8	-0.3	-0.5	0.0	0.0
Emerging Economies	6.3	4.8	5.0	5.6	5.5	5.5	4.5	6.0	4.9	3.9	0.0	0.0	-0.6	-0.4	0.0	-0.2	0.1	0.2
Global								5.5	3.5	3.2						0.0	0.0	-0.1

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

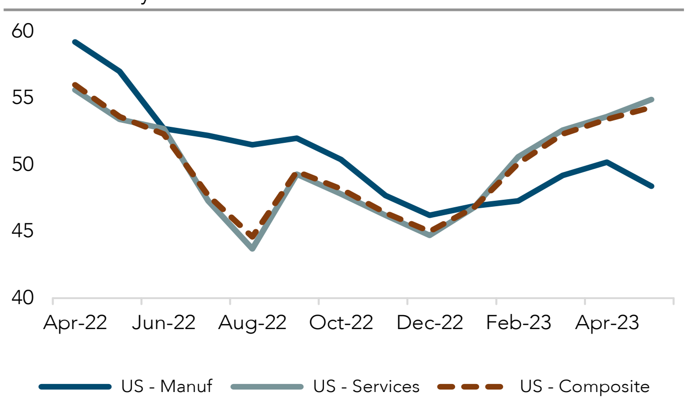
United States

Growth: The S&P Manufacturing PMI fell sharply in May to 48.4 from 50.2 in April, which suggests a sharp deterioration in operating conditions since February. Weaker new orders, the steepest decline in three months, explains much of the deterioration seen in May, slightly offset by a record improvement in supplier delivery performance. In contrast, the conditions within the services sector continued to improve as PMI came in at 54.9 in May, up from 53.6 previously. Overall, the Atlanta Fed GDP Q2 forecast was revised up to 2.2% (08/06), compared to 1.7% previously (28/04) (Exhibit 3) which suggests that growth remained above trend in the second quarter of 2023.

Inflation: Headline CPI rose 4.1% YoY in May (down from 4.9% last month), the lowest reading since March 2021 (Exhibit 4). Energy remained a drag for headline inflation, while food inflation picked up slightly. Moreover, core CPI rose 5.3% YoY (down from 5.5%) last month which was slightly above consensus expectations, amid another month of acceleration in used car prices. Broader measures are showing that wage growth is slowing, with the average hourly earnings increasing 4.3% YoY in May versus the prior 4.4% and the Atlanta Fed wage tracker declining once again in May to 6.0% from the prior 6.1%. This should help bring the core services inflation down further (excluding housing, which is still on an upward trend on a month-on-month basis). The job-workers gap remained largely unchanged, though the low response rate in the JOLTS survey somewhat reduces the reliability of the indicator (Exhibit 5).

Exhibit 2 – US S&P Manufacturing, Services and Composite PMI

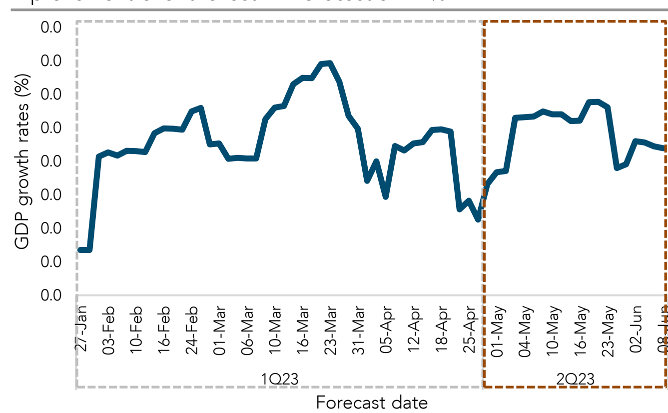
The divergence between the manufacturing and services sector widened in May



Source: Bloomberg

Exhibit 3 – Atlanta FED GDP estimate

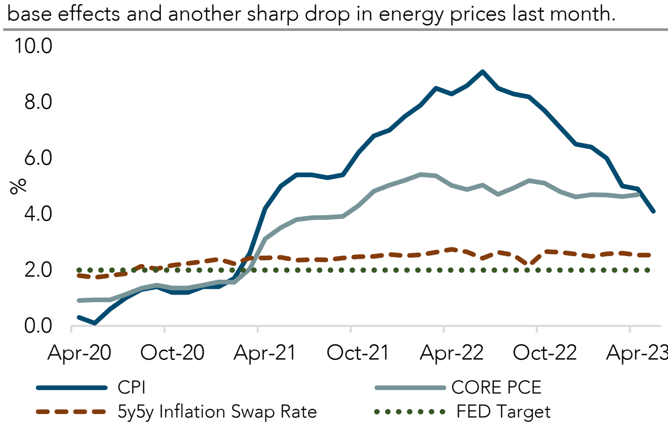
The Atlanta Fed is now forecasting the Q2 GDP at 2.2%, an improvement over the last Q1 forecast of 1.1%.



Source: Atlanta FED

Exhibit 4 – US Inflation rate

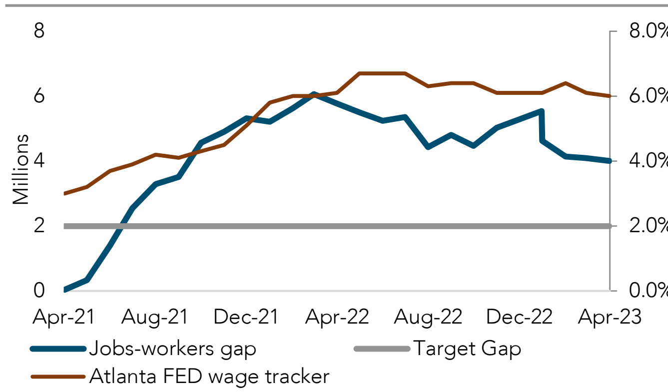
Headline inflation fell to a low of 4.0% in May, thanks to favourable base effects and another sharp drop in energy prices last month.



Source: Bloomberg

Exhibit 5 – Job-workers gap (LHS) and Atlanta FED wage tracker (RHS)

The job-workers gap remained at 4 million during April. The Atlanta Fed wage tracker fell once again to 6.0% in May from the prior 6.1%.



Source: FRED, Atlanta FED

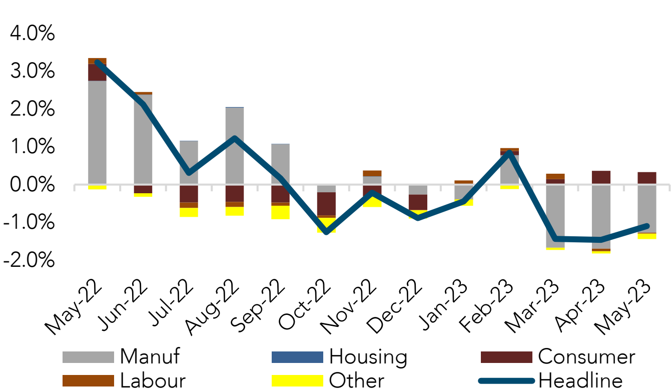
Europe

Growth: The Goldman Sachs Headline CAI for the Euro Area improved slightly in May, however, has so far remained in negative territory, moving from the prior -1.5% to -1.1% (Exhibit 6). The key takeaway from the CAI is that economic activity in the Euro-area has declined significantly since February and will likely weigh on 2Q23 GDP print. In addition, the Euro-area Manufacturing PMI fell deeper in contraction territory in May (44.8 vs 45.8 previously) with Germany showing the largest decline to 43.2 (Exhibit 7). Furthermore, weakness was seen across all sub-components of the PMI, with new orders and new export orders declining significantly (-2.6pts and -3.2pts respectively), resulting in lower output (-2.1pts). All in all, the May PMI print supports the view that growth in the Euro-area has slowed down in 2Q23. However, worth noting is muted demand and lower inventory levels ensued better supply chain conditions.

Inflation: The steep decline in headline inflation from 7.0% in April to 6.1% in May came as no real surprise, with expected base effects being the major driver behind the correction (Exhibit 9). Furthermore, the print also showed food and energy inflation continued to ease last month, as input cost disinflation and improved supply conditions were likely feeding into consumer prices. Core inflation dipped to 5.3% from the prior 5.6%, with the decline partly reflecting the effect of discounted travel tickets in Germany, which pulled services inflation lower by c. 0.2-0.3ppts.

Exhibit 6 – EU Current Activity Indicator

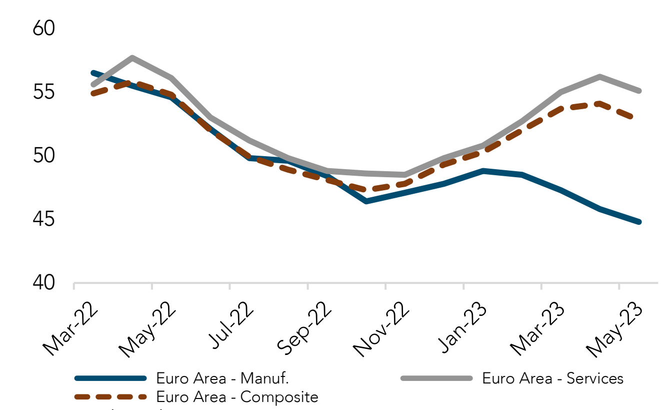
Headline CAI moved 0.36% higher during May from the prior -1.5%, mainly driven by an improvement in Manufacturing CAI.



Source: Goldman Sachs

Exhibit 7 – EU PMIs

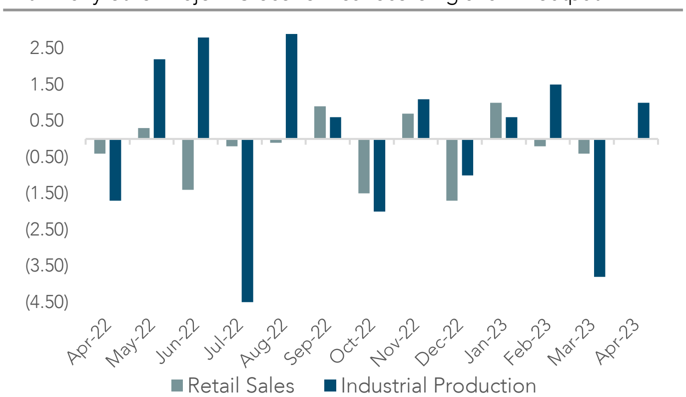
The Composite declined to 52.8 in May from the prior 54.1, driven by a decline in manufacturing production due to rapidly deteriorating order books.



Source: Bloomberg

Exhibit 8 – EU Industrial Production

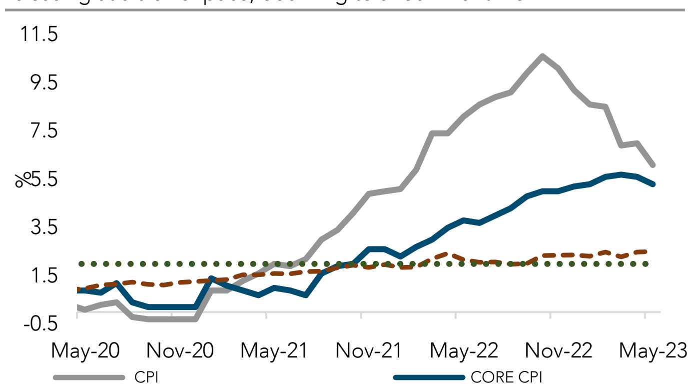
The uptick in IP in April was mostly driven by strong growth in Ireland, with many other major EU economies recording a fall in output.



Source: Bloomberg

Exhibit 9 – EU Inflation rate

Euro Area headline disinflation is well underway, while core inflation is easing at a slower pace, declining to a four-month low.

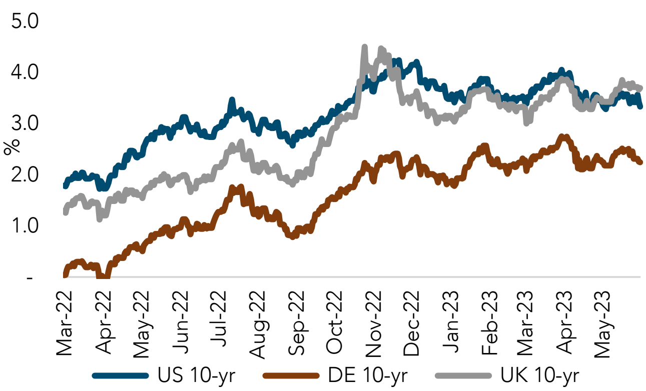


Source: Bloomberg

Rates

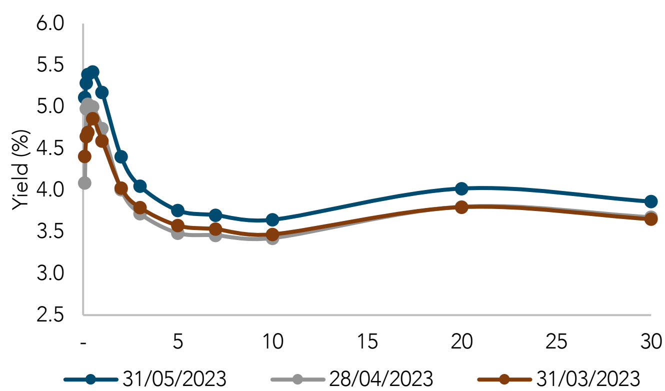
Sovereign yields were mixed during the month of May. The yield on the US ten-year rose by 22bp to close the month at 3.6% as economic data released during May remained overall resilient. Volatility in US rates remained high, with yields moving from a low of 3.4% to a high of 3.8% during May. In the UK, the 10-year yield rose 46bp to close the month at 4.2%, driven by persistently higher inflation and tighter credit conditions. Finally, the German 10-year declined 3bp, as economic data released was generally weaker than expected amid concerns of a China slowdown. Data released in May showed that the German economy had entered a technical recession (two consecutive quarters of negative GDP growth), with the economy contracting 0.3% in 1Q23, following the 0.5% contraction in 4Q22.

Exhibit 10 - 10-year nominal bond yield for the US, Germany and UK
Payroll figures and weakening economy drove USTs and Gilts higher, respectively. Weaker German manufacturing drove Bund yield lower.



Source: Bloomberg

Exhibit 11 – US Yield Curve
The U.S. sovereign yield curve inverted further in May, as the 2s10s spread widened by circa 18bp during the month.



Source: Bloomberg

United States

During its June meeting, the Federal Reserve ("FED") decided to keep rates unchanged after 10 consecutive meetings that saw interest rate hiked. The decision not to hike rates was largely in-line with market expectations. The stronger-than-expected payroll data, coupled with surprise rate hikes announced by the Reserve Bank of Australia and the Bank of Canada last week increased the uncertainty around the FED decision. However, after communication of a desire to "skip" in June, and with the market pricing less than a 30% chance of a FED rate hike, it would have been uncharacteristic of the FED to surprise the market.

Yet, core inflation remains well above the FED target despite the aggressive tightening cycle that started in March 2022. The continued strength in the services sector will continue to support the labour market, which adds to core inflation persistence. Therefore, we were not entirely surprised by the hawkish message delivered, with the dot plot showing two additional rate hikes in 2023 rather than one. Chair Powell stated that the main reason for the increase in dots was that *"inflation pressures continue to run high and the process of getting inflation back down to 2% has a long way to go"*. Chair Powell noted that *"there are some signs that supply and demand in the labour market are coming into better balance"* and that inflation will come down with a lag.

Europe

The ECB's Governing Council announced another 25bp rate hike yesterday, taking the policy rate up to 3.5% and lifting rates to a 22-year high. This was the ECB's eight consecutive interest rate hike. Furthermore, the Governing Council decided to discontinue the reinvestments under the APP from July 1st and left PEPP forward guidance unchanged, based on which maturing securities will be reinvested in a flexible manner at least until the end of 2024. Overall, the policy decisions taken during yesterday's meeting were in-line with market expectations.

We note that the inflation outlook remains a key concern for the ECB policymakers. The June macro-economic projections for core inflation in 2023 and 2024 were revised higher and lifted the 2025 forecasts by 0.1pp to 2.3% for core and 2.2% for headline inflation, against expectations for unchanged 2025 forecasts. Furthermore, the outlook for economic growth was more constructive. The monetary policy statement noted that the *"euro area economy has stagnated in recent months"* and that *"economic growth is likely to remain weak in the short run but strengthen in the course of the year as inflation comes down and supply disruptions continue to ease"*. They noted that *"manufacturing continues to weaken, partly owing to lower global demand and tighter euro area financing conditions, while services remain resilient."*

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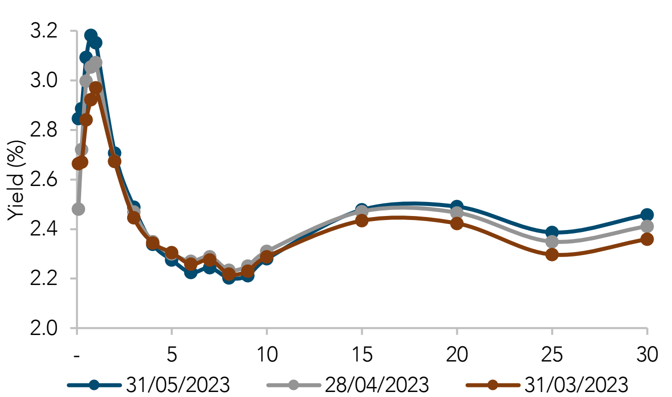
Finally, ECB officials reiterated that more tightening is needed. The guidance in the monetary policy statement was unchanged in noting that "future decisions" will ensure that rates will be brought to "levels [that are] sufficiently restrictive." During the press conference, President Lagarde stated that a hike in July was "very likely" and reiterated that the ECB has "more ground to cover." She added that the Governing Council had not discussed a pause or a skip.

In the U.K., the economic situation continues to deteriorate. Mortgage approvals and lending have surprised to the downside. In fact, the U.K. property market is showing signs of a slowdown given the tighter lending conditions and persistently high levels of inflation. Core inflation rose 6.8% in April, the highest since March 1992, compared to the prior month's 6.2% and forecasts of 6.2%. However, headline inflation did fall MoM to 8.7% from 10.1% due to a slowdown in electricity and gas prices. The rise in core inflation was due to higher food prices.

Exhibit 12 – German 10-year yield curve

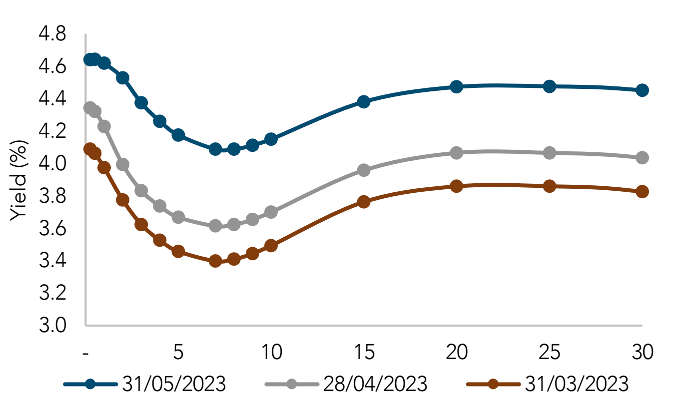
The Bund yield declined 3bp in May due to German manufacturing weakness and China's economic slowdown amid hike expectations.



Source: Bloomberg

Exhibit 13 – UK 10-year yield curve

The Gilt yield rose by c. 46bp in May as housing market shows signs of slowdown amid tighter credit conditions and high inflation.



Source: Bloomberg

Credit

The UK bond market underperformed both the EU and US mainly due to higher concerns around inflation, that might lead to more rate hikes being delivered by the Bank of England. Labour market conditions in the UK remain tight, with the resultant wage pressures supporting high inflation expectations. Elsewhere, the performance of markets was mixed MoM, with the US underperforming Europe in both IG and HY. EUR HY performed well, with all indices contributing to the positive return. On the other hand, US HY generated negative total returns across all the HY universe. Performance within the IG space mirrored that of HY, with EUR IG generating positive returns and US IG generating negative total returns.

While EUR IG issuance started the year strongly, on a year-to-date basis, supply is now back in line with original forecasts with non-financials expected to make up the majority of issuance volumes going forward as September and November are expected to be the busiest months for supply for IG. However, forecasts for EUR HY have been cut to €70.0 billion for FY2023 with a total of €42.5 billion of issuance expected for the remainder of the year. On a YTD basis, 60% of issuance volume in EUR HY has been used for refinancing versus 14% for M&A/LBO purposes. The remainder has been used for general corporate purposes (i.e. liquidity). However, CCC supply has slowed down drastically with the the last CCC issue that came to market was in January 2022 as the higher rate regime that we currently find ourselves in has deterred CCC issuers from coming to market.

S&P expect the default rate to reach 3.6% by March 2024 up from 2.8% in March of this year according to their latest 12-month trailing European speculative grade corporate default rate forecast. The expected prolonged slowdown in economic growth or recession could push the default rate as high as 5.5% in a worst-case scenario. Distressed exchanges contributed to the majority of defaults as issuers view out-of-court restructuring more favourably than other options such as traditional bankruptcy.

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

Total Returns indices	MoM Δ	YTD Δ
USD IG	-1.4%	2.8%
USD HY	-0.9%	3.6%
AAA	-2.0%	3.7%
AA	-1.6%	3.0%
A	-1.4%	2.6%
BBB	-1.4%	2.9%
BB	-1.1%	3.1%
B	-0.8%	3.7%
CCC	-1.3%	6.0%

Total Returns indices	MoM Δ	YTD Δ
EUR IG	0.2%	2.6%
EUR HY	0.9%	4.3%
AAA	0.1%	1.3%
AA	0.1%	1.9%
A	0.1%	2.3%
BBB	0.2%	3.0%
BB	0.6%	3.7%
B	1.0%	5.1%
CCC	0.4%	1.5%

Total Returns indices	MoM Δ	YTD Δ
GBP IG	-2.5%	0.2%
GBP HY	0.3%	4.5%
AAA	-3.3%	-3.2%
AA	-2.8%	-1.6%
A	-2.6%	0.0%
BBB	-2.3%	0.7%
BB	N/a	N/a
B	N/a	N/a
CCC	N/a	N/a

Spread Movements	MoM Δ	YTD Δ
USD IG	1.99	7.86
USD HY	7.41	-9.43
AAA	-1.68	-3.84
AA	-0.38	0.04
A	1.02	8.20
BBB	3.69	10.19
BB	16.56	7.68
B	13.45	-18.75
CCC	25.04	-50.45

Spread Movements	MoM Δ	YTD Δ
EUR IG	8.92	3.91
EUR HY	-7.72	-16.01
AAA	15.62	46.53
AA	5.95	14.54
A	11.21	11.06
BBB	8.14	-1.01
BB	2.02	7.38
B	-0.98	-36.36
CCC	-148.04	41.65

Spread Movements	MoM Δ	YTD Δ
GBP IG	1.54	-20.25
GBP HY	-41.29	-98.52
AAA	-0.33	-0.20
AA	3.01	0.21
A	2.74	-19.54
BBB	0.43	-22.87
BB	N/a	N/a
B	N/a	N/a
CCC	N/a	N/a

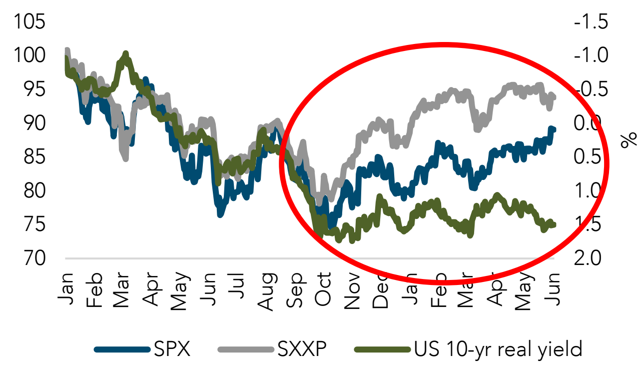
Source: Bloomberg

Equity

Global equities fell 0.9% ($Dollar) in May, the first month of negative performance since February. Europe (-2.3%), the UK (-5.0%) and Emerging markets (-1.7%) all declined in May, while the Dow Jones Industrial Average, a US index with a value tilt, fell 3.2%. We think that equity market performance during May was a function of (1) Concerns around debt ceiling negotiations, which could have led to a shutdown in the US and (2) mixed economic data, which provided little clarity around the global economic backdrop for investors. Notwithstanding, most equity markets we follow have generated positive returns so far on a year-to-date basis despite the clouded outlook.

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

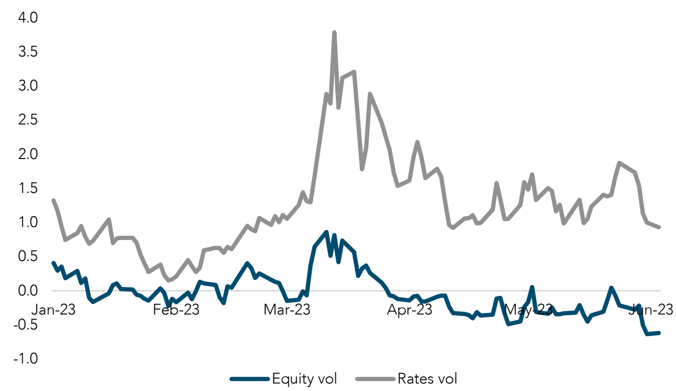
The disconnect between real yields and equities persisted during May, fuelled by investor interest in AI



Source: Bloomberg
Performance rebased from 31 December 2021

Exhibit 16 – Z-score of equity and rates volatility

Equity volatility remains depressed, well below average levels with the gap versus rates volatility



Source: Barclays

In the US, the debt ceiling discussions made headlines during the month, with a deal reached in early June. Despite this headwind, the S&P 500 generated a positive total return during May. This positive performance was driven by investor craze on Artificial Intelligence, which seems to have eased some investor concerns about growth in the technology sector. For many years, technology stocks have been able to grow at a much faster pace than the index. Yet, analysts expected this gap to narrow significantly this year, reducing the relative attractiveness of the sector. Also, Technology companies (growth stocks) generally generate a significant portion of their cash flows in the future, as opposed to mature companies, where cash flows are more consistent throughout. The valuation levels of the technology sector has been under pressure from higher interest rates (higher discount rate), which has a significantly larger impact on cash flows generated in the future. However, it seems that investors looked through such concerns and demand for AI stocks soared during May.

The 24bp increase in real rates seen in May takes the yield up to 1.5%, well above the 1.1% seen post the bank collapse. Generally, equities tend to fall during periods of rising real yields, but this has not been the case this time around (Exhibit 15). Despite the rebound in real rates, equities have continued to rise. Although European equities are flat since the bottom in real yields seen on 06/04, US equities are up 4.1% boosted by the positive narrative around AI. Also, we think that the resilience shown by the US economy relative to other regions, and the strong US$, has increased the attractiveness of US stocks.

Equity market volatility remained low in May compared to historical levels and also compared to volatility seen in rates markets. The VIX index is currently at 14.0 (06/06), levels not seen since October 2019, and a level that is well below the average calculated since 1990 (19.7). Additionally, the gap in volatility between equities and rates is at very high levels (Exhibit 16). The current level for equity volatility represents the widest gap versus rates when looking at data since the global financial crisis. The low volatility during periods of high uncertainty points towards complacency, which could have implications for price action in the coming months.

After a strong start to 2023 for European stocks, the outperformance relative to US stocks has reversed as sentiment around China worsened in recent weeks. Apart from US, Japanese equities have also been favoured by investors in 2Q23, boosted by a weaker Yen and on hopes of higher inflation after decades of stagflation. Furthermore, Japan equities benefited from the AI craze with several companies exposed to the sector (Japanese stocks are around 20-30% in Global Robotics and AI ETFs). That said, we continue to like European equities as we believe: (1) Valuations remain supportive, with EU stocks trading at a 44% discount to US which we believe is unwarranted unless the Bloc experiences a hard landing; (2) Positioning in Europe is light compared to the US, which implies that downside risk is greater in the latter; (3) Concentration risk in the US is significant, with a small number of stocks explaining most of the performance YTD; (4) Change of benchmark index composition in Europe should lead to less divergence in growth going forward and (5) China seems to be back in stimulus mode which we believe is a positive for European stocks. We think that China exposed stocks will react well to the PBOC's announcement of accommodative monetary policy.

The positive performance seen so far in equities markets masks investor caution. Cyclical stocks in Europe outperformed in January and February, but then underperformed in March and April. Despite recent concerns around the global macro-economic outlook, cyclicals are still outperforming defensives on a YTD basis. Our recommendation is for a balanced approach between cyclicals and defensives at this stage as we believe equity markets could continue to grind higher until a US economy weakens, and a recession looks likely. We have a similar view for Value vs Growth strategy exposure where we also recommend a balanced approach. The rising yield environment has put pressure on the yield gap, with higher yielding equities being more attractive for investors. Finally, we note that the recent investor interest in AI has been supportive of growth strategies.

Exhibit 17 – Valuations – Developed markets

Valuations have expanded by c.5% on average since the end of March but are still below levels seen before the banking crisis

Historical Data	SPX	SXXP	SX5E	DAX	CAC	FTSE100	FTSE250
Current Forward PE ratio (FPE)	17.7x	12.4x	11.9x	10.5x	12.3x	10.4x	10.5x
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	13.8x
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	10.6x
Historical rank (since 2006)							
Percentile	87.9%	46.1%	48.2%	29.1%	47.3%	26.3%	23.2%
Current FPE, % above/ (below) 10-YR median	9.8%	-9.2%	-7.5%	-13.6%	-7.4%	-19.3%	-23.4%
Current FPE, % above/ (below) Dec 22	5.1%	4.9%	5.2%	0.6%	9.2%	3.3%	-5.2%

Source: Bloomberg

Key – Our view

Positive | Positive /neutral | Neutral | Neutral/ negative | Negative

Key – Allocation

Overweight | Neutral | Underweight

Asset Class			Positioning
Developed Market Sovereign Bonds			We are moderating our view on Sovereign bonds as we are seeing less headwind from central bank action going forward. We believe that the worst is over in terms of future rate hikes. Also, we think that a higher allocation is appropriate given the cloudy macro-economic backdrop. In this respect we are recommending increasing exposure to DM Sovereign bonds and adding to duration, in view of the attractive risk/reward trade-off given the monetary tightening seen over the past months. Yet, we recommend to remain underweight the asset class given the elevated volatility which we believe will persist until investors are comfortable around peak terminal rate.
Investment Grade Corporate Bonds			We expect spreads to contract further in the coming months driven by flows 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. Given our current view on the macro-economic backdrop, we moderate our view on duration, from shorter duration to slightly shorter or equal to the benchmark index. We also continue to recommend investing in high quality credits to reduce probability of defaults.
High Yield Corporate Bonds			We downgraded our allocation on HY to Underweight from Neutral recently in view of the deteriorating 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 asset class. 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 moderate our view on duration and seek a duration that is slightly shorter or equal to the benchmark index.
Developed Market Equities			Despite the rising uncertainty, equity markets have generated strong 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 is a concern (though stimulus measures announced could help growth in 2H23). Also, the persisting downward trend in the equity risk premium despite the rising risk environment suggests a certain degree of complacency. Investor positioning has turned cautious in recent months, which suggests concerns are rising. On balance, we expect equities to trade in a range until the probability of a recession in the US increases, but we believe that near-term risks are skewed to the downside.
Emerging Market Equities			The outlook for EM has weakened over the past months. The disappointing activity data released by China for April is a key source of pessimism for investors which led to concerns on the growth expectations for the country and region. As DM equities entered a bull market, Chinese equities fell into a bear market despite their high allocation to the technology sector. Stimulus announcements could boost sentiment. Also, Chinese stocks have in the past been known for their defensive characteristics during economic downturns. As for LATAM, the region's prospects revolve largely on the outlook for commodities, which in turn is largely dependent economic activity.

Disclaimer