CURMI & PARTNERS

August 8th, 2023

Monthly Strategy Update

The month in summary:

On a macro front, the main theme during July was rising probability of a soft landing in the US as the growth/inflation trade-off continues to improve. US activity data published has, on average, come in better than economist expectations whilst inflation moderation seems to be gathering pace. On the flipside, Europe seems to be faring much worse, with the economy showing more signs of a slowdown whilst inflation remains relatively high and moderating slowly. China's growth remains muted, though policy measures announced by the Politburo in July should help over the coming months.

Despite the inflation moderation in the US, as both headline CPI and PCE came in below expectations, the yield on the US 10-year Treasury bonds rose 11bp to 4.0%. Similarly, despite the slowdown observed in Europe, the yield on the 10-year Bund rose 10bp to 2.5%. Market-implied expectations have not changed significantly over the past month, with the year-end yield on the US 10-year expected at 4.89% (prev: 4.85%), whilst the German 10-year is expected to close 2023 at 3.80% (prev. 3.87%). All credit markets we follow generated a positive return during July, driven by an improvement in inflation expectations. The surprise slowdown in UK inflation led to a rally in GBP Investment Grade, the best performing credit market from those we follow during July, closely followed by GBP High Yield.

Global equities delivered a total return of 3.4% in July, as equities rallied almost everywhere during July as more bears turned into bulls. The US economy continued to surprise investors with its resilience, and this was supportive for risky assets throughout the month. Furthermore, the decelerating inflation narrative was also a source of reassurance for investors. It was a strong month for Emerging markets in what has been a difficult year so far for the asset class. Chinese equities rallied 5.4% driven by a more dovish than expected Politburo meeting. Policymakers acknowledged the insufficient domestic demand, and highlighted the challenges faced in the housing market that has been under pressure for some time.

Finally, the S&P GSCI Index (basket of commodities) rallied 9.8% in July, boosted by oil and copper prices. Oil prices are now up 18% since mid-June, as record high demand and Saudi supply cuts have brought back deficits, and as the market has become more constructive on the near-term outlook.

Sovereign			
		Movement in bp	
	Yield	Jul	YTD
US 10-year yield	4.0%	11	8
DE 10-year yield	2.5%	10	-8
UK 10-year yield	4.3%	-6	65
Credit			
LCL Total returns		MoM %	YTD %
EUR IG		1.1%	3.3%
EUR HY		1.3%	6.1%
USD IG		0.3%	3.6%
USD HY		1.4%	6.8%
GBP IG		2.4%	1.3%
GBP HY		2.2%	6.7%
Equities			
LCL Total returns		MoM %	YTD %
Global		3.4%	19.4%
S&P 500		3.2%	20.6%
Nasdaq 100		4.1%	37.7%
STOXX 600		2.1%	13.2%
DAX		1.9%	18.1%
CAC		1.4%	19.0%
FTSE 100		2.3%	5.5%
Emerging markets		6.3%	11.7%
EM ASIA		6.2%	9.5%
EM LATAM		5.1%	24.6%
EM EMEA		6.9%	8.8%
Currencies			
Total return		MoM %	YTD %
EURUSD		0.8%	2.7%
EURCHF		-1.9%	-3.1%
GBPEUR		0.3%	3.3%
GBPUSD		1.0%	6.2%
Commodities			
Total return		MoM %	YTD %
Oil WTI		15.6%	3.1%
Oil Brent		13.5%	2.8%
Natural Gas		-5.9%	-41.1%
Gold		2.4%	7.7%
Copper		6.2%	5.5%
Iron Ore		-0.3%	0.1%
S&P GSCI Index		9.8%	-2.7%

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Macro-economic views

The global regional divergencies between the growth and inflation trade-off are becoming more evident, even as we are getting closer to the end of the tightening cycle. In the July meeting, both the FED and FOMC increased interest rates by 25bp, as expected, and both left the door open for more hikes. Finally, the BOE hiked by 25bp during its August meeting, surprising the market who were expecting another 50bp rate hike. Yet we believe that we are at the tail end of this hiking cycle.

On balance, the US economy continued to stand-out, with an ideal combination of resilient growth and falling inflation. The labour market remains robust, which should support consumer spending, and the easing of supply chain constraints and deceleration in the Producer Price Index have provided a favourable signal for inflation. In Europe, the outlook is much less encouraging given the softer PMI readings, with the weakness now also visible in other survey data (German IFO, EC Business Confidence). At the same time, the Bank Lending Survey for July showed that credit conditions tightened further in 2Q23, from both the supply and the demand sides. On balance, tighter lending conditions coupled with a slowdown in lending, and broad money growth continued to decline will likely weigh on the region's economic growth.

The global manufacturing sector remained in contraction territory in July (48.7), though was unchanged when compared to the previous reading. Output declined further in July, whilst new order intakes fell for the thirteenth consecutive month. The main drag on output was a severe downturn in activity in the euro area, where production contracted to levels not seen since the height of the global pandemic in spring of 2020.

Moreover, the Global Composite index fell to 51.7 in July, down from 52.7 in June, the lowest reading since January. The services sector slowed to 52.7 in July, down from 53.9 in June. Service sector business activity rose in almost all nations covered, the exceptions being France and Australia.

Exhibit 1 – Consensus real GDP growth and inflation expectations

Global economic growth expectations for FY23 and FY24 were unchanged in June

	Consensus Forecast, % QoQ								Cons. Forecast, % YoY			Revisions since last meeting							
Real GDP, YoY%	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F*	*4Q24*	*FY23F*	*FY24F*	*FY25F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F*	*FY23F*	*FY24F*	*FY25F*
United States*	2.0	2.4	0.5	-0.3	0.3	1.1	1.6	1.8	1.6	0.6	1.9	0.5	0.2	-0.4	-0.2	-0.1	0.3	-0.1	0.0
Japan*	2.7	1.1	0.8	0.8	0.8	1.2	1.3	1.2	1.3	1.0	1.0	-0.1	0.0	-0.1	0.0	0.1	0.1	-0.1	0.0
Germany	-0.3	0.1	-0.6	0.0	0.5	0.8	1.0	1.3	-0.3	1.0	1.6	-0.1	-0.2	-0.4	-0.3	-0.4	0.0	-0.1	0.1
France	0.9	0.9	0.5	0.6	0.8	0.8	0.9	1.0	0.7	1.0	1.3	-0.1	0.0	0.0	-0.1	-0.3	0.1	0.0	-0.2
Italy	1.9	0.9	0.7	0.9	0.5	0.8	0.9	0.9	1.1	0.8	1.1	0.0	-0.1	-0.2	0.0	0.0	0.0	-0.1	-0.1
Spain	4.2	1.8	1.6	1.4	1.3	1.2	1.6	1.9	2.2	1.5	1.8	0.3	0.1	0.1	-0.1	0.0	0.2	0.0	0.0
Eurozone	1.1	0.6	0.2	0.5	0.8	1.0	1.1	1.3	0.5	1.0	1.6	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	0.0	0.0
UK	0.2	0.2	0.4	0.4	0.2	0.4	0.5	0.8	0.2	0.6	1.5	0.0	0.1	-0.2	-0.3	-0.4	0.0	-0.3	0.0
DM Economies	1.8	1.1	0.6	0.3	0.6	1.1	1.5	1.7	1.3	1.0	1.8	0.3	0.1	-0.3	-0.1	-0.1	0.2	-0.1	0.0
China	4.5	6.3	4.6	5.1	4.3	4.9	4.7	4.9	5.2	4.7	4.6	-0.4	-0.3	-0.1	0.1	-0.1	-0.3	-0.1	0.0
EM Economies	3.6	5.6	4.0	4.3	3.9	4.3	4.3	4.4	3.9	4.1	4.3	-0.1	-0.1	0.0	0.0	-0.1	-0.4	-0.1	0.1
Global									2.6	2.7	3.1						0.0	0.0	-0.2

* - QoQ SAAR

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

	Consensus Forecast, % QoQ								Cons. Forecast, % YoY			Revisions since last meeting									
Consumer prices, YoY %	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F*	*4Q24*	*FY23F*	*FY24F*	*FY25F*	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F*	*FY23F*	*FY24F*	*FY25F*
United States	5.8	4.0	3.4	3.0	2.7	2.6	2.5	2.3	4.0	2.5	2.3	0.0	-0.1	-0.1	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Japan	3.6	3.3	2.9	2.3	2.2	1.8	1.7	1.5	2.9	1.7	1.5	0.0	3.0	0.2	0.3	0.2	0.1	0.3	0.1	0.2	0.2
Germany	8.8	6.9	5.6	3.3	3.1	2.7	2.6	2.5	6.0	2.7	2.1	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.1
France	7.0	6.1	5.2	4.2	3.5	2.9	3.2	3.1	5.5	2.7	2.1	0.0	0.0	-0.1	0.0	0.3	0.4	1.0	0.0	0.1	0.1
Italy	9.5	7.8	5.9	1.7	2.4	2.5	2.3	2.2	6.3	2.4	1.9	0.0	0.0	0.1	0.4	0.2	0.0	-0.1	0.0	0.0	0.0
Spain	5.0	2.8	2.1	3.4	2.9	2.8	2.6	2.2	3.4	2.6	1.9	0.0	0.0	-0.5	-0.5	-0.2	0.0	-0.1	-0.4	0.0	0.0
Eurozone	8.0	6.2	4.7	3.0	2.8	2.6	2.5	2.4	5.4	2.6	2.1	0.0	0.0	-0.1	0.1	0.1	0.0	0.2	0.0	0.1	0.1
UK	10.2	8.4	6.9	4.7	4.3	2.8	2.8	2.5	7.5	3.0	2.0	0.0	0.1	0.3	0.2	0.2	0.2	0.2	0.3	0.1	-0.1
DM Economies	7.1	5.2	4.9	4.1	3.7	3.6	3.2	2.9	5.4	3.2	2.6	0.0	-0.5	0.1	0.0	0.0	0.2	0.1	-0.1	0.1	0.0
China	1.3	0.1	0.5	1.0	1.8	2.0	1.9	1.8	0.9	2.0	2.0	0.0	-0.1	-0.1	-0.2	-0.4	-0.2	-0.1	-0.3	-0.2	0.0
EM Economies	6.3	2.8	5.0	5.4	5.3	5.4	4.8	4.2	5.9	5.2	4.0	0.1	-2.1	0.0	0.0	0.0	0.1	0.3	0.0	0.3	0.2
Global									5.5	3.9	3.4								-0.2	0.0	-0.2

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

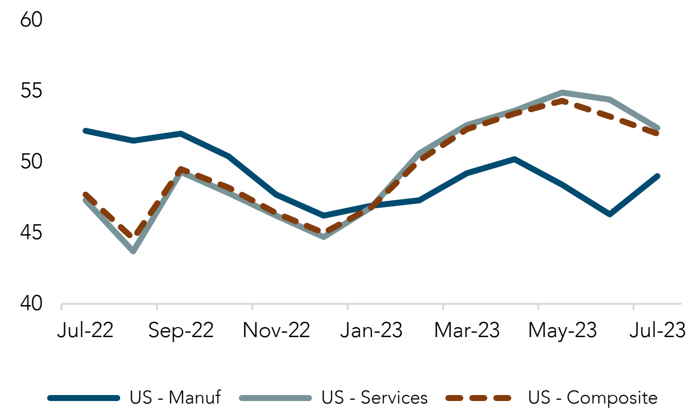
United States

Growth: The S&P Manufacturing PMI improved to 49.0 in July, up from 46.3 in June, to signal a further but slower downturn in operating conditions for the sector (Exhibit 3). The deterioration in July was primarily driven by a further fall in new order inflows, as clients are hesitant against the current uncertain backdrop, primarily the challenging economic conditions across key export markets, especially in Europe. Additionally, the services sector expanded as business activity and new orders increased again, albeit at slower rates, as high interest rates reportedly weighed on domestic customer spending. Finally, the Atlanta FED GDP growth final estimate for 2Q23 was 2.4% (Exhibit 3), with the first growth estimate for 3Q23 of 3.9% (01/08).

Inflation: The core PCE price index increased 4.1% year-on-year (Exhibit 4), which was softer than economist expectations (4.2%) and a deceleration when compared to the previous month (4.6%). June inflation data was encouraging, as the PCE print was the lowest since September 2021 and follows the softer than expected CPI number released earlier in July. Furthermore, the supercore PCE price measure was flat month-on-month in June at 0.2% but below the average in Q1 (0.4%). Moreover, the various labour market indicators released recently suggest that labour supply and demand are gradually coming into better balance, even if the latest report is a mixed bag. Although job gains of 187k missed expectations, it is still probably too strong, whilst at the same time, average hourly earnings accelerated, and the unemployment rate fell to 3.5%.

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

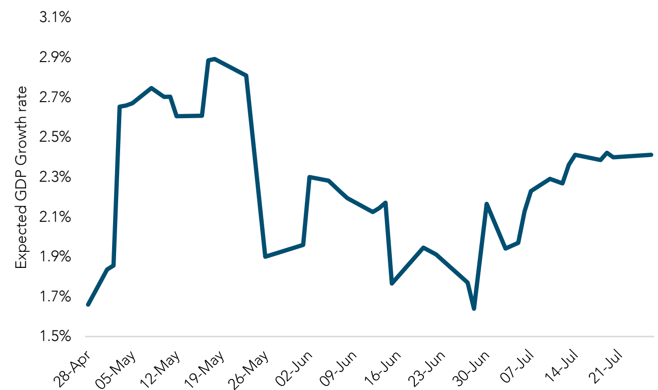
The Manufacturing sector seems to have recovered slightly in July, though the Services sector eased slightly



Source: Bloomberg

Exhibit 3 – Atlanta FED GDP estimate

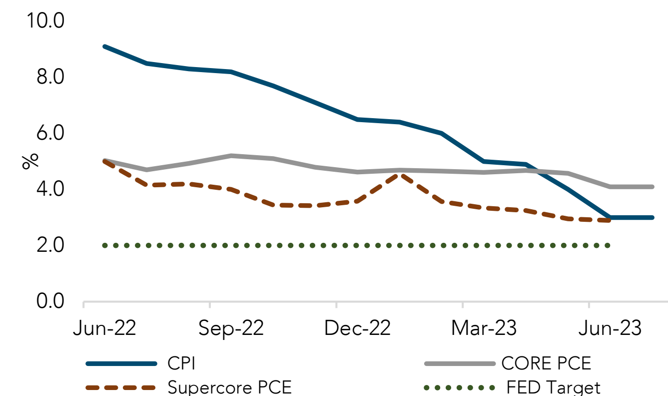
The last Atlanta Fed forecasts points to 2Q GDP growth of at 2.4% (26/07) slightly ahead of the forecast at the end of June (2.2%)



Source: Atlanta FED

Exhibit 4 – US Inflation rate

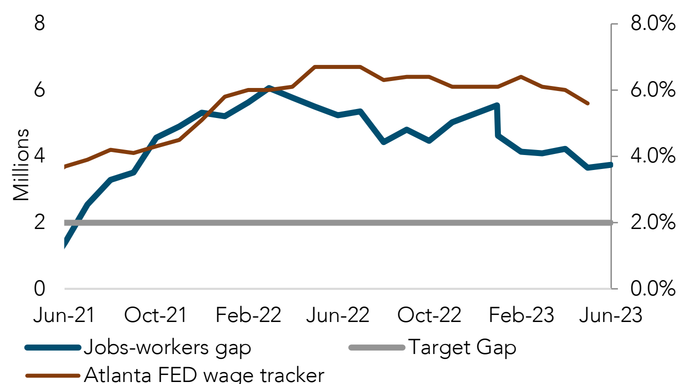
Headline CPI rose 3.0% in June (May:4.0%) whilst Core PCE moderated to 4.1% in June (May: 4.6%)



Source: Bloomberg

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

The job-workers gap remained below the 4 million mark in July, rising slightly compared to June



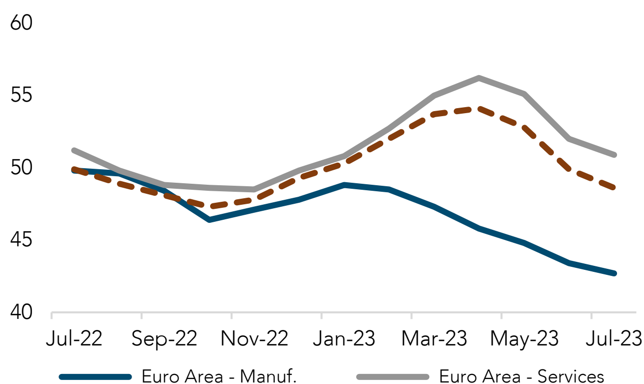
Source: FRED, Atlanta FED

Europe

Growth: The conditions for the manufacturing sector in Europe continued to deteriorate in July as the PMI fell to 42.7 (June: 43.4), a 38-month low (Exhibit 6). Production volumes, new orders, employment and purchasing activity all declined at faster rates than in June. Excluding pandemic-related and lockdown-hit months, the reductions seen for factory output and demand for eurozone goods were the most severe since the global financial crisis in 2008-09. This was also true of other survey indicators such as new export orders, backlogs of work, and quantity of purchases. Furthermore, the services sector showed signs of weakening, as the PMI fell for the third consecutive month to 50.9 (June: 52.0), a six-month low. The drag from the manufacturing sector led to the Composite PMI falling deeper into contractionary territory in July at 48.6 (June: 49.9) which represented an 8-month low. Overall, economic growth during the second quarter of 2023 (Exhibit 7) came in better than expected but the economy is entering 2H23 on a weak footing as composite PMI fell deeper into contractionary territory.

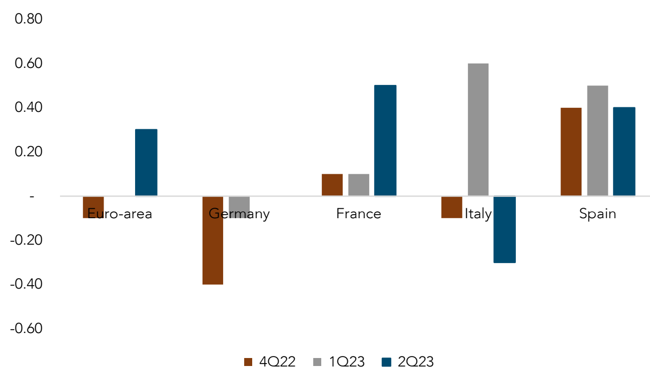
Inflation: Although core inflation remains well above the ECB's target at 5.5%, we believe that the deteriorating economic backdrop implies that inflationary pressures will recede further. More data points will be needed to confirm the trend, economic data has deteriorated significantly and has so far failed to rebound. At this stage it looks likely that the July rate hike was the last one in this tightening cycle.

Exhibit 6 – EU S&P Composite, Manufacturing and Services PMI
The Composite PMI declined to 48.6 in July as the deterioration in the manufacturing sector persisted



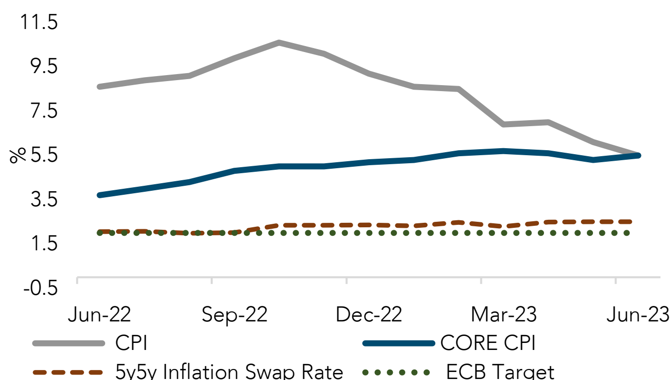
Source: Bloomberg

Exhibit 7 – EU GDP growth over the past three quarters
GDP growth was better than expected in 2Q23 but is entering 3Q23 on a weak footing



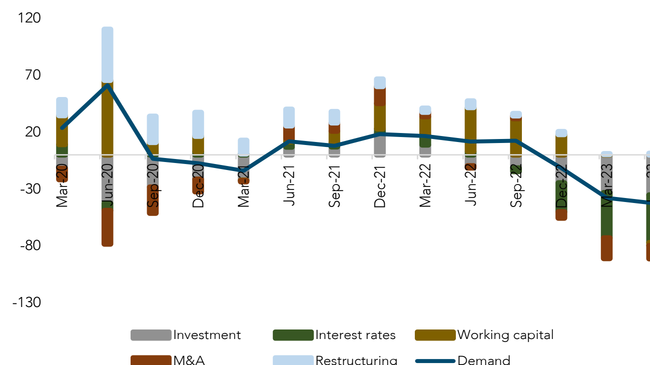
Source: Bloomberg

Exhibit 8 – EU Inflation Rate
The inflation rate significantly declined to 5.5% from 6.1%, while the core rate edged up to 5.4% from 5.3%



Source: Bloomberg

Exhibit 9 – Loan demand by firms
Loan demand deteriorated more than expected and the survey showed that they should continue to deteriorate in Q3



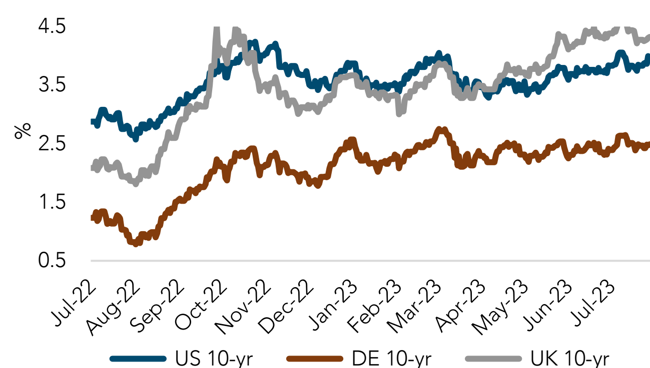
Source: ECB

Rates

The shift higher in sovereign yields continued in July, with all yields in all regions we follow moving upwards, except for the UK. The FED, ECB and BOC hiked rates by 25bp in July, whilst the RBA and BOJ left rates unchanged. Meanwhile, the BOE surprised the market with a 25bp hike, a step-down from the 50bp delivered in June. Policymakers left the door open for additional tightening, though we are approaching the tail end of the tightening cycle in developed economies.

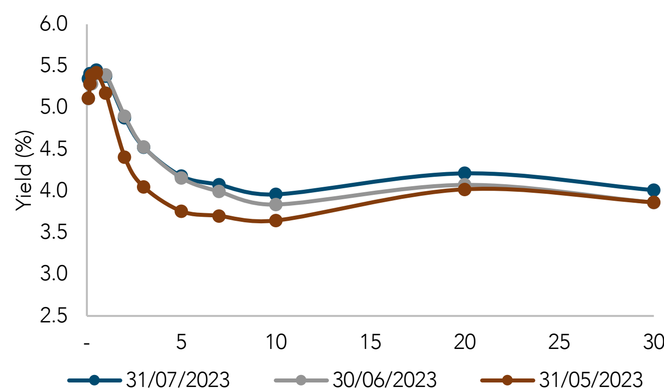
The yield on the Japanese 10-year bond rose the most in July, rising 21bp to 0.6%, whilst the yield on the 10-year Canadian bond rose 23bp during the same period. The moves in the US (+12bp), German (+10bp), Swiss (+5bp) and Australian (+4bp) were much less pronounced.

Exhibit 10 - 10-year nominal bond yield for the US, Germany and UK
Sovereign bond yields edged higher during the month as the FED and ECB hiked rates by an additional 25bp



Source: Bloomberg

Exhibit 11 – US Yield Curve
The U.S. sovereign yield curve flattened in July, as the 2s10s spread narrowed by circa 14bp during the month.



Source: Bloomberg

United States

The FOMC unanimously decided to raise the target range for the funds rate by 25bp, to 5.25 – 5.50%, as was widely expected by the market. The additional hike reflects the continued resilience shown by the US economy, with activity levels surprising to the upside, the labour market remaining tight with very low unemployment, though the job-workers gap moderated to 3.7 million (from 5.3 million at the start of the year) and inflation that is still well above target.

The FOMC statement noted that *"economic activity has been expanding at a moderate pace. Job gains have been robust in recent months, and the unemployment rate has remained low. Inflation remains elevated".* Overall, this seems to be an upgrade from the June statement, when the rate of expansion was described as "modest", which suggests that economic data published in July was stronger than anticipated. In addition, the statement maintained the reference to "elevated" inflation which could suggest some scepticism around the soft June CPI print and whether this can be sustained.

Chair Powell also struck a hawkish tone during the press conference, reiterating that the FOMCs remains "*committed to bringing inflation back to our 2 percent goal and to keeping longer-term inflation expectations well anchored".* He indicated that the FED would only consider rate cuts *"a full year from now and it'll be about how confident we are that inflation is in fact coming down to our 2 percent goal".* This contrasts with the market-implied fed funds pricing, where some are looking at rate cuts as early as December.

Europe

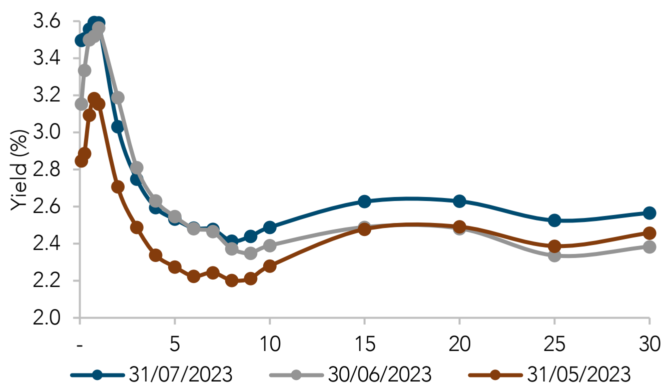
The Governing Council ("GC") decided to raise the three key ECB interest rates by 25bp in July, bringing the deposit facility rate up to 3.75% and the main refinancing rate to 4.25%. The decision was unanimous. Furthermore, the GC highlighted that the *"APP portfolio is declining at a measured and predictable pace, as the Eurosystem no longer reinvests the principal payments from maturing securities."* The forward guidance for the PEPP has been maintained, with the GC intending to continue reinvesting the principal payments from maturing securities at least until the end of 2024. During the press conference, President Lagarade noted that the GC did not discuss the reduction of the balance sheet, but acknowledged its reduction after TLTRO repayments and the end of APP re-investments.

The statement noted that the GC will "*ensure that the key ECB interest rates will be set at* (previously "brought to") *sufficiently restrictive levels for as long as necessary to achieve a timely return of inflation to the 2% medium-term target*". During the press conference, President Lagarde noted that the GC was adopting a data dependent approach going forward and that it could hike or pause, but definitely not cut. She added that at this point in time, she wouldn't say there is more ground to cover. Given the deterioration in activity, it seems very likely that the ECB will pause at the next meeting on the 14th September.

The Bank of England Monetary Policy Committee (MPC) hiked rates by 25bp to 5.25%, in a 1-6-2 split vote (0bp/25bp/50bp), and kept guidance on the future path of interest rates unchanged, reiterating that evidence of persistent inflationary pressures (tightness in the labour market, wage growth and services inflation) would require further tightening. However, for the first time this tightening cycle, the MPC stated that the policy stance is restrictive, and that rates will be kept at a sufficiently restrictive level for sufficiently long to ensure that inflation returns sustainably to the 2% target in the medium term. During the press conference, the governor explained that the term restrictive is *"a reasonable description of where we all are at the moment in terms of the way that monetary policy is working"* given *"the lags in the vex of monetary policy it's not necessarily surprising that it's taken some time for this evidence to come through."* Furthermore, the 25bp rate hike was as a result of "*headline inflation on the latest number is pretty much exactly where we thought it would be in the May forecast"* which was partially offset by "*pay*" in the labour market which remains high.

Exhibit 12 – German 10-year yield curve

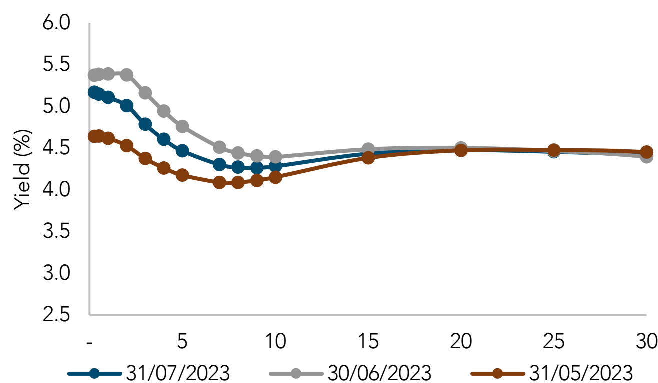
The Bund yield rose 10bp in July following the ECB's decision to hike rates against a backdrop of a deteriorating economic activity



Source: Bloomberg

Exhibit 13 – UK 10-year yield curve

The Gilt yield fell by circa 6bps following the release of softer inflation figures for the month of June



Source: Bloomberg

Credit

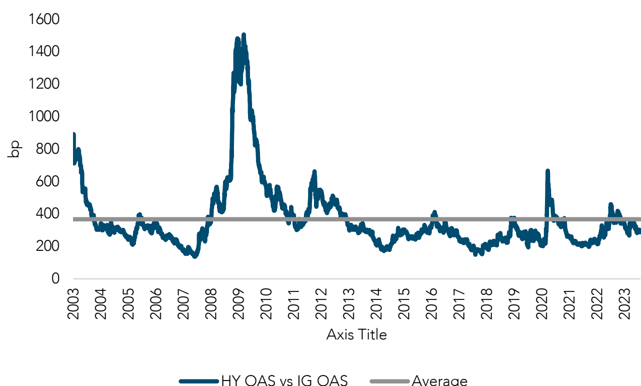
The overall performance of credit markets during July was positive, with all geographies we follow and most rating buckets generating returns for investors. The UK market outperformed in both the IG space (+2.4%) and HY (+2.2%) following the downside June inflation surprise. Elsewhere, the EUR HY (+1.3%) outperformed EUR IG (+1.1%) during the month with all rating buckets contributing positively with the exception of the CCC space (-1.8%). The BB (+1.4%) was the best performing bucket during July, followed by BBB (+1.2%) and B (1.1%). In the US, USD HY (+1.4%) also outperformed USD IG (+0.3%), with the CCC (+2.1%) rating bucket outperforming. On the other hand, within the USD IG space, the safer asset classes suffered losses during July, as both the AAA (-0.6%) and AA (-0.1%) ending the month in the red.

At an index level, IG spreads have only tightened by c.16bp in Europe and c.10bp in the US, as the resilience of the US economy has increased the probability of a soft landing. The deterioration in Europe and China remains a concern, though policy easing by the People's Bank of China should help stabilize global growth in 2H23. Spreads have come down significantly since the peak seen in March after the collapse of several US regional banks. This implies that there is less of a cushion in the event of any negative catalyst. Overall, we continue to prefer IG over HY given that the latter is more susceptible to idiosyncratic risk. Despite this, the current spread differential between HY and IG is currently below the average (Exhibit 14), with IG OAS currently 12bp above the 20-year average, whilst HY OAS currently 66bp below the 20-year average. The spread differential generally increases as uncertainty rises, as can be clearly seen for extreme events like the GFC. Yet, this widening is also evident in 2011 (US credit downgrade and rising probability of a recession, EU debt crisis), 2015/2016 (China slowdown), 2020 (COVID) and 2022/2023 (Russia invasion, US regional banks crisis).

As we highlighted last month, even though the current HY YTW of 8.3% looks attractive (well ahead of the average since 2010 of 5.8%), the current HY spread of 435bp and at the 54th percentile offers much less protection for investors should the macro-economic backdrop deteriorate further. HY spreads tightened c. 200bp since October despite the riskier outlook. Idiosyncratic stories continued to dominate HY over July, with the investigation into alleged corruption, tax fraud and money laundering at Altice dominating headlines. Recent economic data coming out of the US and the recent inflation moderation in UK has been supportive, though the deterioration in the EU at a time when costs and financing cost pressures remain could lead to a rising default and/or downgrade rate.

Exhibit 14 – Euro-Area HY OAS vs IG OAS

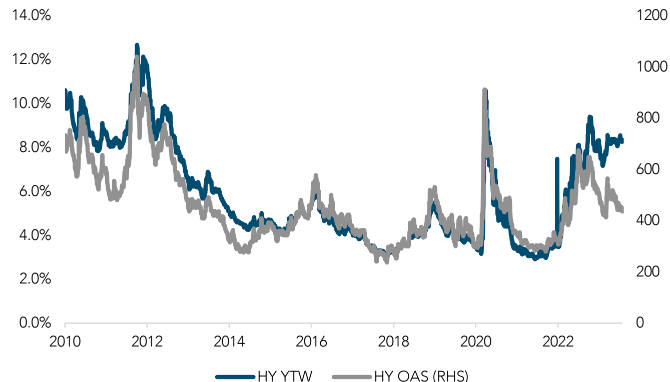
Despite the increasing risk of rising defaults, the spread differential between HY and IG is below the average



Source: Bloomberg

Exhibit 15 – Euro-Area HY OAS compared to YTW

Although YTW for HY bonds appear to be attractive, they offer much less cushion should the macro backdrop deteriorate further



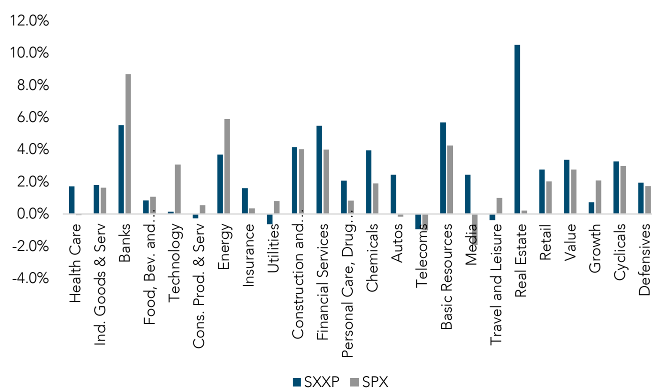
Source: Bloomberg

Equity

Equity investors enjoyed another month of positive performance during July, the second consecutive month of positive performance and the fifth month of positive performance so far in 2023. US equities were the main drivers of performance, as the moderating inflation coupled with resilient growth is starting to look increasingly like Goldilocks. Yet we note that interest rates remain very high (especially when compared to the post-GFC period) and are likely to remain at these levels for a long period of time. It was also a good month for Emerging Markets, in what has been a very difficult year so far for the asset class.

Exhibit 16 – STOXX 600 and S&P 500 returns by sector and strategy

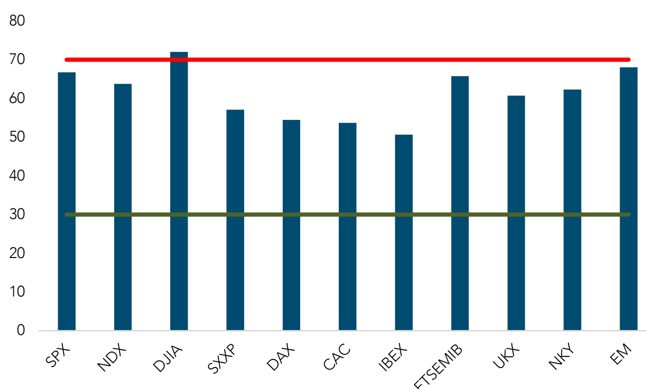
Equity market returns have been flat for most regions over the past year except for the Nasdaq



Source: Bloomberg

Exhibit 17 – Relative Strength Index ("RSI")

The rally in equities so far this year means that many regions are trading closer to overbought levels (70)



Source: Bloomberg

July was a traditional risk-on month, where most geographies, strategies and sectors generated a positive return (Exhibit 16). All geographies we follow closed July in the green, except for Japan (Nikkei) which closed the month flat on a total return basis. When looking at the performance of different investment strategies, European Cyclical strategies outperformed during July on rising hopes of a soft landing in the US. The outperformance in Cyclicals is jarring when compared to the PMI releases since the start of the year, which point to a much bleaker outlook for the global economy. Some economists are arguing that PMIs are less reliable given the impact on supplies from COVID-19 and the Ukraine invasion.

Furthermore, the improved backdrop led to a strong outperformance in European Value strategies during the month. The top three performing sectors in Europe were Real Estate, Basic Resources and Banks. The Real estate sector has been under pressure for several months and has underperformed the broader index on a year-to-date basis. This underperformance was primarily driven by the rising yield environment which weighed on property valuations. Moreover, the potential for policy easing in China, following the Politburo meeting, buoyed the Basic Resources sector whilst the within the Banking sector, high interest rates should act as a tailwind for revenues.

In the US, the top three performing sectors during July were Banks, Energy and Basic Resources. We discussed Banks and Basic Resources above and we think similar factors were at play in the US. As for Energy, we believe that the demand/supply dynamics for the sector have improved following the surprise Saudi Arabia supply cuts as well as improving demand dynamics.

Equity market valuations expanded further in July following the rally seen in risky assets (Exhibit 18). On average, valuations have increased 7.6% since the start of the year, with US equities expanding the most (16.8% for the SPX and 25.5% for the Nasdaq), whilst the FTSE 250 valuations contracted (-3.2%) due to the pressures from inflation on the UK economy (the FTSE 250 has a strong domestic skew as opposed to more international FTSE 100). As a reference, the current P/E for the S&P 500 ranks in the 90th percentile (2006 to 2023), the highest among the indices we follow. On the other hand, the current valuation for the STOXX 600 index ranks at the 46th percentile.

We see limited upside for valuations given the high interest rates, though we note that with the bulk of interest rates behind us, rates should be less of a drag on P/E's. Conversely, the re-rating since the start of the year suggests that valuations have less of a cushion in the event of disappointments. This implies that growth rates for corporate earnings will be particularly important for equity market performance over the coming months. Some high-profile profit warnings before the start of the earnings season led to negative revisions to estimates for the second quarter of 2023. Estimates had already been cut, particularly for Cyclical names following the deterioration seen in PMI releases throughout the year. The revisions in June effectively lowered the bar even further.

Goldman Sachs note that European companies' earnings for the second quarter of 2023 have been (so far) in-line with expectations, with a low number of positive beats. Only 30% of companies that have reported so far have beaten expectations by more than 2%, below the long-term average of 40% and levels seen in recent quarters. Moreover, Barclays note that, on balance, European companies have been optimistic on the outlook.

We think equities could continue to grind higher with positioning now back to neutral (NAAIM Exposure index climbed to 100.8% on 26th July, up from 41.9% in March) and boosted by the continued push-back of a US recession. However, broader market upside seems limited from here. Investors are pricing-in continued inflation moderation coupled with above-trend economic growth which seems unlikely. Europe and China are weakening, though stimulus measures could help stabilise global growth over the coming months. Over the short-term, we note that most regions are trading close to overbought levels on the RSI scale (Exhibit 17). The combination of the strength of the recent rally, the high valuations and the summer lull could lead to weakness in equities in August, which could present a buying opportunity going into the fourth quarter of 2023.

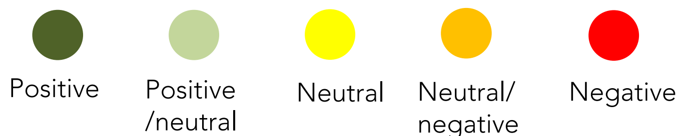
Exhibit 18 – Valuations – Developed markets

Valuations in the US are in the 90th percentile and screen as expensive compared to other international markets

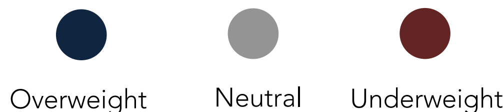
Historical Data	SPX	NDX	SXXP	SX5E	DAX	CAC	FTSE100	FTSE250
Current Forward PE ratio (FPE)	19.0x	24.5x	12.4x	12.2x	10.8x	12.6x	10.8x	10.8x
Forward PE ratio (31/12/2022)	16.8x	21.1x	11.9x	11.3x	10.5x	11.3x	10.0x	11.1x
10 Year data								
Highest	22.1x	30.8x	17.5x	18.0x	15.7x	18.2x	15.4x	17.9x
Highest (date)	31/12/2020	25/01/2021	29/12/2020	29/12/2020	28/12/2020	04/12/2020	02/12/2015	29/12/2020
Lowest	12.2x	15.2x	10.0x	9.0x	8.4x	9.1x	8.4x	8.3x
Lowest (date)	23/03/2020	15/04/2014	18/03/2020	18/03/2020	18/03/2020	18/03/2020	03/10/2022	23/03/2020
Median	16.2x	19.5x	13.7x	12.8x	12.2x	13.3x	12.8x	13.8x
95th percentile	20.4x	28.2x	16.0x	16.3x	14.5x	15.9x	14.9x	15.2x
5th percentile	14.2x	16.4x	11.8x	11.4x	10.9x	11.1x	9.9x	10.5x
Historical rank (since 2006)								
Percentile	90.9%	89.4%	46.4%	58.2%	33.0%	53.5%	34.7%	27.8%
Current FPE, % above/ (below) 10-YR median	16.8%	25.5%	-9.3%	-4.7%	-11.8%	-5.6%	-15.5%	-21.8%
Current FPE, % above/ (below) Dec 22	12.6%	16.1%	4.8%	8.3%	2.8%	11.3%	8.1%	-3.2%

Source: Bloomberg

Key – Our view



Key – Allocation



Asset Class	Positioning
Developed Market Sovereign Bonds	We recently moderated 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. In this respect we reduced our Underweight position in the asset class during May. In June, we extended our duration to match that of the benchmark index. The recent inflation prints in the US seems to support our view, as both CPI and PPI in June came in below expectations. We will watch closely the language used by the FED during the upcoming meetings to evaluate whether we are at or close to peak terminal rate.
Investment Grade Corporate Bonds	At index level, spreads have tightened by c. 10bp in Europe and c.11bp in the US, which is a relatively small move. Yet, this disguises the significant moves that have hit the IG market this year, especially the spread widening following the US regional banking crisis when spreads widened by c.53bp in a week in Europe. The key theme for IG remains the rising idiosyncratic risk, as it is quite clear that pressures from higher financing costs are rising on weak IG names. The risk from a continued deterioration in the macro-economic backdrop and the high inflation levels will add to the pressure on weak IG credits. This supports our preference for higher quality credits that has been in place for some time. On balance, we believe that the IG space provides investors with an attractive risk/return trade-off against the current macro-economic backdrop with a yield of c. 4.2% being offered in Europe.
High Yield Corporate Bonds	Our view of HY is less positive (compared to IG) despite the high yields on offer for investors. At a high level, yields look attractive at 8.3% yield-to-worst for European HY market. Indeed, YTW has been lower 82% of the time since 2010. Also, yields have only been this high back in 2014 when the Bloc was a risk of breaking up. However, the current spread of 435bp, at the 54th percentile, offers much less cushion should the broader macro-economic backdrop deteriorate further. Historically, the average spreads when YTD was around the current levels amounted to 560bp. This implies that the risk/return trade-off for HY is less attractive for investors. Spreads partly reflect what investors should be compensated for defaults. According to Barclays, spreads below 400bp suggest a default rate of below 2.0%, which is optimistic given the current backdrop. Therefore, despite the relatively attractive yields on offer, we retain the underweight recommendation for HY.
Developed Market Equities	Equity markets have rallied strongly from the October lows as the risk outlook has improved. The feared consequences of the US regional banking crisis, debt ceiling negotiations and inflationary pressures have faded away over the past weeks. The US economy has proved to be much more resilient than expected and a soft landing is being priced-in. However, we note that the global growth picture is more mixed. China's growth momentum has dwindled, disappointing expectations whilst the economic backdrop in Europe is deteriorating. A key risk for investors is that the soft PMI reading could start to weigh on earnings revisions in 2H23, especially as inflation moderates further (translates into less top-line growth). On balance, we believe that a lot of the good news is now priced into equities though we acknowledge that asset class could continue to grind higher if US recession expectations are pushed back further.
Emerging Market Equities	The disappointment of the China re-opening coupled with the mixed global growth expectations have weighed on EM equities so far this year. We believe that Chinese equities offer the most upside, given their underperformance over the past two years and their relatively defensive characteristics. Yet, the performance of Chinese equities depends on the success of monetary easing measures announced over the coming weeks by the PBOC as well as the country's relationship with the US.

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