

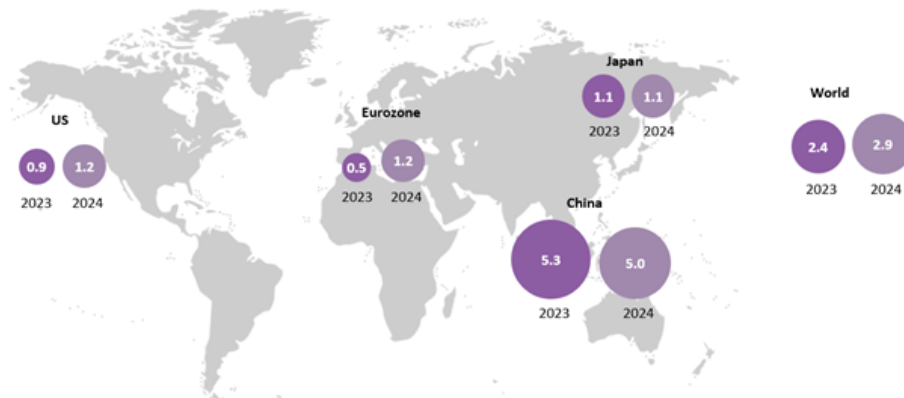
April 11, 2023

BILBoard April 2023: Following the fundamentals



Growth Expectations

Bloomberg Consensus Expectations for Real GDP Growth (% YoY)



	Bloomberg Consensus Expectations (Real GDP QoQ, %)				12m Recession Probability
	Q1	Q2	Q3	Q4	
US	0.6	-0.4	-0.1	0.7	60%
Eurozone	-0.2	0.1	0.3	0.2	49%

Source: Bloomberg, *BIL*

Recently, equity markets have had a spring in their step. The S&P 500 has eked out fresh multi-

week highs, and is up 7.4% year-to-date. The Nasdaq is in a bull market having risen by over 20% in the first quarter. The EuroStoxx 600 was up by about 8% over the same period. All this is in spite of an environment of rising interest rates and the biggest banking failures since the financial crisis. From a fundamental perspective, this is somewhat perplexing.

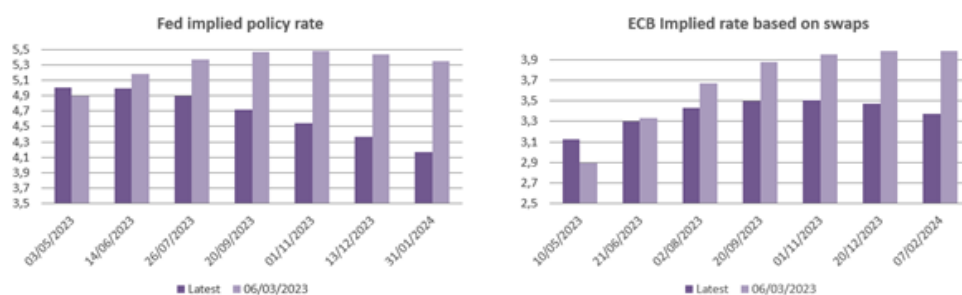
MACRO OUTLOOK

The macro landscape is a challenging one. Much ink has been spilled as to whether the US economy will have a soft or a hard landing as the Fed attempts to stamp out inflation; it seems we will soon find out. Because monetary policy kicks in with a lag, only now are we starting to see the impact of a culmination of interest rate hikes and quantitative tightening. Inflation is coming down, albeit slowly (current pace is 6% YoY). The labour market has adjusted at a snail's pace, but is now weakening (the most layoffs in any given February since 2008, average hourly earnings growth has come down from recent peaks, the unemployment rate rose from 3.4% to 3.6%). Moreover, consumers are starting to pull back on discretionary spending amid a cloudier outlook and tighter financial conditions. The Michigan Consumer Sentiment Index dropped for the first time in four months in March, with households increasingly expecting a recession ahead.

According to Bloomberg consensus estimates, economists expect a very mild US recession over Q2 and Q3. Marginally negative growth and no spike in unemployment might still be considered a soft landing. However, nothing is guaranteed.

Much depends on how restrictive monetary policy has to become. The Fed delivered another 25bp rate hike in March, accompanied by softer forward guidance ("some additional policy firming may be appropriate"). Being less hawkish doesn't necessarily mean the Fed will become dovish, yet recent banking turmoil has led investors to heavily revise their rate expectations, betting that the Fed will already begin to cut rates this year. In the grid below, the lilac bars show the market's current expectations for the Fed Funds Rate, markedly lower than what was expected just a few weeks ago on 6 March (represented by the dark purple bar). We believe that the market has overshot – absent a major crisis, the Fed will likely be apprehensive to cut rates until it can be sure that the inflation genie is safely back in the bottle.

Markets have strongly repriced rate expectations on both sides of the Atlantic



Source: Bloomberg, *BIL*

In Europe, generous fiscal stimulus, a pick-up in sentiment, and the avoidance of an energy crisis could mean that a recession is averted this year. While the US might soon have its landing, Europe seems destined for a slow-burning period of lethargic growth and still-high inflation. While headline inflation has begun to recede (now running at 6.9% YoY, down from a peak of 10.6%), this is largely due to a decrease in energy prices (which could always resurge if Chinese demand picks up). Core inflation, which removes volatile components like food and energy, continues to scale new highs (currently running at a clip of 5.7% YoY). Quite worryingly, second-round effects are starting to kick in – a tight labour market (unemployment at an all-time low of 6.6% with a high participation rate) is emboldening workers to ask for pay increases (e.g. in a rare occurrence, German unions Verdi and EVG joined forces and called a major transport strike to demand higher pay for millions of workers). As such, it is safe to say that the ECB still has “more ground to cover”, as Lagarde has stated. With the latest projections from the central bank estimating that inflation will still be above target by 2025, clearly market expectations for rate cuts already this year are wishful thinking (again, in the absence of a major crisis).

China is an outlier in the global tightening cycle. So far, its reopening has been slow to materialise with consumers “stunned” coming out of the zero-Covid era that disrupted many businesses. As seen after the Sars outbreak in 2003, when consumers in the hardest hit areas took time to recover their confidence, it is expected that it will take some time for normal habits to resume and for households to start spending their pent-up savings. At the same time, China’s policy-driven infrastructure investment is expected to be largely preserved throughout 2023 to support economic development and create jobs. Ultimately, despite a conservative GDP growth target (5%), we do believe that China will be an important driver of global economic growth over the course of the year as other regions slow.

INVESTMENT STRATEGY

Key highlights

- Broadly, we remain underweight equities and fixed income
- Switched approximately 10% of European government bonds into US Treasuries
- Equity regions: underweight the US, Europe and EM. Overweight China
- Sectors: favour European healthcare, US utilities, energy & selected IT names
- Style: emphasise quality – cash (on the balance sheet) is king
- Begin to build exposure to emerging market debt
- Neutral on gold, constructive on oil

In our investment decision-making process, we remain focused on the fundamentals. Not only is the macroeconomic landscape challenging, but micro fundamentals are also deteriorating. Earnings growth expectations have been revised sharply downwards. At best, this could mean prices move in a horizontal fashion from here; at worst, it could mean a correction is forthcoming.

As such, we maintain a cautious portfolio make-up, with underweight positioning on both equities and fixed income. To add, we also keep gold (despite the recent rally), believing that now is not the right moment to throw away our proverbial safety net.

Equities

Within our equity allocation, we are underweight on both the US and Europe. The US still exhibits the most expensive valuations (leaving ample room for disappointment), while profit margins are deteriorating. Europe is about 30% cheaper than the US, yet that discount comes with an increasingly worrying macro outlook. Where we do hold equities, we emphasise quality companies, those that are cash rich and those that have the ability to pass on costs to consumers. We side-step cyclicals, with the exception of energy given that scarcity is set to be a theme for the coming months (recent OPEC+ cuts of 100m barrels per day, US building strategic reserves, ban on Russian crude, etc.). As the Fed nears its terminal rate, we have become more fond of Tech, especially large-cap names that have ample cash piles on their balance sheets. With the fasten seatbelt sign illuminated in markets, it also makes sense to have exposure to more defensive sectors like healthcare (predominantly in Europe due to drug price reforms in the US) and utilities (US-centric due to the forthcoming Inflation Reduction Act that will see the largest ever US investment into clean energy). We also have an overweight exposure to China, which we believe will be fruitful over the longer-term while offering the added benefit of diversification.

Fixed Income

We are still reluctant on fixed income given that the battle with inflation is not yet won. Should no major crisis materialise, rates look poised to drift upwards throughout the year and we think the market is over-optimistic regarding the prospect of rate cuts by central banks. For now, we keep our duration below benchmark.

After the rally in bond prices stemming from banking sector woes, we took profit by selling some of our Core European Sovereigns at an ad-hoc Asset Allocation Committee in mid-March. Believing that the Fed is closer to the end of its hiking cycle than the ECB, at our most recent Committee, we continued to adjust our Sovereign exposure, switching approximately 10% of our remaining allocation in European govies into US Treasuries (currency hedged).

In addition, we reduced exposure to total return (held as an alternative to cash), in favour of adding some Emerging Market (EM) Debt denominated in Hard Currency. The Fed's softer forward guidance bodes well for the asset class and inflows have picked up while supply is limited. We give preference to EM Sovereigns which held up better during recent turmoil than EM corporates. On top of that, EMD Sovereign debt still gives a historically high pick-up over US Treasuries and we feel adequately compensated for the additional risk we take.

Conclusion

The market is priced for something close to perfection believing that central banks will soon step away from their tightening campaigns, refocusing on the other component of their mandates: economic growth. In reality, central banks have been clear that recent stress in the financial sector does not eclipse the risk of not containing price pressures. While bringing inflation back to target will cause pain, not doing so is "non-negotiable", as Lagarde put it. As rates continue to drift upwards, economies falter and profit margins decline, few asset classes look highly appealing. Cash is indeed king and that doesn't necessarily mean moving money into a savings account. Focusing on cash can mean seeking out attractive short-term cash alternatives, or more broadly, pinpointing companies that are more equipped to deal with any incoming storm, due to large cash balances.

Asset Allocation Matrix

	Strategic Weight	Previous	New	Stance	Change
Equities	50,0%	44,0%	44,0%	●	→ 0,0%
Fixed Income	42,0%	36,0%	37,0%	●	↑ 1,0%
Cash / Equivalents	0,0%	5,0%	5,0%	●	→ 0,0%
USD	28,0%	25,5%	25,5%	●	→ 0,0%
Total Return	0,0%	7,0%	6,0%	●	↓ -1,0%
EQUITIES					
US	20,0%	17,0%	17,0%	●	→ 0,0%
Europe	20,0%	17,0%	17,0%	●	→ 0,0%
Japan	5,0%	5,0%	5,0%	●	→ 0,0%
China	2,0%	3,5%	3,5%	●	→ 0,0%
Emerging Markets Ex-China	3,0%	1,5%	1,5%	●	→ 0,0%
FIXED INCOME					
Government Bonds - Developed	20,0%	16,0%	16,0%	●	→ 0,0%
Emerging Market Debt	3,0%	1,0%	2,0%	●	↑ 1,0%
Corporate - Investment Grade	14,0%	15,0%	15,0%	●	→ 0,0%
Corporate - High Yield	5,0%	4,0%	4,0%	●	→ 0,0%
Gold	8,0%	8,0%	8,0%	●	→ 0,0%

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