

May 4, 2023

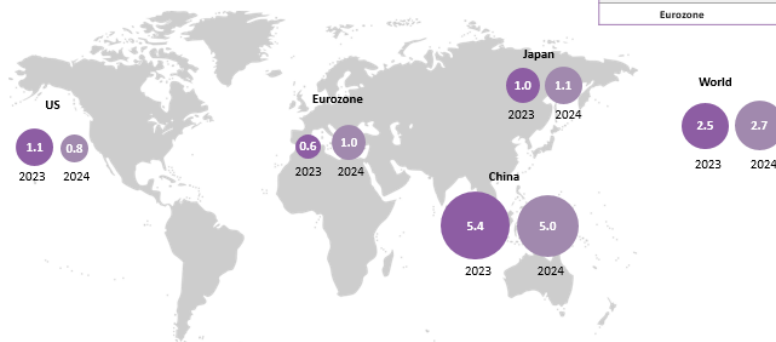
BILBoard May 2023 – Getting defensive



Lingering inflation is keeping major central banks in a tightening mode, even as macro headwinds gather. Expecting a choppy investment landscape in the coming quarters, we added a further layer of protection to our portfolios by implementing a bias towards defensive sectors.

Growth Expectations

Bloomberg Consensus Expectations for Real GDP Growth (% YoY)



Bloomberg Consensus Expectations - 12m Recession Probability	
US	65%
Eurozone	45%

Macro View

Looking Stateside, the Fed appears to be nearing the end of its tightening campaign. Inflation, though still quite a bit above the 2% target, is declining, with the next leg down set to come from falling shelter costs (the Zillow rent index, which tends to lead CPI by 6-12 months, has come down convincingly). Further, as Richmond Fed President noted, “the labour market has moved from red-hot to merely hot”, as layoffs gather steam, wage growth eases and job openings fall.

Facing a cloudier outlook, households are beginning to pull back on discretionary spending, while industrial activity is running at its slowest pace in two years. GDP growth is already decelerating sharply (1.1% annualised in Q1, down from 2.6% in Q4 and below expectations of 2.0%) and the market foresees a recession on the horizon (albeit a mild one). The key risk is that the Fed tightens too much, leading to a deeper downturn – we will almost always only know they have pushed too far after the fact.

Closer to home, the Eurozone economy returned to growth in Q1 (it expanded 0.1%, below expectations of 0.2% as Germany stalled). The common thread running through most of the regional reports is that elevated prices and still-negative real wages are weighing on consumption. Sticky core inflation is an ominous cloud hanging over the economy with second-round effects becoming more likely; as supply issues fade and energy costs retreat, demands for higher pay could become a new powerful driver of price increases. As such, the ECB will likely have to continue tightening in the near-term – and its war on inflation might last for longer than the Fed’s.

Given that monetary tightening kicks in with a lag, it is probable, even plausible, that we haven’t yet experienced the full blow from this yet. Such concerns are compounded by the recent collapse of San Francisco-based First Republic: the second-largest bank failure in US history and the third in the country since March.

China is an outlier in the tightening cycle with inflation running at a feeble 0.7% (versus the target of around 3%). Its economy got off to a solid start, registering growth of 4.5% in Q1, though some of this might stem from backloaded activity from Q4 2022. While the export engine at the heart of the economy has roared into life (exports up 14.8% YoY in March), consumption is yet to bounce back meaningfully – we expect this to play out over the coming quarters.

Investment Strategy

- Broadly, we remain underweight equities and fixed income
- Within equities, we underweight the US, Europe and EM, while being overweight China
- We made several adjustments to our sector preferences to implement a bias towards defensive sectors
- Style-wise, we emphasize quality – cash is king

- We keep an allocation to gold as a hedge in case of stress periods on markets

Markets are still not pricing in a scenario of “higher for longer” in the Western hemisphere. In the US, futures prices imply one more 25 bp hike before a rapid pivot to sustained easing this summer. What is more likely is a Fed pause to assess the impact of its actions so far on the real economy, without ruling out more hikes further down the line. In Europe, while a strong downtrend in core inflation has not yet materialised, markets envisage a terminal rate of around 3.6% and expect the ECB to start trimming rates early 2024.

Absent a sudden unforeseen shock or collapse in inflation (which would, in any case, probably catalyse a flight to safety), it seems that there is still too much optimism around central bank easing baked into prices.

All things considered, we believe it is time to batten down the hatches and prepare for some for some volatile quarters ahead. We are therefore still comfortable with our **underweight exposure to developed market equities and bonds**.

Where we do hold equities, we made several adjustments to our sector preferences to reduce cyclical and implement a **bias towards defensive sectors**, namely:

- **Consumer Staples** - earnings forecasts are relatively stable while the Q1 earnings season has demonstrated that consumer companies are successfully passing on higher prices for now.
- **Utilities** - the sector is benefiting from banking turbulence as investors adopt a more cautious view and shift into haven stocks; high dividends are the main attraction versus other defensive sectors while stimulus packages are set to provide strong tailwinds on both sides of the Atlantic. Moreover, in response to the US Inflation Reduction Act, a package that includes \$369bn of subsidies and tax credits for clean energy technologies, Brussels has cleared the way for EU member states to “match” multi-billion dollar incentives as they fight to keep projects in Europe.
- **European Healthcare** - another winner from banking turmoil and the best performing sector since the collapse of SVB in the US. EPS growth over the next two years should be robust on higher revenues and margin expansion, with pharmaceutical and equipment companies contributing the most.

We also fortify portfolios with **high-quality stocks** – those with strong balance sheets, stable earnings, low debt and the financial firepower to weather a downturn in profits. As such, we maintain an **overweight to IT**, where many such companies are found. Good earnings releases from industry bellwethers so far confirm this stance.

We simultaneously downgraded **Industrials to underweight** and **Energy to neutral**, with both sectors beginning to flag as recession fears mount. It seems that the oil price rally in response to OPEC+ production cuts was a false dawn and that for a sustained rebound, China’s recovery

will be key (+1.8mpd YoY potential demand growth). However, it is increasingly clear that it will take time before all the cogs of the Chinese economy are turning smoothly again after the prolonged pandemic shock.

Looking at **fixed income**, we are becoming more constructive on duration as central banks enter the final stages of the inflation battle and without trying to time the exact peak, we are monitoring for technical entry points to reduce our underweight. We have a slight preference for Treasuries over European equivalents, given that the Fed is coming closer to a pause in its hiking campaign.

For now, our fixed income holdings are concentrated in the investment grade space. As with equities, we emphasise quality in our selection. It seems that markets have become desensitised to the risks of high debt levels because of the extended period of low or zero interest rates since the global financial crisis. Now, with a sea change in the availability and cost of money underway, caution is needed, especially on those bonds at the lower end of the quality spectrum.

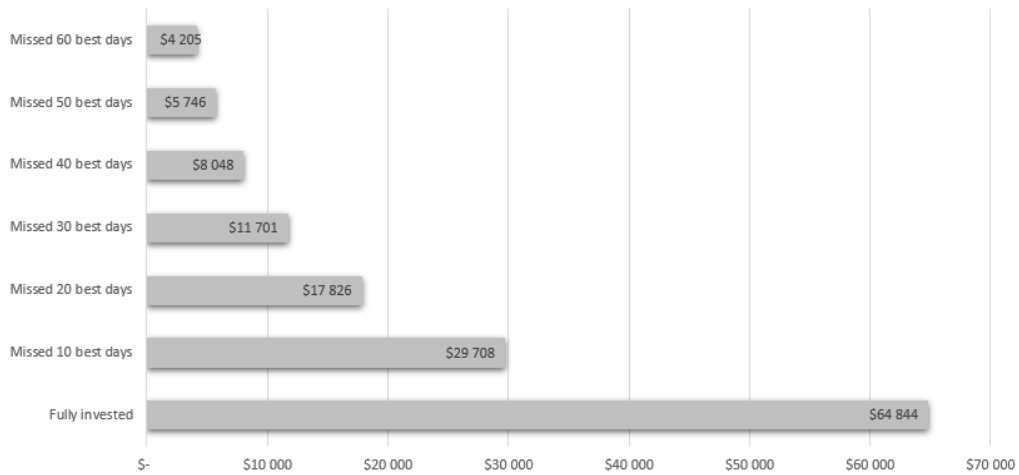
In the high-yield space, our exposure to contingent convertibles (CoCos), was obviously impacted by the Credit Suisse (CS) debacle (with some USD 17bn of these instruments written off while equity investors saw their shares partially converted to UBS equivalents). We held on to our positions rather than crystallising the losses and this has proven to be a good decision. The global market is rebounding, helped by the fact that other jurisdictions made clear their positions on the treatment of these instruments in the event of insolvency. To participate in this upturn, we have rebalanced our positioning upwards in order that these instruments account for the same percentage of our portfolios as they did before the CS affair.

We maintain our gold exposure in order to somewhat shield portfolios during any potential stress periods on markets.

Conclusion

While we do have a larger-than-usual allocation to cash, we don't advocate exiting the market altogether. Time and again, studies have shown that missing just a few good days on markets can adversely affect performance in a meaningful way. No one can predict when those days will be. Rather, it is better to stay systematically invested, while diligently managing risk. By adopting a defensive and diversified approach, we hope to limit the overall volatility of our portfolios, as well as the downside, should markets conditions take a turn for the worst. We do this by having a) a conservative exposure to risk assets b) a moat of safe-havens such as gold c) a defensive sector selection, and d) a preference for strong, dividend-paying businesses whose fortunes don't rise and fall with the economy...

Performance of \$10,000 invested in S&P 500 in 20 years to end of 2022



Source: Bloomberg, BIL

	Strategic Weight	Previous	New	Stance	Change
Equities	50,0%	44,0%	44,0%	●	⇒ 0,0%
Fixed Income	42,0%	37,0%	37,0%	●	⇒ 0,0%
Cash / Equivalents	0,0%	5,0%	5,0%	●	⇒ 0,0%
USD	28,0%	25,5%	25,5%	●	⇒ 0,0%
Total Return	0,0%	6,0%	6,0%	●	⇒ 0,0%
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%	2,0%	2,0%	●	⇒ 0,0%
Corporate - Investment Grade	14,0%	15,0%	15,0%	●	⇒ 0,0%
Corporate - High Yield	5,0%	4,0%	4,0%	●	⇒ 0,0%
Oil	0,0%	0,0%	0,0%	●	⇒ 0,0%
Gold	8,0%	8,0%	8,0%	●	⇒ 0,0%

Based on a Medium risk portfolio. The dots indicate whether we are negative, neutral or positive on the asset class.

The arrows indicate the change in our exposure since the previous month's asset allocation committee: increase, decrease or no change.

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