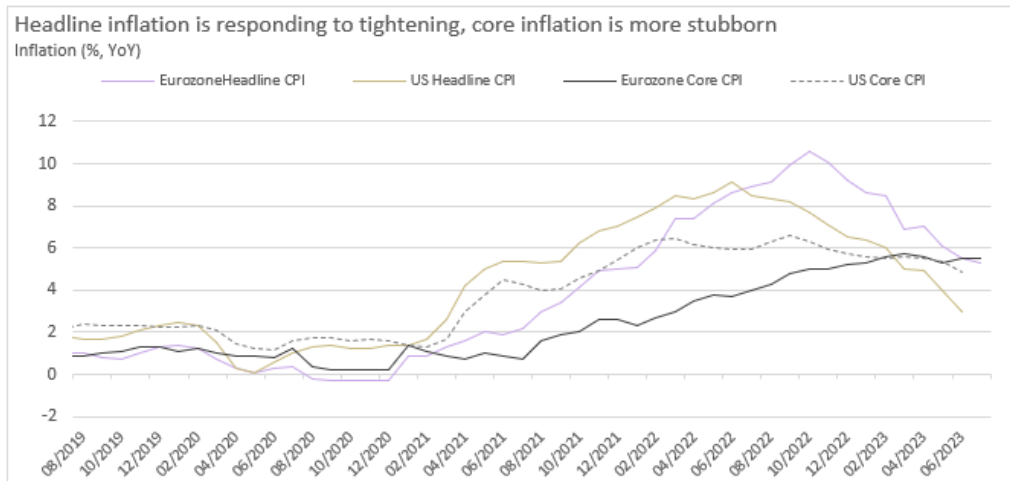


August 2, 2023

BILBoard August 2023 – Challenging resilience



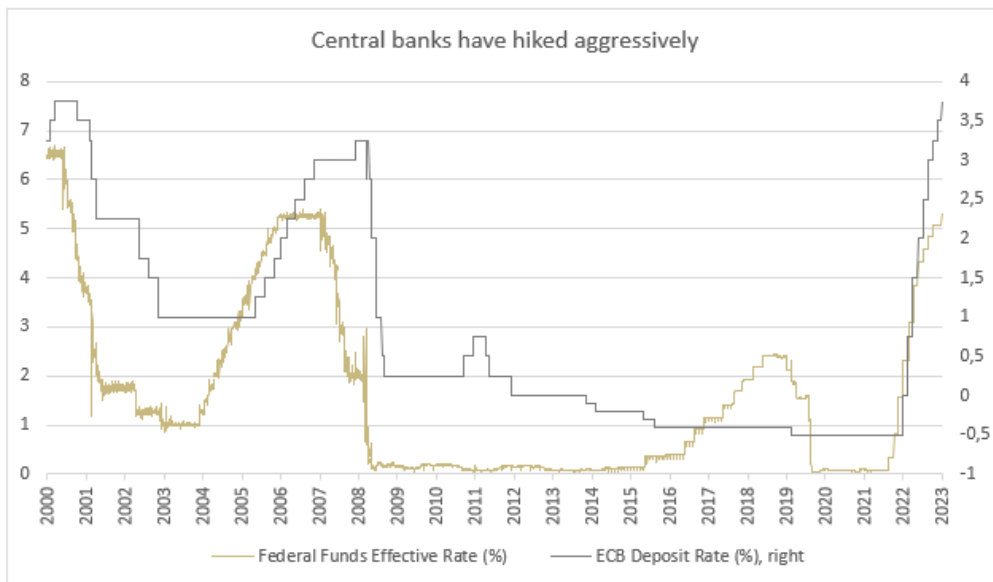
The idea that central banks might be finished hiking rates is gaining prominence. In the US, the Federal Reserve has now hiked rates eleven times, bringing the federal funds rate to a range of 5.25-5.50%, a 22-year high. Closer to home, the European Central Bank has raised interest rates nine times, leaving the deposit rate at 3.75%, which is on par with an all-time high reached in 2001 when the ECB was trying to boost the value of the newly launched single currency.



Source: Bloomberg, BIL

In response, **headline inflation continues to fall. Core inflation**, on the other hand, has been **less susceptible to tightening**, with the **services sector** the main culprit.

In our view, **the Fed is probably finished hiking**, while **one more 25 bp increase from the ECB can't be ruled out**. However, what is more important for investors is the fact that both will probably have to maintain their cruising altitude for some time to be confident that inflation risks are fully contained. No flight plan has been laid out, with Powell and Lagarde both implying that any **additional hikes will be based on incoming data**.



Source: Bloomberg, BIL

Until now, **economic activity has held up surprisingly well** in the face of aggressive monetary tightening – albeit the rule of thumb is that there is a **12-18-month lag between policy enactment and when it shows up in the real economy**.

In this sense, it is still early days. The **US** actually accelerated in Q2, expanding 2.4% on an annualised basis, up from 2% in Q1 and well above consensus expectations of 1.8%. Consumer

spending did slow after a surprisingly strong start to the year, but the decline was more than compensated by business investment (thanks in part to the CHIPS Act and the Inflation Reduction Act). Incoming data tallies with our base case for a soft landing (not to be confused with “immaculate disinflation”, rather a mild downturn as consumption weakens and the labour market loosens up). This is opposed to a hard recession with a major spike in unemployment.

The **Eurozone** also managed to accelerate in Q2, with growth coming in at 0.3% after stagnation in Q1. However, prospects on the continent have darkened since our last BILBoard, with weakness in the beleaguered manufacturing sector threatening to seep into services. Worsening matters for Europe is the fact that China’s re-start appears to have tapered off.

Following lockdowns, domestic demand in **China** remains lackluster, while external demand conditions are less certain, whether it be for political or economic reasons. At our June Asset Allocation committee, market participants had their hopes pinned on two upcoming events: high-profile meetings between US and Chinese delegates, and the July Politburo meeting, at which an economic stimulus package was expected. Neither of those two events gave investors much to chew on. In terms of fiscal support, the central government seems to be rather reluctant to turn to immediate measures to boost the economy and is instead focusing on providing incentives/administrative support to revamp business activities and address unemployment.

INVESTMENT STRATEGY

Equities

In all, the current context is neatly summarised by the title of the IMF’s latest Economic Outlook, “**Near-Term Resilience, Persistent Challenges**”. For now, markets are fully focused on the “**resilience**” part of that equation; all three major US indices closed July in the green, while the S&P 500 recorded a fifth-straight month of gains, marking its best streak since 2021, helped by the fact that companies are beating (very low) EPS expectations and the AI frenzy.

The evolution of the market has meant that our positions have drifted, in that we now have a **slightly higher exposure to US equities** than before. Given that recent US data offers us some comfort about the very near-term economic outlook, as well as the fact that we don’t want to fight the market, we have decided to maintain the drift effect on our portfolios, resulting in a smaller underweight to US equities than before.

However, we do believe that sooner or later, the “**persistent challenges**” will garner more attention, as central banks stick to “**higher for longer**” and the real impact of monetary tightening becomes more apparent. As such, we have **used options to hedge 1/3 of our US equity exposure and 1/3 of our European equity exposure** until the end of the year. By doing so,

we have a degree of protection should we see a market downturn: anecdotal but still worth noting is the fact that over the last 30 years, August and September have been the worst two months for the S&P 500.

With a bumper rescue package in China seemingly off the cards, we took advantage of the recent rally following the announcement of some diluted policy measures, to shift our **Chinese equity exposure towards emerging markets more broadly**. As a result, we now have a neutral stance on both China and Emerging Markets.

Sector-wise, we made two downgrades. Firstly, **IT was moved from positive to neutral**. Following the AI rally, valuations for the sector are rich and there could be a pullback as investors come to realise that profitability and productivity gains from AI will take years to materialise, making it more of a strategic play (note the disappointment following Microsoft's Q2 earnings). We also **downgraded Materials from neutral to negative**. China is a primary consumer of raw materials and the fact that its post-pandemic recovery is losing steam (manufacturing PMI below 50 for three months running), will no doubt weigh on the sector.

Fixed Income

With the hiking cycle now in its old age in both the US and Europe, our view on **duration** is becoming more neutral and we continue to add when attractive entry points present themselves.

Higher rates have left yields at attractive levels and we can safely say that TINA's crown (There Is No Alternative [to equities]) has been stolen by BARBARA (Bonds Are Really Back And Really Attractive).

To capture some of those yields, this month, we focused on building a greater exposure to **quality European fixed income** (with hedging costs denting the attractiveness of US equivalents). More specifically, we added a mix of **European Sovereigns** (beyond decent yields, they should also deliver some protection as the "persistent challenges" weighing on the economy grow heavier) and **European investment grade (IG) credit** (via the **broad index** and **Danish Mortgage Bonds**). Fundamentals in the EUR IG space are strong with low leverage and still-high debt coverage ratios, implying that the sector could weather an economic downturn without any major problems.

Those trades were funded by **reducing our exposure to gold** (as it is non-yielding and expected to move largely sideways throughout the remainder of the year) and **total return** (believing that we no longer need *such* strong protection against rate volatility now that the end of the hiking cycle is in sight).

While some might be tempted by alluring yields in the **high-yield bond space**, our fundamental attitude to the credit market is still based on the long-term thesis that above-target inflation and

central bank tightening will ultimately result in spread widening and higher defaults. Thus, we prefer to play it safe at the higher end of the quality curve.

We cannot let near-term resilience blind us to the persistent challenges still faced by the global economy. Central banks may be approaching the end of their hiking campaigns, but the effects are only just beginning to be felt...

27/07/2023	DEFENSIVE		LOW		MEDIUM		HIGH	
	Stance	Change	Stance	Change	Stance	Change	Stance	Change
Global Allocation								
Equities	[Hatched]		●	→	●	→	●	→
Fixed Income	●	↑	●	↑	●	↑	●	↑
Cash & cash equivalents	●	↓	●	→	●	→	●	→
Alternatives	●	↓	●	↓	●	↓	●	↓
Equities								
USA	[Hatched]		●	→	●	→	●	→
Europe	[Hatched]		●	→	●	→	●	→
Japan	[Hatched]		●	→	●	→	●	→
China	[Hatched]		●	↓	●	↓	●	↓
Emerging Markets Ex-China	[Hatched]		●	→	●	↑	●	↑
Fixed Income								
Government Bonds - Developed	●	↑	●	↑	●	↑	●	→
Emerging Market Debt	●	→	●	→	●	→	●	→
Corporate - Investment Grade	●	↑	●	↑	●	↑	●	↑
Corporate - High Yield	●	→	●	→	●	→	●	→
Alternatives								
Gold	[Hatched]		●	↓	●	↓	●	↓
Total Return	[Hatched]		●	↓	●	↓	●	↓

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