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BILBoard January 2024 – Are we there yet?



ECONOMIC OVERVIEW

- The Fed and the ECB have concluded their hiking cycles.
- The easing cycle is likely to begin with the Fed (but later than March, as markets currently expect).
- The ECB has hinted that rate cuts could come in summer – much depends on incoming data.
- Rate cuts will be accompanied by slower economic growth, meaning fewer companies will be able to deliver on earnings expectations. Quality is key, as is a focus on names benefitting from long-term structural shifts.

In 2023, markets were largely driven by expectations about how soon western central banks would start easing monetary policy. A mini banking crisis, clear progress on inflation, and some weaker-than-expected data prints served to shorten the market's perceived distance to a much-anticipated rate cutting cycle. However, as with navigation apps on a snowy day, the estimated

time of arrival is ever changing, with resilient labour markets, enduring consumption and sticky services inflation all serving to lengthen the expected journey time.

In 2024, as we continue along the road towards eventual rate cuts, the market is like the child in the backseat, asking “are we there yet?” every five minutes and unfastening its seatbelt, ready for arrival. Central banks (the proverbial parents in the driving seats) are advising patience, knowing that speeding would be dangerous – in the 1970s, when policymakers eased too quickly, inflation reaccelerated, and it took years to bring it back under control.

January saw several policy makers trying to reason with the market and push back on hopes that a fast and furious rate cut cycle is just around the corner.

Speaking at Davos, Christine Lagarde conceded that absent another major shock, the ECB has indeed reached peak rates, but she also said that market bets on rate cuts as soon as spring were “not helping” in the fight against inflation. In turn, she added, the ECB must “stay restrictive for as long as necessary” to be sure that inflation is on a sustainable trajectory towards the 2% target. Minutes from the December ECB meeting showed that rate cuts were not discussed, while policymakers are concerned that investor bets on rate cuts as early as March had loosened financial conditions so much that they “could derail the disinflationary process”. Lagarde suggested that the first rate cut is only likely to occur in summer and we believe markets should heed this guidance.

In the US, the Fed also appears to have concluded its hiking cycle, while pencilling in a moderate three rate cuts for 2024. However, the market foresees as many as six rate cuts over the same period, beginning as early as March. In our view, this is overly optimistic and leaves room for disappointment. Such a plunge in rates would imply recession – a scenario that does not square with incoming macro data. The Fed’s Bowman warned that “there is the risk that the recent easing in financial conditions encourages a reacceleration of growth [...] or even causing inflation to reaccelerate.”

We believe that central banks will continue to push back on rate cut hopes, while any stronger-than-expected macro releases will also serve as speedbumps (as seen when UK and US inflation came in above expectations), subsequently causing market volatility.

When rate cuts do finally arrive, investors should bear in mind that they will be accompanied by slowing economic growth. 2024 will bring the moment of truth as to whether central banks have managed to control inflation without causing a hard landing for economies – something we will only know after the fact, given the 18-24 month lag with which monetary policy actions show up in the real economy. While the prospect of a soft landing is increasingly conceivable in the US, growth is still expected to be about half of what it was in 2023. In the Eurozone, the economy might have already tipped into a shallow recession, and from here, we expect only very meagre growth at best.

The macroeconomic situation in China remains challenging. The property downturn is well into its third year, deflationary pressures linger, and an ongoing price war in key sectors (EV and new energy technologies) is pressuring company margins. Thus far, government support has failed to stimulate demand, and from here, the trajectory of the economy largely depends on further stimulus.

Global macroeconomic uncertainty is compounded by geopolitical tensions. Shipping disruptions in the Red Sea are affecting supply chains (e.g. Tesla will pause most production at its German plant due to delayed components), and we must closely observe the potential implications for both growth and inflation – especially considering the high volume of petroleum products that flow through this region and Europe's still-fragile energy situation.

All of the above suggests a challenging terrain for risk assets.

INVESTMENT STRATEGY

- Reduce European equity exposure further, in favour of the US.
- Half Chinese equity exposure, bringing overall stance to underweight.
- Lock in some gains in the investment grade bond space: Allocate proceeds to cash and US high-yield.
- Actively manage duration, monitoring for opportunities to lock in yields.

Equities

For equity investors, earnings delivery will ultimately take over from policy expectations in driving returns, but slowing growth will make it more challenging for companies to deliver. We believe that the US is best poised on this front: on one hand, earnings expectations have receded lately, giving companies a lower hurdle to beat; and on the other hand, it boasts a sturdier macro landscape. Moreover, the region offers unique exposure to structural themes such as artificial intelligence, digitalisation and cloud computing, which we believe will continue to energise markets.

In light of this, we decided to lock in profits on our European equity exposure, **in favour of increasing our overweight to the US**. Note that the downside protection we added in December (covering half of our US equity exposure at the time) was maintained – hopefully these are the airbags on the car that we won't need, but it is good to know that they are there.

In a further adjustment to our equity exposure, we also decided to half our allocation to China, bringing our stance to underweight, given continued macro weakness.

With regard to style, an asymmetric approach is advisable, balancing exposure to aggressive corners of the market (like IT), with more defensive plays, like utilities and staples. Overall, we suggest a bottom-up approach, aimed at identifying quality companies with relative earnings stability.

Fixed income

In the bond space, we spent 2023 gradually building up duration and yield-generating capabilities; this proved beneficial amid December's rapid repricing. Now, as expectations about the timing and magnitude of rate cuts are buffeted by cross currents of central bank communication, macro data, hope and fear, we believe it is time to actively manage duration and size opportunities to capture and lock in income.

In order to have dry powder on hand to do so, in low and medium risk profiles, we crystallised some gains on our investment grade bond (IG) holdings, moving a portion of the proceeds to cash: cash yields are comparable to those now on offer in the IG space. Note that overall, we remain overweight and constructive on the IG segment, where high supply is being met with strong demand as seen from oversubscribed books. At the same time, corporate balance sheets in this segment appear robust enough to weather a macro slowdown.

The remainder of the proceeds from trimming our IG exposure was used to top up our US high-yield (HY) corporate bond exposure in order to take advantage of the attractive yields on offer. We opted to make this move in the US, again because of the more benign macro landscape, and also because here, maturity walls are less of a concern. While selecting the instruments, we emphasised higher quality US HY (B and BB rated). We are still worried about a tick-up in default rates, particularly in Europe where growth is meagre and where monetary easing is likely to arrive later than in the US.

CONCLUSION

We are not there yet with regard to the easing cycle, and until we arrive at that destination, volatility is expected as the market adjusts and readjusts its calculations for speed, distance and time. This calls for a cautious approach, but also an opportunistic one, especially in fixed income, where price fluctuations might give investors nice opportunities to lock in attractive yields for the long haul.

ASSET ALLOCATION MATRIX

15/01/2024	DEFENSIVE			LOW			MEDIUM			HIGH						
	Bonds: 100%			Equities: 15% - 45% Bonds: 55% - 85%			Equities: 25% - 75% Bonds: 25% - 75%			Equities: 40% - 100% Bonds: 0% - 60%						
	Strategic Weight	Tactical Allocation		Change	Strategic Weight	Tactical Allocation		Change	Strategic Weight	Tactical Allocation		Change				
	Previous	New		Previous	New		Previous	New		Previous	New					
Equities																
Fixed Income	100,0%	97,0%	97,0%	⇒ 0,0%	30,0%	30,0%	30,0%	⇒ 0,0%	50,0%	50,0%	49,0%	↓ -1,0%	70,0%	75,0%	75,0%	⇒ 0,0%
Cash & cash equivalents	0,0%	0,5%	0,5%	⇒ 0,0%	0,0%	0,5%	1,5%	↑ 1,0%	0,0%	0,0%	2,0%	↑ 2,0%	0,0%	0,0%	0,0%	⇒ 0,0%
Other	0,0%	2,5%	2,5%	⇒ 0,0%	5,0%	5,0%	5,0%	⇒ 0,0%	8,0%	5,0%	5,0%	⇒ 0,0%	10,0%	5,0%	5,0%	⇒ 0,0%
Equities																
USA					12,0%	13,5%	14,5%	↑ 1,0%	20,0%	23,0%	25,0%	↑ 2,0%	28,0%	36,5%	40,5%	↑ 4,0%
Europe					12,0%	10,5%	9,5%	↓ -1,0%	20,0%	17,0%	15,0%	↓ -2,0%	28,0%	24,5%	22,0%	↓ -2,5%
Japan					3,0%	3,0%	3,0%	⇒ 0,0%	5,0%	5,0%	5,0%	⇒ 0,0%	7,0%	7,0%	7,0%	⇒ 0,0%
China					1,0%	1,0%	0,5%	↓ -0,5%	2,0%	2,0%	1,0%	↓ -1,0%	3,0%	3,0%	1,5%	↓ -1,5%
Emerging Markets Ex-China					2,0%	2,0%	2,5%	↑ 0,5%	3,0%	3,0%	3,0%	⇒ 0,0%	4,0%	4,0%	4,0%	⇒ 0,0%
Fixed Income																
Government Bonds - Developed	50,0%	36,0%	36,0%	⇒ 0,0%	30,0%	23,5%	23,5%	⇒ 0,0%	20,0%	18,0%	18,0%	⇒ 0,0%	10,0%	8,0%	8,0%	⇒ 0,0%
Emerging Market Debt	7,0%	4,0%	4,0%	⇒ 0,0%	5,0%	3,0%	3,0%	⇒ 0,0%	3,0%	2,0%	2,0%	⇒ 0,0%	1,0%	1,0%	1,0%	⇒ 0,0%
Corporate - Investment Grade	33,0%	49,0%	47,0%	↓ -2,0%	23,0%	33,0%	30,0%	↓ -3,0%	14,0%	21,0%	19,0%	↓ -2,0%	7,0%	9,0%	9,0%	⇒ 0,0%
Corporate - High Yield	10,0%	8,0%	10,0%	↑ 2,0%	7,0%	5,0%	7,0%	↑ 2,0%	5,0%	4,0%	5,0%	↑ 1,0%	2,0%	2,0%	2,0%	⇒ 0,0%
Other																
Gold					5,0%	2,5%	2,5%	⇒ 0,0%	8,0%	2,5%	2,5%	⇒ 0,0%	10,0%	2,5%	2,5%	⇒ 0,0%
Total Return	0,0%	2,5%	2,5%	⇒ 0,0%	0,0%	2,5%	2,5%	⇒ 0,0%	0,0%	2,5%	2,5%	⇒ 0,0%	0,0%	2,5%	2,5%	⇒ 0,0%
Currency Exposure																
EUR	100,0%	100,0%	98,0%	↓ -2,0%	77,0%	82,0%	79,5%	↓ -2,5%	62,0%	72,0%	71,0%	↓ -1,0%	48,0%	61,0%	60,5%	↓ -0,5%
Other FX	0,0%	0,0%	0,0%	⇒ 0,0%	6,0%	4,5%	4,5%	⇒ 0,0%	10,0%	7,5%	6,5%	↓ -1,0%	14,0%	10,5%	9,0%	↓ -1,5%
USD	0,0%	0,0%	2,0%	↑ 2,0%	12,0%	11,0%	13,5%	↑ 2,5%	20,0%	18,0%	20,0%	↑ 2,0%	28,0%	26,0%	28,0%	↑ 2,0%
Gold (in USD)	0,0%	0,0%	0,0%	⇒ 0,0%	5,0%	2,5%	2,5%	⇒ 0,0%	8,0%	2,5%	2,5%	⇒ 0,0%	10,0%	2,5%	2,5%	⇒ 0,0%

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