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BILBoard March 2024 – Rate cut bets recede on brighter data



Spring is around the corner. The days are getting a little longer and brighter, while the cherry blossom tree in the BIL grounds is already in bloom. The latest economic data also has a Spring feeling about it.

As the IMF wrote in its latest economic outlook, *"the global economy continues to display remarkable resilience, and we are now in the final descent toward a soft landing with inflation declining steadily and growth holding up."* Consensus expectations about the probability of a recession in the next twelve months have receded on both sides of the Atlantic.

It is the **US economy that really stands out for its continued strength**. Businesses are optimistic about future conditions and manufacturing appears to be catching up with services amid

restocking and firm domestic demand. Consumer confidence hit a two-year high in January, largely due to the fact that the sun continues to shine in the labour market: It added 353K jobs in January, almost double market forecasts and well above the 100k per month needed to keep pace with growth in the working population, while the unemployment rate hovers at 3.7%.

The strong data we have seen so far this year gives the Fed much-needed flexibility to wait for more certainty that inflation is on a durable path towards 2%. The headline figure currently sits at 3.1%, but the services component is proving particularly sticky (+5.4% YoY), in part due to rising wage costs that companies are passing onto buyers. **The good news is that market expectations for rate cuts have receded without disrupting markets.** At the onset of 2024, traders banked on as many as 7 cuts this year; they now envisage only 3 to 4. This better aligns with the Fed's dot-plot, which shows rates declining by a total of 0.75% through December. At BIL, we think three cuts this year is a fair assumption, beginning in July.

Even in the **Eurozone**, some mild improvements are visible in the data. With a technical recession avoided, inflation trending down and interest cuts on the horizon, sentiment is improving among institutional investors (as measured by the ZEW), consumers, and businesses. While the PMIs do not indicate an economy that is blossoming, they do indicate one that is bottoming. But not everything is rosy. Tighter financial conditions are still working their way into the real economy, with much of the impact yet to be felt. 30% of fixed rate mortgages in the Eurozone will expire this year, exposing households to higher rates. This might constrain the consumption rebound which was expected to support growth. At the same time, the construction sector remains under intense pressure, with the markets for residential and commercial real estate disrupted by higher rates and the work-from-home trend.

January inflation came in at 2.8% in the bloc, down only slightly from a prior 2.9%. Again, the key culprit is the services sector, where disinflation has stalled, with price growth coming in at 4% for three consecutive months. Linked to this, the ECB has emphasised that it needs to see wage growth slowing. Encouragingly, negotiated wage growth fell from 4.7 to 4.5% in Q4. However, to confirm whether a downtrend is setting in, the ECB needs at least another quarter of data and it won't have that until its June meeting.

As in the US, markets have tempered their rate cut bets in the Eurozone. They now see a 65% probability of an ECB rate cut in April, down from 1.5 cuts priced in early January. At BIL, we expect the first cut to come in June or July (June would mean pre-empting the Fed but it is possible if data weakens).

In the East, **China's economy remains weak** with a recovery largely dependent on government stimulus. Strong consumption during the Lunar New Year holiday should not be misinterpreted as the onset of a recovery in spending, with households exhibiting a tendency to save and spend only on major occasions. At the same time, the potential spill-over risk from US presidential election cannot be underestimated, especially for the stock market. On that same

note, Beijing is pursuing stricter regulation enforcement in the financial industry; while this is a necessary improvement for the long-term development of China's capital markets, it threatens to exacerbate already-gloomy market sentiment.

INVESTMENT STRATEGY

Fixed Income

In line with our objective to gradually increase duration, we took advantage of a sell-off to **add exposure government bonds**. Given that European rates sold off in sympathy with US Treasuries and that the economic outlook in Europe is softer, we prefer adding to European government bonds over US Treasuries. While yields could still move marginally higher, we believe that the bulk of the upwards move has already played out. This allows us to lock in attractive yield levels before the opportunity passes, and to add protection against an economic slowdown. We financed this trade by **selling all of our remaining exposure to Floating Rate Notes**.

In all profiles except high (where we have more equity exposure), **we trimmed our investment grade (IG) bond exposure, in favour of US high yield (HY)** which offers attractive carry. High yield bonds have started the year on a positive note on both sides of the Atlantic. However, with maturity walls looming in Europe, we give preference to the US, where this issue is less prevalent. As is the case in the IG market, investors are betting on a soft landing scenario leading to tight spread levels. Momentum for HY remains strong and company guidance does not suggest we are facing a sudden slowdown. Default rates are expected to rise further this year but should remain manageable and well below the levels seen during past crises. Nonetheless, we concentrate on the highest quality bucket of the market. Note that the trades were EUR-hedged. From a longer-term perspective the USD seems overvalued against the euro and we prefer to keep a **neutral exposure to the greenback**.

Overall, we remain overweight on IG bonds, where technicals are very strong, with demand outstripping supply. We do note that spreads are tight though, so a small widening cannot be ruled out. European IG still trades wide over US IG.

Equities

Broadly, we maintain a **neutral stance on equities**, with an **underweight to Europe and China**, and a **neutral stance on Emerging Ex-China and Japan**.

We maintain our overweight to the US. Amid a 14-week winning streak (the likes of which hasn't been seen since 1972), US equities are downright expensive. However, slashed earnings estimates create the optimal platform for US companies to beat expectations, especially with

growth as strong as it currently is. We also take comfort in the fact that we still have downside protection in place (via options) should volatility arise.

The US offers unique exposure to structural themes such as AI and digitalisation. There is the possibility that we are on the brink of a new AI-driven cycle that drives efficiencies, productivity gains and higher profitability. On the back of the reshoring trend and government stimulus (CHIPs Act, IRA), American firms have been investing heavily in manufacturing capacity, AI and robotics. This already appears to be bearing fruit, with domestic productivity hitting levels unseen since 2009 (excluding the pandemic period).

Sector-wise, we keep **our overweight stance on Energy** (a geopolitical hedge), **Consumer Staples** (a defensive play), and **US consumer discretionary**. **IT was kept on overweight** with the asterisk that investors who have benefitted from the strong AI-driven rally that kicked off in October 2023, should make sure to **rebalance their exposure, in order to monetise some of the gains**.

The Utilities sector was downgraded from positive to neutral. The price at which Utilities companies can sell electricity is closely linked to the gas price and, as such, we might see some margin pressure moving forward. Europe entered 2024 with a record gas storage level of 86%: Weak demand has been the biggest driver due to low economic activity, and benign weather (as evidenced by our aforementioned unseasonably pink cherry tree). While rates remain high, the sector's attractiveness as a dividend play is tarnished.

Asset Class	20/02/2024															
	DEFENSIVE			LOW			MEDIUM			HIGH						
	Strategic Weight	Tactical Allocation		Strategic Weight	Tactical Allocation		Strategic Weight	Tactical Allocation		Strategic Weight	Tactical Allocation					
		Previous	New	Change		Previous	New	Change		Previous	New	Change				
Equities	100,0%	97,0%	97,0%	⇒ 0,0%	30,0%	30,0%	30,0%	⇒ 0,0%	50,0%	49,0%	49,0%	⇒ 0,0%	70,0%	75,0%	75,0%	⇒ 0,0%
Fixed Income	0,0%	0,5%	0,5%	⇒ 0,0%	65,0%	63,5%	63,5%	⇒ 0,0%	42,0%	44,0%	44,0%	⇒ 0,0%	20,0%	20,0%	20,0%	⇒ 0,0%
Cash & cash equivalents	0,0%	0,5%	0,5%	⇒ 0,0%	0,0%	1,5%	1,5%	⇒ 0,0%	0,0%	2,0%	2,0%	⇒ 0,0%	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%	14,5%	14,5%	⇒ 0,0%	20,0%	25,0%	25,0%	⇒ 0,0%	28,0%	40,5%	40,5%	⇒ 0,0%
Europe					12,0%	9,5%	9,5%	⇒ 0,0%	20,0%	15,0%	15,0%	⇒ 0,0%	28,0%	22,0%	22,0%	⇒ 0,0%
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%	0,5%	0,5%	⇒ 0,0%	2,0%	1,0%	1,0%	⇒ 0,0%	3,0%	1,5%	1,5%	⇒ 0,0%
Emerging Markets Ex-China					2,0%	2,5%	2,5%	⇒ 0,0%	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%	39,0%	↑ 3,0%	30,0%	23,5%	26,0%	↑ 2,5%	20,0%	18,0%	19,5%	↑ 1,5%	10,0%	8,0%	9,0%	↑ 1,0%
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%	47,0%	41,0%	↓ -6,0%	23,0%	30,0%	25,5%	↓ -4,5%	14,0%	19,0%	16,5%	↓ -2,5%	7,0%	9,0%	8,0%	↓ -1,0%
Corporate - High Yield	10,0%	10,0%	13,0%	↑ 3,0%	7,0%	7,0%	9,0%	↑ 2,0%	5,0%	5,0%	6,0%	↑ 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%	98,0%	98,0%	⇒ 0,0%	77,0%	79,5%	79,5%	⇒ 0,0%	62,0%	71,0%	71,0%	⇒ 0,0%	48,0%	60,5%	60,5%	⇒ 0,0%
Other FX	0,0%	0,0%	0,0%	⇒ 0,0%	6,0%	4,5%	4,5%	⇒ 0,0%	10,0%	6,5%	6,5%	⇒ 0,0%	14,0%	9,0%	9,0%	⇒ 0,0%
USD	0,0%	2,0%	2,0%	⇒ 0,0%	12,0%	13,5%	13,5%	⇒ 0,0%	20,0%	20,0%	20,0%	⇒ 0,0%	28,0%	28,0%	28,0%	⇒ 0,0%
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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