CURMI & PARTNERS

December 15th, 2022

Monthly Strategy Update

The month in summary:

Monetary policy expectations remained top of mind for investors during November, with a softer than expected US inflation print for October driving a rally in risky assets. Sovereign yields moderated, with the UST10-year falling c.40bp to 3.6% as estimates for the terminal rate fell below 5% for the first time since Chair Powell's hawkish comments in October. Elsewhere, equities rallied strongly with European stocks delivering a total return of 6.9%, outperforming their US counterparts (SPX – 5.6% in local currency terms).

In our opinion, last month's move in bond markets is overdone, bearing in mind the current inflation level. Although there are signs of macro-economic deterioration in the US, especially in the property market, the labour market remains resilient, and probably implies that prices will fall at a slower pace than the slowdown in economic activity. Should this happen, we expect central banks to be reluctant to cut rates to support the economy, with inflation still well above target. We stress that a pause in the hiking cycle does not imply a pivot, and we expect interest rates to remain high for longer.

Monetary policy expectations was also a key driver in the FX market, leading to a sell-off in the US Dollar. The currency weakened against both the Euro (-5.3%) and the Pound (-5.1%) during November.

Apart from the positive developments on the inflation front, European equities benefited from the relatively milder weather so far during the winter, easing some concerns around potential energy shortages. Moreover, the positive news flow around China's possible re-opening, with 20 measures announced in November to deal with curtailment measures as well as 15 policies announced to tackle the softness in the property market, helped boost sentiment. EM equities rallied 14.8% during the month, boosted by an 18.8% rally in EM Asia as a result of these measures.

Despite this, even though we expect China's re-opening to be a positive catalyst for Europe (in terms of economic activity and investor sentiment), we expect the country to remain a disappointment over the short term. China is yet to allow foreign vaccines (BionTech) to be used by the local population. Also, there is no widespread vaccination program, and an announcement of such program would take several months to implement. Finally, considering that China has not experienced a second-wave, we expect cases to surge once the country re-opens its economy, which makes us less optimistic about China's prospects in 1H23.

Sovereign		
	MoM bp	YTD bp
US 10-year yield	22	254
DE 10-year yield	3	232
UK 10-year yield	-58	255
Credit		
Total return	MoM %	YTD %
EUR IG	0.1%	-14.5%
EUR HY	2.0%	-13.4%
USD IG	-1.0%	-19.6%
USD HY	2.6%	-12.5%
GBP IG	4.4%	-21.2%
GBP HY	2.3%	-13.7%
Equities		
LCL Total returns	MoM %	YTD %
S&P 500	8.1%	-17.7%
Nasdaq 100	3.9%	-29.3%
STOXX 600	6.3%	-13.5%
DAX	9.4%	-16.6%
CAC	8.8%	-9.9%
FTSE 100	3.0%	-0.9%
Emerging markets	-3.1%	-29.2%
EM ASIA	-6.1%	-32.1%
EM LATAM	9.7%	13.0%
EM EMEA	4.3%	-29.1%
Currencies		
Total return	MoM %	YTD %
EURUSD	0.8%	-13.1%
EURCHF	2.3%	-4.6%
GBPEUR	1.8%	-2.5%
GBPUSD	2.6%	-15.3%
Commodities		
Total return	MoM %	YTD %
Oil WTI	8.6%	21.5%
Oil Brent	9.7%	25.0%
Natural Gas	-6.1%	70.4%
Gold	-1.5%	-10.6%
Copper	-1.5%	-23.4%
Iron Ore	-15.3%	-4.6%
Lumber	9.3%	-59.8%

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Macro-economic views

A combination of tighter monetary and fiscal policy, China's zero Covid policy, high inflation and the Ukraine/Russia war, as well as a lower boost from re-opening (compared to 2021) have all weighed on economic growth in 2022. As we approach 2023, economists believe that persistently high inflation and the impact from the aggressive monetary policy tightening in 2022 will likely be a headwind for economic growth. Global economic growth of 2.1% in 2023 is currently expected by consensus, with developed economies growing by just 0.5% (vs. 2.6% expected in 2022). On the other hand, emerging economies are expected to grow at 4.0%, (vs. 3.1% expected for 2022). However, we believe that there is downside risk attached to this forecast bearing in mind the Covid-19 situation in China.

The global economy has been deteriorating for several months, as evidenced by the JP Morgan Composite PMI, which has been in contraction territory since July. However, we note that, especially in the US and Europe, the labour market has remained resilient, which could support demand over the short-term. The implication here could be a scenario where demand remains robust (i.e. inflation pressures would persist for longer), but economic activity weakens at a fast pace, leading to a stagflation environment. We think central banks would be reluctant to cut rates in a scenario where inflation is still well above target. Consensus expects global inflation to slow down to 5.1% by end of 2023, from 7.5% in 2022.

In summary, economic activity in developed economies is expected to slowdown next year, as the tightening that occurred in 2022 impacts growth and inflation, although moderating, stays above target.

Exhibit 1 – Consensus real GDP growth and inflation expectations

Expectations for developed economies have been revised lower over the past month, with growth of just 0.5% expected in FY23

		Consensus Forecast, % QoQ						Consensus Forecast, % YoY			Revisions since last meeting								
Real GDP, YoY%	3Q22A	4Q22F	1Q23F	2Q23F	3Q23F	4Q23F	1Q24F (New)	FY22F	FY23F	FY24F	3Q22A	4Q22F	1Q23F	2Q23F	3Q23F	4Q23F	FY22F	FY23F	FY24F
United States*	2.9	0.5	0.0	-0.1	0.6	1.0	1.6	1.8	0.4	1.3	0.3	-0.1	0.1	-0.3	-0.2	-0.2	0.1	0.0	-0.1
Japan*	-1.2	2.8	1.0	1.1	0.9	1.2	1.4	1.5	1.3	1.1	-2.6	0.9	0.2	0.7	1.4	0.1	-0.1	-0.1	0.0
Germany	1.3	0.5	-0.9	-0.7	-0.7	0.0	1.1	1.7	-0.6	1.3	0.6	0.3	0.1	0.2	-0.1	-0.5	0.2	0.0	-0.3
France	1.0	0.2	0.4	0.0	0.2	0.7	1.4	2.5	0.4	1.2	0.0	-0.2	0.0	-0.2	-0.1	-0.1	0.0	0.0	-0.4
Italy	2.6	1.2	0.6	-0.4	-0.3	0.2	1.0	3.7	-0.1	1.0	0.7	0.4	0.2	0.1	-0.2	-0.5	0.4	-0.1	-0.3
Spain	3.8	1.4	1.3	0.4	0.6	1.4	2.0	4.5	1.0	1.9	0.0	-0.1	-0.2	-0.2	-0.7	-0.2	0.0	0.0	-0.1
Eurozone	2.1	1.1	0.0	-0.6	-0.4	0.4	1.3	3.2	-0.1	1.5	0.2	0.2	0.0	0.1	-0.2	-0.3	0.2	0.0	0.0
UK	2.4	0.2	-0.9	-1.5	-1.1	-0.7	0.3	4.2	-0.8	1.0	0.2	-0.1	-0.4	-0.6	-0.6	-0.8	0.0	-0.4	-0.2
Developed Economies	2.4	1.0	0.3	0.0	0.4	0.9	1.5	2.6	0.5	1.5	0.4	0.1	0.0	-0.2	-0.3	-0.3	0.1	-0.1	-0.1
China	3.9	3.8	3.6	6.8	4.4	4.4	4.7	3.3	4.9	4.9	0.0	0.0	0.1	0.1	-0.3	0.0	0.0	-0.1	0.0
Emerging Economies	3.9	3.0	2.7	5.0	3.8	4.1	4.4	3.1	4.0	4.4	0.5	0.2	0.0	0.0	-0.3	0.0	0.1	-0.2	0.0
Global								2.9	2.1	2.9							0.0	-0.2	0.0

	Consensus Forecast, % QoQ						Consensus Forecast, % YoY			Revisions since last meeting							
Consumer prices, YoY %	4Q22F	1Q23F	2Q23F	3Q23F	4Q23F	1Q24F (New)	FY22F	FY23F	FY24F	4Q22F	1Q23F	2Q23F	3Q23F	4Q23F	FY22F	FY23F	FY24F
United States	7.5	6.2	4.4	3.7	3.1	2.8	8.1	4.3	2.5	0.2	0.3	0.2	0.1	0.1	0.1	0.2	0.0
Japan	3.5	2.5	1.9	1.2	1.0	1.5	2.4	1.6	1.0	0.5	0.1	0.2	0.0	0.2	0.1	0.1	0.2
Germany	11.3	9.6	7.6	6.1	3.6	2.6	8.6	6.5	2.5	0.8	0.6	0.4	0.3	0.0	0.2	0.3	0.1
France	7.2	6.7	5.4	4.6	3.5	2.4	5.9	4.9	2.3	0.6	0.6	0.5	0.6	0.4	0.1	0.4	0.2
Italy	11.7	9.3	7.7	5.7	2.5	2.1	8.3	6.0	1.9	2.2	1.5	1.3	1.2	-0.4	0.4	0.7	0.0
Spain	7.7	6.6	5.2	3.6	3.5	2.7	8.7	4.6	2.2	-0.9	-0.3	0.0	0.0	0.3	-0.2	0.1	0.0
Eurozone	10.5	9.0	6.9	5.5	3.1	2.5	8.5	5.9	2.1	0.9	0.9	0.5	0.5	-0.3	0.2	0.4	0.0
UK	10.5	9.9	7.5	6.5	4.6	3.8	9.0	7.0	2.6	0.2	0.2	1.1	1.3	1.1	0.0	0.7	0.0
Developed Economies	9.2	7.7	5.8	4.8	3.8	3.3	8.5	5.3	2.8	0.4	0.5	0.5	0.3	0.3	0.1	0.4	0.1
China	2.6	2.8	2.2	2.2	2.0	2.0	2.2	2.3	2.1	-0.1	0.0	-0.2	-0.1	0.0	0.0	-0.1	-0.1
Emerging Economies	6.9	6.5	5.3	5.0	4.9	4.7	6.4	5.6	4.2	0.0	0.3	-0.1	-0.1	0.0	0.1	0.2	0.0
Global							7.5	5.1	3.4						0.1	0.3	0.1

Source: Bloomberg (Note: QoQ figures for the US and Japan are QoQ SAAR

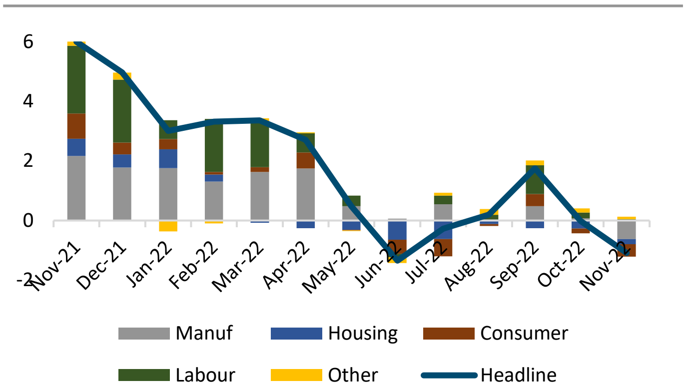
United States

Growth: Real GDP growth was revised up by three tenths to +2.9% for the third quarter, slightly above estimate of +2.6%. This was driven by firmer consumption growth, with upward revisions to personal consumption (+0.3pp to +1.7%) and business fixed investment (+1.4pp to +5.1%).However, activity in the fourth quarter has continued to deteriorate as shown by Goldman Sachs's Current Activity Index falling to -1.1 in November from 0.0 last month (Exhibit 2). The Atlanta GDPNOW tracker shows the US economy growing 2.8% in 4Q22, which is significantly below the 4.0% growth expected at the end of November (Exhibit 3). However, although expectations have come down, they remain above trend despite the aggressive tightening cycle in 2022.

Inflation: The October inflation print reinforced beliefs that it is past the peak, with both headline and core CPI slowing more than expected (Exhibit 4). October core CPI rose to 6.3% YoY (vs median expectations of +6.5%). Whilst this is clearly a positive, we caution that inflation has flattered to deceive in the past. The March and July core inflation prints were both weak, only to be followed by sharp inflation spikes in subsequent months. We note that the job-workers gap continued to close, which is a sign that the employment market is slowly adjusting (Exhibit 5). Yet, wage growth remains particularly high, with the Atlanta FED wage tracker showing nominal growth of 6.4% in November, which is still at cycle highs.

Exhibit 2 – US Current Activity Indicator

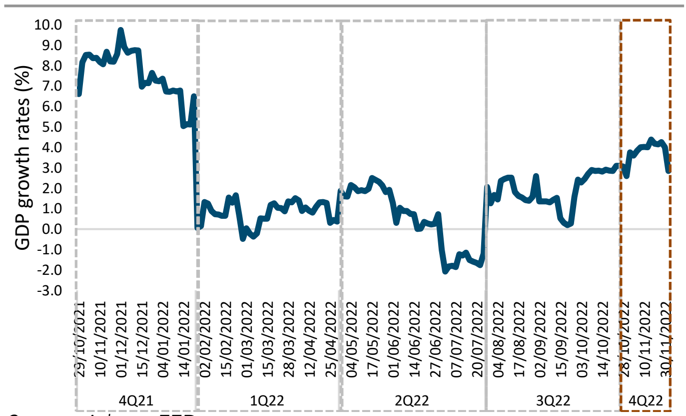
Economic activity continued to fall in November, with weakness mainly driven by Manufacturing CAI…



Source: Goldman Sachs

Exhibit 3 – US PMIs

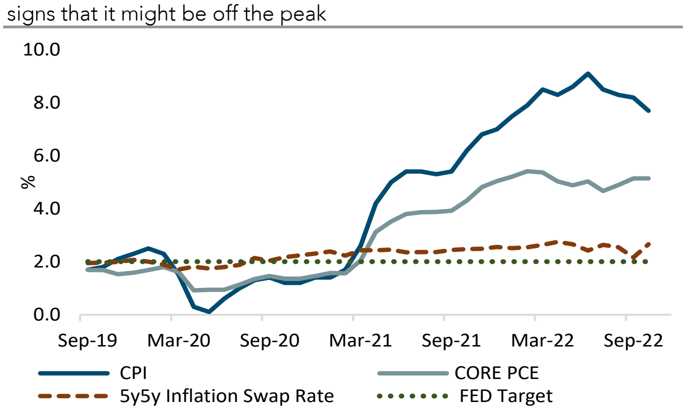
The Atlanta FED growth forecast for the fourth quarter has come down significantly in recent weeks



Source: Atlanta FED

Exhibit 4 – US Inflation rate

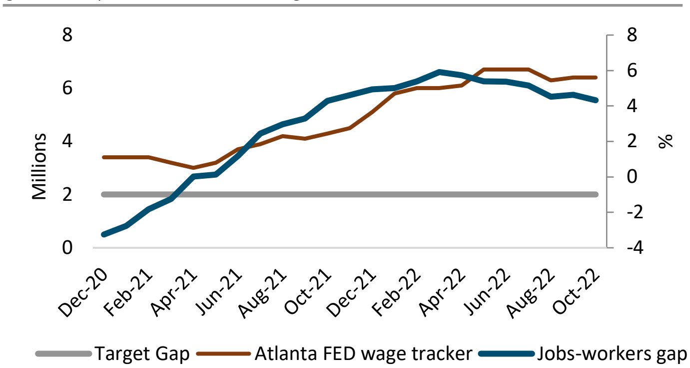
Inflation remained well above target in November but there are signs that it might be off the peak



Source: Bloomberg

Exhibit 5 – Job-workers gap (LHS) and Atlanta FED wage tracker (RHS)

The jobs-workers gap tightened slightly in November but wage growth expectations remain high



Source: FRED, Atlanta FED

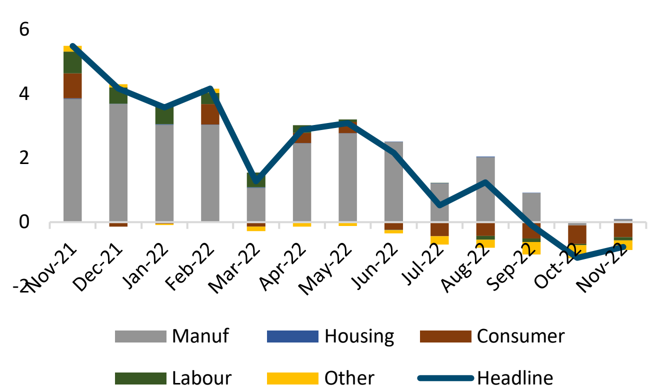
Europe

Growth: The Euro area is still facing an energy crisis that begun following the Ukraine invasion, which led to a surge in gas prices of c.70% this year. Gas flows from Russia have fallen to around 80% of pre-war levels, but still the Bloc managed to refill storage to around 95% during the summer months. Moreover, warmer than expected weather during October and November led to a fall in energy demand, easing concerns of gas shortages during the winter months. Economic activity seems to have picked-up slightly during November, though the GS Current Activity indicator remains in negative territory (Exhibit 6). Also, PMIs releases came in better than expected but still in contraction territory (Exhibit 7). Energy remains a key risk for Europe going into 2023. The Nord Stream pipeline seems to be permanently offline and, assuming China re-opens, demand for energy will be higher next summer during the refill season.

Inflation: Headline inflation in Europe fell 59bps to 10% YoY, which was slower than the 10.4% expected. Moreover, core inflation rose 20bps to 6.4% in November (Exhibit 8). Energy inflation fell 6.6pps to 34.9% year-on-year. Although European gas prices have come down sharply since the summer, wholesale prices remain 6-7 times higher than pre-Ukraine war, according to GS. Additionally, the labour market remains tight, which could see wage inflation persist for longer. Euro-area unemployment rate is currently 6.5%, still well below the 10-year median of 8.6% (Exhibit 9).

Exhibit 6 – EU Current Activity Indicator

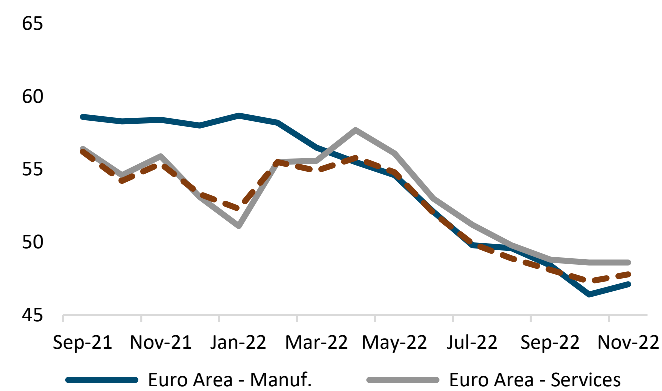
Economic activity seems to have picked up somewhat during November, following three consecutive months of deterioration…



Source: Goldman Sachs

Exhibit 7 – EU PMIs

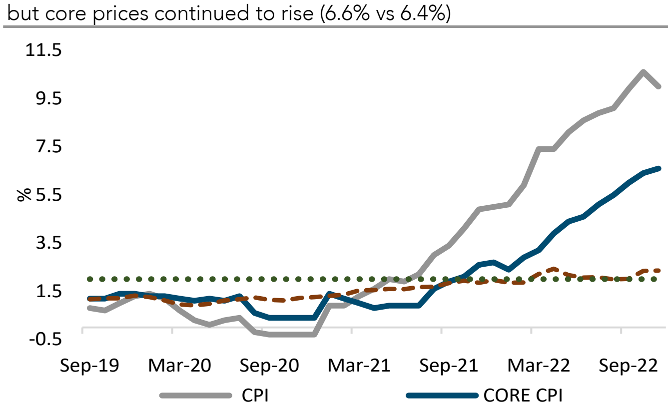
…which was also evidenced in PMIs, where the composite reading came in ahead of expectations



Source: Bloomberg

Exhibit 8 – EU Inflation rate

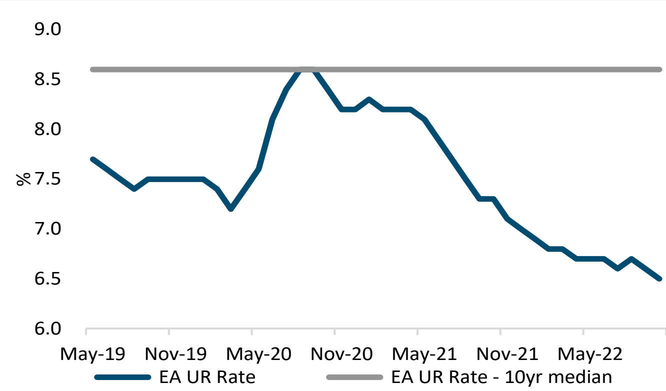
Headline inflation moderated during October to 10.0% (from 10.6%) but core prices continued to rise (6.6% vs 6.4%)



Source: Bloomberg

Exhibit 9 – Euro-area unemployment rate

…with unemployment still well below 10-year median



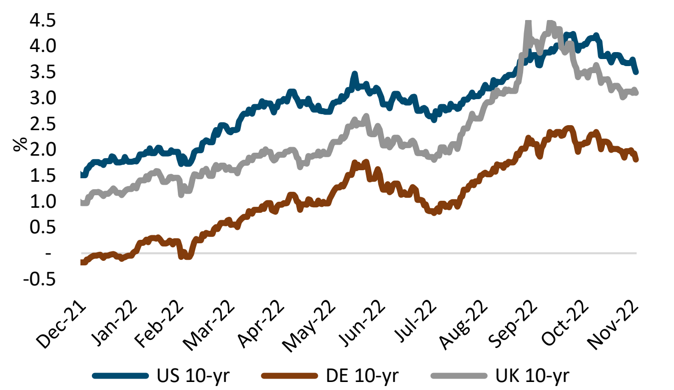
Source: Bloomberg

Rates

November was the first month of moderation in yields since July as the inflation print in the US led to a rally in the Sovereign bond market. US Yields fell 44bp to 3.6%, reversing all the October move. Inflation expectations, as measured by the 10-year breakeven rates also fell by 14bp to 2.4%. By all accounts, the move over November suggests that investors are now much more optimistic about rate cuts in 2023. Yet, one CPI reading does not provide confirmation that inflation has peaked, especially when US inflation has flattered to deceive in the past.

Exhibit 10 - 10-year nominal bond yield for the US, Germany and UK

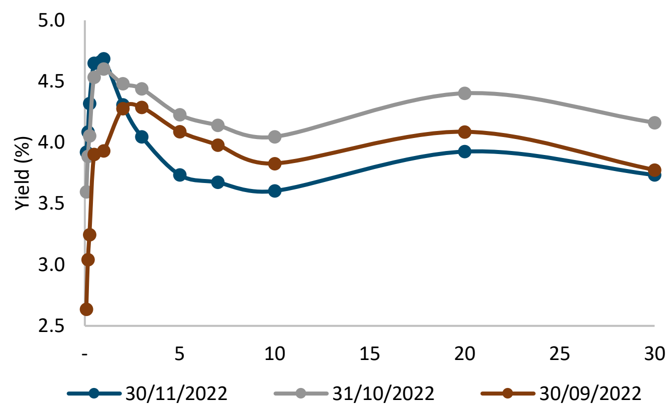
The lower than expected US inflation print for October led to a downward move in nominal yields across the countries we follow



Source: Bloomberg

Exhibit 11 – US Yield Curve

The Core inflation miss (relative to expectations) in November led to a rally in bond markets, reversing the shift upwards in yields seen during October



Source: Bloomberg

United States

In October, the narrative around rates started to shift with central bankers hinting to a slowdown in the pace of the hiking. The lower-than-expected inflation print for October, especially in core CPI, raised hopes around the FED's hiking path. This led to a repricing of expectations along the curve, bringing the peak rate below 5% and pricing-in additional easing beyond the (lowered) peak. The US 10-year Treasury yield fell back to 3.6%, levels not seen since the end of September implying a full reversal of the shift upward in yields seen during October (Exhibit 11).

However, we think that the bond market rally is overdone. The October inflation print might bring about some minor downward revisions to consensus inflation expectations but is unlikely to materially alter the future FOMC hiking path. Firstly, the October inflation number is a single-data point and should not be interpreted as a new trend. The March and July core CPI prints were both weak, only to be followed by sharp inflation spikes in subsequent months. Secondly, with unemployment levels at cycle lows, it is very likely that prices will fall at a slower pace than the rate at which the economy slows. We believe central banks would be reluctant to significantly cut rates during a period where inflation is still well above target. Currently consensus expects a 50bp rate hike at the December meeting, with a peak rate of 4.9% by the end of 2Q23, falling to around 4.3% by year end.

Europe

Headline HICP inflation in Europe for November fell 59bp to 10.0% YoY, below expectations for a +10.4% increase. In addition, Core HICP inflation fell 7bp to 5.0%, broadly in-line with consensus expectations. Despite this, economists expect core inflation to peak at 5.2% in December.

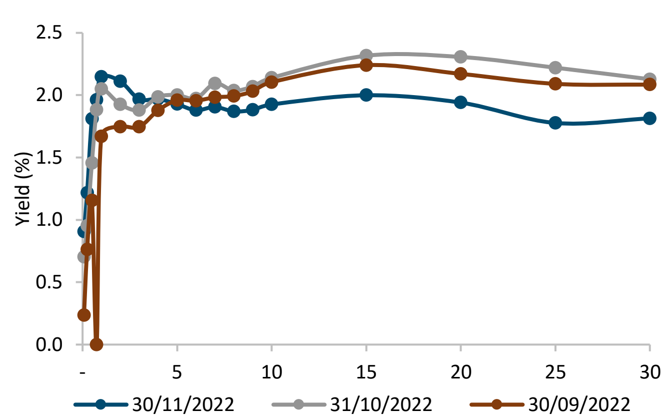
During November, the German 10-year yields fell below 2% for the first time since September, down 21bp to +1.9%, reversing the upward move during the month of October. Yet, inflation pressures in the Euro-area remain, with a tight labour market fueling wage growth. Additionally, the region is facing various headwinds to economic growth, especially in terms of energy.

As in the US, the expectation is that the ECB will slow down the pace of hiking over the coming meetings. However, with a high probability of a recession in the region, it is still very unlikely that the ECB will be able to cut rates any time soon in an effort to boost economic activity. Economists suggest that the Euro area economy is already in recession, and with inflation still in double-digits and core inflation still well above target rate, we think the ECB will be reluctant to prioritize growth over inflation. Also, like the US, with unemployment still relatively low, prices will likely fall at a slower pace.

In the UK, Chancellor Hunt announced a reversal of all tax cuts previously announced as part of the September mini-budget. On balance, the budget was a negative for growth (less fiscal stimulus) and implies upside risk to inflation (energy guarantee possibly significantly less post-April). Yields on the UK Gilts fell 36bp to 3.2% during November, levels last seen before the mini-budget announcement in September. This is roughly 140bp off the highs seen following Truss's budget announcement. Given the recovery seen it is likely that the BoE will be comfortable to start unwinding the £19billion worth of financial stability purchases conducted in October. Goldman Sachs say that the sale process will be "demand-led", with no preset reverse-auction size in contrast to sales conducted in the context of QT.

Exhibit 12 – German 10-year yield curve

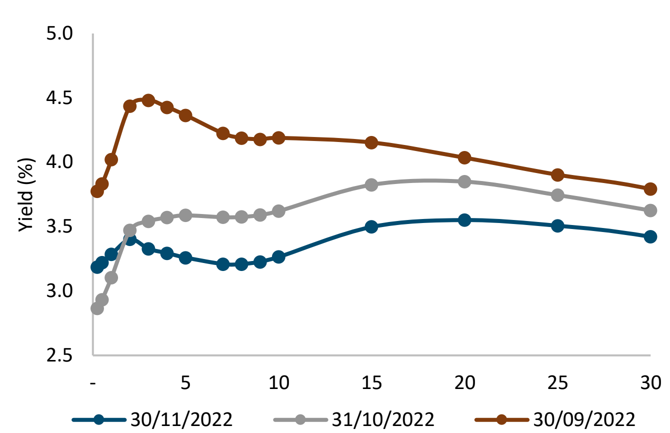
German yields also moved lower following the October inflation miss seen in the US, despite not signs of an inflation peak in Europe (till 30/11)



Source: Bloomberg

Exhibit 13 – UK 10-year yield curve

Yields continued to fall after the September shock brough about by the budget announcement



Source: Bloomberg

Credit

October was a better month for bondholders as markets provided some respite to investors, with the UK serving as the notable outperformer. Better than expected labour market data and an upside surprise in inflation out of the US reinforced a hawkish response by the Fed in October, which drove some weakness in the treasury market, impacting the IG space. In the UK, political events continued to dominate the headlines, with the introduction of Rishi Sunak as the new prime minister and a fiscal U-turn bringing some stability to the market as the BOE ended its Gilt purchase programme. In Europe, the ECB raised rates by an expected 75bp toward the back end of the month, however the communication was interpreted as predominantly dovish in nature, as Ms Lagarde noted increasing concerns over the region's growth outlook, in part due to ongoing weak activity data across the region, with manufacturing PMIs now deep into contractionary territory whilst inflation breaches new all-time highs year over year. Although US and European government bond yields were marginally higher over the month, the ensuing tightening of credit spreads drove excess returns during the month, whilst UK credit also enjoyed the tailwinds provided by a shift lower in the Gilt curve.

Financial markets have now started running with the narrative that central banks are beginning to pivot away from aggressive rate hikes, an argument which began gathering steam at the ECB meeting toward the end of October and was boosted in early November following dovish interpretations out of the BOE, and commentary out of the Fed which has hinted at a slowdown in the pace of rate hikes. The challenge facing the ECB in terms of policy trade-off was evident in the October flash PMI data, with the composite Euro area reading falling by 0.9pts to 47.1 - more than expected - with weakness broad-based across sectors and regions. This is seen as a clear indication that the Euro area has entered a period of decline in economic activity. The outlook bias, an indicator of future rating actions, dropped deeper into negative territory across each region, and the weakest link ratio rose, signalling that lower ratings are under increasing pressure.

Exhibit 14 – Spread movements and total returns for Investment Grade and High Yield credit
A stronger month from credit, with Sterling outperforming following the fiscal policy U-turn

	31/10/2022	30/09/2022	31/12/2021	MoM Δ	YTD Δ
Total Returns (%)					
EUR IG	225.44	225.2	263.64	0.10%	-14.50%
EUR HY	379.23	371.68	437.87	2.00%	-13.40%
USD IG	2,834.50	2,864.12	3,523.57	-1.00%	-19.60%
USD HY	2,153.03	2,098.50	2,461.43	2.60%	-12.50%
GBP IG	244.06	233.86	309.61	4.40%	-21.20%
GBP HY	768.27	750.67	890.43	2.30%	-13.70%
	31/10/2022	30/09/2022	31/12/2021	MoM Δ	YTD Δ
Spread Movements (bps)					
EUR IG	220.93	225.25	94.99	-4.33	125.94
EUR HY	605.09	630.98	318.01	-25.88	287.09
USD IG	158.49	158.98	92.37	-0.49	66.12
USD HY	464.14	552.22	282.98	-88.08	181.16
GBP IG	228.62	234.02	113.77	-5.4	114.85
GBP HY	747.45	702.13	375.68	45.32	371.76

Source: Bloomberg

For these reasons, our preference remains to position portfolios defensively, with a move up in credit quality by advocating a reduction in the current overweight positioning to Euro High Yield, with proceeds being redistributed to Investment Grade credit. With this defensive bias in mind, we caveat that we may be forced to revisit this view sooner than might be expected depending on how the macro environment progresses. For now, it would appear that the macro situation will continue to worsen near-term, including a recession in Europe starting this quarter and lasting until roughly 2Q of next year.

We continue to favour Euro IG credit over USD and GBP, as the spread pickup provided, particularly around the 3-5 year maturity bucket, is close to the wides reached at the height of the European debt crisis in 2012. Similarly, relative spread within this maturity bucket relative to the rest of the Euro curve remains at multi-year wides. There remains a long list of challenges facing the Euro area, chief amongst which is the length and severity of the recession. That said, a number of key hurdles have been cleared, which should limit the risk of further material widening in the spread pickup offered by the Euro market. Quantitative tightening is now well-anticipated, even though the details of the implementation have yet to be provided. Further, with the latest 75bp rate hike now behind us, policy rates have gotten much closer to most estimates of the neutral rate, which should pave the way for a slowdown in the pace of hikes going forward. Finally, policy risk in Italy has abated to a degree, and the prospect of a deteriorating growth backdrop and the ensuing reduction in the fiscal space will likely push the new government to postpone the myriad fiscal proposals put forward during the electoral campaign.

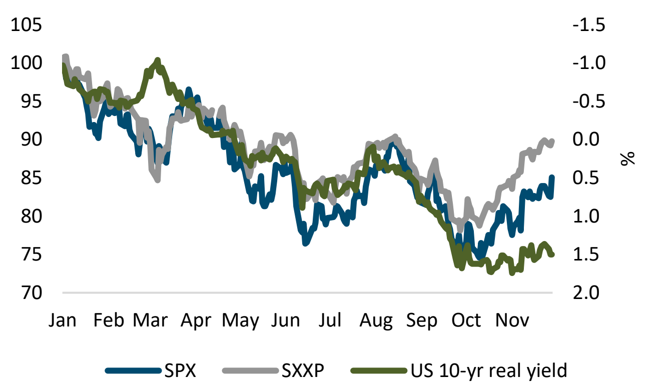
With respect to sector preferences, we note the underperformance during October for European Senior Financial paper relative to subordinated notes. The subordinated premium has contracted to 41bp over Euro swaps compared to 83bp at the end of September, creating a potential opportunity to rotate existing financials subordinated exposure into senior portions of the capital structure at attractive rates. Outside of financials, we continue to see spreads within the utilities and the relatively defensive TMT space as attractive.

Upcoming quantitative tightening from the ECB remains an overhang for the asset class, and one which we will receive further information on in December. Though, assuming the ECB follows a passive run-off approach under QT, around €200bn worth of corporate bonds will likely remain on the portfolio by the end of 2027, from €388bn currently. From a market standpoint, quantitative tightening may drive some IG/HY spread decompression, though this may be offset to a degree depending on the pace of new issuance in early 2023. For the time being, forecasts on both gross and net IG issuance going into 2023 remain varied. On the one hand, difficult conditions in capital markets given tepid risk appetite and elevated funding costs could keep issuers at bay. Euro IG supply has this year persisted at a relatively normal pace, implying that the near term refinancings needs have essentially stayed flat, and may drive a decline for issuance going into 2023. On the other hand, should spreads peak in 2023, the subsequent rally will likely be met with a plethora of supply which may drive overall higher issuance for the full year. In the case of the Euro HY market, given the rock bottom levels of issuance that have taken place this year, issuers now face a steeper maturity wall that will have to be addressed, leading to a general forecast consensus for an uptick in both gross and net supply for 2023. Ultimately, with this wide range of projections for 2023 issuance, much will likely come down to the course of inflation, recession, and central banks' monetary policies in reaction.

Equity

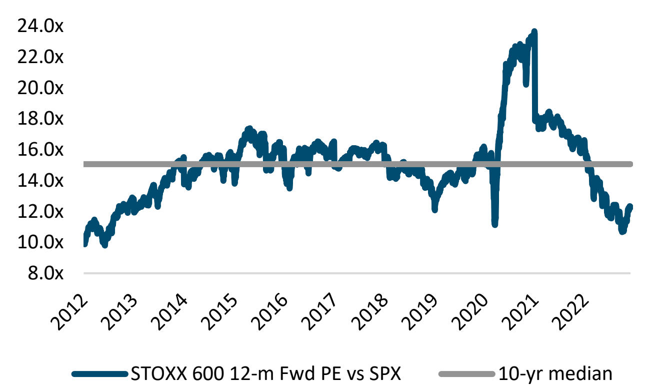
The stock market continued to benefit from improved sentiment during November as global equities rallied 7.0% (US$) following a weaker than expected US inflation print for October. Furthermore, European equities (SXXP - +6.9%) outperformed their US counterparts (SPX - +5.6%) as investors sentiment around the Bloc's prospects improved, at least for the time being, due to milder than expected winter and positive news flow coming out of China. Whilst we acknowledge these positive developments, we remain sceptical around the global macro-economic outlook as we head into 2023. We believe that the weakness in equities this year was primarily driven by valuation contraction due to the higher interest rates. In our opinion, downside risk remains if the expected slowdown materialises.

Exhibit 15 – S&P 500, STOXX 600 and US Real yield (RHS)
There is a clear negative correlation between real yields and equity market performance



Source: Bloomberg
Performance rebased from 31 December 2021

Exhibit 16 – SXXP 12-mth FWD P/E
Consensus seems to be more optimistic around Euro-area and China real GDP growth in 2023



Source: Bloomberg
Performance rebased from 31 December 2021

The obsession over peak policy rate overlooks a very important point. What matters to us is that rates will probably remain high even with DM economies in recession. The labour market (US and EU) remains relatively strong, despite a clear deterioration in activity in 2H22. Even though we expect unemployment to rise as the tighter financial conditions impact the economy, it is likely that prices will fall at a slower pace than the deterioration in economic activity. It is also unclear how equity investors will react to an environment of rising unemployment without policy intervention. This will be a clear shift from what the market has become accustomed to, as since the global financial crisis central bankers have been quick to cut rates to zero or beyond following a negative NFP print.

We expect investors will reward companies that can generate high margins given the outlook for growth (slow) and inflation (above target) in 2023. The impact on margins from high inflation will be a key theme in 2023. It tends to be easier to pass through inflation to customers when the economy is expanding (such as post-pandemic), less so during a slowdown. Apart from rising raw material costs and wages, companies will also have to bear significantly higher finance expenses, impacting the bottom line. Given this, we highlight our preference for companies that have a strong balance sheet and that generate high income margins and free cash flows. Consensus EPS have come down slightly since the summer months but are still positive. The recent falls in PMI would be consistent with the EPS estimates starting to decline by 6-8pp over the next 3 months.

China's re-opening could be a silver bullet for Europe but uncertainty remains high. The country announced 20 policies in mid-November aimed at relaxing Covid-19 policies. The announcement was especially significant as it came at a time when cases were rising at a rapid pace not seen since April. Local Governments were asked to be reasonable on imposing restrictions, and limit disruptions to productions and mobility. Almost simultaneously, China announced 15 measures to help the real estate market. Yet, by month-end, China residents were protesting the end of the draconian zero-Covid measures. Moreover, China will probably have to experience a second wave which could lead to further disruption. We believe that a gamechanger would be China using a foreign effective vaccine for its entire population, but this is a process that would take months to implement and unlikely to have a significant impact in 1H23.

Uncertainty brought about by Europe's energy dependency on Russia has been a source of concern for investors since the Ukraine invasion. Since then, Europe has done a good job filling up storage aggressively to c. 95% over the summer months. Moreover, unseasonably warm weather lowered usage during October and November, with EU heating days in October 30% below the five year average. Notwithstanding, we believe that gas scarcity remains a key risk for Europe, with summer 2023 another inventory refill season, potentially with even stronger demand (assuming China re-opens). European equities have been sensitive to changes in gas prices so far this year, with a 10% increase in TTF price leading to a c. 0.7% decline in European cyclicals. The FTSE 100 on the other hand, which has a relatively high exposure to Energy, was the outperformer in the region.

European equity valuations have de-rated roughly 20% during 2022, mainly as a result of the rising interest rate environment (Exhibit 16). Although we still believe that valuations could come down further, especially in the event of a hard landing, the downside risk is lower than other regions (like the US). The STOXX 600 valuation currently ranks at the 40th percentile compared to the 87th percentile in the US (Exhibit 17).

Exhibit 17 – Valuations – Developed markets

Valuations have come down significantly since the start of the year

Historical Data	SPX	SXXP	SX5E	DAX	CAC	FTSE100	FTSE250
Current Forward PE ratio (FPE)	17.4x	12.1x	11.7x	11.4x	11.3x	9.9x	11.3x
Forward PE ratio (31/12/2021)	21.1x	15.7x	15.3x	13.2x	14.6x	12.1x	14.8x
10 Year data							
Highest	22.1x	17.5x	18.0x	15.7x	18.2x	15.4x	17.9x
Highest (date)	31/12/2020	29/12/2020	29/12/2020	28/12/2020	04/12/2020	02/12/2015	29/12/2020
Lowest	11.8x	10.0x	9.0x	8.4x	9.1x	8.4x	8.3x
Lowest (date)	08/01/2013	18/03/2020	18/03/2020	18/03/2020	18/03/2020	03/10/2022	23/03/2020
Median	15.9x	13.7x	12.8x	12.1x	13.3x	12.8x	13.7x
95th percentile	20.4x	16.0x	16.3x	14.5x	15.9x	14.9x	15.3x
5th percentile	13.2x	11.3x	10.5x	10.4x	10.5x	10.0x	11.0x
Historical rank (since 2006)							
Percentile	86.5%	39.7%	45.8%	42.5%	33.9%	20.5%	32.9%
Current FPE, % above/ (below) 10-YR median	9.4%	-11.5%	-8.1%	-6.1%	-14.9%	-22.7%	-17.6%
Current FPE, % above/ (below) Dec 21	-17.4%	-23.0%	-23.5%	-13.8%	-22.3%	-18.6%	-23.6%

Source: Bloomberg

Key – Our view

Positive | Positive /neutral | Neutral | Neutral/ negative | Negative

Key – Allocation

Overweight | Neutral | Underweight

Asset Class			Positioning
Developed Market Sovereign Bonds			Our negative view on Government bonds remains unchanged given inflation pressures on central bank's commitment to fight inflation. We continue to see upside risks to terminal rates as inflation pressures remain elevated. However, we appreciate that given the rising probability of a recession, 2-year US Treasury paper, as close to a risk free investment as you can get, yielding in excess of 4% could be seen as a suitable alternative to risky assets.
Investment Grade Corporate Bonds			Investment grade returns will continue to depend on movements in benchmark rates and corporate spreads, though following the material widening since the onset of the Ukraine conflict, the asset class has begun providing reasonable opportunities to add risk on a selective basis. At current levels, the asset class offers a significantly better cushion against adverse movements in benchmark bond yields than we have seen for a number of years. The default and rating environment for global credit is beginning to show signs of weakness, reinforcing our preference to move further up in credit quality where possible. Whilst we acknowledge the risks for benchmark rates to move higher, we prefer to increase our exposure to IG corporate bonds. Given the growing narrative around peak inflation, we are marginally more comfortable with moderating our short duration stance and extending further out the curve to be closer to neutral vs the benchmark.
High Yield Corporate Bonds			The elevated uncertainty on the growth outlook and higher inflationary forces as a result of the war in Ukraine has led to a substantial widening in credit spreads. We continue to like the asset class at current valuations, though as we begin to see signs of weakness in the outlook for global credit quality, we are becoming all the more selective in the names we choose to hold on portfolios. The focus remains on identifying positions on a name-by-name basis, screening for issuers based on resilience of cash flow and strength of balance sheets that should see limited drag on operational performance as finance costs and input costs increase in the face of slowing growth. We place additional focus on names and sectors less exposed to a potential macroeconomic slowdown and on issuers at the upper end of the HY rating scale to avoid downgrades into distressed territory.
Developed Market Equities			Equity markets have been hit by a combination of rate volatility and economic growth concerns so far this year. While equity valuations in most regions we follow have normalised, bonds have re-priced lower too. The equity risk premium for equities is at the lowest it has been over the past decade. Therefore, fixed income instruments are now offering a viable alternative to equities. Furthermore, the total return of bonds and equities on a YTD basis is fairly similar, which is unusual when considering the rising recession risk. Normally, as economic activity slows, bonds tend to outperform equities as investors look to cut their exposure to the riskier asset classes. Equities have probably held up better this year due to their status as an inflation hedge. However, once inflation peaks there will be less scope for bond sell-off and the market narrative will shift to recession concerns, which could provide more downside.
Emerging Market Equities			We have downgraded Emerging market equities to underweight as we believe that the strengthening of the US Dollar and the deterioration in the global macro economic prospects will likely weigh on the asset class. There has been a significant outperformance in LATAM (where we were o/w until recently) relative to Asia and EMEA, which is mostly explained by the rally in commodity prices. We think that this performance could reverse the closer we get to an inflation peak in developed economies, and we get a better understanding of that damage suffered by the global economy.

Disclaimer

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