CURMI & PARTNERS

March 15th, 2023

Monthly Strategy Update

The month in summary:

At the end of 2022, we expected that during the early parts of 2023 the narrative would shift away from inflation concerns to economic growth. Inflation (Core PCE) was on a downward trend, falling for three consecutive months from 5.1% in September to 4.4% in December. Additionally, central banks were starting to slow down the pace of rate hikes, with a 50bp hike announced by the FED in December, down from 75bp announced in the previous four meetings. On balance, we felt that this supported our belief that inflation had been brought under control, though we were less sure about the global growth prospects given the extent of the tightening in 2022.

Yet, developments in the early weeks of 2023 led to significant changes in global growth expectations. Apart from inflation moderation and less drag from tight financial conditions, global economic expectations were boosted by warmer than expected weather in Europe and a faster than expected re-opening in China. Economic forecasts were revised higher on this basis, which made for a smooth transition in narrative away from inflation concerns to growth. Correlation between financial assets during January was positive, with equities and bonds rallying together. Yet, we highlighted in last month's report that higher "consumer spending could have implications for inflation".

February brought about a turnaround in narrative, with inflation concerns back on the agenda as several data points suggested that there is upside risk to inflation. The release of the Core PCE price index on 24/02 in the US, which showed an acceleration in prices during January (first month of acceleration since September 2022), put a 50bp rate hike for March back on the table. The expectation of additional tightening led sovereign yields higher and credit markets lower. Within equities, the performance was mixed, with the long-duration US equity markets lower on the month, whilst European equities outperformed. Inflation fears led to a strengthening of the US Dollar, which led to a steep sell-off in Emerging Market ("EM") equities. Also, the uptick in political risk caused by increased tensions between the US and China, as well as the disappearance of China Renaissance CEO were unhelpful for sentiment in EM. Finally, the increase in demand for oil from China as a result of its re-opening was offset by Russia's production, which remained higher than expected. However, expectations are that the supply/demand dynamics will move to a significant deficit again in the summer, which should support the price of oil.

Sovereign		
	MoM bp	YTD bp
US 10-year yield	41	5
DE 10-year yield	37	8
UK 10-year yield	49	15
Credit		
LCL Total returns	MoM %	YTD %
EUR IG	-1.3%	0.7%
EUR HY	0.1%	3.3%
USD IG	-2.7%	0.7%
USD HY	-1.1%	2.5%
GBP IG	-2.6%	1.4%
GBP HY	1.1%	4.4%
Equities		
LCL Total returns	MoM %	YTD %
Global	-2.4%	4.6%
S&P 500	-2.4%	3.7%
Nasdaq 100	-1.0%	9.6%
STOXX 600	1.9%	8.7%
DAX	1.6%	10.4%
CAC	2.6%	12.4%
FTSE 100	1.8%	6.2%
Emerging markets	-6.5%	0.9%
EM ASIA	-6.8%	0.8%
EM LATAM	-6.2%	3.1%
EM EMEA	-4.3%	-2.1%
Currencies		
Total return	MoM %	YTD %
EURUSD	-2.6%	-1.2%
EURCHF	0.1%	0.7%
GBPEUR	0.2%	0.7%
GBPUSD	-2.4%	-0.5%
Commodities		
Total return	MoM %	YTD %
Oil WTI	-2.7%	-4.3%
Oil Brent	-2.0%	-2.1%
Natural Gas	2.3%	-38.6%
Gold	-5.3%	0.2%
Copper	-2.8%	7.0%
Iron Ore	1.6%	3.7%
Lumber	-23.1%	7.8%

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Macro-economic views

Global growth expectations have improved so far in 2023, boosted by several positive unexpected developments. Not only was inflation on a downward trend, but China re-opened much quicker than the market expected and the winter in Europe has been less of a challenge than previously expected. Despite some weaker GDP data releases recently, forward looking data remains positive on balance, as economic activity picked up since the start of the year. Growth expectations for 2023 were largely unchanged in February (Exhibit 1), except for Germany where the 2023 growth forecast was revised down to -0.4% (from 0.0%). We think the updated 2023 estimate for Germany takes into consideration the lower-than-expected 4Q22 growth rate.

However, the recent pick-up in inflation, especially in developed market economies, remains a concern. Core inflation has trended higher in the US and Europe which opens the door for more monetary policy tightening, a drag for economic growth. Also, the uptick in inflation could lead to uncertainty as to whether inflation has been brought under control. Financial markets had reacted positively to the inflation moderation seen since September, with the rate hike slow down seen as a confirmation of sorts that central banks were comfortable enough with price pressures. Despite this, we saw no material updates to inflation expectations for 2023.

Finally, we believe that the level of growth in China could be an important global growth driver in 2023. China's PMI came in much better than expected for both manufacturing and services in February, which bodes well for global growth if the pace of growth persists. We caution that the recent uptick in tensions between the US and China could have negative implications for the country's growth trajectory. Also, the draft plan of the State Council institutional reform was released on 07/03. The Communist Party's institutional reform plan will be released after the 13th of March. This should provide more colour on China's future economic and financial regulatory policies.

Exhibit 1 – Consensus real GDP growth and inflation expectations

Developed economies economic growth for 2023 has been revised higher over the past month but inflation expectations remain unchanged

	Consensus Forecast, % QoQ							Cons. Forecast, % YoY			Revisions since last meeting									
Real GDP, YoY%	4Q22F	1Q23F	2Q23F	3Q23F	4Q23F	1Q24F	2Q24F	FY22F	FY23F	FY24F	4Q22F	1Q23F	2Q23F	3Q23F	4Q23F	1Q24F	2Q24F (New)	FY22F	FY23F	FY24F
United States*	2.9	0.1	-0.6	-0.2	0.7	1.5	1.8	2.1	0.5	1.2	0.2	-0.4	-0.1	-0.1	-0.1	0.2	0.0	0.0	-0.3	-0.1
Japan*	3.0	0.9	1.0	0.9	1.1	1.0	1.2	1.3	1.3	1.0	2.4	-0.6	0.0	0.0	0.1	-0.2	0.0	0.2	0.1	-0.1
Germany	1.1	-0.4	-0.5	-0.6	0.1	1.0	1.3	1.9	-0.4	1.3	0.2	-0.5	-0.5	-0.4	-0.3	0.1	0.0	0.1	-0.4	0.0
France	0.5	0.4	-0.1	-0.1	0.3	0.8	1.2	2.5	0.3	1.2	0.4	0.6	-0.3	-0.3	0.1	0.5	0.8	-0.1	-0.2	0.0
Italy	1.3	0.8	-0.3	-0.5	0.0	0.7	1.0	3.8	0.1	1.0	-0.4	-0.4	-0.5	-0.4	-0.5	0.0	0.0	0.0	-0.4	0.0
Spain	2.7	1.7	0.4	0.6	1.1	1.6	1.9	5.5	1.0	1.9	0.0	-0.1	0.0	-0.1	0.1	0.0	0.0	0.0	-0.1	0.0
Eurozone	1.9	0.4	-0.2	-0.3	0.4	1.0	1.3	3.3	0.0	1.3	0.0	-0.7	-0.5	-0.6	-0.1	0.0	-0.1	-0.1	-0.4	0.1
UK	0.3	-0.7	-1.2	-1.2	-0.9	-0.1	0.8	4.1	-0.9	0.9	-0.1	-0.2	-0.3	-0.5	-0.4	-0.3	-0.1	0.1	-0.2	0.0
DM Economies	1.9	0.4	-0.2	0.0	0.7	1.3	1.6	2.7	0.5	1.4	-0.2	-0.3	-0.2	-0.2	0.0	0.0	0.0	0.0	-0.2	0.0
China	2.9	2.6	6.9	4.8	5.9	5.4	5.1	3.0	5.1	5.0	0.0	-0.6	-0.2	-0.2	0.2	0.0	0.0	0.0	-0.1	0.0
EM Economies	2.6	2.2	5.1	4.0	4.9	4.6	4.5	3.1	4.1	4.4	0.0	-0.4	-0.1	-0.1	0.3	0.0	0.0	-0.5	-0.1	0.0
Global								**3.4**	**2.1**	**2.9**								**0.0**	**-0.3**	**0.0**

	Consensus Forecast, % QoQ							Cons. Forecast, % YoY			Revisions since last meeting									
Consumer prices, YoY %	4Q22A	1Q23F	2Q23F	3Q23F	4Q23F	1Q24F	2Q24F	FY22A	FY23F	FY24F	4Q22A	1Q23F	2Q23F	3Q23F	4Q23F	1Q24F	2Q24F	FY22A	FY23F	FY24F
United States	7.1	5.6	3.8	3.1	2.9	2.7	2.5	8.0	3.8	2.5	0.0	-0.2	-0.3	-0.3	-0.3	-0.1	-0.1	0.0	-0.2	0.0
Japan	3.8	2.9	2.4	1.7	1.2	1.1	1.1	2.5	2.0	1.1	0.0	-0.4	-0.2	-0.2	-0.2	-0.2	0.0	0.0	-0.1	-0.1
Germany	10.8	9.4	7.5	6.1	3.9	3.1	3.0	8.6	6.6	2.9	0.0	0.6	0.6	0.4	0.4	0.4	0.3	0.0	0.5	0.2
France	7.0	6.7	5.5	4.8	3.6	2.6	1.9	5.9	5.1	2.3	0.0	0.1	0.3	-0.2	0.2	0.2	0.0	0.0	0.2	0.0
Italy	12.5	10.1	8.4	6.9	2.7	2.3	2.0	8.7	6.5	2.0	0.0	0.0	0.4	0.8	0.7	0.3	-0.1	0.0	0.1	-0.1
Spain	6.5	5.0	4.1	3.3	3.6	3.4	2.8	8.3	4.2	2.5	0.0	-0.2	-0.1	-0.1	-0.1	0.0	0.0	0.0	-0.1	0.0
Eurozone	10.0	8.4	6.6	4.9	3.4	2.9	2.8	8.4	5.9	2.3	0.0	0.5	0.5	0.2	0.5	0.2	0.4	0.0	0.4	-0.1
UK	10.8	10.1	8.0	6.5	4.2	3.6	2.4	9.1	7.0	2.5	0.0	0.2	0.4	0.7	0.3	0.4	0.2	0.0	0.3	0.1
DM Economies	8.6	7.3	5.5	4.6	3.7	3.4	3.0	8.5	5.2	2.9	0.0	-0.1	-0.1	-0.1	-0.2	0.0	-0.1	0.0	-0.1	0.0
China	1.8	2.3	2.2	2.2	2.5	2.4	2.2	2.0	2.3	2.2	0.0	0.1	0.0	-0.2	-0.1	-0.1	0.0	0.0	-0.1	-0.1
EM Economies	4.8	6.3	5.4	5.2	5.2	4.9	4.3	5.1	5.8	4.3	0.0	0.1	0.0	-0.1	-0.1	-0.1	-0.3	0.0	-0.1	-0.1
Global								8.8	5.2	3.5								0.0	-0.1	-0.1

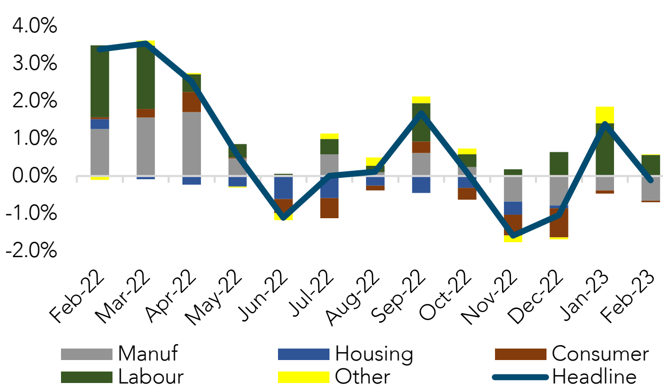
Source: Bloomberg (Note: QoQ figures for the US and Japan are QoQ SAAR, Shaded areas indicate Actuals)

United States

Growth: Goldman Sachs' Current Activity Indicator ("CAI") stood at -0.1% in February, down from +1.3% in January (Exhibit 2). The deterioration during the month was primarily driven by Labour and Other CAI. It is worth noting that CAI inputs are released on different schedules and some data for February may still be unreleased at the time of writing. Despite the apparent slowdown in activity, the Atlanta FED GDP estimate was revised upwards from +2.2% on 08/02 to +2.6% a month later (Exhibit 3). This represents a significant improvement in expected growth for the quarter given that the initial estimate was +0.7%. Finally, economic data released by the US so far has been, on balance, better than expected.

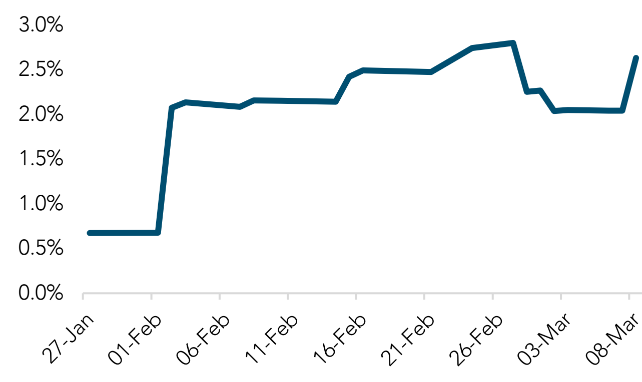
Inflation: January Core PCE price index accelerated to 4.7% in January, from 4.6% in December (Exhibit 4). This was the first month of acceleration in prices since September 2022 and raised concerns that inflation has not yet been brought under control. The uptick in inflation could be simply a product of the "January effect", when contracts are renegotiated and price lists are revised. Therefore, the upcoming releases will provide more clarity as to where we stand in terms of inflation outlook. Additionally, the February payrolls report gave mixed indications, with the strong pace of jobs growth offset by a rising unemployment rate and softer than expected wage growth. Also, we note that the job-workers gap narrowed during the month to 4.9 million jobs, the lowest since November 2022 (Exhibit 5).

Exhibit 2 – US Current Activity Indicator
February headline CAI was back in negative territory driven primarily by a deterioration in labour and other sectors



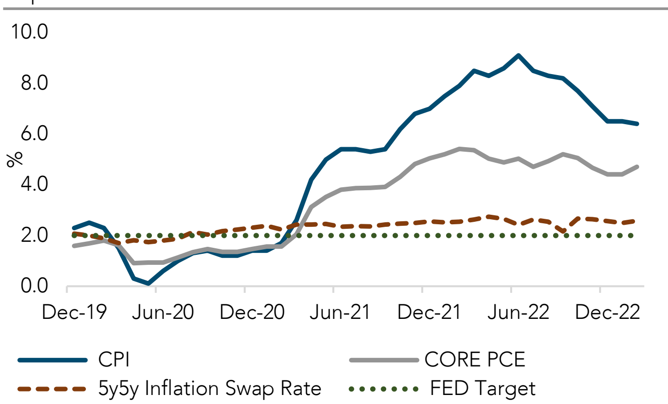
Source: Goldman Sachs

Exhibit 3 – Atlanta FED GDP estimate
The Atlanta FED growth forecast for 1Q23 has improved from +0.7% on the 27th of January to +2.6% on the 8th of March



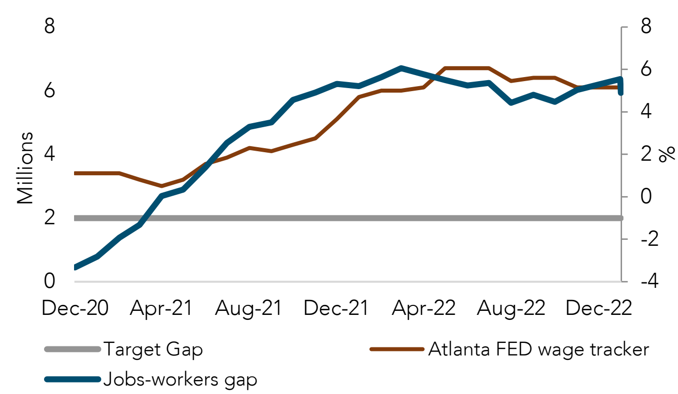
Source: Atlanta FED

Exhibit 4 – US Inflation rate
Core inflation accelerated in January for the first time since September 2022



Source: Bloomberg

Exhibit 5 – Job-workers gap (LHS) and Atlanta FED wage tracker (RHS)
The jobs-workers gap climbed slightly in December as the number of unemployed (-278k) fell by more than job openings (54k)



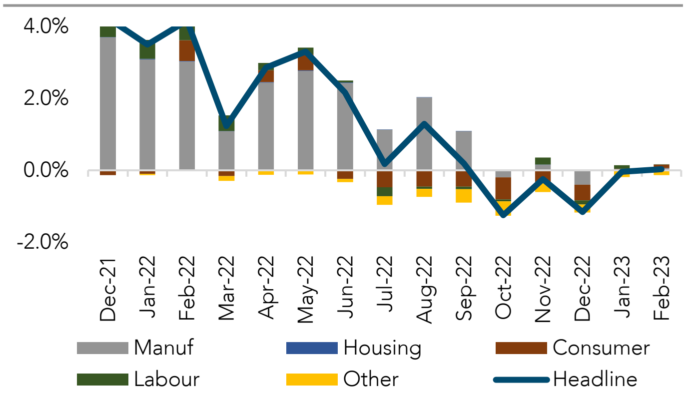
Source: FRED, Atlanta FED

Europe

Growth: Europe's economic activity remained stable according to the Goldman Sachs' CAI (Exhibit 6). There was a small improvement in Consumer CAI which was offset by a deterioration in Labour CAI. This improvement in economic activity was also seen in the PMI release, where the Composite PMI improved to 52.0 in February, the highest since June 2022 (Exhibit 7). The recovery was again driven the Services sector (to 52.7 from 50.8 in January), whilst Manufacturing remained in contraction territory and deteriorated month-on-month (48.5 from 48.8 in January). Despite the positive developments, we note that Europe is exposed to risks on which it has little control upon. The energy crisis remains a concern, even if storage levels might be much higher than previously expected for the upcoming refill season. Also, China is an important trading partner for Europe, which implies that increased activity in China would be positive for the Bloc and vice-versa.

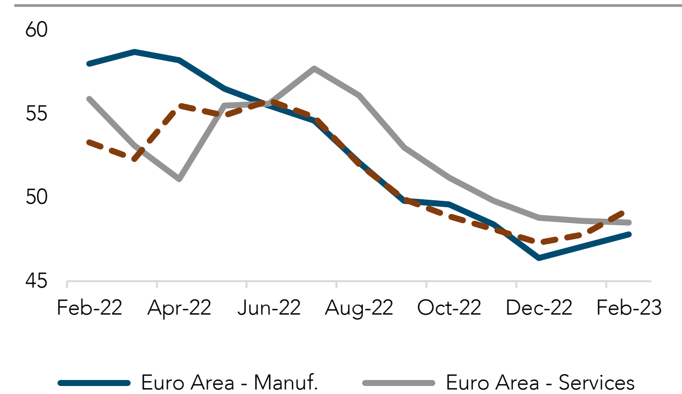
Inflation: Headline inflation in Europe came in at 8.5% in February, unchanged from January (Exhibit 9). Notwithstanding, we note that Core inflation in Europe accelerated to 5.6% in February, up from 5.2% in January. The positive surprise in services inflation (0.9% m/m) was notably large, and likely due to a strong rebound in travel and hospitality services inflation after a seasonal dip in January.

Exhibit 6 – EU Current Activity Indicator
Economic activity was stable during February with an improvement in Consumer set-off by a slight deterioration in Labour



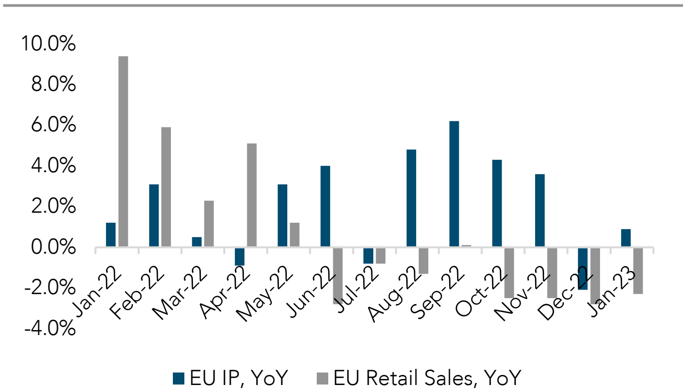
Source: Goldman Sachs

Exhibit 7 – EU PMIs
The Composite PMI for the Euro-area rose to 52, the highest since June 2022



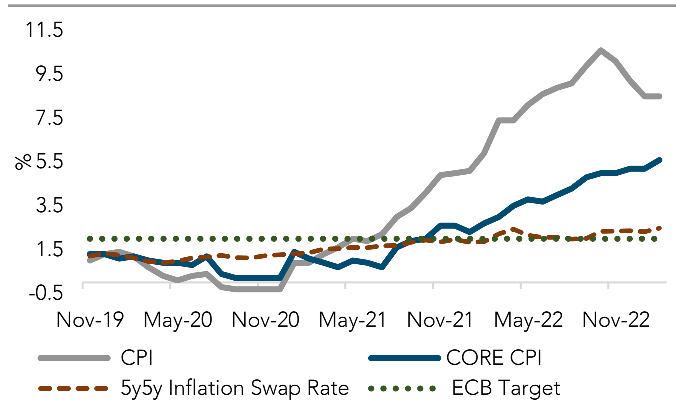
Source: Bloomberg

Exhibit 8 – EU Industrial Production
Industrial production accelerated 0.9% in January following the 2.1% decline in December



Source: Bloomberg

Exhibit 9 – EU Inflation rate
Headline inflation has been on a downward trend since October 2022 but Core inflation remained unchanged

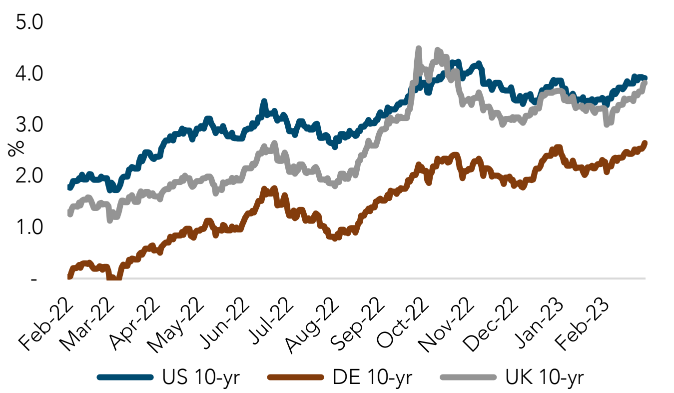


Source: Bloomberg

Rates

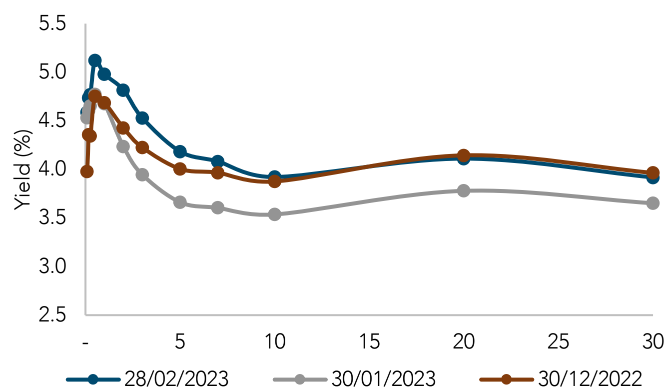
February saw the reversal of the shift downwards seen in yields in January. Inflation concerns came back to haunt the rates markets, with the short-end of the curve impacted to a larger extent than the long-end. This yield curve flattening was driven by hawkish commentary from central bank officials during the month. Also, the higher-than-expected Core inflation in the US and Europe raised doubts as to whether inflation has been brought under control. The build up in inflationary pressures brought a 50bp rate hike back on the table, though recent developments in the US where Silicon Valley Bank and Signature Bank collapsed, led to an uptick in financial stability concerns. This makes a FED pause in March likely.

Exhibit 10 - 10-year nominal bond yield for the US, Germany and UK
February saw a reversal of the shift downwards in yields seen in January as inflation concerns returned



Source: Bloomberg

Exhibit 11 – US Yield Curve
The U.S. sovereign yield curve continued to invert during January to levels not seen since the 1980s



Source: Bloomberg

United States

US 10-year Treasury yields rose by circa 41bp during February to close the month at 3.9%. The US sovereign curve continued to flatten as the spread differential between the 2s10s compressed by 20bp. The higher Treasury yield and flatter sovereign curve was driven by hawkish comments by FED officials as well as data that continues to demonstrate the resilience of the US economy. Chair Powell's testimony was given particular importance by investors to get clues as to the FED's path. During his testimony, Chair Powell reiterated his message of higher and potentially faster rate hikes during the upcoming meetings but emphasized that no decision has yet been taken on the size of the March rate hike. The testimony, which was held over two days, ending on 09/03, led to the market quickly repricing a higher probability of a 50bp rate hike in March.

However, the closing down of Silicon Valley Bank (10/03) and Signature Bank (12/03) led to concerns around the financial stability in the US. The deposit flow out of US regional banks could have severe implications, which might force the FED's hand in the upcoming meeting. Both banks had a meaningfully different deposit base than the rest of the US banking sector, though a pause by the FED would provide policy makers with some breathing space to understand whether Silicon Valley Bank and Signature Bank were isolated cases related to their riskier operations, or if the situation is more systemic.

Europe

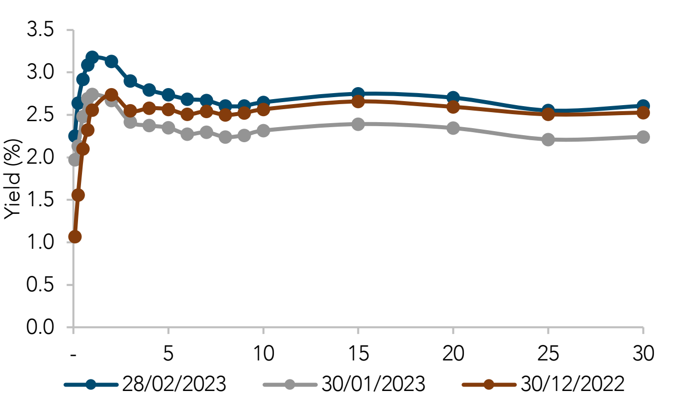
A similar story to the one seen in the US unfolded in the Euro-area. The yield on the 10-year Bund climbed higher to close the month at 2.5%. Furthermore, the German sovereign curve remained inverted and continued to flatten as the 2s10s declined by a further 12bp. The rise in yields was primarily driven by the high level of inflation and the ECB's hawkishness throughout the month of February as core inflation remained stubbornly high. Economists are forecasting inflation to remain elevated and above the historical average however the peak of core inflation may be reached soon. In the meantime, the ECB will likely reiterate its hawkish message as it continues to battle high inflation with the terminal rate recently revised to 3.5% which is 25bp higher than the previous forecast.

We recently saw the ECB commence its balance sheet reduction program, with the plan applying to the Asset Purchase Programme ("APP"). Maturing bonds will no longer be reinvested, and so the balance sheet will shrink via passive run-off. Active asset sales do not seem to be under consideration, and nor will the run-off apply to asset holdings under Pandemic Emergency Purchase Program ("PEPP"). The ECB has set out an initially capped reduction in APP holdings of €15bn per month for the period from March to June. The gradual reduction of the ECB's balance sheet will likely push yields higher due to the impact on available supply which could eventually lead to a steeper yield curve, all else equal.

The story was not that much different in the U.K. during the month of February than what was seen both in the U.S. and the Euro Area. However, there was one notable difference. While the yield on the 10-year Gilt rose by circa 49bp to 3.8%, the U.K. sovereign curve flattened during February as the spread differential between the two-year and the ten-year widened by circa 27bp. The higher Gilt yield was driven by the higher inflation prints and the expected hike that is set to be announced by the Bank of England. Inflation in the U.K., as is the case in Europe, remains high but is showing signs of a decline as January core inflation declined from the December figure that was released with a similar decline also seen in headline inflation. However, the U.K. economy is expected to enter a recession later on this year and therefore, unlike the U.S. and the Euro Area, the macro-economic picture going forward is less certain.

Exhibit 12 – German 10-year yield curve

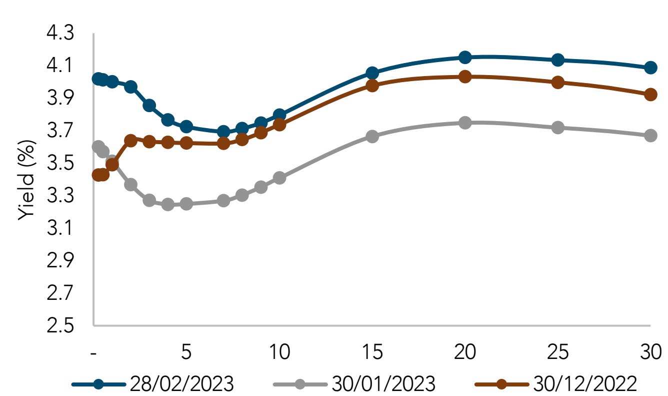
German 10-year yields rose 37bp during February, reversing the fall seen in January. Yields are up 8bp YTD



Source: Bloomberg

Exhibit 13 – UK 10-year yield curve

The 10-year Gilt yield rose by c.49bp during February though unlike other countries/regions, the yield curve flattened



Source: Bloomberg

Credit

The move higher in rates that we saw during February weighed on credit markets. In the US, both Investment Grade ("IG") and High Yield ("HY") markets suffered losses of 2.7% and 1.1% respectively (Exhibit 14). In fact, if we look at returns by credit rating in the US, only CCC bonds generated a positive return during February of +0.5%. In Europe, the IG market suffered losses of 1.3% whilst the performance in HY remained positive, closing the month at +0.1%. Similar to the US, only CCC and B rated bonds generated a positive return during February of 1.1% and 0.1% respectively.

In the US, the yield pickup offered by A-rated bonds over the 3-month Treasury bills (a proxy for cash) has virtually vanished. Put another way, until the yield curve re-steepens, credit and duration risk taking incentives will likely rest lower. This pressure from cash could act as a speed limit for higher rated credit in terms of spread movements over the near term, and possibly explains the outperformance of lower rated paper during February. At the time of writing, competition from cash like instruments is less of an issue for European credit. Since the start of the ECB hiking cycle, the yield cushion offered by EUR IG has materially compressed. However, the yield offered on average by the IG market is still close to the median calculated over the period post-2012 sovereign crisis of 1.5%. As the ECB hiking cycle extends further, and yields on cash like instruments rises, the EUR IG market will undoubtedly experience similar pressures to those currently seen in US credit markets.

S&P forecast the US default rate to reach 4% at end-2023 (1.7% end-2022) given elevated interest rates and expectations for a short and shallow US recession. Furthermore, S&P expect the European default rate to reach 3.25% by end-2023 (2.2% end-2022), as energy prices remain elevated. This suggests that even though spread movements at higher rated credit could possibly disappoint, we continue to prefer companies that we consider to be financially sound, operating a strong balance sheet and generating sufficient cash flows to service their debt obligations.

Exhibit 14 – Spread movements and total returns for Investment Grade and High Yield credit

Total Returns indices	MoM Δ	YTD Δ
USD IG	-2.7%	0.7%
USD HY	-1.1%	2.5%
AAA	-3.3%	0.6%
AA	-2.7%	0.4%
A	-2.6%	0.6%
BBB	-2.8%	0.8%
BB	-1.6%	1.4%
B	-1.0%	2.7%
CCC	0.5%	6.4%

Total Returns indices	MoM Δ	YTD Δ
EUR IG	-1.3%	0.7%
EUR HY	0.1%	3.3%
AAA	-2.3%	-1.0%
AA	-1.5%	-0.1%
A	-1.5%	0.3%
BBB	-1.2%	1.2%
BB	-0.3%	2.4%
B	0.1%	3.6%
CCC	1.1%	6.4%

Total Returns indices	MoM Δ	YTD Δ
GBP IG	-2.6%	1.4%
GBP HY	1.1%	4.4%
AAA	-3.5%	-0.4%
AA	-3.0%	0.5%
A	-2.7%	1.3%
BBB	-2.5%	1.7%
BB	N/a	N/a
B	N/a	N/a
CCC	N/a	N/a

Spread Movements	MoM Δ	YTD Δ
USD IG	4.74	-6.03
USD HY	-5.40	-56.53
AAA	3.34	2.88
AA	2.27	-0.24
A	4.14	-5.57
BBB	5.22	-7.74
BB	2.95	-28.01
B	-10.92	-68.13
CCC	0.88	-117.61

Spread Movements	MoM Δ	YTD Δ
EUR IG	-3.42	-19.69
EUR HY	-23.67	-77.97
AAA	6.82	20.56
AA	-0.34	-3.34
A	-1.58	-11.34
BBB	-5.24	-28.45
BB	-8.98	-52.92
B	-36.77	-104.01
CCC	39.19	-75.54

Spread Movements	MoM Δ	YTD Δ
GBP IG	2.30	-24.41
GBP HY	-67.99	-125.46
AAA	1.67	-7.10
AA	2.55	-7.99
A	1.39	-21.23
BBB	2.51	-28.57
BB	N/a	N/a
B	N/a	N/a
CCC	N/a	N/a

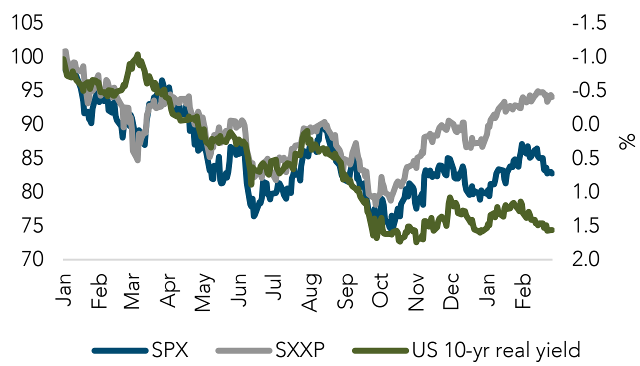
Source: Bloomberg

Equity

Equity market performance was mixed during February as the rally started to lose steam after a very strong start to 2023. European equities continued to outperform, generating a total return of +1.9% during the month, with UK equities close behind (+1.8% in £ terms). On the other hand, US equities underperformed, with long-duration equities surprisingly outperforming. The Nasdaq closed February with a total return of -1.0% ($ terms) compared to -3.9% for the value-tilted Dow Jones Industrial Average. Emerging market equities had a torrid month, losing 4.2% (€ terms) as the return of the inflation narrative hurt prospects. We highlighted the negative correlation that has existed between rates and equities over the previous months (Exhibit 15). This persisted during February for US equities, but was less evident in Europe, where investors were focused on economic growth prospects rather than rates anxiety, at least for the time being.

Exhibit 15 – S&P 500, STOXX 600 and US Real yield (RHS)

The negative correlation between rates and US equities held during February, less so for Europe

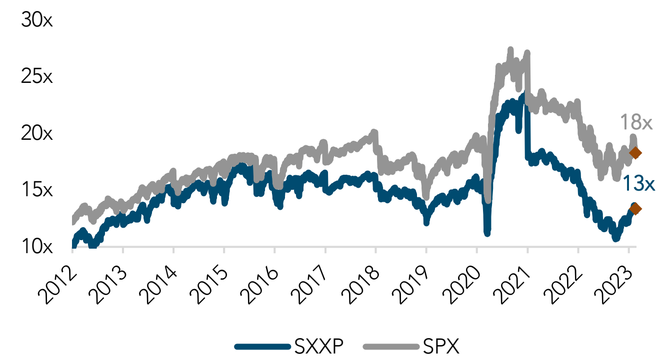


Source: Bloomberg

Performance rebased from 31 December 2021

Exhibit 16 – 12-month forward PE for US and EU stocks

European equities are trading at an unwarranted discount to US equities despite favourable conditions for Europe



Source: Bloomberg

Inflation concerns spooked investors in the latter part of February as equities sold-off following the release of the US PCE data, which came in higher than expected, leading to an uptick in rates volatility. Real yields bottomed out at around 1.1% on the 1st of February, a 44bp decline since the start of the 2023, as the disinflation narrative pushed bonds and equities higher. However, robust growth and inflation led to a re-pricing higher of the real yield, closing the month at 1.6%, reversing the January move downwards.

Firmer economic and inflation data led to tighter financial conditions. The tightening was more pronounced in the US than other regions, though this partly reflects the reversal of the loosening seen in January. This could act as a headwind for long-duration assets over the coming weeks, especially if strong economic data persists for longer. In addition, tighter financial conditions for longer could act as a drag for global growth if they persist for long enough. We think that the strength of the recent data puts a 50bp rate hike on the table in Europe, but less likely in the US due to stress in the banking sector. The rate hike slowdown narrative provided the equity market with comfort over the peak rate, and we think that a re-acceleration, unless combined with dovish commentary, could lead to an uptick in volatility. Also, higher peak rates are likely to weigh on corporate profitability as finance costs are revised higher.

On balance, risk of a recession is lower today compared to the start of the year, though this could change if inflation is not under control. There has been a significant impact to economic activity over the past month. China's faster re-opening was a significant boost which is starting to be reflected in forward looking data. The European Composite PMI moved deeper in expansionary territory as the weakness in the manufacturing sector was more than offset by the strength in the services sector. Furthermore, the labour market (both US and EU) has remained resilient which bodes well for consumer spending. Yet, risks remain as inflation is still well above target and the possibility of tighter financial conditions and higher peak rates could lead to downward revisions in global growth. Also, political risks are rising, as evidenced by tensions between US and China, as well as intensification of the war in Ukraine.

At the end of 2022 we argued that investor attention would move away from inflation and monetary policy in 2023. Indications were that inflation had peaked as the US Core PCE index decelerated over four consecutive months, from 5.1% recorded in September to 4.4% in December. Additionally, the FED's decision to slow down the rate of hikes was also seen as a confirmation that inflation had been brought under control. This supported our belief that the narrative would shift from inflation concerns to growth concerns and was the basis for our U/W in equities.

Yet, the year started on a good note from a macro-economic standpoint. Not only was inflation believed to be under control, several developments (China re-opening, warmer weather in Europe etc.) improved the macro-economic backdrop. This was the basis for the strong rally in equity markets in January, with global equities up 7.1% in US$ terms. Yet, we decided to maintain our U/W position at the end of January as we believed that the risk/reward trade-off was less attractive as a lot had already been priced-in whilst also noting that, in our opinion, "the improvement in the macro-economic backdrop could have implications for inflation".

Inflation worries returned however as central bank narrative became more hawkish. First, Chair Powell noted that the FED might need to hike rates by more than the market is currently expecting. This was followed by an acceleration in the Core PCE price index. The upcoming inflation releases will provide the market with additional colour around the inflation outlook, especially since the January release could include one-off effects. In the near-term we would prefer to see inflation stabilize before deploying additional capital into equity markets.

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)	18.3x	12.9x	12.9x	12.3x	12.5x	10.6x	11.1x
Forward PE ratio (31/12/2022)	16.8x	12.0x	11.6x	11.1x	11.2x	10.0x	11.0x
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	12.0x	10.0x	9.0x	8.4x	9.1x	8.4x	8.3x
Lowest (date)	25/02/2013	18/03/2020	18/03/2020	18/03/2020	18/03/2020	03/10/2022	23/03/2020
Median	16.0x	13.7x	12.8x	12.2x	13.3x	12.8x	13.8x
95th percentile	20.4x	16.0x	16.3x	14.5x	15.9x	14.9x	15.2x
5th percentile	13.4x	11.4x	10.7x	10.5x	10.7x	10.0x	10.9x
Historical rank (since 2006)							
Percentile	89.8%	56.2%	73.1%	67.0%	50.0%	30.3%	30.2%
Current FPE, % above/ (below) 10-YR median	14.2%	-5.5%	0.7%	0.7%	-6.4%	-17.1%	-19.6%
Current FPE, % above/ (below) Dec 22	8.6%	8.1%	11.0%	10.0%	11.1%	5.9%	0.8%

Source: Bloomberg

Key – Our view

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

Key – Allocation

Overweight | Neutral | Underweight

Asset Class	Positioning
Developed Market Sovereign Bonds	We remain cautious on Government bonds as in our opinion the moderation seen in headline inflation over the past months is more than offset by core inflation remaining well above central bank targets. We also believe that the declining probability of a recession makes rate cuts unlikely over the short-term. Concerns over the stability of the banking sector in the US led to a sell-off in global yields recently, but unless we see an intensification of deposit withdrawal and an uptick in the risk of a liquidity crunch, we still see limited scope for rate cuts in 2023 given the high level of inflation.
Investment Grade Corporate Bonds	Investment grade returns will continue to depend on movements in benchmark rates and corporate spreads. The asset class continues to provide reasonable opportunities to add risk on a selective basis. At current levels, the spread differential between EUR IG and 10-year BTP bonds has dramatically compressed, reverting to post-COVID levels. We believe that spreads could compress further from here. We also see room for the recession risk premium that built up over the past months in EUR IG spreads to compress further. Given our expectation for rates volatility we remain marginally more comfortable with our short duration positioning, though we see scope to extend further out the curve to be closer to the benchmark as we approach mid-2023. In the meantime, we see short-duration IG as a quasi-cash alternative with attractive yields.
High Yield Corporate Bonds	High Yield spreads have contracted during January as investors started to price-in the possibility of rate cuts in 2H23. Also, the improving macro-economic backdrop led to a compression in the recession risk premium that had built up in 2022. We continue to like the asset class as we think that HY is more insulated from rates anxiety, should they arise. We continue to prefer issuers that generate high cash flows combined with a strong balance sheet as we believe their earnings will be less susceptible to higher finance and input costs. Also, S&P see default rates rising towards the long-term average of 3.3% by September 2023 compared to 1.6% in November 2022, which makes credit quality more relevant in the screening process.
Developed Market Equities	We remain underweight developed market equities as a lot of good news is now being included in the price. Also, the recent acceleration in inflation makes is a concern given the implications this could have on the future monetary policy. We would like to get more comfort around inflation, more specifically whether the acceleration in core inflation was a one-off related to the usual inflation volatility in January, when contracts are re-negotiated and price-lists are updated. If inflation is more sticky, than we could see more upside for the peak rates and consequentially could lead to tighter financial conditions, a drag for economic growth. In addition, we would expect higher inflation for longer to weigh on equity market sentiment. Finally, the collapse of Silicon Valley Bank and Signature Bank could pose risks to global growth and financial sector stability if: (1) withdrawals out of smaller banks to bigger banks persists; (2) Banks stop lending to each other, which could lead to a wider-scale liquidity crunch; and (3) Banks stop lending to the real economy which would weigh on economic growth. We believe that action taken by the FDIC and FED should help restore confidence in the US banking system and avoid an uptick in systemic risk.
Emerging Market Equities	In our opinion Emerging market equities performance could be boosted by China's commitment to re-open its economy at a faster rate than previously expected at the start of the year. The China growth story should also be beneficial for commodity exporting regions like Latin America. We note that EM equities are negatively impacted by the strength in the US Dollar and inflation news flow due to the high level of US Dollar denominated debt issued by EM countries. Finally, we see rising political risk as a potential headwind for EM equities, with tensions between US and China rising in recent months.

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