CURMI & PARTNERS

July 20th, 2023

Monthly Strategy Update

The quarter in summary:

On a macro front, the main theme during the second quarter was the resilience of the US economy, and how momentum has shifted away from Europe and China to the US. Headline inflation continued to ease somewhat during the quarter as energy prices fell further. Also, the strength shown by the labour market has been a surprise, as unemployment rates across developed economies remain at record lows. This should have been supportive for consumer spending in 2Q23. Yet, the labour market needs to cool down for inflation to get back to the central bank target rates, and recent data suggests that this is starting to happen.

Government bond yields increased on average during the second quarter following the sharp fall seen in March after the collapse of Silicon Valley Bank and other US regional banks. Back then investors expected the stress in the US banking sector would lead to a recession, hence the 45bp fall in the US 10-year yield. However, market-implied recession expectations have come down since then and investor focus turned away from economic growth back to inflation. The UK saw the largest increase during the quarter, as persisting inflation led to a surprise 50bp rate hike in June with the expectation that more tightening will be required to tame inflation. Despite the rising yield environment corporate bonds delivered positive returns during the second quarter. The falling recession expectations boosted high yield, whilst Euro Investment Grade bonds outperformed both US and UK Investment Grade bonds.

Global equities delivered a total return of 7.0% during the second quarter after a strong performance in June. US stocks outperformed within Developed Market equities, benefiting from rising investor interest in Artificial Intelligence. In fact, the Nasdaq (an index with a strong tilt to the technology sector) was the best performing index out of those we follow with a total return of 13.1%. Emerging Markets lagged behind as concerns over China's growth prospects weighed on performance.

Finally, the S&P GSCI Index (basket of commodities) fell 5.8% during the second quarter with industrial metals and energy the worst performing sectors, except for Natural Gas where prices rose 26.3% during the second quarter, though are still down 37.5% year-to-date.

Sovereign			
	Jun bp	2Q23 bp	YTD bp
US 10-year yield	19	37	-4
DE 10-year yield	11	10	-18
UK 10-year yield	21	90	72
Credit			
LCL Total returns	MoM %	2Q23 %	YTD %
EUR IG	-0.4%	0.4%	2.2%
EUR HY	0.5%	1.8%	4.8%
USD IG	0.4%	-0.3%	3.2%
USD HY	1.7%	1.7%	5.4%
GBP IG	-1.2%	-3.4%	-1.0%
GBP HY	-0.1%	0.6%	4.3%
Equities			
LCL Total returns	MoM %	2Q23 %	YTD %
Global	4.9%	7.0%	15.4%
S&P 500	5.5%	8.7%	16.9%
Nasdaq 100	5.3%	13.1%	32.3%
STOXX 600	1.6%	2.3%	10.9%
DAX	1.9%	3.3%	16.0%
CAC	4.0%	3.5%	17.4%
FTSE 100	0.7%	-0.4%	3.1%
Emerging markets	3.5%	1.0%	5.0%
EM ASIA	2.7%	-1.2%	3.1%
EM LATAM	9.0%	14.0%	18.5%
EM EMEA	4.4%	2.8%	1.8%
Currencies			
Total return	MoM %	2Q23 %	YTD %
EURUSD	2.1%	0.6%	1.9%
EURCHF	0.4%	-1.5%	-1.3%
GBPEUR	0.0%	2.3%	3.0%
GBPUSD	2.1%	3.0%	5.1%
Commodities			
Total return	MoM %	2Q23 %	YTD %
Oil WTI	3.5%	-6.4%	-11.0%
Oil Brent	4.0%	-4.7%	-9.3%
Natural Gas	23.5%	26.3%	-37.5%
Gold	-2.2%	-2.5%	5.2%
Copper	2.8%	-7.5%	-0.7%
Iron Ore	18.6%	0.2%	0.4%
S&P GSCI Index	2.3%	-5.8%	-11.4%

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Macro-economic views

Macro-economic data released during the second quarter of the year highlighted the divergence between the US and Europe. The early boost from the re-opening of the Chinese economy has faded away and activity in Europe is stagnating. In contrast, despite the uncertainty at the start of the quarter after the collapse of Silicon Valley Bank and other regional banks, the US economy continued to defy bearish expectations as the strength of the labour market is supportive for consumer spending.

The slowdown in China has become hard to ignore. Both Manufacturing and Services PMIs have deteriorated in the second quarter, whilst inflation was flat in June, highlighting the soft domestic and external demand. The highly anticipated Politburo meeting which will likely be held on 28th July, will give investors more colour around the economic policy for the second half of 2023, and potentially more information on stimulus measures.

Global Manufacturing PMI fell to a six-month low (48.8) in June, the tenth consecutive month of worsening conditions for the manufacturing sector. Factory output declined, having risen over the past four months due to easing supply chain constraints and the lifting of restrictions in China. Only 10 countries (out of 29) saw production increase in June, seven of which are in Asia. International trade remains weak, as new export data contracted for the sixteenth consecutive month. The rate of decline has accelerated to the strongest in six months.

The Global Composite index fell to a four-month low in June with the expansion continued to be driven by the services sector where activity rose in the business, consumer and financial services category. Companies expect the outperformance of services over manufacturing to persist over the coming months, as business optimism strengthened at service providers but dipped to a seven-month low at manufacturers.

Exhibit 1 – Consensus real GDP growth and inflation expectations

Global economic growth expectations for FY23 and FY24 were unchanged in June

	Consensus Forecast, % QoQ							Consensus Forecast, % YoY			Revisions since last meeting								
Real GDP, YoY%	1Q23F	2Q23F	3Q23F	4Q23F	1Q24F	2Q24F	3Q24F	FY23F	FY24F	FY25F	1Q23F	2Q23F	3Q23F	4Q23F	1Q24F	2Q24F	FY23F	FY24F	FY25F
United States*	2.0	1.3	0.0	-0.5	0.7	1.3	1.7	1.3	0.7	1.9	0.7	0.7	0.5	-0.1	-0.1	-0.3	0.2	-0.1	-0.1
Japan*	2.7	1.1	0.9	0.8	0.9	1.2	1.2	1.2	1.1	1.0	1.1	-0.3	-0.1	-0.1	-0.1	0.0	0.2	0.0	-0.1
Germany	-0.5	-0.3	-0.5	0.2	0.9	1.1	1.4	-0.3	1.1	1.5	0.0	-0.4	-0.3	-0.3	0.2	0.1	-0.3	0.0	-0.1
France	0.9	0.5	0.6	0.6	0.8	0.9	1.2	0.6	1.0	1.5	0.0	0.0	0.2	0.0	0.1	0.1	0.0	0.0	0.0
Italy	1.9	0.9	0.7	1.0	0.7	0.8	0.9	1.1	0.9	1.2	0.0	0.0	0.1	0.1	0.1	0.0	0.1	0.0	-0.1
Spain	4.2	1.4	1.3	1.3	1.2	1.3	1.6	2.0	1.5	1.8	0.4	0.0	0.1	0.2	0.0	0.0	0.2	0.1	-0.2
Eurozone	1.0	0.5	0.4	0.7	0.9	1.1	1.2	0.6	1.0	1.6	-0.3	0.0	0.1	0.2	0.2	0.1	0.0	0.0	-0.1
UK	0.2	0.2	0.4	0.3	0.4	0.7	0.9	0.2	0.9	1.5	0.0	0.1	0.1	0.1	0.1	0.0	0.0	0.0	-0.2
Developed Economies	1.8	1.0	0.3	0.2	0.9	1.2	1.6	1.1	1.1	1.8	0.4	0.3	0.2	0.0	0.0	-0.3	0.1	0.0	-0.1
China	4.5	7.5	5.0	5.4	4.4	4.8	4.8	5.5	4.8	4.6	0.0	-0.2	0.0	0.0	-0.3	0.1	0.0	-0.1	-0.1
Emerging Economies	3.7	5.7	4.1	4.4	3.9	4.3	4.4	4.3	4.2	4.2	-0.2	0.1	0.0	-0.1	-0.3	0.1	0.1	-0.1	0.0
Global								2.6	2.7	3.3							0.0	0.0	0.1

* - QoQ SAAR

	Consensus Forecast, % QoQ							Consensus Forecast, % YoY			Revisions since last meeting							
Consumer prices, YoY !	1Q23F	2Q23F	3Q23F	4Q23F	1Q24F	2Q24F	3Q24F	FY23F	FY24F	FY25F	4Q22F	1Q23F	2Q23F	3Q23F	4Q23F	FY23F	FY24F	FY25F
United States	5.8	4.1	3.5	3.2	2.8	2.7	2.6	4.1	2.6	2.4	0.0	0.0	-0.1	0.0	0.0	0.0	0.1	0.0
Japan	3.6	0.3	2.7	2.0	2.0	1.7	1.4	2.8	1.5	1.3	0.0	0.0	-2.9	0.1	0.0	0.1	0.0	0.0
Germany	8.8	6.9	5.6	3.3	3.1	2.6	2.5	6.0	2.7	2.0	0.0	0.0	-0.2	-0.2	-0.5	-0.1	-0.1	-0.1
France	7.0	6.1	5.3	4.2	3.2	2.5	2.2	5.5	2.6	2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Italy	9.5	7.8	5.8	1.3	2.2	2.5	2.4	6.3	2.4	1.9	0.0	0.0	0.0	0.1	-0.2	0.0	0.0	-0.1
Spain	5.0	2.8	2.6	3.9	3.1	2.8	2.7	3.8	2.6	1.9	0.0	0.0	-1.1	-0.3	-0.1	-0.1	0.0	0.1
Eurozone	8.0	6.2	4.8	2.9	2.7	2.6	2.3	5.4	2.5	2.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1	0.0	0.0
UK	10.2	8.3	6.6	4.5	4.1	2.6	2.6	7.2	2.9	2.1	0.0	0.0	0.6	0.7	0.6	0.3	0.3	0.1
Developed Economies	7.1	5.7	4.8	4.1	3.7	3.4	3.1	5.5	3.1	2.6	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.1
China	1.3	0.2	0.6	1.2	2.2	2.2	2.0	1.2	2.2	2.0	0.0	0.0	-0.4	-0.5	-0.9	-0.4	-0.1	-0.2
Emerging Economies	6.2	4.9	5.0	5.4	5.3	5.3	4.5	5.9	4.9	3.8	0.0	-0.1	0.1	0.0	-0.2	-0.1	0.0	-0.1
Global								5.7	3.9	3.6						0.2	0.4	0.4

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

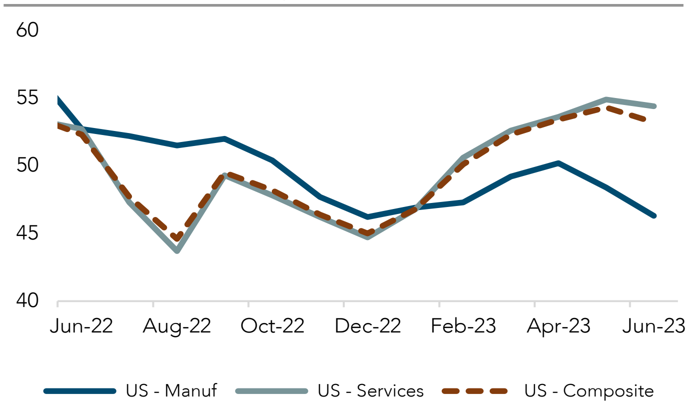
United States

Growth: The S&P Services PMI (Exhibit 2) continued to point to a robust services performance during June, supported by strong business activity, new orders and employment. Companies noted that strong client demand and a sustained uptick in new business supported the latest expansion in the sector. The S&P Manufacturing PMI remained in contractionary territory in June, with the index signalling the steepest decline in operating conditions so far this year. Manufacturing performance has deteriorated in seven of the past eight months. The deterioration in June was driven by a marked contraction in new orders, the steepest so far this year and the second fastest in over three years. Finally, the Q2 GDP estimate by the Atlanta Fed (Exhibit 3), rose to 2.3% on 10/07 from 2.1% on 06/07 following the recent economic releases (including the labour report and wholesale inventories) which raised expectations for an improved real gross private domestic investment growth.

Inflation: The June headline CPI rose 3.0%, well below the prior 4.0% and just below consensus expectations of a 3.1% rise. The main drivers of this decline were base effects from last year when energy and food inflation pushed the rate to 9.1%. The core inflation rate came in at 4.8%, below the prior 5.3% and the expected 5.0%. This was due to lower used cars inflation from a lagged effect of lower wholesale used car prices. Despite inflation slowing down, wage growth for Q2 was consistent at 0.4% MoM per month which is still significantly faster than values consistent with the 2% inflation target.

Exhibit 2 – US S&P Manufacturing, Services and Composite PMI

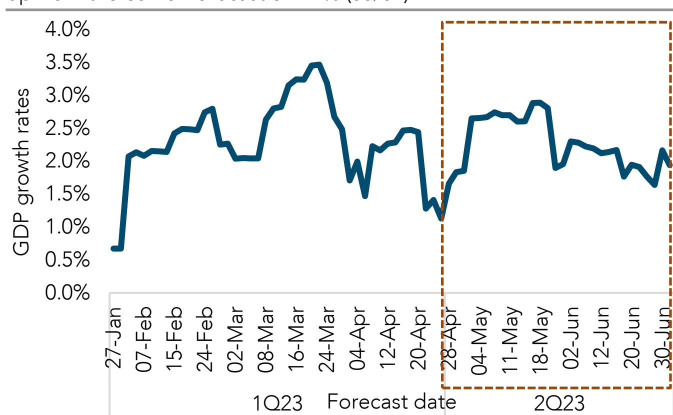
The deterioration within the Manufacturing sector worsened in June whilst Services remained in expansionary territory



Source: Bloomberg

Exhibit 3 – Atlanta FED GDP estimate

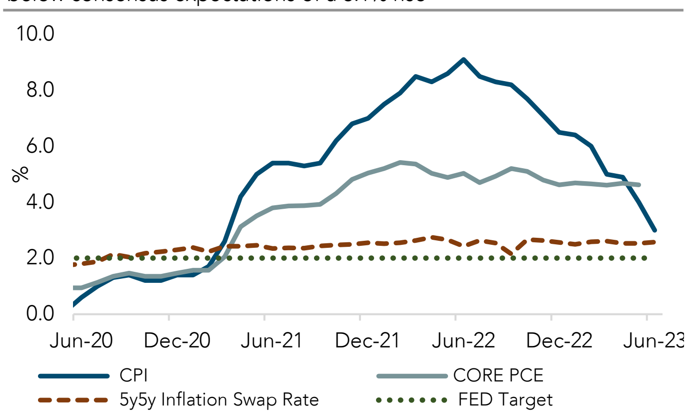
The Atlanta Fed is now forecasting the Q2 GDP at 2.3% on 10/07, up from the earlier forecast of 2.1% (06/07)



Source: Atlanta FED

Exhibit 4 – US Inflation rate

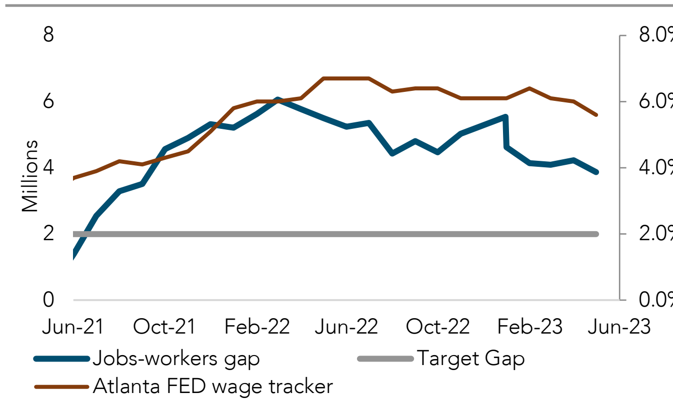
Headline CPI rose 3.0% in June, well below the prior 4.0% and just below consensus expectations of a 3.1% rise



Source: Bloomberg

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

The job-workers gap fell below the 4 million mark for the first time in 20 months



Source: FRED, Atlanta FED

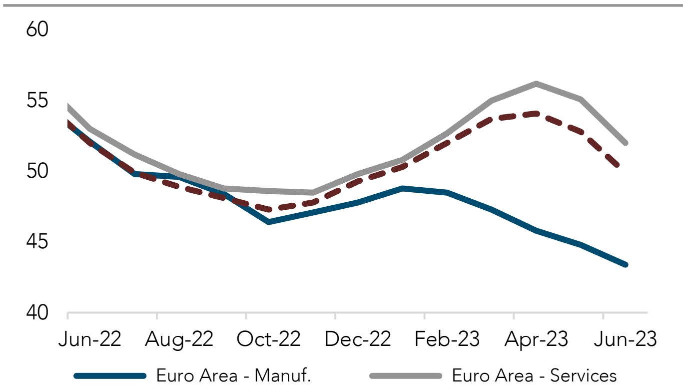
Europe

Growth: The slowdown in the Eurozone's economy became clearer in June, as both the Manufacturing and Services sector showed signs of deterioration (Exhibit 6). The Manufacturing PMI fell to 43.6, down from 44.8 in May and represented a 37-month low and the third consecutive month of deterioration. The steep decline in production was driven by an increasingly sharp downturn in new orders for goods, which fell to the greatest extent since last October. The Services PMI eased slightly to 52.4 in June, from 55.1 last month. Business activity in the service sector grew at the slowest rate since January, down sharply from April's recent peak, with growth of new business dropping to register only a modest increase in demand, contrasting with the strong gains seen in the three months to May. In contrast, Industrial production increased 0.2% MoM in May driven by capital goods (+1.0%), intermediate and durable consumer goods (+0.5%) and non-durable goods (+0.3%), which was slightly offset by a fall in the production of energy goods (-1.1%) (Exhibit 7).

Inflation: Recent data confirmed the trend of headline disinflation, with the headline rate easing to 5.5% in June (-0.6pp versus May). The trend is less clear for core inflation, following an acceleration to 5.4% in June (+0.1pp versus May). Softness was noted in services inflation component. Endorsing this was the high frequency indicators which have been pointing to disinflation in the services sector.

Exhibit 6 – EU S&P Composite, Manufacturing and Services PMI

The Composite PMI declined to 49.9, the first reading below 50 since December 2022 and a clear indication that the Euro-area economy is stalling



Source: Bloomberg

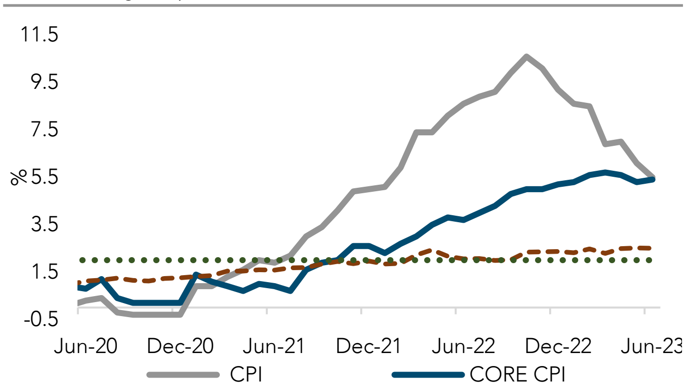
Exhibit 7 – EU Industrial Production and Retail Sales

Industrial production for May increased 0.2% MoM, while retail sales showed nil growth for the second consecutive month, highlighting a slowdown in activity

Source: Bloomberg

Exhibit 8 – EU Inflation Rate

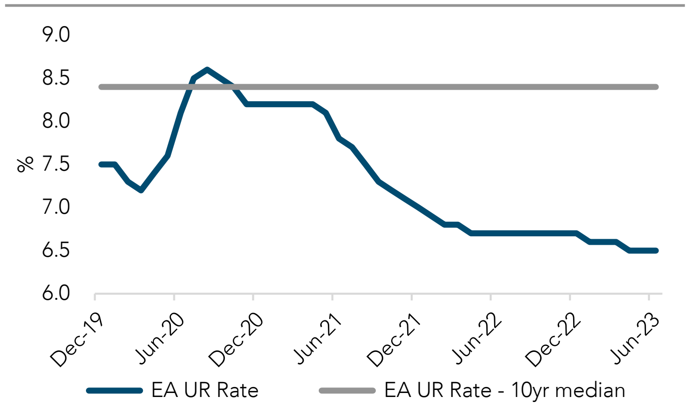
The inflation rate significantly declined to 5.5% from 6.1%, while the core rate edged up to 5.4% from 5.3%



Source: Bloomberg

Exhibit 9 – EU Unemployment Rate

The unemployment rate has remained at 6.5% for the second consecutive month, the lowest ever recorded



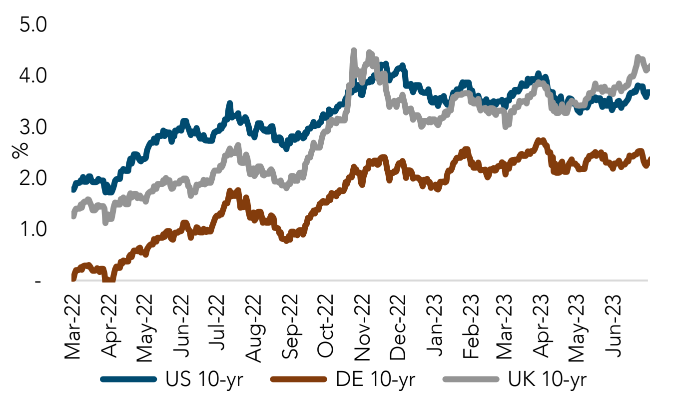
Source: Bloomberg

Rates

Sovereign yields rose during the month of June within the U.S., U.K. and Euro Area. The higher yields were driven by the continued hawkishness of the Federal Reserve ("Fed"), the announcement of rate hikes by the Fed, European Central Bank ("ECB") and the Bank of England ("BoE") during their respective June meetings and also the release of inflation figures in the Euro Area and the U.K.

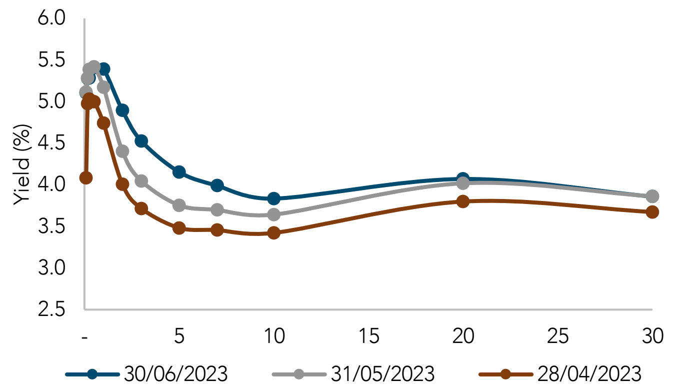
In fact, the yield on the U.S. Treasury rose by 19bp in June to 3.84% while the German ten-year and U.K. ten-year rose by 11bp and 21bp respectively to 2.39% and 4.39%. Sovereign curves, particularly the U.K., inverted further as the spread differential across each of the three economies that we follow widened.

Exhibit 10 - 10-year nominal bond yield for the US, Germany and UK
Central bank hawkishness, rate hikes and inflation figures released during the month drove yields higher during the month.



Source: Bloomberg

Exhibit 11 – US Yield Curve
The U.S. sovereign yield curve inverted further in June, as the 2s10s spread widened by circa 30bp during the month.



Source: Bloomberg

United States

At its June meeting, the Fed decided to pause hiking rates, as was widely expected. However, the Fed did signal its support for two more interest rate rises this year including one that could be implemented at the July meeting. The FOMC voted unanimously to forgo hiking at the June meeting and hold the federal funds rate at 5.00% - 5.25%. The updated dot plot showed that FOMC officials project two additional 25bp hikes this year which would lift the benchmark rate to 5.50% - 5.75%. Powell noted that the Fed needed *"credible evidence that inflation is topping out and then beginning to come down"* before concluding it had squeezed the economy enough as he noted that there had been little progress in bringing core inflation down in recent months.

While the Fed expects core inflation to decline to 3.9% this year before slowing to 2.6% in 2024 and 2.2% in 2025, Fed officials also penciled in much higher growth with the economy expected to expand by 1% which is higher than the 0.4% estimate released in March. Besides projections, data released during the month of June continued to show that the U.S. economy remains robust. Economic growth was that of 2% during the second quarter, annualised. While the unemployment rate rose marginally to 3.7% during the month of May, wage growth remained resilient as wages grew by 5.7% during the same month while average hourly earnings rose by 0.3% to $33.44.

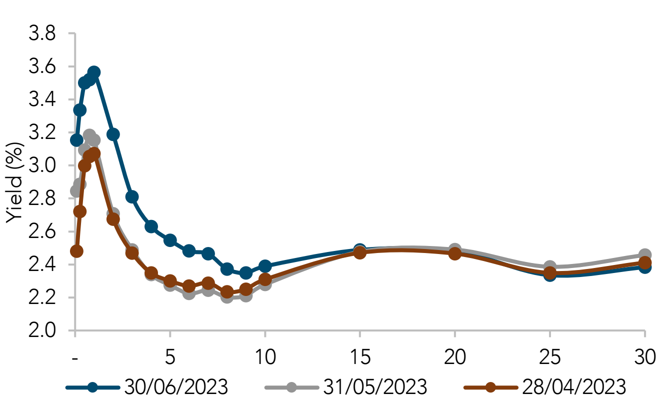
Europe

In June the ECB decided to raise rates by a quarter point to 3.50% while signaling that it will increase them again in July. It also warned that the fight against inflation is not yet over. The ECB also raised its inflation forecast and trimmed growth expectations over the next three years. At the meeting, Lagarde also noted that Governing Council members *"still have ground to cover"* and they were likely to tighten borrowing conditions again at the next policy meeting in July. The ECB also noted that it expects inflation *"to remain too high for too long"* and is not expected to return to its 2% target even by 2025.

German preliminary inflation figures came in higher than forecasted during the latter part of the month which drove yields substantially higher. Figures released show that prices rose by 6.5% YoY in June and the German core inflation rate rose to 5.8% during the same month, with both figures coming in higher than expected. The higher energy and services prices were due to the low base effect and also due to the introduction of a travel subsidy which was introduced in June 2022. The softer growth in China is weighing on global activity, particularly the Euro Area. After a strong Q1, China's post-reopening recovery momentum has slowed down dramatically with the People's Bank of China recently cutting rates. The slower growth in China has affected the bloc's largest economy with the PMI composite number for Germany, particularly manufacturing, weakening during the month.

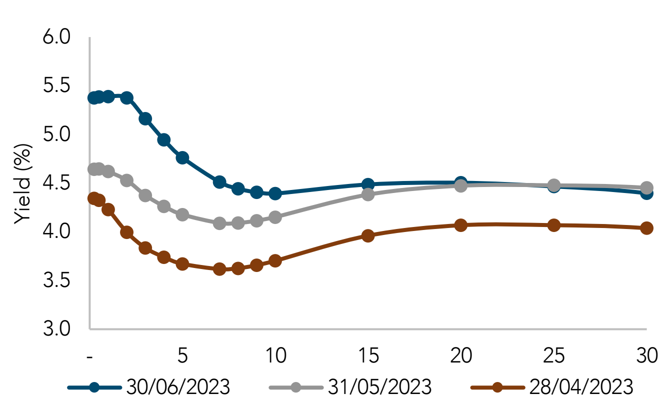
U.K. rates rose in June following the release of above consensus inflation figures and the surprise 50bp hike announced by the BoE. The rate of inflation in the U.K. remained high in May at 8.7%, unchanged from the pervious month's 12-month low and above market expectations of 8.4% and significantly above the BoE's target. The core inflation rate rose to 7.1% in May, which is an increase from the prior month's 6.8% and the highest since March 1992. The main drivers of the higher inflation were air travel, recreational and cultural goods and services and second-hand cars, despite falling fuel costs. While the market was expecting a 25bp hike by the BoE during its June meeting, following the inflation prints which were published before the meeting, the BoE surprised investors with a 50bp hike, which is the 13th consecutive rate rise, to 5.00%. The MPC also stated that it expects interest rates to climb to a peak of about 6% by the end of the current year.

Exhibit 12 – German 10-year yield curve
The Bund yield rose 11bp in June following the ECB's decision to hike rates, weak PMI number and the release of inflation figures.



Source: Bloomberg

Exhibit 13 – UK 10-year yield curve
The Gilt yield rose by circa 21bps following the release of inflation figures for the month of May and surprise 50bp BoE hike.



Source: Bloomberg

Credit

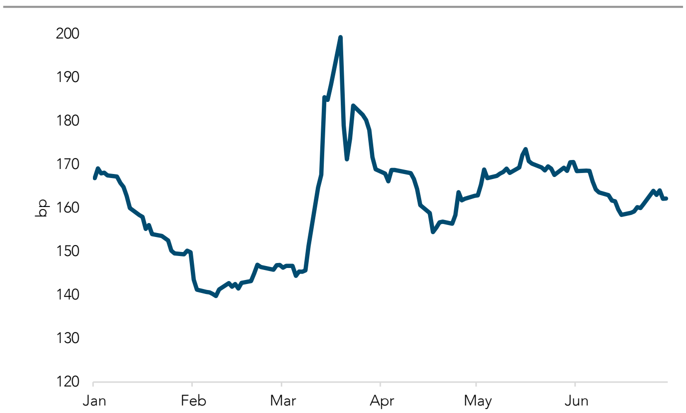
On a total return basis, during June, the USD market gained the most both in the IG space (+0.4%) and HY (+1.7%) on a month-on-month basis, across all rating buckets. The highest return within US IG was seen in the BBB bucket (+0.6%), while in HY, the CCC bucket returned the most (+3.1%). In the EUR market, EUR IG declined on a month-on-month basis (-0.4%) due to declines in all IG rating buckets, the most in the AA-bucket by -0.7%. The EUR HY market increased 0.5%, with the CCC bucket contributing the most to returns (+1.7%). The GBP market declined in IG (-1.2%) and marginally in HY (-0.1%) on a month-on-month basis. The rating-buckets which declined the most were the single-A (-1.2%) and BBB (-1.3%).

At an index level, IG spreads have only tightened by c.4bp in Europe and c.7bp in the US, which is relatively low considering the number of key events so far this year which included the US regional banking crisis, US debt ceiling negotiations and continued tightening of monetary policy by central banks. Yet, the relatively small move YTD masks the outsized moves seen in 2023 (Exhibit 14). Spreads fell to a 2023 low of 139bp in February before a spike to 199bp by March. European IG had several single name events this year, including CreditSuisse AT1s, SBB, Lanxess, Unibail and Thames Water. We have held a preference for high quality credit for some time, and it is becoming clear that pressure on weak credit has increased significantly due to the softer demand environment and rising financing costs. We expect this to remain the case in 2H23, with defaults expected to rise against a deteriorating economic backdrop.

For much of the past decade, interest rates have been under pressure as central banks cut rates aggressively to revive the economy. The average YTW during that period amounted to 4.5%, falling to a low of 2.7% in 2021. However, despite the attractive yields, the spread tightening seen since March should be taken into consideration (Exhibit 15). The current yield looks attractive at 8.4% and at the 83rd percentile since 2010. Notwithstanding, spreads, at 452bp and at the 59th percentile, offer much less protection for investors should the macro-economic backdrop deteriorate further. At similar levels of yield, spreads have been on average c. 100bp higher. Spreads partly reflect what investors should be compensated for defaults. The more likely driver for spreads to widen is continued macro weakness. Although the US economy remains on track for a soft landing, activity in Europe has decelerated. Hence, despite the protection from high yields, the current level of spreads in not attractive.

Exhibit 14 – Euro-Area Aggregate corporate index OAS

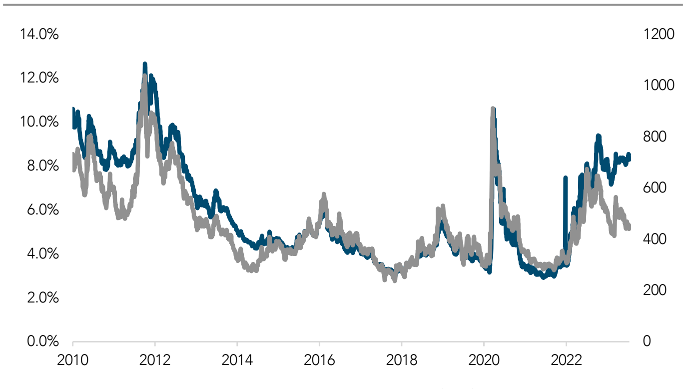
Despite spreads tightening by just c.4bp, there have been some outsized moves in 2023



Source: Bloomberg

Exhibit 15 – Euro-Area HY OAS compared to YTW

Although YTW for HY bonds appear to be attractive, they offer much less cushion should the macro backdrop deteriorate further

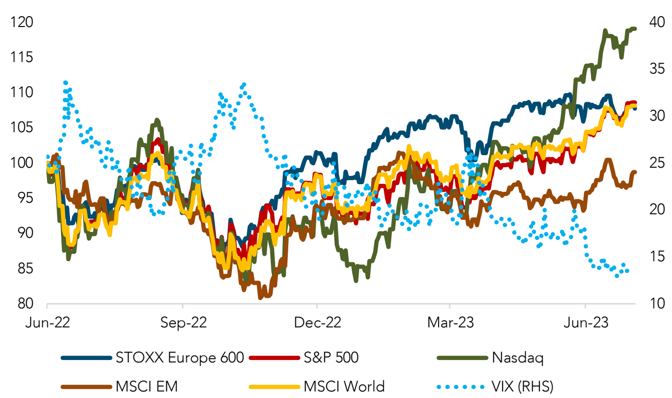


Source: Bloomberg

Equity

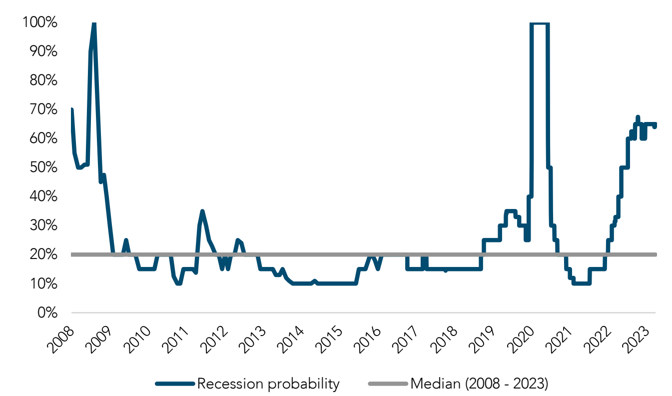
Global equities rallied 6.1% (LCL) in June, the best month on a total return basis since January, taking total return generated during 2Q23 to 7.0%. In the first six months of 2023, global equities generated total returns of 15.4% despite the uncertain backdrop at the start of the year, which was made worse by the collapse of several US regional banks. Most regions we follow closed 2Q23 in the green, with China being the notable exception, as the re-opening boost disappeared quicker than the market had previously anticipated. The Nasdaq was the best performing index during the second quarter with a total return of 13.1%.

Exhibit 16 – Index performance (Total return in LCL, rebased Jun-22)
Equity market returns have been flat for most regions over the past year except for the Nasdaq



Source: Bloomberg
Performance rebased from 31 December 2021

Exhibit 17 – Market-implied probability of a recession in the US
The current market-implied probability of a recession of 65% is well ahead of the median calculated since 2008 of 20%



Source: Bloomberg

At the start of the year, our expectation was for equities to trade in a range. This seems inconsistent to actual equity market performance given that most regions are already in double-digit total return territory. Yet, returns over a 1-year period are quite low (Exhibit 16). Since late April, equity markets have rallied whilst volatility has fallen as risks started to fade, including: (1) the resolution of the debt ceiling; (2) less concern over the US regional bank sector; and (3) falling commodity prices implying less inflationary pressures. Additionally, the AI craze has fuelled investor interest in Tech/Growth stocks at a time when growth rates for the sector were converging with the broader index. Hence, the expectation is that AI will boost revenue/earnings growth making the sector attractive again for investors.

A recession or a high probability of a recession will likely be the catalyst for the next stage of the investment cycle. The resilience shown by the US economy has meant that recession expectations have been pushed back. Bloomberg consensus currently assigns a 65% probability of a recession in the US over the next 12 months, well above the median calculated since 2008 of 20% (Exhibit 17). The measure has only moved above the median in 2008/2009, 2011 and 2019 – 2021. In our opinion equities could continue to grind higher until the US economy enters a recession, or the likelihood of a recession increases significantly. It could be argued that the market-implied probability of a recession over the next 12-months is already high at 65% compared to the median calculated since 2008 of 20% (Exhibit 16). Yet, equity investors seem unmoved, with economic sensitive sectors and strategies still delivering double-digit returns so far in 2023.

As noted earlier, the risk outlook has improved somewhat over the past weeks, but a lot of the good news seems to now be priced-in. Despite the improvements in recent weeks that have helped lift sentiment, we think that the upside for equity markets is constrained by both high valuations and high interest rates. Even though inflation has started to show signs of moderation, it's still well above levels where central banks would be comfortable with. We note that in June, both the FED and ECB delivered hawkish surprises, whilst the BoE and Norges Bank surprised to the upside with 50bp rate hikes. Meanwhile, the weakness seen in the Manufacturing sector this year seems to be extending to services as well.

We have discussed the negative correlation between real rates and equity markets in our earlier reports, but clearly the relationship has de-coupled in recent months. The S&P 500 has rallied sharply since the end of April despite the rise in real yields, which implies that either investors expect rapid rate cuts, or that long-term growth expectations have gone up, or a combination of both. Rapid rate cuts are unlikely given the current level of inflation, all else equal.

We believe that the 2Q23 earnings season could set the tone for equity market performance in 2H23. Around 90% of the STOXX 600 constituents should have reported by the end of August. The third week of July (beginning 24th July) will be the busiest week in terms of earnings releases with around 50% of the constituents expected to report. In our opinion, investors will focus on the strength (or otherwise) of the earnings season, and this could have implications for equity market performance in the second half of the year. Of particular importance will be the guidance provided by companies. EPS expectations have been supported by stronger-than-expected Q1 earnings, though it remains to be seen if this can be carried forward in Q2. The disconnect between activity data and earnings growth expectations cannot continue forever.

European STOXX 600 FY23e EPS has been revised up by 1% since the start of 2Q23. Although the growth momentum has slowed, earnings estimates have remained surprisingly resilient. Generally, the current PMI levels in Europe would be consistent with negative EPS revisions, which is inconsistent with current consensus growth expectations. However, it should be noted that the SXXP constituents generate a large proportion of its earnings outside of the Bloc. Furthermore, the hawkish ECB should be beneficial for the earnings of Financials. Finally, lower commodity prices should have improved purchasing power, supporting earnings for exposed sectors.

Exhibit 18 – Valuations – Developed markets

Valuations in the US are in the 90th percentile and screen as expensive compared to other international markets

Historical Data	SPX	NDX	SXXP	SX5E	DAX	CAC	FTSE100	FTSE250
Current Forward PE ratio (FPE)	18.4x	24.9x	12.1x	12.0x	10.6x	12.5x	10.4x	10.3x
Forward PE ratio (31/12/2022)	16.8x	21.1x	11.9x	11.3x	10.5x	11.3x	10.0x	11.1x
10 Year data								
Highest	22.1x	30.8x	17.5x	18.0x	15.7x	18.2x	15.4x	17.9x
Highest (date)	31/12/2020	25/01/2021	29/12/2020	29/12/2020	28/12/2020	04/12/2020	02/12/2015	29/12/2020
Lowest	12.2x	14.0x	10.0x	9.0x	8.4x	9.1x	8.4x	8.3x
Lowest (date)	23/03/2020	28/06/2013	18/03/2020	18/03/2020	18/03/2020	18/03/2020	03/10/2022	23/03/2020
Median	16.1x	19.4x	13.7x	12.8x	12.2x	13.3x	12.8x	13.8x
95th percentile	20.4x	28.2x	16.0x	16.3x	14.5x	15.9x	14.9x	15.2x
5th percentile	13.9x	16.2x	11.7x	11.3x	10.9x	11.1x	9.9x	10.5x
Historical rank (since 2006)								
Percentile	90.1%	90.7%	39.1%	52.9%	29.7%	50.8%	26.6%	18.2%
Current FPE, % above/ (below) 10-YR median	14.3%	28.1%	-11.9%	-6.2%	-13.4%	-6.3%	-19.3%	-25.5%
Current FPE, % above/ (below) Dec 22	9.6%	18.1%	1.8%	6.6%	0.8%	10.5%	3.3%	-7.8%

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 recently moderated our view on Sovereign bonds as we are seeing less headwind from central bank action going forward. We believe that the worst is over in terms of future rate hikes. In this respect we reduced our Underweight position in the asset class during May. In June, we extended our duration to match that of the benchmark index. The recent inflation prints in the US seems to support our view, as both CPI and PPI in June came in below expectations. We will watch closely the language used by the FED during the upcoming meetings to evaluate whether we are at or close to peak terminal rate.
Investment Grade Corporate Bonds	At index level, spreads have tightened by c. 4bp in Europe and c.7bp in the US, which is a relatively small move. Yet, this disguises the significant moves that have hit the IG market this year, especially the spread widening following the US regional banking crisis when spreads widened by c.53bp in a week in Europe. The key theme for IG remains the rising idiosyncratic risk, as it is quite clear that pressures from higher financing costs are rising on weak IG names. The risk from a continued deterioration in the macro-economic backdrop and the high inflation levels will add to the pressure on weak IG credits. This supports our preference for higher quality credits that has been in place for some time. On balance, we believe that the IG space provides investors with an attractive risk/return trade-off against the current macro-economic backdrop with a yield of c. 4.4% being offered in Europe.
High Yield Corporate Bonds	Our view of HY is less positive (compared to IG) despite the high yields on offer for investors. At a high level, yields look attractive at 8.0% yield-to-worst for European HY market. Indeed, YTW has been lower 78% of the time since 2010. Also, yields have only been this high back in 2014 when the Bloc was a risk of breaking up. However, the current spread of 454bp, at the 59th percentile, offer much less cushion should the broader macro-economic backdrop deteriorate further. Historically, the average spreads when YTD was around the current levels amounted to 560bp. This implies that the risk/return trade-off for HY is less attractive for investors. Spreads partly reflect what investors should be compensated for defaults. According to Barclays, spreads below 400bp suggest a default rate of below 2.0%, which is optimistic given the current backdrop. Therefore, despite the relatively attractive yields on offer, we retain the underweight recommendation for HY.
Developed Market Equities	Equity markets have rallied strongly from the October lows as the risk outlook has improved. The feared consequences of the US regional banking crisis, debt ceiling negotiations and inflationary pressures have faded away over the past weeks. The US economy has proved to be much more resilient than expected and a soft landing is being priced-in. However, we note that the global growth picture is more mixed. China's growth momentum has dwindled, disappointing expectations whilst the economic backdrop in Europe is deteriorating. A key risk for investors is that the soft PMI readings will start to weigh on earnings revisions in 2H23, especially as inflation moderates further (translates into less top-line growth). On balance, we believe that a lot of the good news is now priced into equities though we acknowledge that equities could continue to grind higher if US recession expectations are pushed back further.
Emerging Market Equities	The disappointment of the China re-opening coupled with the mixed global growth expectations have weighed on EM equities so far this year. China equities offer the most upside, given their underperformance over the past two years and their relatively defensive characteristics. Yet, the performance of Chinese equities depends on the success of monetary easing measures announced over the coming weeks by the PBOC as well as the country's relationship with the US.

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