CURMI & PARTNERS

September 14th, 2023

Monthly Strategy Update

The month in summary:

Negative news flow out of China weighed on investor sentiment during the month of August, increasing market volatility. The Chinese property sector was again a key source of concern, as Country Garden, the country's largest private real estate developer, failed to meet a coupon payment. Additionally, Evergrande filed for US bankruptcy protection and Zhongrong Trust, a major Chinese investment trust, missed payments to corporate investors. The issues pertaining to the China property market, combined with the disappointing economic data coming out of China, has uneased investors over the last month.

August got off to a tough start, as Fitch Ratings downgraded its US debt rating from the top-tier AAA rating to AA+, citing the "deterioration" of the country's finances due to its growing debt burden and the "erosion of governance". The Fitch downgrade coincided with the US Treasury announcement of a larger than expected debt issuance over the coming months, which led the yield on the 10-year Treasury closing on a year-to-date high of 4.3% on 21/08, before re-tracing back to 4.1% by month end. In Europe, the deterioration in economic data meant that yields on the German 10-year was largely unchanged in August. The Bank of England raised its policy rate by 25bp to 5.25% during the month, as expected.

Credit markets performance in local currency terms was mixed, with Euro credit outperforming USD. The bleaker outlook for Europe's economy weighed somewhat on the region's credit market, as evidenced by the widening in spreads during the month. Moreover, high yield credit for each region we follow outperformed IG.

In the equity space, global shares fell in August as risks around the global macro backdrop intensified. Europe underperformed the US, as the former is much more sensitive to the economic outlook. Energy and real estate were the only sectors to register a positive return during the month.

Finally, the S&P commodities index fell slightly, as small price gains for energy and livestock were set-off by weaker prices in agriculture, industrial metals and precious metals. Energy was the best performing component of the index amid production cuts from Saudi Arabia and other Opec producers.

Sovereign			
		Movement in bp	
	Yield	Aug	YTD
US 10-year yield	4.1%	16	23
DE 10-year yield	2.5%	-3	-11
UK 10-year yield	4.4%	3	69
Credit			
LCL Total returns		MoM %	YTD %
EUR IG		0.2%	3.4%
EUR HY		0.3%	6.5%
USD IG		-0.8%	2.8%
USD HY		0.3%	7.1%
GBP IG		-0.2%	1.1%
GBP HY		0.3%	7.0%
Equities			
LCL Total returns		MoM %	YTD %
Global		-2.3%	16.6%
S&P 500		-1.6%	18.7%
Nasdaq 100		-2.1%	34.9%
STOXX 600		-2.5%	10.4%
DAX		-3.0%	14.5%
CAC		-2.4%	16.1%
FTSE 100		-2.6%	2.8%
Emerging markets		-6.1%	4.8%
EM ASIA		-6.4%	2.5%
EM LATAM		-7.3%	15.6%
EM EMEA		-5.3%	3.0%
Currencies			
Total return		MoM %	YTD %
EURUSD		-1.4%	1.3%
EURCHF		-0.1%	-3.2%
GBPEUR		0.1%	3.5%
GBPUSD		-1.3%	4.9%
Commodities			
Total return		MoM %	YTD %
Oil WTI		2.8%	6.8%
Oil Brent		2.2%	5.8%
Natural Gas		5.1%	-38.1%
Gold		-1.3%	6.4%
Copper		-4.6%	0.6%
Iron Ore		13.3%	1.4%
S&P GSCI Index		-0.3%	-3.1%

Robert Ducker, CFA
+356 23426112

Macro-economic views

The divergence between the economic performance of the US compared to China and Europe has surprised investors for very different reasons. The resilience of US data, despite the fastest FED rate hike in decades, has been supported by several factors. Tax credits in the Inflation Reduction Act and the Chips act have boosted a manufacturing construction boom. Also, rising mortgage rates led to a fall in existing home sales as potential sellers postpone selling their property to hold on to their existing low mortgage rates. This led to new buyers having no option but to opt for new homes, supporting construction employment which remains at an all-time high a year after mortgage rates hit 7%.

The recent months have been tough on China after reaching herd immunity more quickly than the market had anticipated. July activity data surprised sharply to the downside, but there were early signs of stabilisation in August. Yet, the real estate sector remains a big drag for economic growth and consumer consumption has stalled, not helped by rising youth unemployment. Also, foreign demand is waning, partly driven by companies shifting their production back to their home countries following the supply side issues faced during COVID.

In Europe, following the stronger than expected economic growth in Q2, high frequency data implies that growth has flat-lined in Q3. August composite PMIs dropped to near three-year low, with services PMIs falling below 50 for the first time this year. Falling inflation could boost real income, which in turn could boost consumer spending, though the probability for a managed slowdown continues to rise.

In terms of outlook, US growth is likely to slow over the coming quarters, whilst lacklustre growth in China and EU could persist. Households are likely to reduce spending to replenish their savings, whilst the high mortgage rates and tighter credit conditions are likely to weigh on growth.

Exhibit 1 – Consensus real GDP growth and inflation expectations

Global economic growth expectations for FY23 revised slightly higher driven by the strength seen in the US and Japan economy

	Consensus Forecast, % QoQ								Cons. Forecast, % YoY			Revisions since last meeting							
Real GDP, YoY%	*1Q23A*	*2Q23A*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F*	*4Q24F*	*FY23F*	*FY24F*	*FY25F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F*	*FY23F*	*FY24F*	*FY25F*
United States*	2.0	2.1	2.0	0.4	0.1	0.9	1.4	1.8	2.0	0.9	1.9	1.5	0.7	-0.2	-0.2	-0.2	0.4	0.3	0.0
Japan*	3.2	4.8	-1.3	0.4	0.9	1.2	1.3	1.2	1.8	1.0	1.0	-2.1	-0.4	0.1	0.0	0.0	0.5	0.0	0.0
Germany	-0.3	-0.1	-0.6	-0.1	0.3	0.6	0.8	1.2	-0.3	0.8	1.5	0.0	-0.1	-0.2	-0.2	-0.2	0.0	-0.2	-0.1
France	0.8	1.0	0.6	0.8	1.0	0.7	1.0	1.1	0.7	1.0	1.4	0.1	0.2	0.2	-0.1	0.1	0.0	0.0	0.1
Italy	2.0	0.4	0.2	0.4	0.1	0.6	0.8	1.1	0.9	0.7	1.2	-0.5	-0.5	-0.4	-0.2	-0.1	-0.2	-0.1	0.1
Spain	4.2	1.8	1.6	1.3	1.1	1.1	1.5	1.8	2.2	1.5	2.0	0.0	-0.1	-0.2	-0.1	-0.1	0.0	0.0	0.2
Eurozone	1.1	0.5	0.2	0.4	0.6	0.6	0.9	1.3	0.6	0.9	1.5	0.0	-0.1	-0.2	-0.4	-0.2	0.1	-0.1	-0.1
UK	0.2	0.4	0.4	0.3	0.2	0.4	0.5	0.8	0.3	0.5	1.5	0.0	-0.1	0.0	0.0	0.0	0.1	-0.1	0.0
DM Economies	1.8	1.6	1.2	0.6	0.5	1.0	1.4	1.6	1.5	1.1	1.8	0.6	0.3	-0.1	-0.1	-0.1	0.2	0.1	0.0
China	4.5	6.3	4.3	5.0	4.1	4.7	4.7	4.8	5.1	4.5	4.5	-0.3	-0.1	-0.2	-0.2	0.0	-0.1	-0.2	-0.1
EM Economies	3.6	5.5	3.8	4.2	3.7	4.1	4.2	4.4	3.8	4.1	4.2	-0.2	-0.1	-0.2	-0.2	-0.1	-0.1	0.0	-0.1
Global									**2.7**	**2.6**	**3.0**						**0.1**	**-0.1**	**-0.1**

	Consensus Forecast, % QoQ								Cons. Forecast, % YoY			Revisions since last meeting									
Consumer prices, YoY %	*1Q23A*	*2Q23A*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F*	*4Q24F*	*FY23F*	*FY24F*	*FY25F*	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F*	*FY23F*	*FY24F*	*FY25F*
United States	5.8	4.0	3.5	3.1	2.7	2.6	2.5	2.3	4.1	2.6	2.3	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.1	0.1	0.0
Japan	3.6	3.3	3.0	2.4	2.2	2.1	1.8	1.6	3.0	1.9	1.4	0.0	0.0	0.1	0.1	0.0	0.3	0.1	0.1	0.2	-0.1
Germany	8.8	6.9	5.7	3.5	3.3	3.0	2.8	2.5	6.1	2.9	2.1	0.0	0.0	0.1	0.2	0.2	0.3	0.2	0.1	0.2	0.0
France	7.0	6.1	5.4	4.5	3.3	2.7	2.4	2.2	5.7	2.7	2.1	0.0	0.0	0.2	0.3	-0.2	-0.2	-0.8	0.2	0.0	0.0
Italy	9.5	7.8	5.8	1.8	2.5	2.2	2.2	2.0	6.2	2.2	1.9	0.0	0.0	-0.1	0.1	0.1	-0.3	-0.1	-0.1	-0.2	0.0
Spain	5.0	2.8	2.5	3.6	3.1	3.2	2.6	2.2	3.5	2.7	1.9	0.0	0.0	0.4	0.2	0.2	0.4	0.0	0.1	0.1	0.0
Eurozone	8.0	6.2	5.0	3.3	3.0	2.9	2.5	2.4	5.6	2.7	2.1	0.0	0.0	0.3	0.3	0.2	0.3	0.0	0.2	0.1	0.0
UK	10.2	8.4	6.7	4.5	4.0	2.5	2.7	2.5	7.5	3.0	2.0	0.0	0.0	-0.2	-0.2	-0.3	-0.3	-0.1	0.0	0.0	0.0
DM Economies	7.1	5.2	5.1	4.4	4.0	3.9	3.4	3.1	5.6	3.4	2.6	0.0	0.0	0.2	0.3	0.3	0.3	0.2	0.2	0.2	0.0
China	1.3	0.1	0.0	0.7	1.3	1.6	1.8	1.8	0.6	1.9	2.0	0.0	0.0	-0.5	-0.3	-0.5	-0.4	-0.1	-0.3	-0.1	0.0
EM Economies	6.3	2.8	5.1	5.6	5.8	5.7	5.2	4.6	5.8	5.5	4.0	0.0	0.0	0.1	0.2	0.5	0.3	0.4	-0.1	0.3	0.0
Global									**6.0**	**4.1**	**3.7**								**0.5**	**0.2**	**0.3**

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

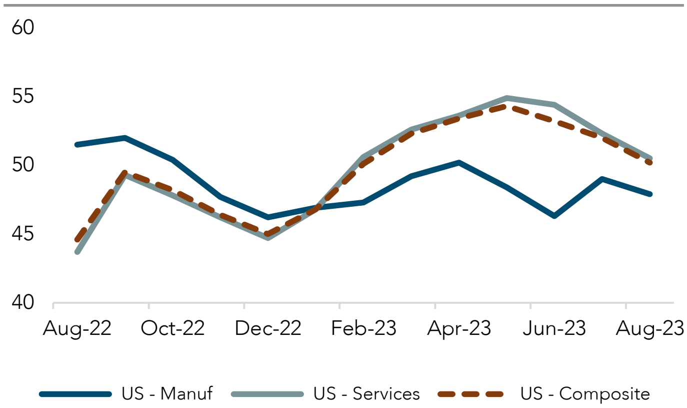
United States

Growth: The S&P Manufacturing PMI deteriorated to 47.9 in August (Exhibit 2), down from 49.0 in the previous month, driven by a sharp fall in new orders leading to a sharp contraction in output, while firms continued to deplete their inventories. The weaker new orders were attributed to a weakening economy and customers being cautious in placing new contracts. Furthermore, the Services PMI fell to 50.5 in August down sharply from 52.3 in the previous month, driven by weak client demand and a contraction in new business. The Atlanta FED GDP Now estimate stood at 5.6% annualized rate on 06/09 (Exhibit 3), which suggests an acceleration over the second quarter of the year.

Inflation: The core PCE price index increased 4.2% year-on-year (Exhibit 4), which was in-line with economist expectations (4.2%) but slightly higher when compared to the previous month (4.1%). Although the acceleration was similar in size to June, the underlying dynamics differed significantly. Core goods prices slipped into deflation, yet the supercore inflation accelerated sharply to 4.7% year-on-year. Yet, we note that the US labour market seems to be moderating nicely. The latest JOLTS job openings for July fell 8.8 million, the lowest number since March 2021. Furthermore, the job-workers gap fell to 2.4 million, down from a peak of 6.1 million, and also close to the 2million level which would be reflective of wage growth in-line with target inflation. Also, the personal savings rate is now at 3.5%, well below the historical average, which could indicate a future slowdown in consumer spending as households replenish their savings.

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

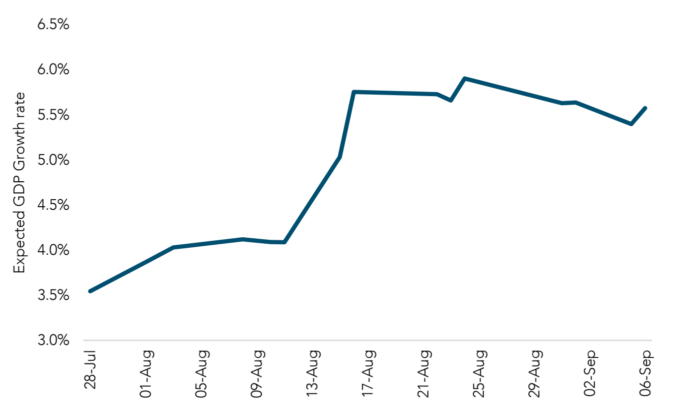
The Manufacturing sector seems to have recovered slightly in July, though the Services sector eased slightly



Source: Bloomberg

Exhibit 3 – Atlanta FED GDP estimate

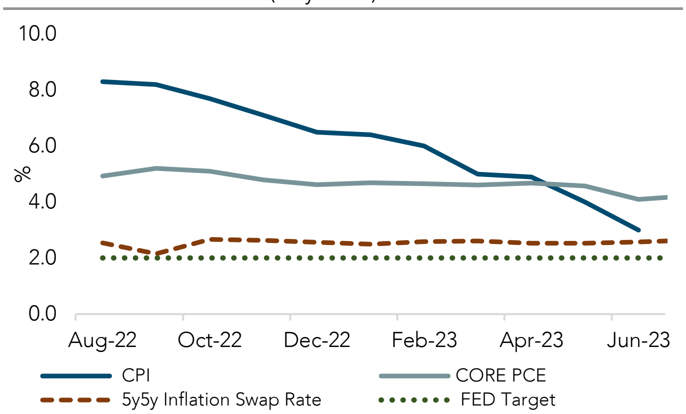
The last Atlanta Fed forecast points to 2Q GDP growth of 2.4% (26/07) slightly ahead of the forecast at the end of June (2.2%)



Source: Atlanta FED

Exhibit 4 – US Inflation rate

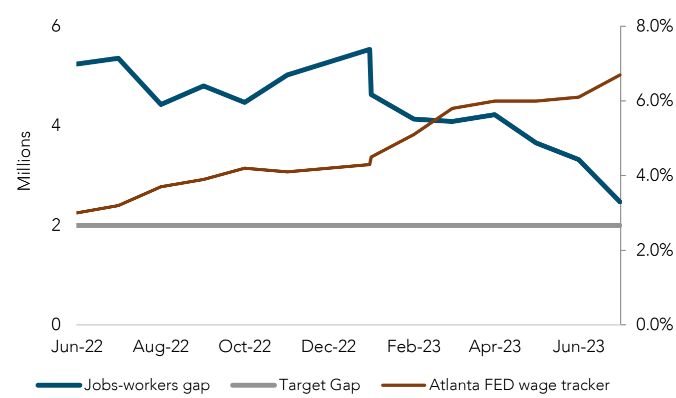
Headline CPI rose 3.0% in June (May:4.0%) whilst Core PCE moderated to 4.1% in June (May: 4.6%)



Source: Bloomberg

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

The job-workers gap remained below the 4 million mark in July, rising slightly compared to June



Source: FRED, Atlanta FED

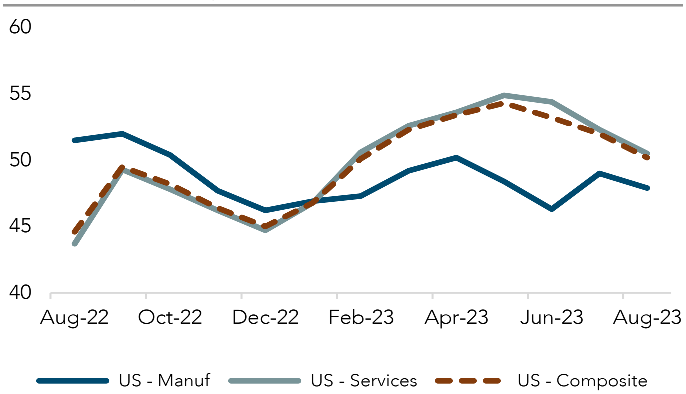
Europe

Growth: The eurozone manufacturing sector remained under intense pressure during August, as new orders plummeted and backlogs of work deteriorated rapidly, whilst factory employment levels continued to fall. The manufacturing PMI came in below 50 for the fourteenth month in a row in August but there are early signs of stabilization, but at very low levels (Exhibit 6). On the other hand, the services sector ended a seven-month run in growth with the steepest contraction since February 2021. The composite PMI has dropped to a three-year low, marking the third consecutive month of a reading below 50. Moreover, Euro-area customers remained pessimistic, with the EC survey on consumer confidence deteriorated further. The 2Q23 economic growth for the Euro-area showed stronger growth than expected by consensus, as the composite PMI averaged 52.3 in Q2. However, with the composite PMI in contraction territory for most of the third quarter, we expect growth to stagnate in 3Q23 (average 47.7).

Inflation: Inflation remains relatively elevated in Europe, though progress must be noted. HICP inflation for August has halved from its 10.6% peak last October, yet the current 5.3% (unchanged from July) reading is still well above the 2% target (Exhibit 9). Also, core inflation moderated to 5.3% in August (down from 5.5% in July) and has averaged 5.5% so far in 2023. The ECB's June forecast had inflation at 4.7% in Q3. Although the slowdown should lead to an easing in inflation, it is unlikely that the 2% average is hit any time soon.

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

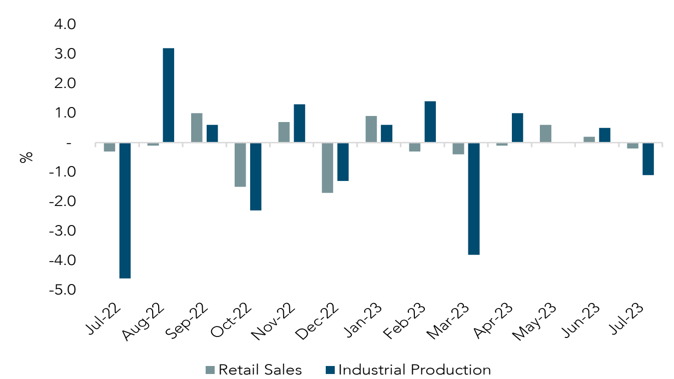
The Composite PMI declined to 48.6 in July as the deterioration in the manufacturing sector persisted



Source: Bloomberg

Exhibit 7 – EU retail sales and industrial production

Euro-area retail sales fell 0.2% in July as real incomes remain under pressure from high inflation whilst IP fell 1.1% in July



Source: Bloomberg

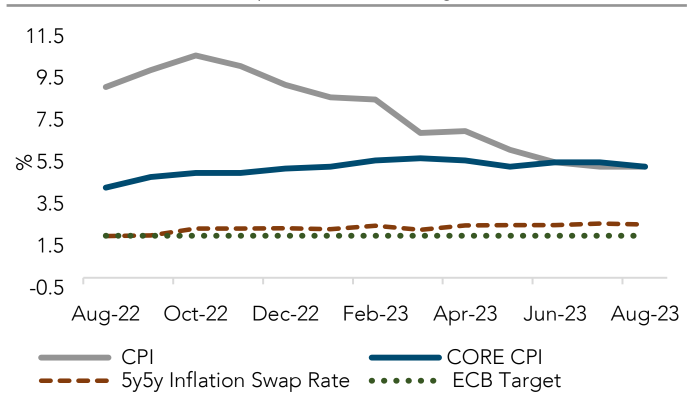
Exhibit 8 – EU consumer confidence indicator

Consumer confidence declined during August for the first time in four months

Source: Bloomberg

Exhibit 9 – EU Inflation Rate

Core inflation declined to 5.3% in August, equalling headline HICP but remains elevated compared to the 2% target



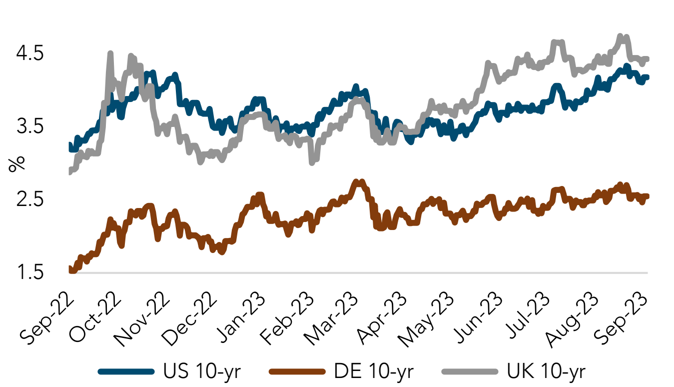
Source: Bloomberg

Rates

The rates market is generally quiet during August, given a lull in volumes and the absence of any major central bank making any changes to its policy rates, except for the Norges Bank announcing a 25bp rate hike during the month taking its policy rate to 4%. Notwithstanding, the Fitch downgrade of US sovereign debt at the start of August was a key event during the month, leading to a 16bp upward move in the US 10-year yield to 4.1%, the biggest move amongst the sovereign markets we follow. The yield on the Canadian 10-year bond, the Japanese 10-year bond and UK 10-year bond rose slightly to 3.6% (+6bp), 0.6% (+5bp) and 4.4% (+5bp) respectively. At the other end of the spectrum, the yield on the 10-year Swiss bond fell 8bp to 1.0% whilst the yield on the 10-year Australian 10-year paper declined to 4.0% (-3bp).

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

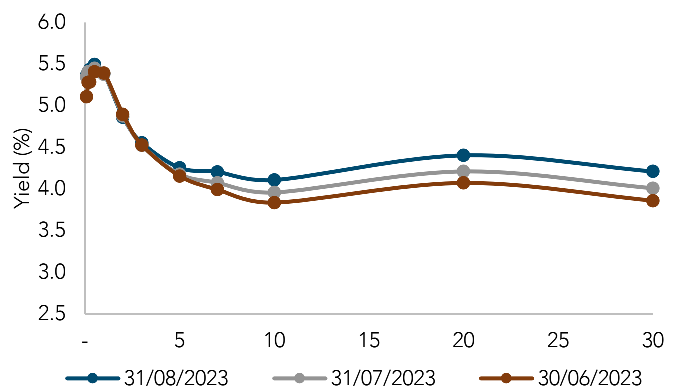
Sovereign bond yields widened 16bp in the US following the Fitch downgrade



Source: Bloomberg

Exhibit 11 – US Yield Curve

The U.S. sovereign yield curve flattened in August, as the 2s10s spread narrowed by circa 17bp during the month.



Source: Bloomberg

United States

August started with Fitch's downgrade of US sovereign debt from AAA to AA+, which coincided with a larger than expected debt issuance announcement by the US Treasury. In theory, due to the strength of the US sovereign, the credit downgrade should not lead to any forced selling or any other similar implications. However, we note that a G-10 downgrade generally weighs on risk sentiment. This led to a notable move in US sovereign paper, with the yield peaking at 4.34% on 21/08, levels not seen since 2007 (07/11/07). This represents a significant move from the low in July (19/07) of c.60bp. Apart from the credit downgrade and Treasury issuance, the big move in the US 10-year yield was also a result of the surprise Bank of Japan tweak of its yield curve control policy.

Another factor behind the rise in yields last month is the continued resilience shown by the US economy and therefore, the implications this could have on inflation. As we pointed out in the macro section, the base case would be for the US economy to slow down over the coming quarters as consumer spending moderates. Another important factor to consider is that the imbalances in the US labour market are starting to ease. All of these factors combined suggest that we are close to peak hawkishness in the US. Yet, the strength over the summer months could have implications in the short-term. With three meetings left until the end of the year, the market currently expects rates to end the year at 5.5% (c.+10bp from the mid-point of the current policy range), with the FED expected to leave rates unchanged in September. This would give the FED 2 additional full months of data till the November meeting, possibly being in a better position to assess whether the conditions have changed for the US economy.

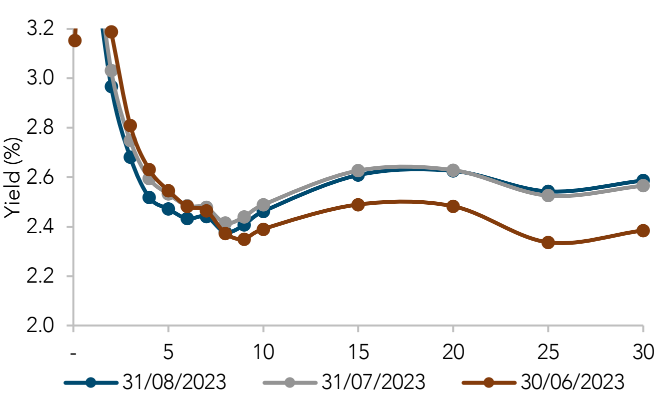
Europe

The narrative around the Euro-area economy has changed starkly since the start of the year. The faster-than-expected re-opening in China was a positive catalyst for the Bloc given their trade relationship, but the China strength quickly faded. The Q2 GDP release for the Euro-area surprised to the upside, even though survey data had deteriorated significantly from an already weak Q1. Yet, based on individual country prints it is likely that Q2 GDP will be revised downwards. Moreover, data in Q3 has not improved which suggests growth has stagnated further. Against this backdrop, inflation remains relatively high, with core HICP at 5.3%, but is moving in the right direction. The August core inflation is the lowest since last January and represents a significant deceleration from the peak reached last March (5.7%).

Against this weaker macro backdrop, the ECB hiked key policy rates by 25bp on 14/09, taking the deposit rate to 4%. The Governing Council reiterated its data dependence, noting that "interest rates will be set at sufficiently restrictive levels for as long as necessary". Moreover, we note that ECB included a new sentence in their press release, where they communicated that "the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target." This suggests that the Governing Council views a 4% deposit rate as appropriate against the current economic backdrop.

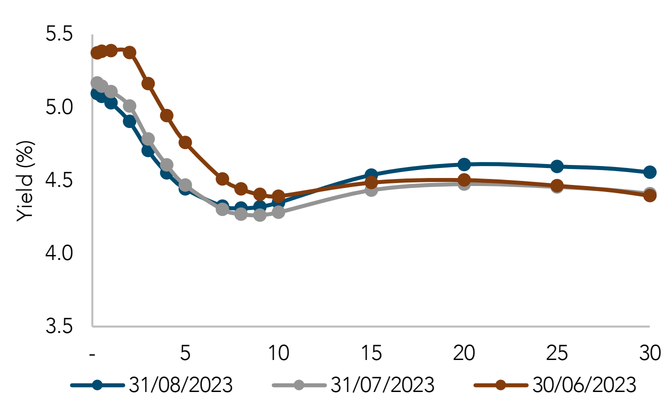
Though growth has been admittedly weak, the UK economy has proved to be more resilient than expected in 1H23. Following a small expansion in 1Q23 (+0.1%), the UK economy unexpectedly expanded again in 2Q23 (+0.2%), largely driven by higher government expenditure but also strong consumer spending. More recent data suggests that the UK's economic conditions have deteriorated. The composite PMIs fell into contractionary territory in August (48.6), for the first time since last January, as the manufacturing sector moved further into contractionary territory (43.0), with the print being below 50 for the past 13 months. The services sector has also moved into contractionary territory (49.5), the first time since last January. The market expects the policy rate to close the year at 5.5%, which implies that more rate hikes are on the way (+25bp from the current policy rate). This seems to be a fair assessment given the weakening in the economic outlook, coupled with a moderation in inflation. Headline inflation has slowed to 6.8% in July, still elevated compared to target but well below the levels seen at the start of the year (10.1%), though core inflation remains unchanged (6.9%) over the past two months.

Exhibit 12 – German 10-year yield curve
The Bund yield was largely unchanged in August, closing the month at 2.5%



Source: Bloomberg

Exhibit 13 – UK 10-year yield curve
The Gilt yield was also largely unchanged, rising just 3bp in August to close the month at 4.4%



Source: Bloomberg

Credit

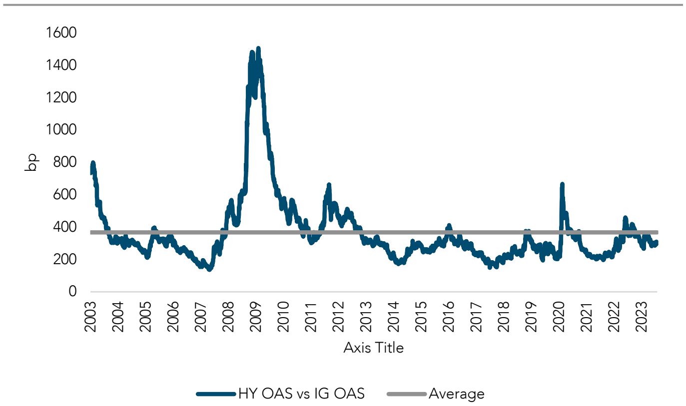
The performance of the credit market was largely mixed across the different geographies and risk buckets we follow. High yield debt performed better across the different geographies, whilst USD IG and GBP IG both returned negative returns in August. Spreads widened across the board, as concerns around the global economic outlook weighed on sentiment. USD IG performed the worst, with a total return of -0.8%, which we believe can be attributed to the Fitch rating downgrade of US government debt. Within the USD credit universe, only B and CCC delivered positive returns during the month. On the flipside, all rating buckets within the EUR credit universe delivered positive returns during the month, except for the BB space, where total return came in at -0.1%.

At an index level, IG spreads have only widened by c.8bp in Europe and c.5bp in the US. The moves were not large, though we continue to see investors focusing on the fading global growth, with the stronger than expected US economy set-off by weakness in Europe and China. Yet, we believe that the outlook for IG is supported by two factors: (1) we are approaching peak hawkishness by central banks; and (2) The gap between bond yields and equity dividend yields has closed. Spreads have come down significantly since the peak seen in March after the collapse of several US regional banks, which implies that there is less of a cushion in the event of any negative catalyst. Overall, we continue to prefer IG over HY given that the latter is more susceptible to idiosyncratic risk. Despite this, the current spread differential between HY and IG is currently below the average (Exhibit 14), with IG OAS currently 20bp above the 20-year average, whilst HY OAS currently 42bp below the 20-year average. The spread differential generally increases as uncertainty rises, as can be clearly seen in extreme events like the GFC.

Within HY, spreads widened slightly by c.16bp in Europe and c.5bp in the US. The current yield on offer (YTW) of 8.3% looks attractive at first glance and is well ahead of the average since 2010 of 5.8%. Yet, on closer inspection, the current HY spread is of 459bp and is at the 61st percentile, implying much less protection for investors should the macro-economic backdrop deteriorate further. There has been a clear dislocation between yields and spreads over the past months. We believe that the risk of default has increased since the start of the year, given the rise in financing costs following the aggressive tightening cycle which is now coming to an end. There is generally some lag between policy action and impact on corporations, as facilities may be rolled over at a later date.

Exhibit 14 – Euro-Area HY OAS vs IG OAS

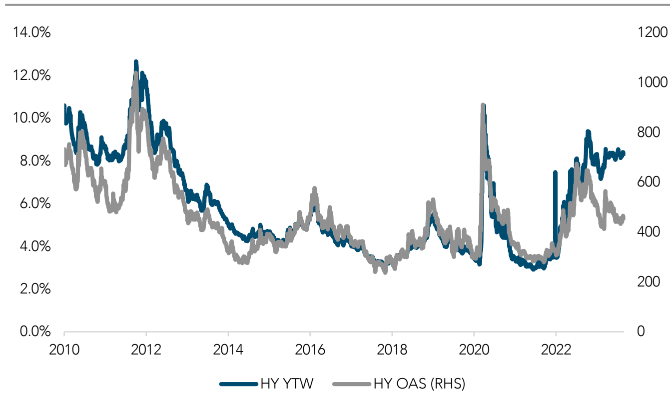
Despite the increasing risk of rising defaults, the spread differential between HY and IG is below the average



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

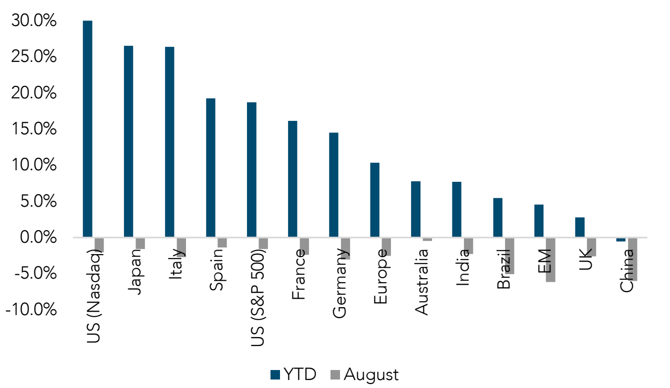


Source: Bloomberg

Equity

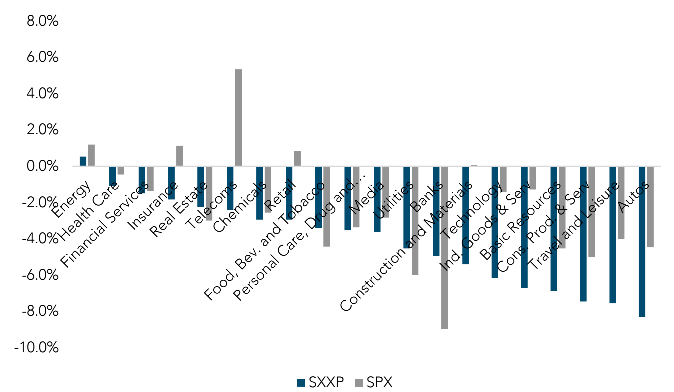
Global equities fell in August, the first month of negative performance since last May, as investors worried over the extent of the weakness within the Chinese real estate sector. The economic data published by China for July were also, in general, softer than market expectations, though there are early signs of stabilisation in August. Moreover, the US 10-year real yield peaked at 2.0% on 20/08 (a 40bp increase from 31/07), before moderating to 1.9% by the end of August. Historically, returns from equities and the movement in real yields have been negatively correlated. This relationship has been discussed extensively in our previous publications.

Exhibit 16 – YTD and August performance by region
All regions we follow generated negative total return during August in local currency terms



Source: Bloomberg

Exhibit 17 - STOXX 600 and S&P 500 returns by sector (US$)
The rally in oil prices supported the energy sector in Europe and the US



Source: Bloomberg

Almost all the geographies we follow generated negative returns during August, with Australian equities (-0.5%) outperforming the rest in local currency terms (Exhibit 16). This outperformance was primarily driven by resilient consumer spending that resulted in discretionary retailers reporting numbers that were better than beaten down analyst estimates. The S&P 500 (US) and Nikkei (Japan) performed the best with a total return of -1.6% for the month, both outperforming European equities, with the latter's total return for the month coming in at -2.5%.

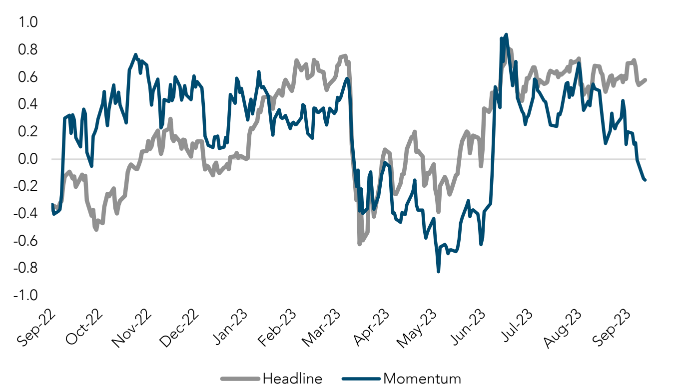
Drilling down into the individual country performance within the European Union provides some additional information on what investors are anxious about. Germany (-3.0%) and Italy (-2.7%),the Bloc's largest exporters, were the worst performers. We believe that this was primarily driven by concerns around the prospects of the Chinese economy, an important trading partner for the EU. China exposed sectors like Basic Resources and Luxury goods lagged in August (Exhibit 17). Spanish equities (-1.4%), a more service-oriented economy, outperformed whilst French equities (with a large exposure to energy) outperformed the Bloc's exporters (-2.4%).

Emerging market equities lost 6.2% in August as risk sentiment deteriorated. The concerns over China obviously weighed on the country's equity market, but these were compounded by concerns around the resilience shown by the US economy which could keep interest rates in the US elevated for longer. As most of emerging market countries have debt denominated in US$, strength in the US$ is generally weighing on the region's equity market performance. Colombia (soft economic data) and South Africa (weaker currency and softer commodity prices) were the worst performers in August.

The performance of equity markets over most of the summer months has been dictated by the macro narrative. In July, investors risk tolerance increased as the positive surprises in US economic data coupled with moderating inflation and better than expected earnings reinforced the soft-landing scenario. Yet, concerns over the health of the Chinese economy has seemingly weighed on sentiment, as evidenced by the Goldman Sachs Risk Appetite Indicator (Exhibit 18). Investor appetite for equities could be negatively impacted by, what seems to be, an end of one of the most aggressive tightening cycles in recent times. Rates are expected to remain higher for longer, and this might lure investors to fixed income as opposed to equities.

Exhibit 18 – Goldman Sachs Risk Appetite Indicator

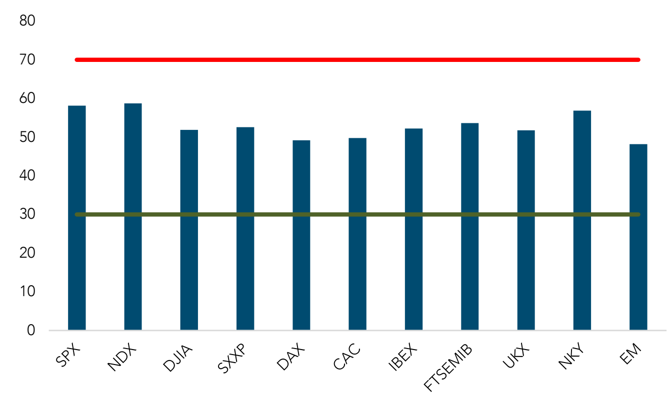
Risk appetite momentum (3-month z-score) has deteriorated in August and turned negative by month end



Source: Bloomberg

Exhibit 19 - Relative Strength Index ("RSI")

The weakness in equity markets seen during August has led to RSIs falling further away from overbought (70) levels



Source: Bloomberg

On balance, despite the underperformance on a YTD basis, our preference for European equities over the US remains. Despite the slowdown in economic activity in the Euro-area, we note that a large proportion of the index's top line is generated outside of the Bloc. Moreover, we do not expect a hard landing. Over the current year the discount to the US has continued to widen despite more resilient earnings revisions. The current discount is larger than in the sovereign crisis, the global financial crisis or any other previous European recession. On a valuation basis, Europe is cheaper than the US, but this seems to be a function of the lower earnings growth. On a PEG ratio basis, it trades similarly to the US. Investors seem to be sceptical about the ability of European companies to grow in the medium term. We believe that this ignores the change in composition in Europe, with the Top 10 holdings of the SXXP index now exposed to industries that can offer growth. Also, the banking sector is currently benefiting from higher rates and the higher oil prices should support the energy sector.

Exhibit 20 – 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)	19.0x	24.5x	12.4x	12.2x	10.8x	12.6x	10.8x	10.8x
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	15.2x	10.0x	9.0x	8.4x	9.1x	8.4x	8.3x
Lowest (date)	23/03/2020	15/04/2014	18/03/2020	18/03/2020	18/03/2020	18/03/2020	03/10/2022	23/03/2020
Median	16.2x	19.5x	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	14.2x	16.4x	11.8x	11.4x	10.9x	11.1x	9.9x	10.5x
Historical rank (since 2006)								
Percentile	90.9%	89.4%	46.4%	58.2%	33.0%	53.5%	34.7%	27.8%
Current FPE, % above/ (below) 10-YR median	16.8%	25.5%	-9.3%	-4.7%	-11.8%	-5.6%	-15.5%	-21.8%
Current FPE, % above/ (below) Dec 22	12.6%	16.1%	4.8%	8.3%	2.8%	11.3%	8.1%	-3.2%

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. The recent inflation prints in the US seems to support our view, as core CPI moderated further and the imbalances in the labour market have eased. 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. 8bp in Europe and c.5bp 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. 4.6% 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 8.3% yield-to-worst for European HY market. Indeed, YTW has been lower 82% of the time since 2010. Also, yields have only been this high back in 2014 when the Bloc was at risk of breaking up. However, the current spread of 459bp, at the 61st percentile, offers 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 reading could start to weigh on earnings revisions in 2H23, especially as inflation moderates further (translates into less top-line growth). The direction during July and August has been dictated by the macro-outlook. We believe that the recent pullback could provide an interesting entry point for investors, assuming the risk for a hard landing does increase from here and the peak rates narrative is reinstated.
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. We believe that Chinese 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 to be announced over the coming weeks by the PBOC as well as the country's relationship with the US.

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