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BILBoard February 2023: Looking East

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At our first Asset Allocation committee of the year, we maintained a conservative approach, emphasising high-quality corporate bonds and an underweight stance on risk assets while we await better visibility on the path of monetary policy in the West. Looking East, China's reopening will have significant economic implications both at home and abroad. Noting Beijing's ardent support for businesses and consumers' well of excess savings, we have increased exposure to Chinese and Emerging equities.

MACRO

China could be a key source of both surprise and volatility in 2023. In the short-term, the end of the zero-Covid policy injects short-term uncertainty. Evidence from other Asian economies implies that growth will probably remain weak in the quarter following reopening, with cases mounting and caution high. We might expect a negative impact on global supply with factories struggling to keep operations going as sick workers stay home. Taking a longer-term perspective, the roll-back of health measures ultimately paves the way for an economic revival. Similar to what was evidenced in the US after pandemic lockdowns, Chinese consumers have amassed a significant amount of excess savings (estimated at around USD 830 billion), suggesting a big reservoir of pent-up demand. Meanwhile, the government has made a rare pledge to "significantly boost market confidence" and has revived the "two unwaverings" slogan — a pledge to "unwaveringly" support both public and private companies. With inflation at 1.8%, below the 2% target, Beijing still has room to stimulate the economy further. GDP growth is expected to rise from 3% in 2022, to 5% in 2023.

For Western economies, China's reopening could be a hindrance or a help: depending on the timing, it could either inject demand into a still-inflationary global economy or provide a welcome boost to growth at a time when other regions are losing steam.

This leads on to the topic of another key source of uncertainty: core inflation. While improving supply chains and lower energy costs have allowed headline inflation prints to come down from their peaks, core readings are proving to be more sticky. The key concern is that services-related price pressures will be hard to weed out, requiring a period of lower growth and higher unemployment.

While tighter monetary policy is now weighing on corporate and consumer demand on both sides of the Atlantic, labour markets have remained incredibly resilient. The US unemployment rate has fallen back to match a 50-year low of 3.5%, while the Eurozone equivalent is at an all-time low of 6.5%. The risk is that in economies that are cooling but not crashing, workers feel emboldened to ask for higher salaries without fear of losing their jobs (look at the ongoing push by German trade union Verdi). This could result in the inflationary spiral that central banks are so desperate to avoid. As such, wage growth data will be a key determinant as to whether central banks need to keep tightening or if they can afford to pause to let their previous actions diffuse into the real economy. If labour markets loosen up without a mass spike in unemployment, a deep downturn could be avoided. That is why markets rallied in January after "Goldilocks" US payroll data that showed job growth slowing but not plummeting.

ASSET ALLOCATION CHANGES

From our perspective, futures markets have baked in too much optimism regarding rate cuts from the Fed and the ECB this year, especially here in Europe, leaving ample room for disappointment. Until we have a clearer picture about the trajectory of monetary policy, volatility will be inherent in markets and we choose to keep a conservative allocation while staying alert to arising opportunities.

A key opportunity this year looks to be the China reopening trade. We have begun to build an exposure to Chinese equities, taking our overall stance to overweight, while simultaneously adding to others Emerging equities, believing the reopening will have a halo effect across the region.

In tune with this trade, we also upgraded our view on Materials from neutral to positive. The sector has become relatively cheap and is poised to be a key beneficiary from China's reopening, which will boost demand for all manner of commodities, particularly for mining products like copper. We are also keeping an overweight on energy, with China's renaissance meaning it will be guzzling more oil. With this in mind, China's reopening will be gradual, and the fundamental impact on demand for commodities is most likely to be felt in the second half of the year.

These plays are balanced out by overweight positions in more defensive sectors like US Utilities and European Healthcare. We are neutral on IT, but within that sector, we like the Semiconductors subsector as companies therein have been quick to re-adjust activity to the slowing economic environment, avoiding gluts.

We are neutral on US equities, and underweight on Europe. Despite the darkening macro picture, equity investors have not yet capitulated, and it appears that we are in the midst of what is a bear market rally – its sustainability is questionable.

In the fixed income space, we give preference to high-quality investment grade bonds. To this effect, we added Danish mortgage bonds, focusing on those priced close to par (4% and 5% series), which offer attractive return perspectives. The Danish Mortgage Bond Market is one of the oldest and most stable in the world, tracing its roots back to 1797 with no records of defaults (AAA rating).

We also switched some of our high-yield bond exposure into contingent convertible bonds (CoCos). High-yield began 2023 on a positive trend however, as, with equities, the market might not be fully pricing in the trickier economic terrain and the risk of recession. Rating trends are drifting lower and downgrades now largely outnumber upgrades. To be prudent, we shifted some exposure into CoCo issues which offer attractive coupons (broadly, the universes offers 7.7% for a contained duration). As TLTRO support is withdrawn, banks have been active in issuing new debt, including CoCos. We note that banks are generally still well capitalised with strong balance sheets. Where we do continue to hold regular high-yield instruments, we give preference to the BB segment.

We are keeping a neutral allocation to gold, which has been supported by falling bond yields and a weakening dollar as of late. Over the longer-term it could come under pressure if the US labour market remains tight and if core CPI surprises on the upside, resulting in renewed dollar strength.

CONCLUSION

China just ushered in the New Year of the Rabbit. In discussing this with our Chinese colleagues, they told us that this could be considered unfortunate for those who were born in previous Rabbit years, bringing them “Fan Tai Sui” – i.e. setbacks, highs and lows, and fluctuating luck. Fan Tai Sui seems like a perfect catch-all phrase to describe what we might expect from markets too, at least in the first quarter, with China’s reopening likely to be bumpy in its early stages, and with Western central banks wrangling with market expectations for a policy pivot.

Those born in the year of the rabbit are often described as being quick, nimble and vigilant. With volatility expected to be high until we have signs of softening wage growth in the US and Europe, easing core inflation and a clearer central bank guidance, these traits will be essential for investors too. But we cannot only be alert to risks, we also have to be attentive to brewing opportunities, one of the most obvious being China’s comeback.

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