

March 1, 2023

BILBoard March 2023: Strong data and sticky inflation



While the economy is slowing, it is proving more resilient than initially expected. At the same time, inflation remains uncomfortably high, supporting the case for sustained central bank tightening. This has caused a risk-off mood in markets with some participants beginning to consider a stagilation scenario once more.

Until now, market participants were eager to believe that central banks were close to having successfully batted inflation off the field and that a dovish pivot was fast approaching. Incoming data implies otherwise. The personal consumption expenditures (PCE) index – the Fed's preferred inflation gauge – recently recorded its biggest monthly gain in almost two years. In the euro zone, core inflation reached a fresh all-time high in January and flash readings from Spain and France indicate that prices continued to accelerate in February. In a nutshell, the details show that there is a limit to goods disinflation and that service sector price pressures are going to be more difficult to weed out.

With the labour market refusing to break on both sides of the Atlantic for now (even if faint cracks are visible to the attentive eye), there is a real risk that upward pressure on wages persists (in turn fuelling demand and consumption).

Central banks need to apply just the right amount of pressure to prevent a wage-price spiral,

while at the same time trying to avoid overtightening and a so-called "hard landing". There is ample room for error, especially when considering that previous actions are still percolating through the real economy.

As Claudio Borio, head of economic research at the Bank of International Settlements (often considered the bank of central banks) recently suggested, it could be a stop-and-go process: "There is nothing wrong with central banks slowing the pace of tightening and then adjusting it, possibly having to accelerate it again... The most important thing at this stage is not to declare victory too early."

Markets had initially priced in a smooth, gentle landing, with central banks simply reaching their terminal rate before embarking on rate cuts towards year-end, allowing the economy to take off once more. Some thought that we might avoid any landing at all. It is becoming increasingly clear that the path back to a level of inflation that the Fed/ECB can live with will be neither quick, painless nor straightforward.

China stands out as a key outlier in the global tightening cycle, where uncertainty around the path of monetary policy is less of a concern for investors. Inflation there is contained and the economy is revving up following the end of zero-Covid policies. Beijing has pledged "unwavering" support for both public and private companies and appears keen to stoke domestic demand with more than CNY 5 billion (USD 720m) earmarked for issuing consumption vouchers and shopping subsidies.

INVESTMENT STRATEGY

Sticky inflation and the policy implications leave investors in a "sticky wicket" – a common metaphor in the English language, used to describe a difficult circumstance. Sports fans will know that the saying has its origins in cricket and describes a pitch that is rapidly being dried by the sun after rain and is difficult to bat on, as it can cause unpredictable ball movements. The metaphor is particularly fitting as it captures the fact that central bank liquidity is now evaporating, leaving financial markets subject to volatility and unpredictable moves. Given this terrain, we remain underweight on equities and fixed income for the time being.

On the equity side, it is hard to envisage global markets pushing much further ahead until there are clearer signs that the Fed and other central banks can ease off on their tightening campaigns. To this end, we further reduced our underweight to US equities and we now have the same allocation to US and European equities. In defensive profiles, where we have no equity exposure, we instead tempered risk by reducing our overweight to investment grade bonds (locking in gains after a period of spread tightening). The proceeds of both trades were kept in cash equivalents – dry powder for when the investment conditions look more inviting. Where we do have equity exposure, regionally we give preference to China and, style-wise, we advocate a barbell approach between growth and value.

In the bond space, the record-breaking global rally has been stymied by fresh inflation fears and the prospects of "higher-for-longer" monetary policies. Market expectations are becoming more aligned with central bank guidance and, with long-term rates now around our year-end target levels, we discussed whether we should add more duration. Given the current bearish market sentiment, and the fact we topped up on duration at an interim committee on 10 February, we decided to wait, but we are actively monitoring for an entry point to take advantage of higher yields.

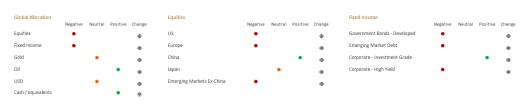
We remain overweight on investment grade bonds. After the strong run, spread compression seems to be taking a breather, however, we note that European spreads remain historically wide versus the US. We particularly like Danish mortgage bonds, which offer attractive return perspectives (particularly now on the 5 and 6% series).

Bond fund flows have reversed in recent weeks – particularly at the riskier end of the credit spectrum. We are comfortable with our underweight position on high yield (HY) for now as we don't believe that valuations fully encapsulate recession risk. Where we do hold this asset class, we give preference to the BB segment as well as CoCo issues (these offer attractive coupons and banks are still well-capitalised and have delivered nice earnings). Note that European HY is slightly better valued, given the longer duration and lower quality of US HY.

Gold closed January up by over 5% before correcting in February as the dollar found renewed strength on prospects of a more hawkish Fed. Longer term, gold remains attractive as a portfolio diversifier and store of value, but we remain neutral noting that continued tightness in the US labour market, as well as stickier core CPI data, could continue to support the dollar, putting pressure on the gold price.

CONCLUSION

Until recently, things were priced for perfection. Investors were betting that central banks could quickly and efficiently reign in price pressures. It is evermore clear that this won't be an easy feat. While monetary authorities have repeatedly warned that rates would be high for some time, the market didn't want to listen. Now, the data is forcing it to realise that central banks are still some way from the metaphorical ninth inning in their fight to tame inflation.



Based on a Medium risk portfolio. The dots indicate whether we are negative, neutral or positive on the asset class.

The arrows indicate the change in our exposure since the previous month's asset allocation committee: increase, decrease or no change

Disclaimer

All financial data and/or economic information released by this Publication (the "Publication"); (the "Data" or the "Financial data and/or economic information"), are provided for information purposes only, without warranty of any kind, including without limitation the warranties of merchantability, fitness for a particular purpose or warranties and non-infringement of any patent, intellectual property or proprietary rights of any party, and are not intended for trading purposes. Banque Internationale à Luxembourg SA (the "Bank") does not guarantee expressly or impliedly, the sequence, accuracy, adequacy, legality, completeness, reliability, usefulness or timeless of any Data. All Financial data and/or economic information provided may be delayed or may contain errors or be incomplete. This disclaimer applies to both isolated and aggregate uses of the Data. All Data is provided on an "as is" basis. None of the Financial data and/or economic information contained on this Publication constitutes a solicitation, offer, opinion, or recommendation, a guarantee of results, nor a solicitation by the Bank of an offer to buy or sell any security, products and services mentioned into it or to make investments. Moreover, none of the Financial data and/or economic information contained on this Publication provides legal, tax accounting, financial or investment advice or services regarding the profitability or suitability of any security or investment. This Publication has not been prepared with the aim to take an investor's particular investment objectives, financial position or needs into account. It is up to the investor himself to consider whether the Data contained herein this Publication is appropriate to his needs, financial position and objectives or to seek professional independent advice before making an investment decision based upon the Data. No investment decision whatsoever may result from solely reading this document. In order to read and understand the Financial data and/or economic information included in this document, you will need to have knowledge and experience of financial markets. If this is not the case, please contact your relationship manager. This Publication is prepared by the Bank and is based on data available to the public and upon information from sources believed to be reliable and accurate, taken from stock exchanges and third parties. The Bank, including its parent,- subsidiary or affiliate entities, agents, directors, officers, employees, representatives or suppliers, shall not, directly or indirectly, be liable, in any way, for any: inaccuracies or errors in or omissions from the Financial data and/or economic information, including but not limited to financial data regardless of the cause of such or for any investment decision made, action taken, or action not taken of whatever nature in reliance upon any Data provided herein, nor for any loss or damage, direct or indirect, special or consequential, arising from any use of this Publication or of its content. This Publication is only valid at the moment of its editing, unless otherwise specified. All Financial data and/or economic information contained herein can also quickly become out-of- date. All Data is subject to change without notice and may not be incorporated in any new version of this Publication. The Bank has no obligation to update this Publication upon the availability of new data, the occurrence of new events and/or other evolutions. Before making an investment decision, the investor must read carefully the terms and conditions of the documentation relating to the specific products or services. Past performance is no guarantee of future performance. Products or services described in this Publication may not be available in all countries and may be subject to restrictions in some persons or in some countries. No part of this Publication may be reproduced, distributed, modified, linked to or used for any public or commercial purpose without the prior written consent of the Bank. In any case, all Financial data and/or economic information provided on this Publication are not intended for use by, or distribution to, any person or entity in any jurisdiction or country where such use or distribution would be contrary to law and/or regulation. If you have obtained this Publication from a source other than the Bank website, be aware that electronic documentation can be altered subsequent to original distribution.

As economic conditions are subject to change, the information and opinions presented in this outlook are current only as of the date indicated in the matrix or the publication date. This publication is based on data available to the public and upon information that is considered as reliable. Even if particular attention has been paid to its content, no guarantee, warranty or representation is given to the accuracy or completeness thereof.

Banque Internationale à Luxembourg cannot be held liable or responsible with respect to the information expressed herein. This document has been prepared only for information purposes and does not constitute an offer or invitation to make investments. It is up to investors themselves to consider whether the information contained herein is appropriate to their needs and objectives or to seek advice before making an investment decision based upon this information. Banque Internationale à Luxembourg accepts no liability whatsoever for any investment decisions of whatever nature by the user of this publication, which are in any way based on this publication, nor for any loss or damage arising from any use of this publication or its content. This publication, prepared by Banque Internationale à Luxembourg (BIL), may not be copied or duplicated in any form whatsoever or redistributed without the prior written consent of BIL 69, route d'Esch I L-2953 Luxembourg I RCS Luxembourg B-6307 I Tel. +352

