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Leaves are falling, growth projections are falling and equity prices have been falling too. However, the latter might have further to fall. Markets have not yet found a bottom, and in order to do so, investors will need to have more confidence as to where interest rates are headed. As such, central banks and inflation are still the central themes driving markets, and volatility will likely continue in the near-term until we have more convincing evidence that price pressures are waning.

MACRO

Growth is slowing as central banks continue their battle against stickier-than-expected inflation. The IMF now projects global GDP to grow 3.2% this year and 2.7% in 2023, the latter marking a 0.2% downgrade from the July forecast, with more than a third of the global economy expected to contract this year or next.

In our view, the Eurozone is already knocking on recession's door amid an unprecedented energy crisis that is weighing on confidence, consumption and output. The impact on Germany has been particularly acute, insofar as the head of the chemical industry lobby VCI, Markus Steilemann, warned that the country risks becoming an "industrial museum". While a EUR 200 billion government support package including a gas price brake for both companies and private households is in the pipeline, it will be no quick fix with the industrial price cap only coming into effect in January. For Europe as a whole, energy prices are weighing heavily on the trade deficit, companies' cost competitiveness and on household purchasing power. This could lead to subdued growth in the coming years and not just the forthcoming winter.

The US is where we see the most macroeconomic strength on a relative basis. The labour market has remained amazingly resilient with the September unemployment rate falling back to 3.5%, matching a 50-year low. Nonetheless, the labour market will likely cool throughout next year as the Fed proceeds with tightening; already we see some inklings of this, for example, nonfarm payroll growth is slowing while the number of people entering the labour market has taken a lurch as high inflation and higher rates punch holes in the Great Resignation. For the time being, favourable employment dynamics, pandemic savings and a fall in gasoline prices have kept US consumption well supported. We expect that this too will eventually weaken.

However, some hairline cracks in US data might not be perceived as a bad thing by markets, as it would be taken as a cue that the Fed's efforts to prevent economic overheating are bearing fruit. For the time being, an atmosphere of "good news is bad news" has taken hold as it dashes hopes for a dovish pivot from the US central bank.

With regards to inflation, prints from the US show signs of cooling, but not as quickly as the market would hope. The October data came in at 8.2% year-on-year (versus 8.1% expected), but the details showed that inflationary pressures are becoming more entrenched, with the core figure – which excludes volatile food and energy prices – hitting 6.6%, its highest level since 1982. Eurozone inflation continues to record new all-time highs (most recently arriving at 10%) with energy costs as a wildcard. The fact that inflation has broadened out means it will take central banks longer to bring it back down to target; the Fed and ECB both expect it will be 2025 before this occurs in their respective jurisdictions.

Looking east, China's economic rebound has been muted despite calibrated stimulus efforts. Zero Covid policies remain firmly in place and reports suggest that 313 million are now under

full or partial lockdown. We do not foresee any major U-turn with regard to Covid-19 policy until the National People's Congress in March 2023 and as such, expect the macro outlook to remain challenging.

INVESTMENT STRATEGY

Equities

Despite large moves, equity correlations are still quite low, implying that there has been no capitulation as of yet, and it appears that stocks have not yet found a bottom. If they are to find one, one prerequisite would probably be more confidence around the trajectory of interest rates. For now, expectations about rates are changing like the weather, influenced by everything from incoming macro data to comments from central bankers and the political sphere (i.e. the UK 'mini-budget' crisis). This creates a volatile landscape for equity investors, and at the same time, TINA (there is no alternative [to stocks]) has left the building now that bonds are offering more enticing yields (enter TARA: there are real alternatives). Adding to that unpalatable cocktail for equities, we also expect that earnings expectations will start to recede.

In light of this, we went further underweight on equities by reducing our exposure to Chinese stocks. China has struggled to maintain its pace of growth, even as it stimulates its economy through various policy measures. We do not see meaningful catalysts for a market rebound in the near term that would justify maintaining an overweight in the current volatile environment.

In our equity portfolio, this leaves us neutral on China and Japan, underweight Emerging Markets and Europe, and overweight the US.

In terms of sectors, we moved US Utilities to overweight. Valuations have become more attractive and this defensive sector is poised to be a key beneficiary of the Inflation Reduction Act, which makes the single largest investment in climate and energy in US history, worth some USD 369 billion. We remain overweight IT, avoiding profitless tech and focusing on companies with stable and resilient earnings, stronger balance sheets and higher margins. The sector should remain supported given the fact that IT budgets among larger corporates for the next 12 months remain strong. At the same time, the aggregated tech sector has the strongest balance sheet, having accumulated a large cash pile. This opens up opportunities for acquisitions (buying earnings) and share buybacks (elevating EPS). Lastly, total debt to EBIT and net interest expenses to EBIT ratios are the lowest among all sectors. Our final preferred sector is European Healthcare, being a defensive pick that is receiving tailwinds from the stronger dollar (versus the euro and sterling), given that 35% of sales occur in the US market.

We reduced exposure to US Healthcare as it could face headwinds from the Inflation Reduction Act, which targets prescription drug pricing reform to the tune of USD 265 billion.

Fixed Income

Within our Fixed Income allocation, we give preference to high-quality investment grade corporates, focusing on low duration. We believe that the IG segment has by now priced in more recession risk than other areas of the fixed income market, while quality names within offer a good mix of solid fundamentals coupled with attractive yields.

Sovereign bonds continue to be caught in the crossfire as central prioritise price stability and remove their outsized support from fixed income markets. The conclusion in financial markets is that the ECB will be on autopilot with regard to hiking for another couple of meetings, or however long it takes to bring rates to neutral. With a neutral rate around 2%, this implies 125 bps of hikes (probably to be reached in December). Meanwhile, a fourth 75 bp Fed hike is expected at the FOMC on 2 November and money markets price a terminal rate around 4.5%, in line with the Fed's dot plot. However, it seems that the market is still challenging the Fed further out in the future, having priced in a rate cut for late 2023. Several Fed governors have pushed back on this idea, implying that they intend to keep rates higher for longer. The ECB's communication increasingly sounds like that of the Fed, and while officials have admitted the possibility of recession, it is not deterring them from their hawkish path. Christine Lagarde has said that the ECB's compass is price stability and that it "will stay riveted to that compass as we fight inflation to deliver stable prices for people across Europe".

With the context still quite volatile, we have further reduced exposure to high-yield corporates. While optically yields are attractive, the risk/return ratio has become less appealing and the market is now essentially only open to well-known issuers who are willing to pay high coupons. On top of that, the upgrade/downgrade cycle has turned, default expectations are rising and CCC-rated bonds are again underperforming, which some perceive as a canary in the coalmine.

We are negative on Emerging Market debt. The strong greenback is a green monster for EM countries, resulting in higher debt servicing costs and import invoices. We expect that the weaker outlook for EM growth and higher inflation will limit further performance of local EMD.

Other

We are neutral on gold. Short-term, gold prices continue to be pressured by higher US real yields and attractiveness of fixed income safe haven alternatives but performance has been made acceptable by the currency effect of a strong USD. Longer-term, gold remains attractive as a portfolio diversifier and store of value.

We continue to be constructive on oil. With Europe's energy crunch at the fore, oil should benefit from the fact that there are few energy alternatives (low wind, nuclear plants closed, etc.), while OPEC+ has agreed to cut production by 2 million bpd.

CONCLUSION

From here, we think markets will continue to be driven by central bank (mainly Fed) rate hike

expectations and by likely reductions in corporate earnings growth expectations. The context remains highly uncertain, and, as such, we have continued our shift towards a more conservative portfolio make-up, further reducing exposure to riskier assets (namely equities and high-yield bonds) in favour of cash and cash equivalents and more defensive sectors.

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