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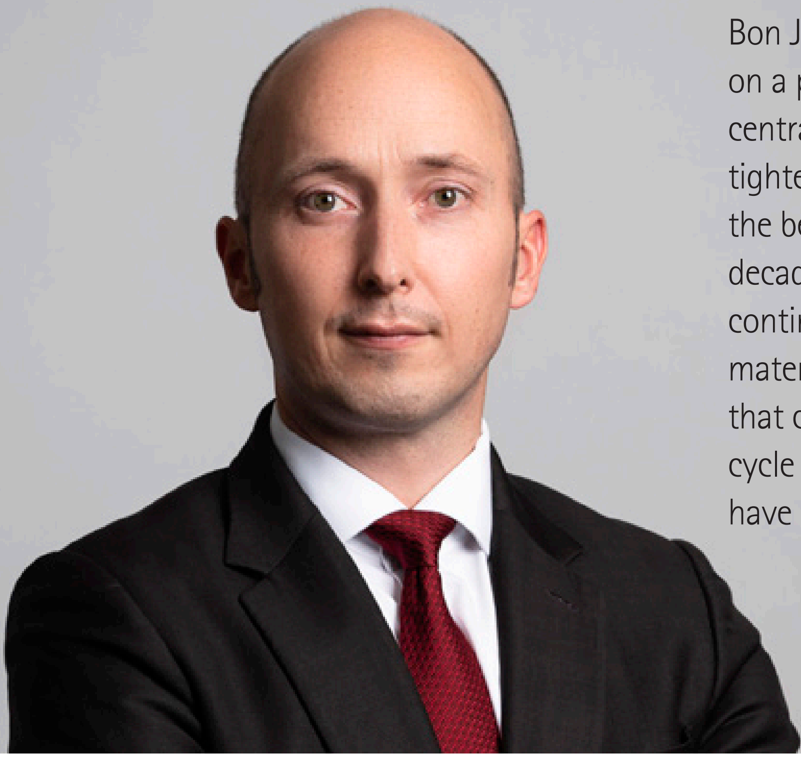
FINANCIAL MARKET NEWS / JUNE 2022

Halfway there



« We have reached the midpoint in what has thus far been a turbulent year in financial markets. The Bon Jovi song about being halfway there and living on a prayer comes to mind – the prayer being that central banks can orchestrate a soft landing as they tighten monetary policy. But this is a tricky task at the best of times. Today, central banks contend with decades-high inflation, a conflict on the European continent and risks to the supply of crucial raw materials including gas and oil. The silver lining is that companies and banks entered this tightening cycle well-capitalised, while strong labour markets have so far supported consumer spending. »

Robin Hamro-Drotz *Head of Portfolio Management*

While economies are still managing to eke out growth, projections are being revised downwards. As per the IMF's forecasts, global growth will slow from 6.1% in 2021 to 3.6% in 2022 and 2023. This is 0.8 and 0.2 percentage points lower for 2022 and 2023, respectively, than it forecast in January. As growth cools, murmurs about recession are growing louder. The indicators we track do not suggest this is something we should expect imminently, but readings are consistent with further deterioration in macro data and higher recession risk over the next 6-18 months, particularly in Europe.

The US is where we see the most economic muscle and data published at the end of May gave a comforting picture. The ISM survey, for example, surpassed expectations at 56.1 versus 54.5, signalling ongoing expansion in factory output despite shortages and supply chain disruptions. Meanwhile, consumer spending grew at a robust 0.9% MoM, while March numbers were revised upwards from 1.1% to 1.4%. Real spending adjusted for price increases also rose a solid 0.7% MoM, and the underlying data suggests that US consumers are still prepared to use savings to continue spending, emboldened by a strong labour market.

For consumer spending to remain ebullient, perceptions about the labour market are important; as such we must carefully watch incoming data for signs that the job market could be cooling down, and if so, to what extent. The most recent JOLTS data provided further confirmation of ongoing strong demand for labour with the vacancy yield (hires-per-job opening) hitting a record low, however, the net percentage of people judging jobs as "plentiful" has dropped to the lowest level since May 2021.

Europe's prospects are far less favourable given that it is more exposed to the conflict in Ukraine and the fallout from sanctions – especially considering its dependence on Russian oil and gas. Already, macro surprises have started to correct downwards, with European corporates once again in the midst of supply chain issues, while European households are exhibiting more hesitancy towards purchasing given falling real disposable incomes. Consumer confidence is in negative territory at -21.1, far below its long-term average.

99 in the shade

Inflation is still red-hot on both sides of the Atlantic. In the US, May's CPI print came in at a four-decade high of 8.6%. Here in the Eurozone, prices rose by 0.8% MoM in May (from 0.6% MoM in April) to 8.1% YoY – a new all-time high. The core figure increased to 3.8% YoY from 3.5% and though Eurozone inflation has largely been driven by energy price increases, digging into the details showed that almost all subcategories printed at new highs.

The Fed is sticking to its guns and going head-to-head with inflation, with Powell confirming 50 bp hikes for both June and July, with June also ushering in the official start of the Fed's balance sheet reduction at a monthly pace of $47.5bn, increasing to $95bn in September. As this has been clearly communicated, the actual start of the programme should not disturb markets.

The ECB seems to have finally taken a leaf from the same hawkish playbook, announcing an end to net bond purchases very early in Q3, allowing for a rate hike at the July meeting, in line with forward guidance. According to Lagarde, the ECB is in a position to exit negative rates by the end of Q3, implying 25 bp rate hikes at both the July and September meetings.

Investment outlook

Given the less favourable growth outlook, we enter the second half of the year with a more prudent stance, neutral on equities. Some may question why we did not go all the way to underweight. The reason is that a global recession is still far from

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certain and just the avoidance of one and the avoidance of an earnings recession for corporates should lead to a recovery in equities. Markets have painted a very bleak forecast moving forward – it's all going to be relative. Economic data or news on central bank tightening doesn't necessarily have to be good – it just has to be better than pessimistic expectations to offer some relief to risk assets. At the same time, corporate earnings are still strong and analysts expect this to continue through 2022.

To arrive at a neutral stance on equities, we went further underweight on regions where we perceive the most risk, namely Europe and Emerging Markets (ex-China). The latter faces a weaker growth outlook, stymied by high inflation, higher US real rates and the Omicron variant, which has been a burden on Asia with many regions in lockdown. We have a strong preference for the US, which still exhibits robust macro data and which also benefits from a flight-to-safety perspective – especially given that it is relatively insulated from the conflict in Ukraine.

We are well-diversified across sectors, with an overweight to late-cycle sectors like **Energy** and **Materials**, as well as more defensive sectors like **European Utilities** and **Healthcare**. With aggressive central bank tightening now priced in, we are keeping our overweight on **IT**. The decision was taken to reduce our exposure to US Financials, as we believe that we have reached the peak in terms of expectations for inflation, interest rate increases and Fed hawkishness. From here, as growth slows, the US yield curve should remain relatively flat (as growth concerns weigh on longer-term yields), which typically isn't good for margins in this sector.

In the fixed income space, Government bonds have once again assumed their role as safe havens. This dynamic completes the transition of the market narrative toward growth concerns, away from being dominated by prospective central bank tightening.

We are neutral on credit risk and have **reduced our underweight to duration**. We did so by decreasing our allocation to US short-term Investment Grade Corporates in favour of **US Treasuries**. This adds some protection to portfolios while allowing us to take advantage of relatively higher yields following the 1H 2022 sell-off.

This trade also leaves us undearweight on investment grade corporates, an asset class which could experience higher volatility and lower liquidity as the Fed winds down its balance sheet and as the ECB gradually steps out of the market. The good news is that corporates enter this tightening cycle well-funded (net leverage in the US and Europe at the lowest since 2017). From here, further modest spread widening is possible but value is clearly emerging for total return/income investors.

We are maintaining our overweight on **high yield**. Though stress pockets are set to build, strong corporate fundamentals provide a cushion and realised defaults are unlikely to spike in the short-term. In the US, there is clearly pressure on the lower-quality rating buckets with increasing dispersion within HY as liquidity, size and quality premiums rise. We favour long-dated BB over CCC which has lagged the market lately.

In the currency space, we changed our view from constructive to neutral on the US dollar. Throughout the first half of 2022, the market has been piling into the USD, leading to an overvaluation. The deterioration in US trade balance and tighter ECB policies could be important headwinds for the USD. We also downgraded our view on Sterling to bearish given weak consumer confidence in the UK and the fact that the Bank of England is now taking a more dovish approach towards hiking.

We are neutral on **Gold** believing that short-term, the gold price might suffer from investor deleveraging and higher real rates on safe-haven government bonds. Longer-term, however, gold remains attractive as a portfolio diversifier and as a store of value.

2022 has thus far brought the biggest commodity outperformance since data began in 1960, on the back of the unprecedented supply shock from the Russia-Ukraine war. This has been especially disruptive to international energy markets given Russia's outsized role as a producer. From here, oil market deficits are likely to persist, though moderated by strategic stockpile releases, production increases from OPEC+ and weaker demand growth. We play higher oil prices via an overweight on the energy sector in our equity allocation while remaining neutral on oil as a commodity.

Conclusion

2022 is the year that central banks will have to pull off one of the trickiest tightening campaigns ever attempted. The ultra-easy policies launched in response to the pandemic which sent markets from new high to new high are now fading into a hangover, calling to mind another Bon Jovi song…

I would drink of your river, it would always get me high
What was once my salvation, now tastes like bitter wine

As monetary policies tighten – alongside financial conditions – downside risks to growth will increase further. Worsening maters is the ongoing conflict in Ukraine, which shows no signs of easing.

As we wait to see if central banks can orchestrate a soft landing – that is, rein in inflation without choking off growth – in this difficult environment, we advocate that investors stay defensive, diversified and patient, with a focus on their long-term investment goals, as well as on secular investment thematics that transgress the vagaries of the cycle, for example digitalisation or the sustainable transition.

Investment Strategy

30/05/2022

Global Allocation	-	N	+	
Equities			●	
Fixed Income	●			▲
Gold		●		
Oil		●		
USD		●		

Equities	-	N	+	
US			●	
Eurozone	●			
China		●		
Japan		●		
Emerging Markets Ex-China	●			

Fixed Income	-	N	+	
Government Bonds - Developed	●			▲
Emerging Market Debt	●			
Corporate - Investment Grade	●			▼
Corporate - High Yield			●	

Stance: Indicates whether we are reluctant (-), neutral (N) or positive (+) on the asset class.
Change: Indicates the change in our exposure since the previous month's asset allocation committee: increase, decrease or no change.

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