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Competing narratives

« The market is oscillating between two competing narratives – one focused on durably higher inflation and the other on the growing risk of recession. Stubbornly high inflation means that, for now, central bank hawks still have the upper hand – but for how long is yet to be seen. We advocate staying safe and liquid in the fixed income space. In our equity allocation, we have further reduced cyclicality in our sector selection, while regionally, we have doubled exposure to China, a clear outlier in the global tightening cycle. »

Lieven De Witte *Head of Fixed Income Strategy, BIL*

The macro landscape

Leading indicators in the US and Europe are still in expansion territory, but the trend points to a marked slowdown in growth moving forward. Heavy clouds hang over Europe in particular, with the threat of energy shortages looming and demand in decline (except for travel, an industry that accounts for 10% of EU GDP). When support from order back-logs and holiday spending fades, we believe that the bloc will enter a mild recession, beginning already this year.

The US is very close to a "technical" recession, with first quarter growth coming in negative (-1.6%) and forecasts signalling stagnation in Q2. However, the biggest risk for markets would be a severe and protracted downturn. This is not our base case given the underlying strength in the labour market (unemployment sits at just 3.6% and payrolls are heading rapidly towards pre-COVID peaks), the fact that households still appear willing to use savings to consume and early signs that inflation might be peaking (for example, the ISM Prices Paid diffusion index fell from 82.2 in May to 78.5 in June, its lowest reading in five months). It is also worth noting that the Q1 contraction was largely due to a jump in imports, which led net foreign trade to subtract a substantial chunk from GDP (3.2 pp) as wholesalers and retailers capitalised on easing supply constraints to rebuild inventories. Real inventories rose by a huge $150 billion in Q1, but because this was smaller than the $193 billion increase in Q4, 1.1 pp was clipped from the GDP figure. Imports of nominal non-oil goods rose at a staggering (and unsustainable) pace of 42% on an annualised basis, while exports rose by 6%. The key question for Q2 is to what extent the inventory surge will backtrack.

Given China's mild CPI and PPI prints (2.1% and 6.4% respectively in May), Beijing has much more room to manoeuvre when it comes to policy stimulus in the coming months, going against the global tide of tightening. We have already seen a wave of fiscal stimulus, with China ordering a $120 billion credit line for infrastructure growth. According to Bloomberg, local governments have drawn up lists of thousands of major projects and planned investment for the full year amounts to some 14.8 trillion yuan (that's $2.3 trillion – double the $1.1. trillion infrastructure package approved by the US Congress which will be spread over five years). Moreover, high frequency data implies that China's real estate sector may be bottoming out thanks to a series of city-specific measures such as reduced down payment requirements, mortgage rate discounts, and so on... Moving forward, our analysts believe there is potential for more relaxation when it comes to curbs on the property and internet sectors, which in turn could unleash existing demand in the second half of 2022. On top of that, looser COVID restrictions have allowed some activity to resume – daily container throughput at Shanghai port, which was running at a severely reduced capacity in April, returned to above 95% of normal levels in late May. China's comeback could provide tailwinds for the US and European economies and help ameliorate global supply chain issues.

Bottlenecks already show signs of easing while outside of the energy sector, commodity prices seem to be peaking. This, in turn, should help cool inflation and perhaps central banks may not have to hit the brakes so hard. However, for now, uncertainty is high and market volatility is likely to persist with sentiment oscillating between the two narratives of durably higher inflation and the increasing risk of recession.

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Central bank watch

The last month was punctuated by a series of central bank interest rate hikes around the world.

Across the pond, the Fed delivered a 75 bp hike as opposed to the 50 bp increase communicated in its forward guidance. We believe the Fed will continue to be hawkish while it still can be, especially with political pressure to contain prices mounting as the midterm elections approach. Powell has declared an "unconditional commitment to fighting inflation", despite the fact that achieving a soft landing will be "quite challenging".

The ECB has pledged to contain price rises by going "as far as necessary" and is expected to hike by 25 bps in July and by at least the same amount in September. With that said, the ECB is somewhat constrained by the lack of homogeneity across Eurozone economies. Already, ECB officials held an emergency meeting to calm markets on 15 June, announcing the creation of an anti-fragmentation tool that will reinvest maturing bonds "flexibly" under its pandemic emergency purchase programme (PEPP). However, the mechanism for reinvestment is unclear and there are significant political constraints: more details are expected at the next policy meeting on 21 July.

Investment strategy

During significant market declines, investors often seek to determine when markets are about to capitulate, i.e. the point at which selling tapers off, which could be the precursor to a sustainable market rebound. Sentiment indicators give a mixed message as to where we stand; some clearly show an oversold situation, but others are much less convincing and there is a chance that we may not have witnessed the real stress phase that normally characterises the end of a bear market yet. As such, we remain neutral on equities.

In the equity allocation we do have, we give preference to the US, and at our latest asset allocation we also brought Chinese equities to overweight, doubling our low exposure in all risk profiles (split evenly amongst onshore A-shares and H-shares traded in Hong Kong). We are neutral on Japan and underweight Europe and Emerging Markets ex-China.

We trimmed our exposure to US and Europe (reducing our overweight and increasing our underweight, respectively). Despite higher rates, inflated input costs and bottlenecks, earnings expectations are high in both regions (especially in Europe which has the conflict in Ukraine on its doorstep), and downgrades are expected.

In terms of sectors, we brought the European Materials sector from overweight to neutral given the fact that companies within are vulnerable to higher natural gas costs (especially in the chemicals sub-sector). In doing so, we further reduced the cyclicality of portfolios. We continue to overweight Energy and US Materials, as well as defensive picks like Healthcare and European Utilities. The latter is at the heart of the secular trend towards decarbonisation, and many firms within should benefit from government infrastructure investment packages aimed at greening the economy (especially in Europe given the ongoing race to find alternative energy solutions and its ambition to become the first carbon-neutral continent). With aggressive central bank tightening now priced in, we are keeping our overweight on IT, a sector that is inextricably linked to another powerful trend: digitalisation.

In Fixed Income, we are neutral on credit risk and underweight duration. As monetary policies tighten (alongside financial conditions), downside risks to growth will increase further. These are conditions which traditionally favour government bonds; however, for now, inflation is still key giving central bank hawks the upper hand.

We reduced our exposure to European high yield bonds in light of the slowdown in growth. While default rates have not yet turned, this is usually a lagging indicator and high yield has not undergone the same extent of re-pricing as investment grade bonds and equities. We are now particularly reluctant on senior loans and where we do have high yield exposure, we favour BB over B/CCC.

We are selective when it comes to investment grade (IG) bonds. The shrinking of the Fed's balance sheet and the end of ECB purchases could lead to higher volatility and lower liquidity for credit, and IG spreads have already broken the 200 bps barrier in Europe and 150 bps in the US, implying a significant slowdown but no major crisis. Where we do have exposure, we focus on quality IG names with solid fundamentals and attractive yields.

We are reluctant on emerging market debt given the tightening of US and global financial conditions, the weaker outlook for EM growth and higher inflation.

Conclusion

The market is trapped between two competing narratives – one focused on persistently higher inflation and the other on the growing risk of recession. While this tug-of-war continues, it will be difficult for expectations about central bank policies to stabilise and for markets to find a bottom. As such, we have a defensive portfolio make-up and have increased exposure to China, where mild consumer price inflation means that central bankers are not caught between a rock and a hard place.

Investment Strategy

30/06/2022

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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