2023 Midyear Outlook

THE LANDING PROCESS

BIL 1856 BANQUE INTERNATIONALE À LUXEMBOURG

INTRODUCTION

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PREPARING FOR LANDING

Our 2023 Investment Outlook, published back in December, was entitled "Preparing for landing". As central banks tighten monetary policy to bring down inflation, the key question is whether they will be able to achieve a soft landing for their respective economies in the form of a mild recession, no major spike in unemployment and just enough demand destruction to curb inflation.

Standing at the midpoint of 2023, the landing process has begun, most notably in the US where we expect a mild recession later this year. Europe's economy has received some tailwinds from fiscal support, the avoidance of an energy crisis and supply chain improvements, but this has not been enough to prop up its manufacturing sector. As a result, we are seeing strong heterogeneity across countries, with Germany already in recession while economies that rely more on services are in better shape. Later in the year, Europe may receive a helping hand from China – if and when its reopening fully materialises – given that this is one of its key export destinations. Indeed, China offers a glimmer of hope for the world economy in that it is an outlier in the global tightening cycle. Moreover, its economic take-off following the end of zero-Covid policies could just be getting underway at a time when momentum is flagging elsewhere amid tighter financial conditions.

Standing at the midpoint of 2023, the landing process has begun, most notably the US where we expect a mild recession later this year. Europe's economy has received some tailwinds from fiscal support, the avoidance of an energy crisis and supply chain improvements but this has not been enough to prop up its manufacturing sector.

Corporate earnings are coming in above expectations but are falling from an absolute perspective, and fear about the remainder of the year dominates.

At present, taking an aerial view of the investment landscape leaves a conflicting picture that is frustrating for bears and bulls alike. Headline inflation is cooling, but the majority of developed market central banks are grappling with a shared problem: core inflation is proving stickier than expected and remains well above their 2% targets. Growth is clearly in descent from post-pandemic highs but labour markets are extremely tight and consumer spending has remained relatively resilient. Corporate earnings are coming in above expectations but falling from an absolute perspective, and fear about the remainder of the year dominates. Banking turmoil – which resulted in the collapse of three high-profile financial institutions – has stabilised, but we are nearing the end of central bank hiking cycles and tighter credit conditions are starting to bite. We will only know if they have tightened too much after the fact.

Markets are struggling to decide whether the glass is half full or half empty. They keep falling back into the habit of assuming that market stress or rising recessionary risk will compel the Fed and other central banks to start cutting rates soon, only for a strong datapoint to make them second guess themselves.

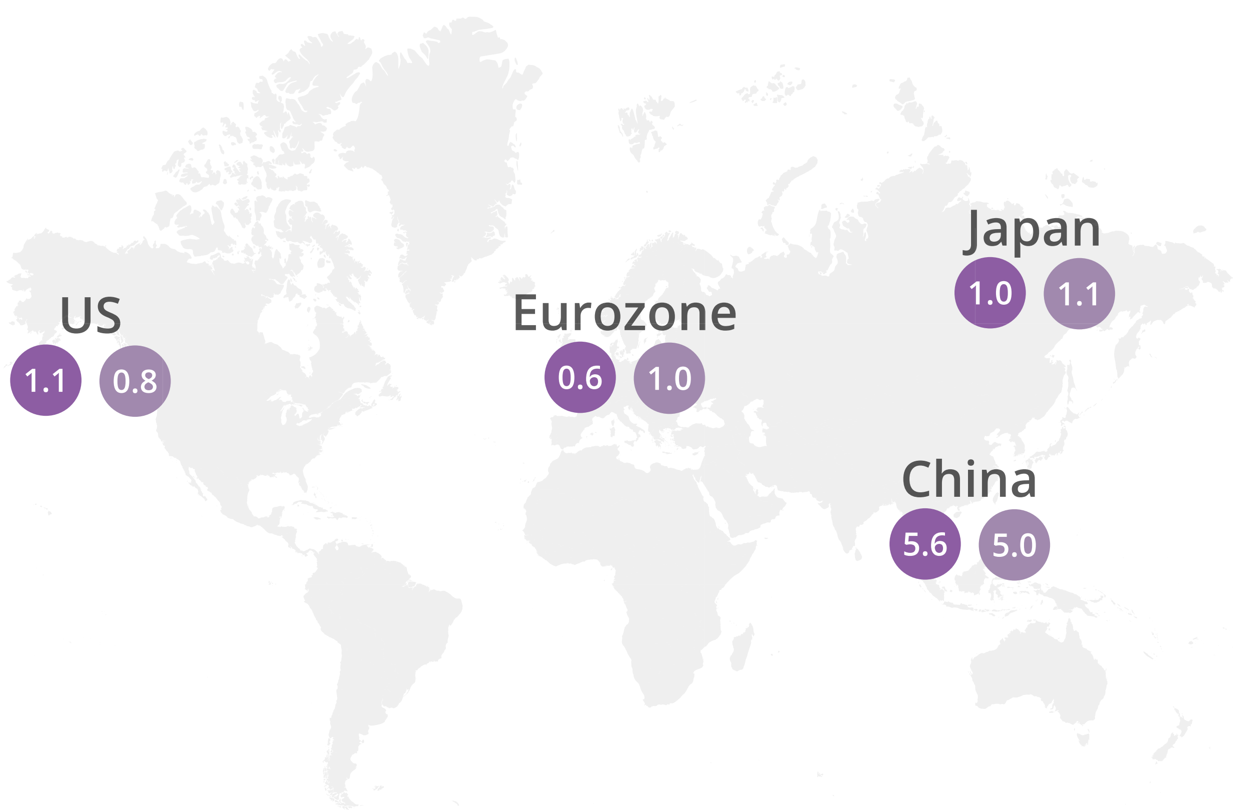
Central banks, on the other hand, are still assessing whether rates will need to stay higher for longer, cognisant that they cannot yet declare victory in their battle against inflation. If market optimism about rate cuts is left to flourish, it could cause financial conditions to loosen, undoing some of their progress on fighting inflation so far. Moreover, policymakers are eager to avoid a repeat of the 1970s when stop-and-go Fed policies resulted in an inflationary spiral that took years to stub out (Appendix 1.1).

The fact that the market-implied policy pathway still diverges from that which policymakers have laid out in their forward guidance leaves room for disappointment and financial market volatility. This, alongside dimming global growth prospects and a lack of certainty as to whether the landing will be soft or hard, is determining our defensive portfolio positioning as we move into the second half of the year.

Lionel De Broux
Group CIO, BIL

THE MACRO LANDSCAPE

Bloomberg Consensus Expectations for Real GDP Growth (%, YoY)



Bloomberg Consensurs Expectations	12m Recession Probability
US	65%
Eurozone	45%

• 2023 • 2024

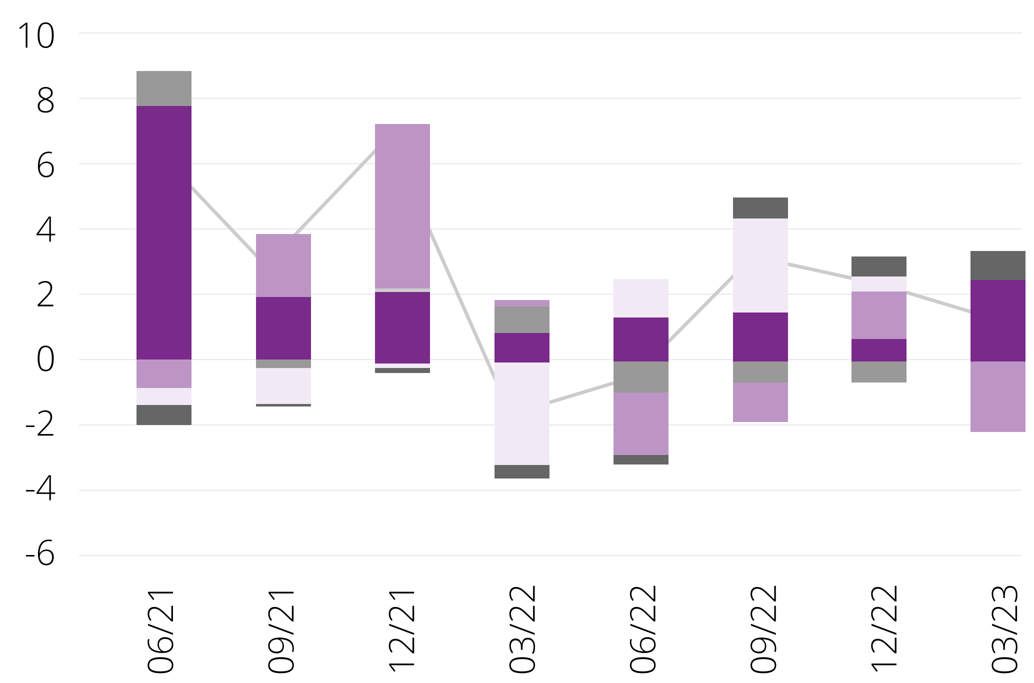
Source: Bloomberg, BIL

US ECONOMY SEATBELT SIGN ILLUMINATED

A few key factors have kept the economy airborne: Consumption, a strong labour market and Government spending.

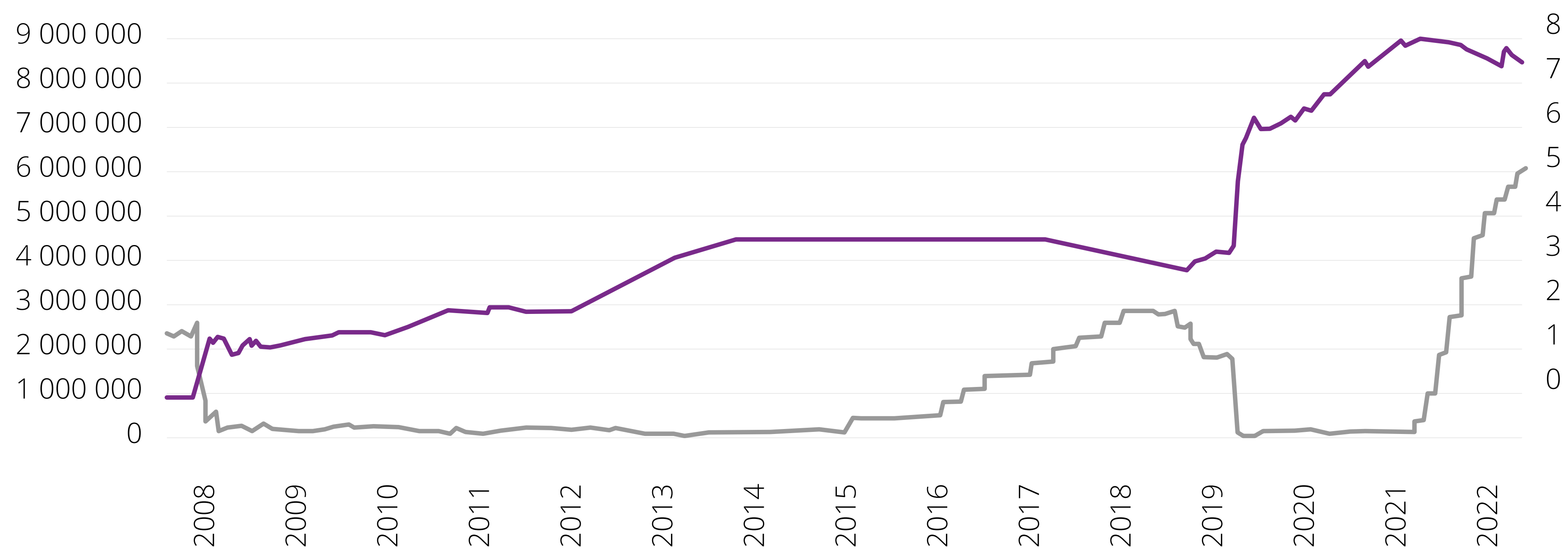
The Federal Reserve now has some 500 bp of rate hikes under its belt. Nonetheless, US activity has been resilient until now. A few key factors have kept the economy airborne: consumption, a strong labour market and government spending. However, tighter monetary policies are starting to take their toll, the most obvious sign of this being the sharp quarter-on-quarter deceleration in growth, which fell from 2.6% to 1.3% in Q1 2023.

Contribution to US GDP Growth (QoQ)



Consumption · Inventories · Net Exports · Government Spending · Fixed Investment · Real GDP Growth

Tighter policies are weighing on the US economy



Fed Balance Sheet ($M) · Federal Reserve Effective Rate (%) (LHS)

Source: Bloomberg, BIL

...the factors propping up the American consumer are looking increasingly shaky.

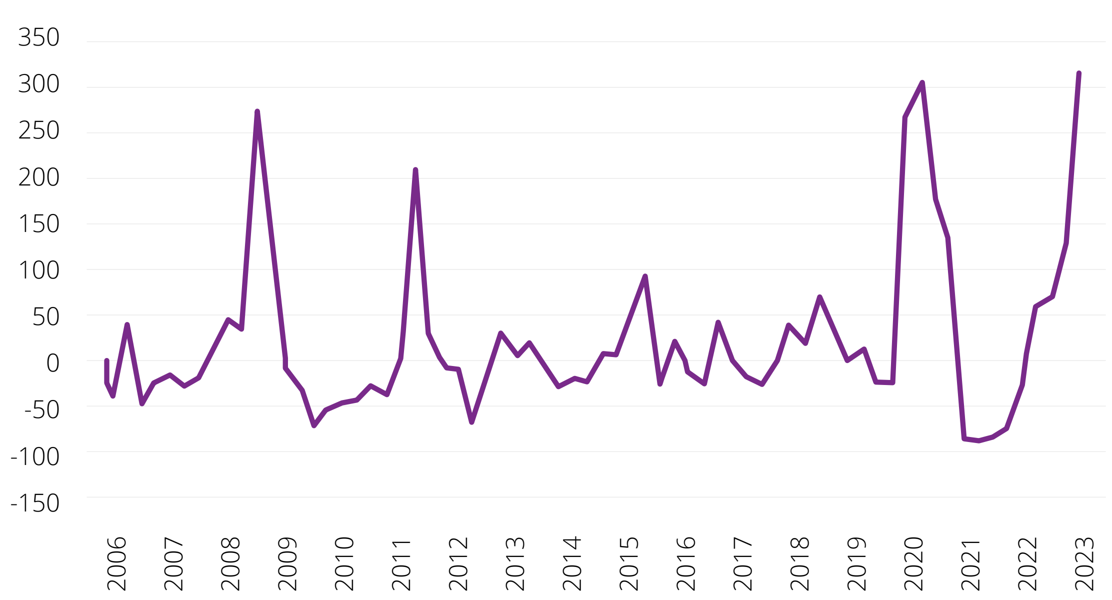
Job growth is slowing, wage growth appears to have peaked, and layoffs are on the rise.

Consumption makes up about 70% of US GDP and as such its enduring strength has propped up growth. However, the factors supporting US consumer spending are looking increasingly shaky. Firstly, the average American has burnt through most of the savings they amassed during lockdown. Many have turned to credit cards to continue spending amid high inflation, and credit card debt sits at an all-time high of USD 986 billion (up 17% from a year ago). This looks increasingly unsustainable as banks begin to focus on building liquidity instead of expanding their loan books. Lending standards are already much more stringent and credit costs extremely high (the US now has an average APR of 29.2%). Delinquency rates have not spiked but are beginning to grind upwards.

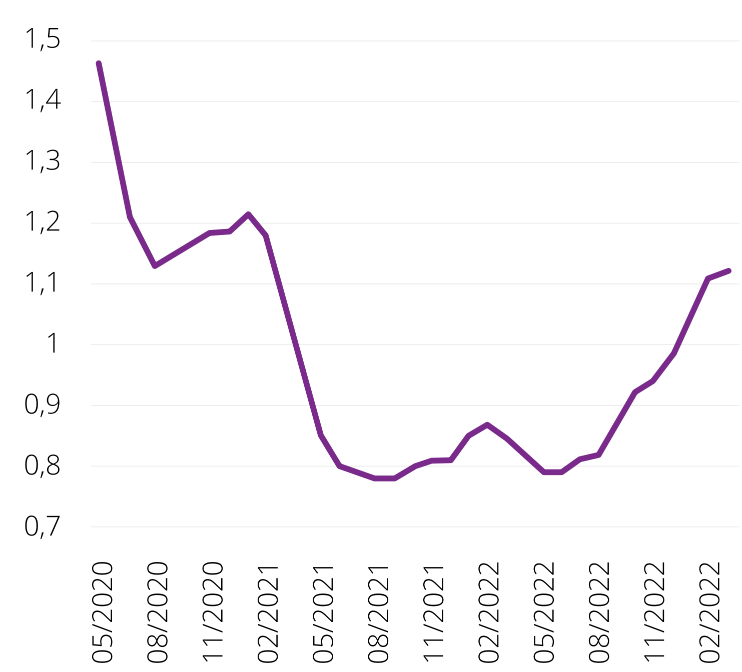
Another key support for consumers has been government stimulus. This persisted through to 2023 and, as can be seen in Appendix 1.2, clearly pushed up consumption in the months when support was disbursed. As 2023 progressed, however, policy started to become a headwind, with several programmes (such as the Supplemental Nutrition Assistance Program and more generous Medicaid rules) expiring in spring. Moving forward, we can assume that the scope for further fiscal support is small with debt ceiling discussions having thrust government spending into the spotlight. It is estimated that a federal spending reduction for 2024 could range from 0.1% to 0.5% of GDP.

The strong job market has also underpinned continued spending. While the unemployment rate sits at just 3.7%, incoming data implies that the once red-hot labour market is now merely hot. Job growth is slowing, wage growth appears to have peaked and layoffs are on the rise.

Challenger US Job Cut Announcements (%, YoY)



US Credit Card Delinquencies



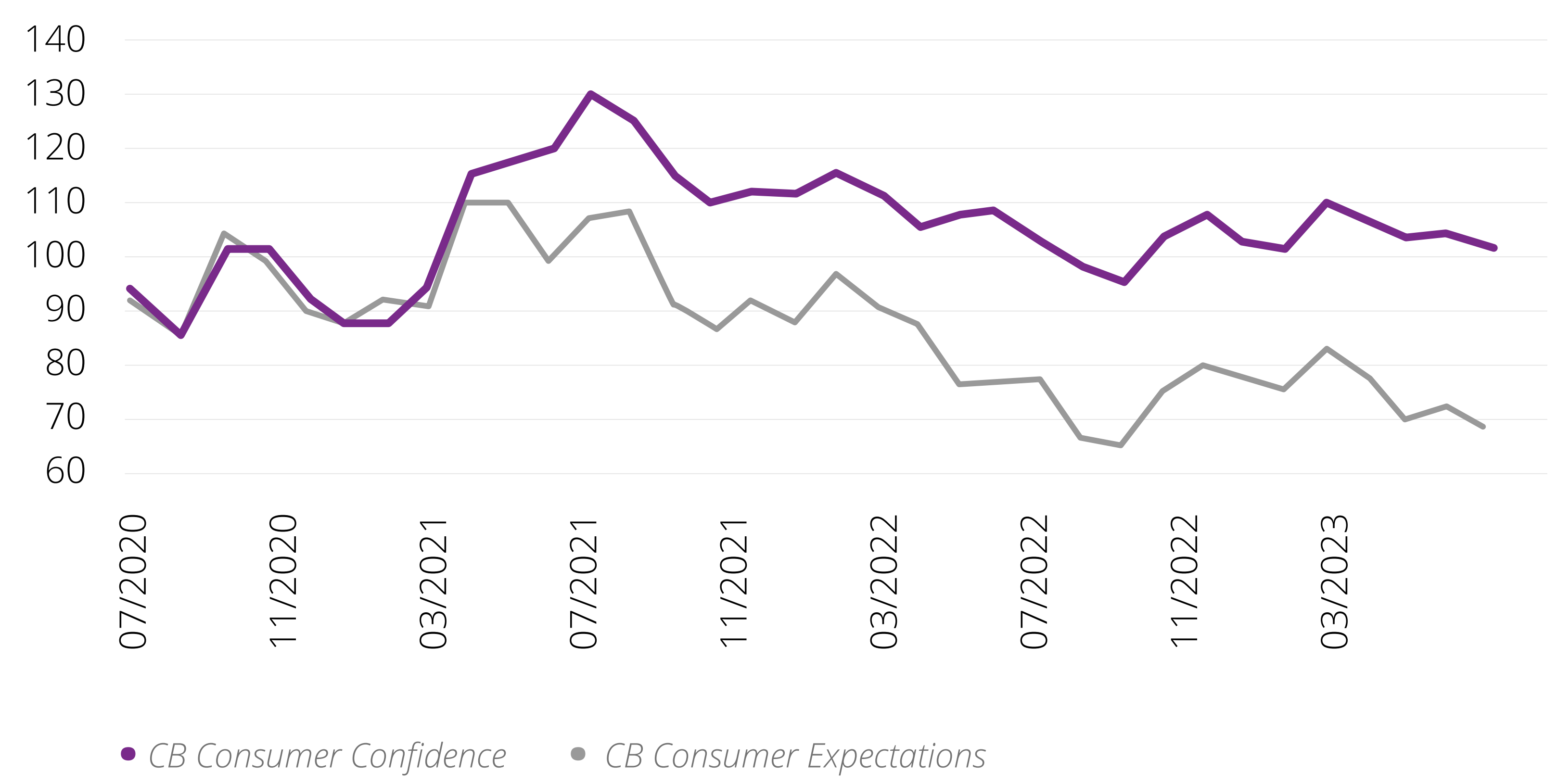
Source: Bloomberg, BIL

1 Average 30-year fixed rate

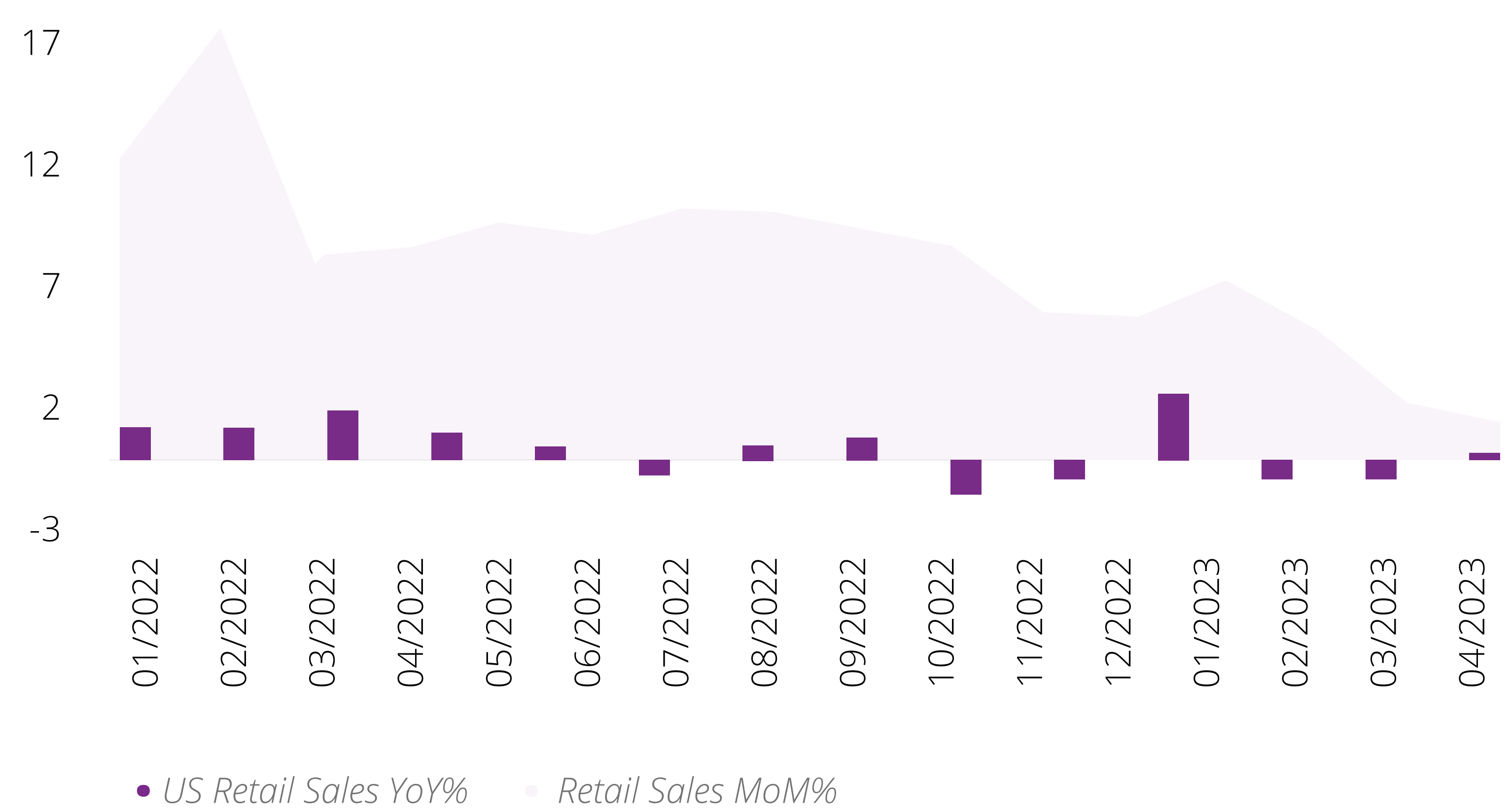
Considering the above, and the fact that surveys suggest more than half of Americans are living paycheck to paycheck, it is unsurprising that consumer confidence (and ultimately consumption) are in decline with demand for services being the last bastion of strength.

Conference Board Consumer Confidence

An expectations index <80 often signals recession in the coming year



US Retail Sales



Source: Bloomberg, BIL

Businesses face the most stringent lending conditions than at any time since the 2008 crisis.

While the US' engine of growth, consumer spending, is losing steam, the impetus from the corporate world looks limited. Businesses face the most stringent lending conditions seen at any time since the 2008 crisis, coupled with waning demand. Supply bottlenecks have ameliorated (Appendix 1.3) and firms that switched from just-in-time to just-in-case logistics are now focused on resetting their supply chains and burning through their excess stock. Inventories shaved some 2.6 pp from Q1 growth and, at the same time, businesses cut back on equipment spending as pressure on corporate profit margins started to mount. Sentiment among small businesses (which employ around half of the US workforce) is at its lowest level in 13 years.

We should not underestimate the impending impact of economic stimulus packages which have already been passed.

There are, however, certain sectors that should be somewhat insulated. We should not underestimate the impending impact of the economic stimulus packages that have already been passed. Companies have already pledged to invest more than USD 200 billion in US manufacturing projects since the government passed the IRA and the CHIPS Act, which offer subsidies for certain manufacturing investments. The amount committed to clean tech and semiconductor projects is nearly double the commitments made to those sectors in 2021, and up almost 20x from 2019.

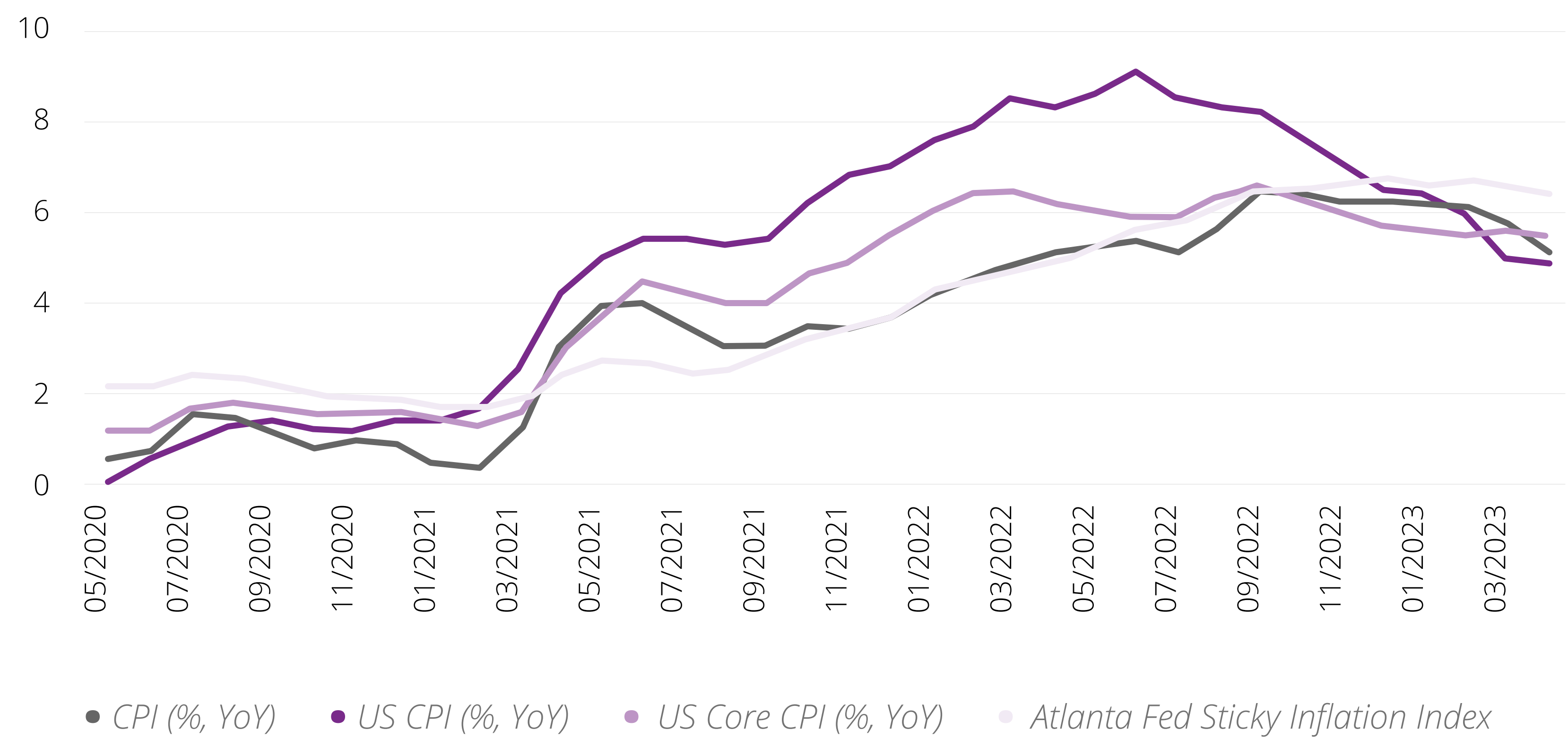
...the Fed is now focusing on "super core" inflation, which excludes food, energy and housing.

What about inflation? In tandem with a slowing economy, the headline inflation rate has come down from a peak of 9.1% in June 2022 to 4.9% today. The cost of shelter (which makes up about one third of the overall CPI basket) finally started to slow in April and private rental data suggests it will continue to come down. As such, the Fed is now focusing on "super core" inflation, which excludes food, energy and housing. That measure, which zooms in on stubborn service prices, rose 0.1% in April (coming in at 3.7% YoY). The "last mile" of getting this figure back to 2% could be particularly difficult, given that continued demand for services is emboldening firms to keep raising prices.

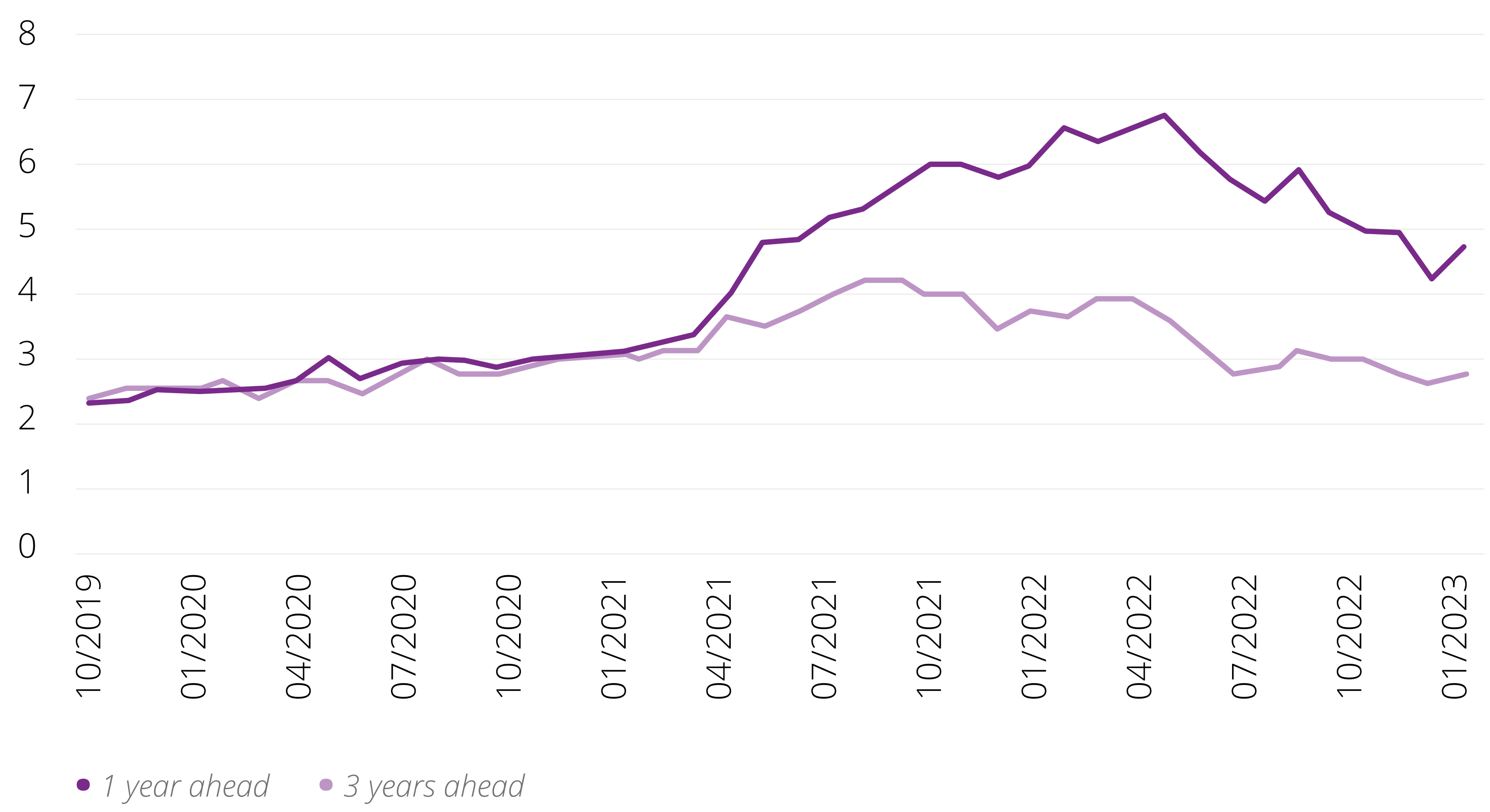
As such, the Fed is right to be vigilant. Inflation risk has not fully diminished. As a cautionary reminder of this, consumer inflation expectations picked up recently. While we think that the Fed has finished hiking, we do not believe it will remove its firm hand and loosen policy in the near term. This firm hand will likely push the economy into a gentle recession this year.

2 https://www.wsj.com

US Inflation *(%, YoY)*



NY Fed Consumer Inflation Expectations



Source: Bloomberg, BIL

The problem is that a lot of hope is still pinned on a dovish pivot by the Fed towards the end of the year, potentially leaving room for disappointment: only incoming macro data will determine whether they are right or wrong.

3 https://libertystreeteconomics.newyorkfed.org

THE EUROZONE ECONOMY – STILL AIRBORNE BUT AT A LOW ALTITUDE

...the economy flies at a low altitude with consensus expecting paltry real GDP growth of 0.5% this year.

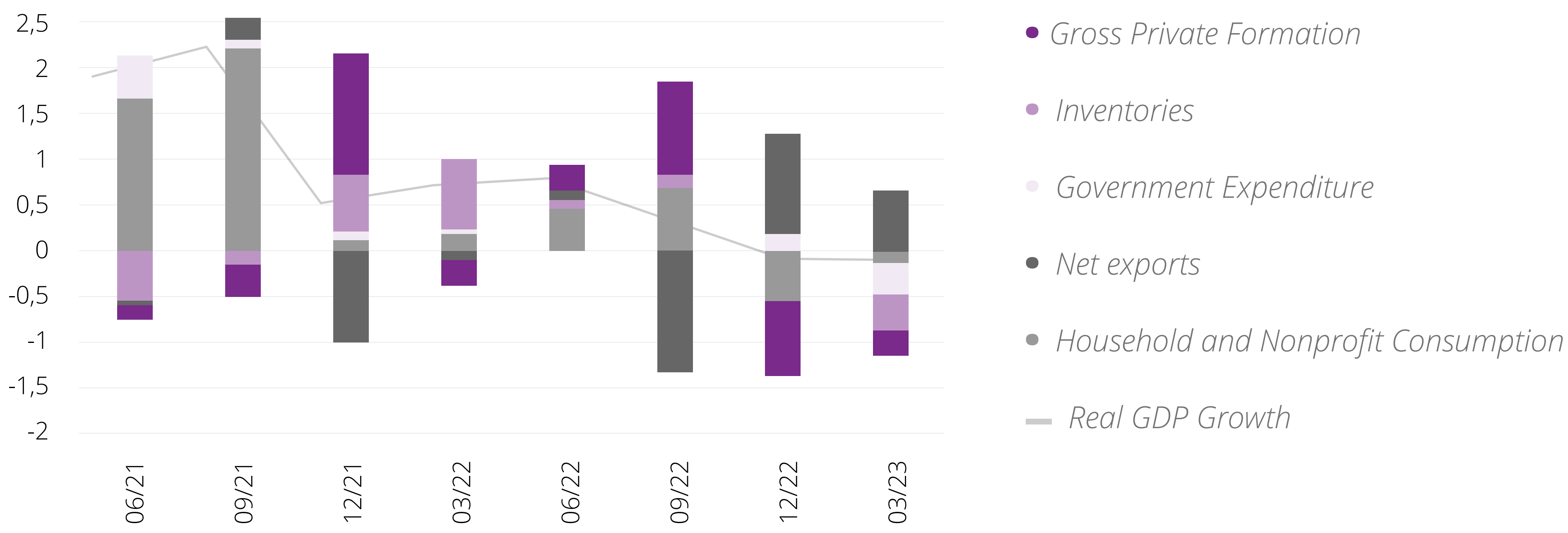
Growth is very unbalanced, driven almost solely by the service sector...

Europe had a slight recession this winter. Now, the economy is flying at low altitude with a consensus expectation of paltry real GDP growth of 0.5% this year.

Growth is very unbalanced, driven almost solely by the service sector with manufacturing struggling to sustain production in the face of falling demand. Despite supply chain normalisation and a marked decline in energy costs (which weighed heavily on energy-intensive industries), the services sector is outperforming relative to manufacturing by the widest margin since 2009.

Q1 GDP Growth in select EZ Countries

Percentage point contribution to Eurozone GDP Growth *(QoQ)*



Source: Bloomberg, BIL

4 Chemicals, metals, refining, paper, minerals

This reality is also evident in regional data. Germany has been hamstrung by weakness in its vast manufacturing sector and is already in recession. Weak consumer and industrial activity are stoking fears that it might suffer a sustained recession. Its saving grace, however, might be its strong labour market, creating a floor for domestic demand, and China's reopening, which will boost external demand. As such, we envisage a stagnation scenario for 2023, as opposed to a major downturn in Europe's largest economy.

Southern countries are the ones boosting eurozone growth for now.

Southern countries are the ones boosting eurozone growth for now. Spain's fixed investment and export activity, along with Italy's rebound in industry and services, have contributed to stronger economic performance. Survey data suggest a tourism boom should keep growth supported moving forward.

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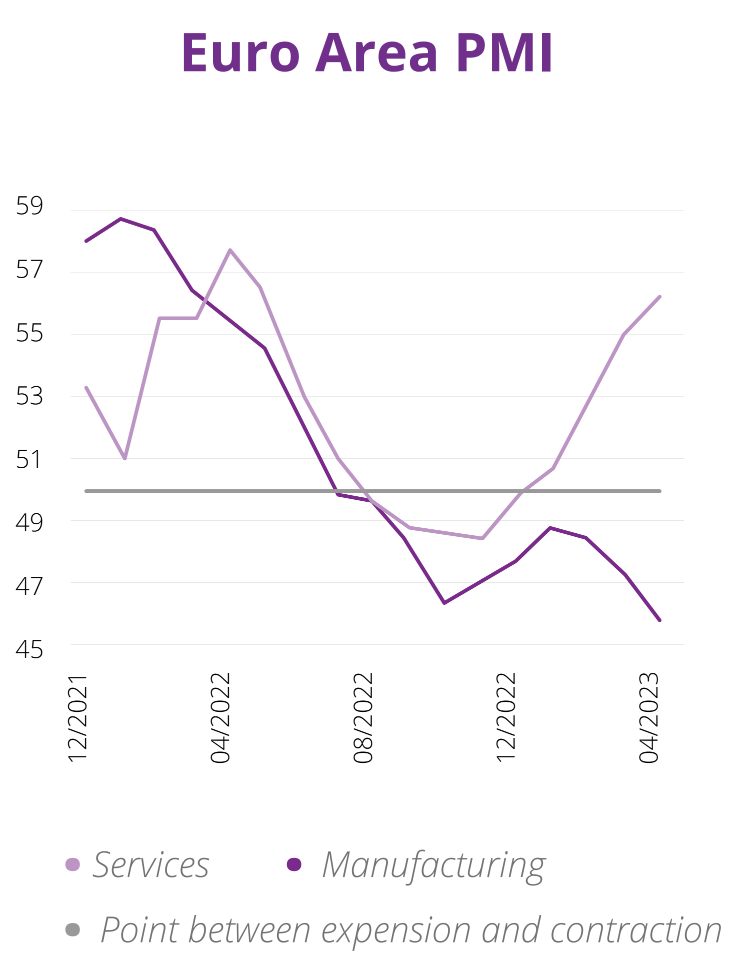
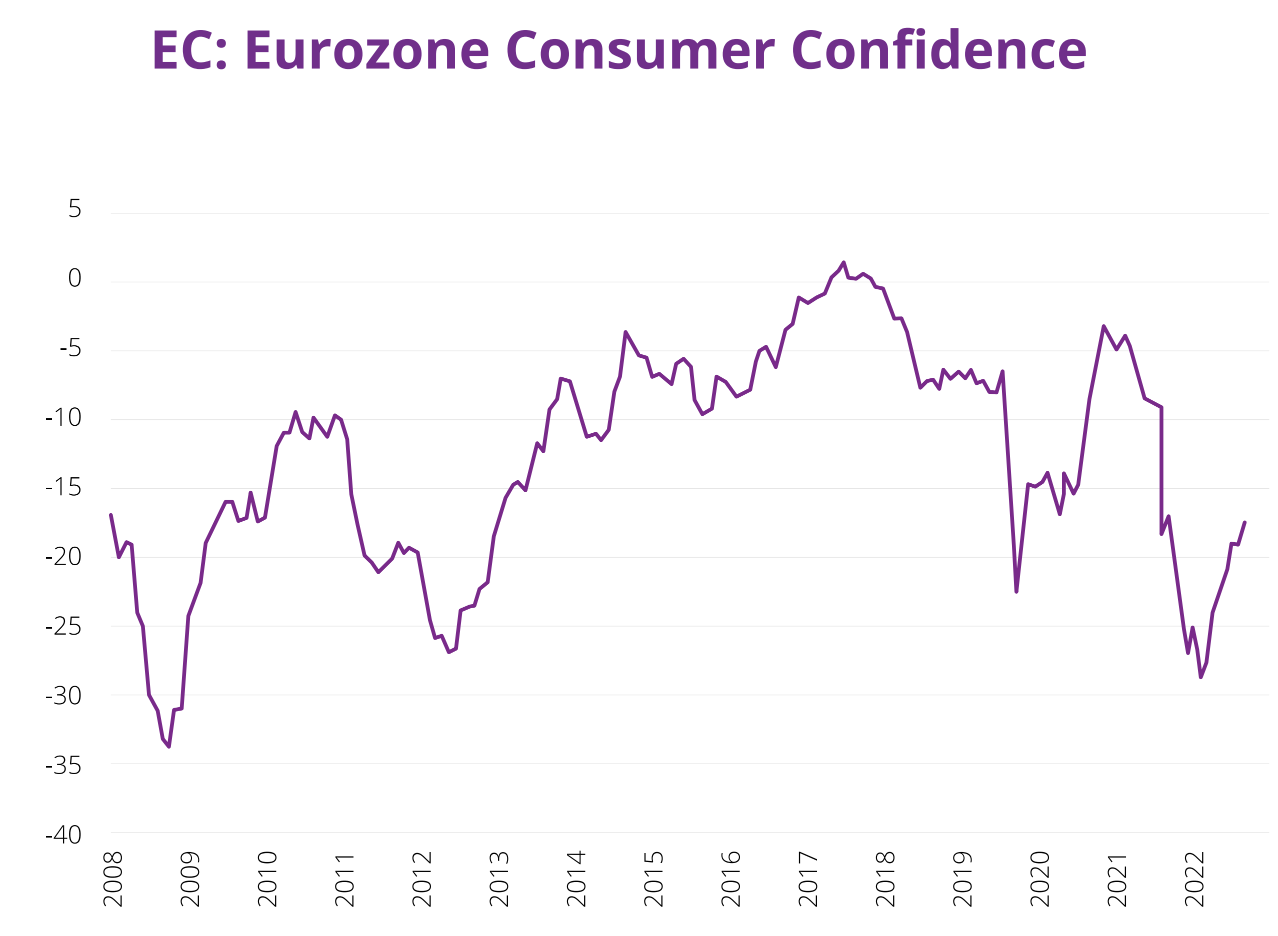
Domestic consumer confidence in the eurozone has recovered slightly but remains well below the long-term average. It could improve in the second half as headline inflation recedes while the labour market remains strong.





Source: Bloomberg, BIL

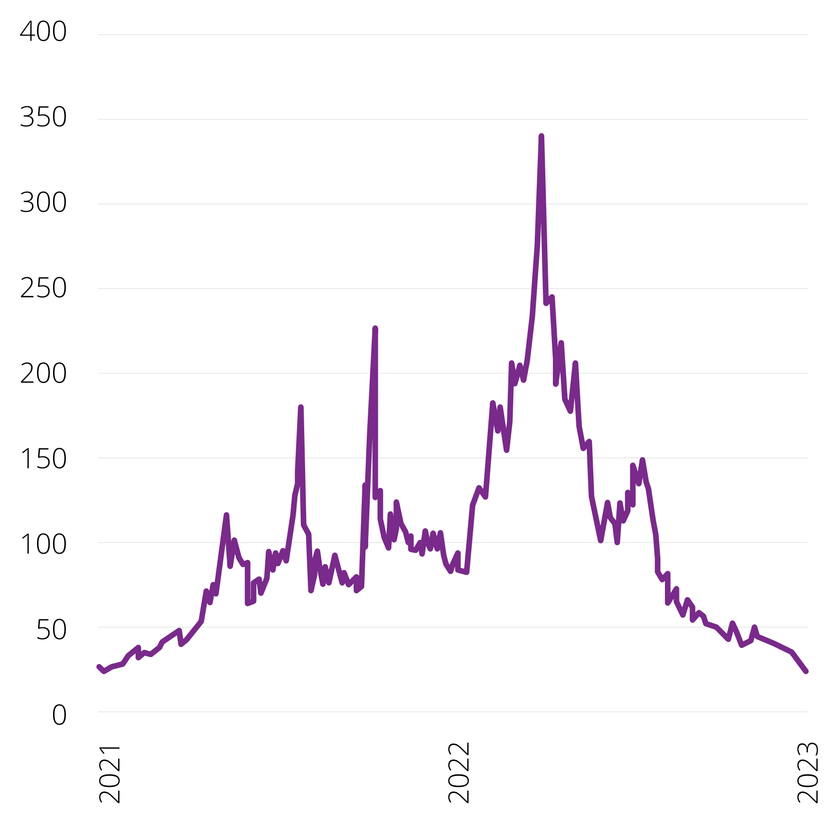
AN UPDATE ON EUROPE'S ENERGY SITUATION

While the Russia-Ukraine conflict still casts a long shadow over the European continent, the reassuring point is that an energy crisis has been avoided.

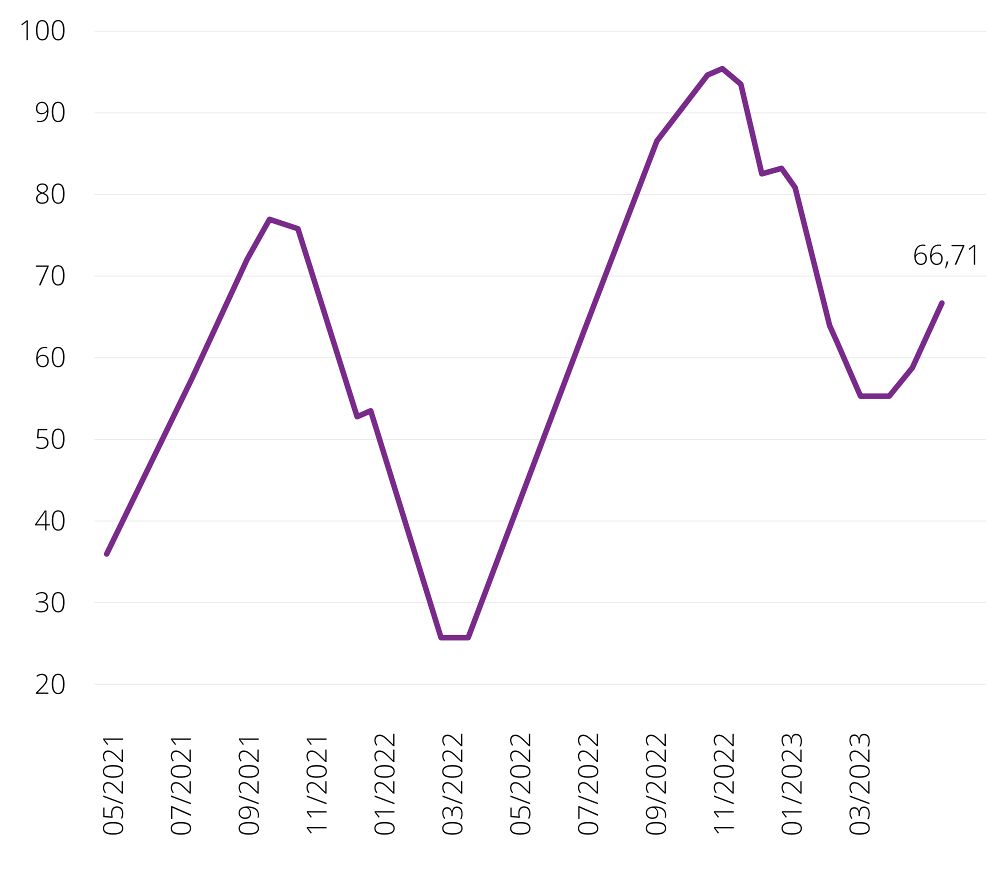
As Russia squeezed Europe's gas supply by demanding payment in roubles, cutting several countries off, and closing the Yamal-Europe and Nord Stream pipelines, the continent suffered a major and immediate adverse impact. Gas prices surged to over ten times the normal rate, causing inflation, reduced corporate income and profits, and slower economic growth.

However, the Kremlin's attempt to weaponize gas led to an extraordinary adjustment. Though pipeline supply fell by 85% from pre-invasion levels, Europe avoided an energy crisis and rationing, aided by increased supply of ship-borne liquefied natural gas (LNG), a warmer winter and efforts across the continent to reduce usage.

Dutch Natural Gas Futures EUR/ MWh



Europe Gas Storage Levels (% full)



Source: Bloomberg, Eurostat, BIL

...the IEA suggests that Europe's efforts to reduce gas demand should be sufficient to cover a complete cut-off of Russian gas next winter, even in a stress scenario.

The question now is how things will evolve for winter 2023-2024.

The simple fact is that weather will be a big factor. Too warm a summer is not good as that will drive electricity demand higher for cooling systems, while too cold a winter is obviously no better. Further key factors include the strength of LNG demand from China's economic reopening, and the speed at which energy-intensive industries ramp up activity in response to lower natural-gas prices.

Not much can be done about the weather, but the IEA suggests that Europe's efforts to reduce gas demand should be sufficient to cover a complete cut-off of Russian gas next winter, even in a stress scenario. Meanwhile gas storage is already increasing. The current plan is to fill storage facilities to 90% by 1 November but ideally the EU should aim for 100%.

Until early May we saw a huge difference in pricing between gas for summer delivery and gas for winter delivery. Summer gas prices fell to the low thirties, while winter gas remained in the fifties. This gap is a sign of the persistent market fragility that could result in another crunch later this year. This pricing structure is a warning for policymakers to guard against complacency.

Supply for the next few months is expected to be healthy, which should allow Europe to stay on a comfortable path towards meeting the storage requirements for next winter, especially if economic activity disappoints. Storage levels are already unusually high.

STICKY INFLATION MAINTAINS PRESSURE ON THE ECB

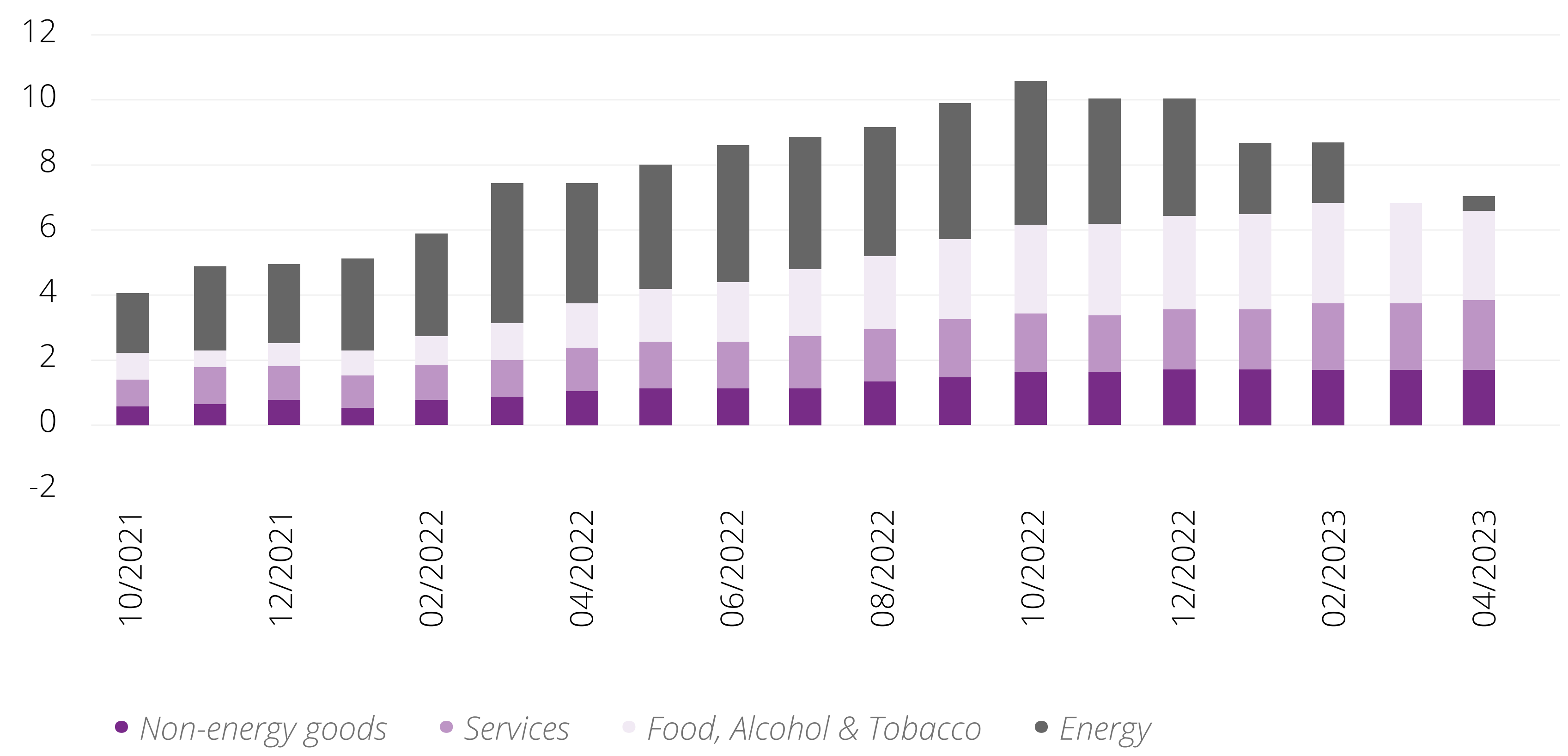
...the ECB is clearly not out of the woods in fighting price pressures. Unlike the US, wage growth in Europe continues to rise as workers and their trade unions push to recoup lost purchasing power.

...wage pressures are already fuelling core inflation.

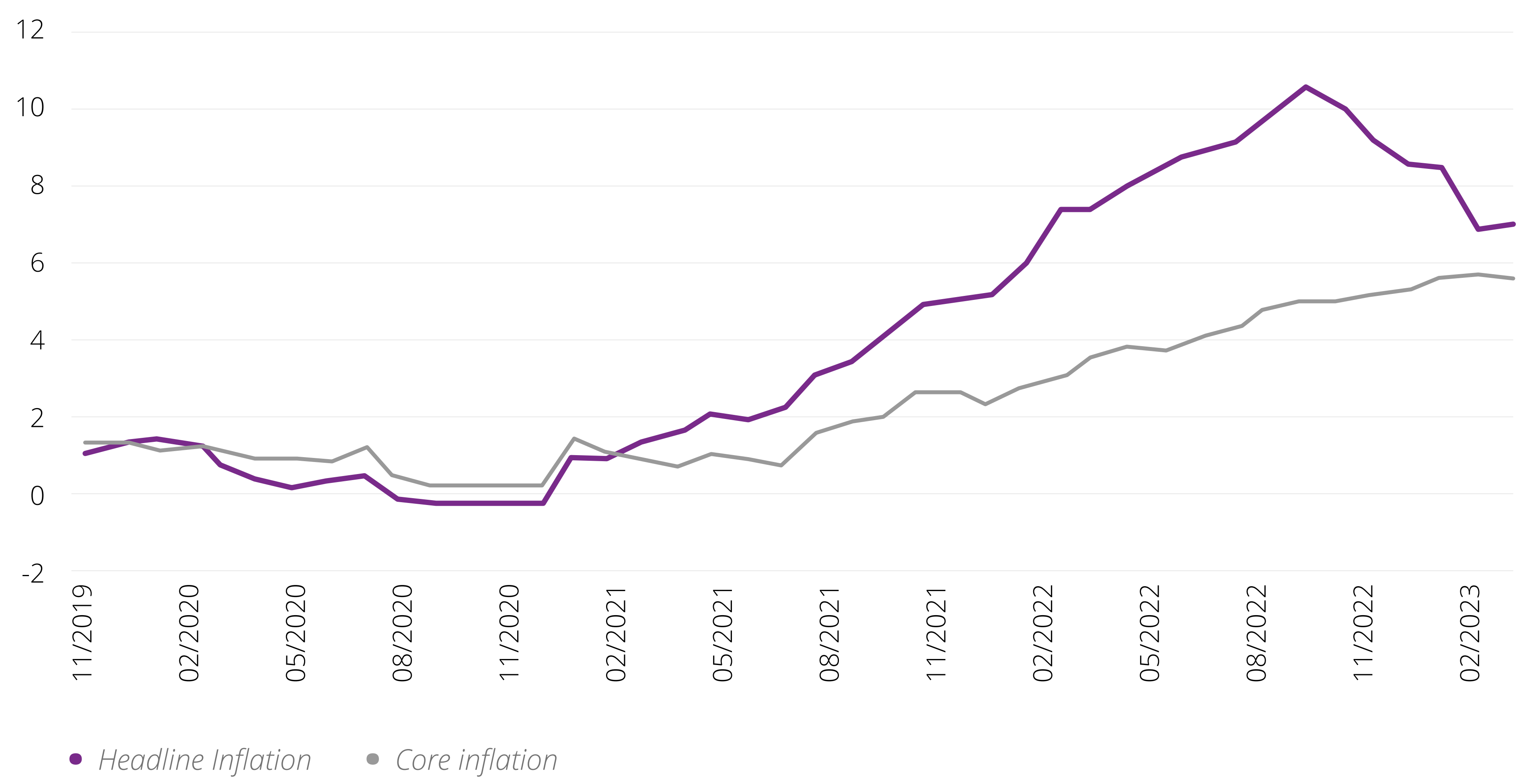
Falling energy prices have allowed headline inflation to recede from a peak of 10.6% in October 2022 to 7% today. While progress has been made, the ECB is clearly not out of the woods in fighting price pressures. Unlike in the US, wage growth in Europe continues to rise as workers and their trade unions push to recoup lost purchasing power. Working in their favour is the fact that labour markets across the continent are tight, with the eurozone unemployment rate at an all-time low of 6.5%.

Labour shortages are replacing supply chain bottlenecks as the main constraint on output for many companies across Europe, especially in Germany. This means a wage-price spiral (whereby higher wages lead companies to charge higher costs, which in turn compel workers to ask for higher pay) is becoming a real risk. According to the ECB, wage pressures are already fuelling core inflation. While wage-sensitive items contributed only around 0.5 percentage points to core inflation before the pandemic, that contribution has more than doubled in recent months. This is not so problematic for goods, as wages represent only around 20% of direct input costs for manufacturing firms. In contrast, wages account for roughly 40% of direct input costs for services providers, and services inflation accounts for almost two-thirds of core inflation. And as previously mentioned, European growth hinges on the services sector.

EZ Inflation Contributions
in percentage points



Inflation Eurozone (YoY)



Source: Bloomberg, Eurostat, BIL

With this in mind, the ECB's forward guidance indicates a restrictive stance, emphasising that rates will continue to rise in the coming months. President Lagarde confirmed "we have more ground to cover and we are not pausing [rate hikes]". Reinvestments under its Asset Purchase Programme are expected to be halted as of July.

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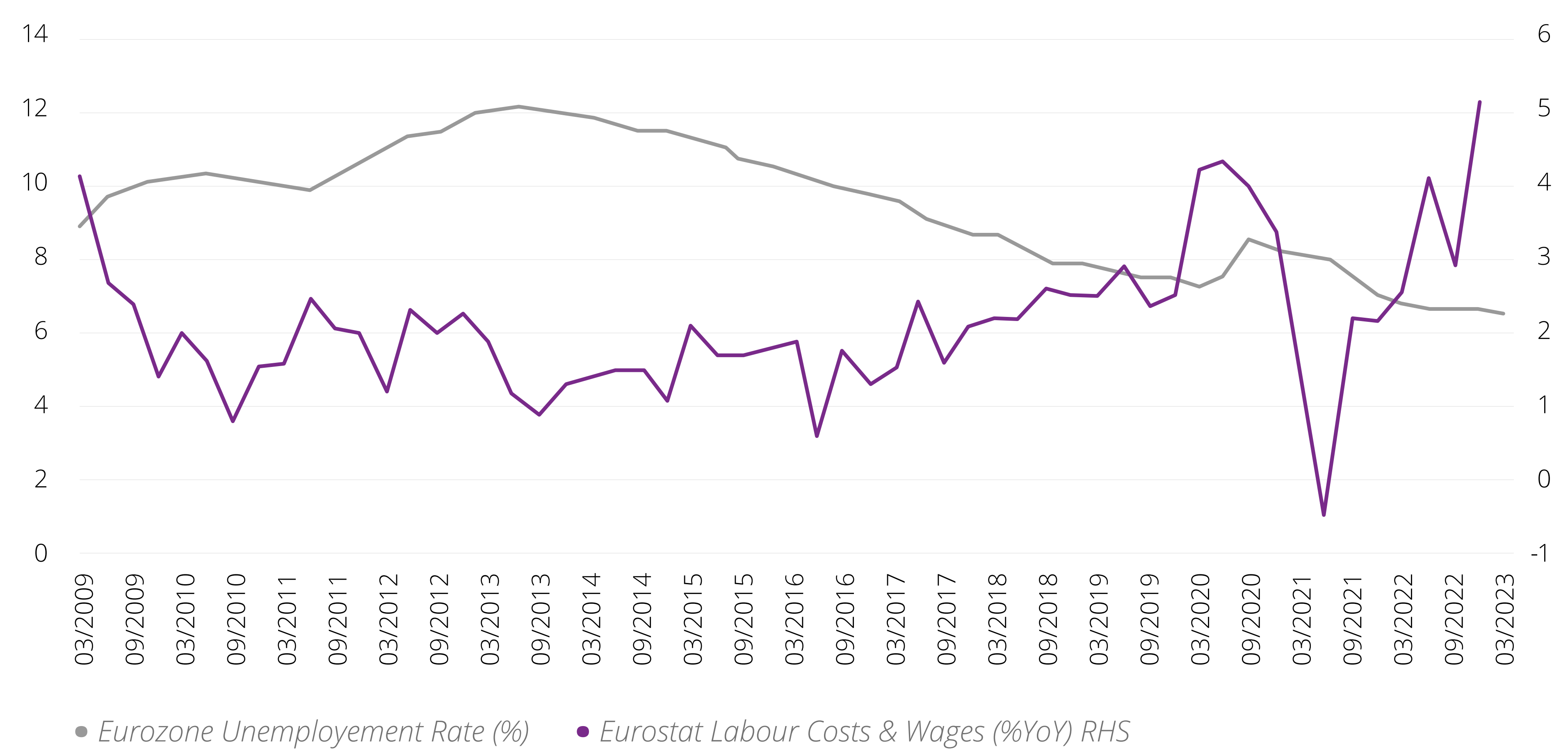
Already, tighter financial conditions are starting to bite. This is particularly evident in the real estate sector, where mortgage rates have risen significantly since the start of 2022. As a result, demand has slowed and with it prices. Data from Europe's statistics office, Eurostat, show house prices dropping for the first time since 2015, and the IMF has warned of "disorderly" house price corrections if markets reprice inflation risks and financial conditions tighten more than expected. These price declines would have adverse effects on household balance sheets.

With demand in decline, the Construction PMI for the bloc has been below 50 since spring 2022, indicating a protracted period of contraction. More recently, among the biggest economies of the eurozone, Germany has lagged furthest behind. Across the eurozone, housing is the main drag on overall construction work, though there were further contractions in both commercial and infrastructure projects. Companies in the sector continue to trim output owing to ongoing declines in new orders and again scaled down input buying, shed jobs and signalled downbeat assessments for the outlook.

Despite these challenges and unlike in the US, futures markets do not foresee the ECB rate declining materially this year as inflation pressures remain stickier. Markets continue to price in a peak policy rate of 3.70% by September, with two 25 bp hikes in June and July, respectively.

Eurozone Unemployment and Wage Growth



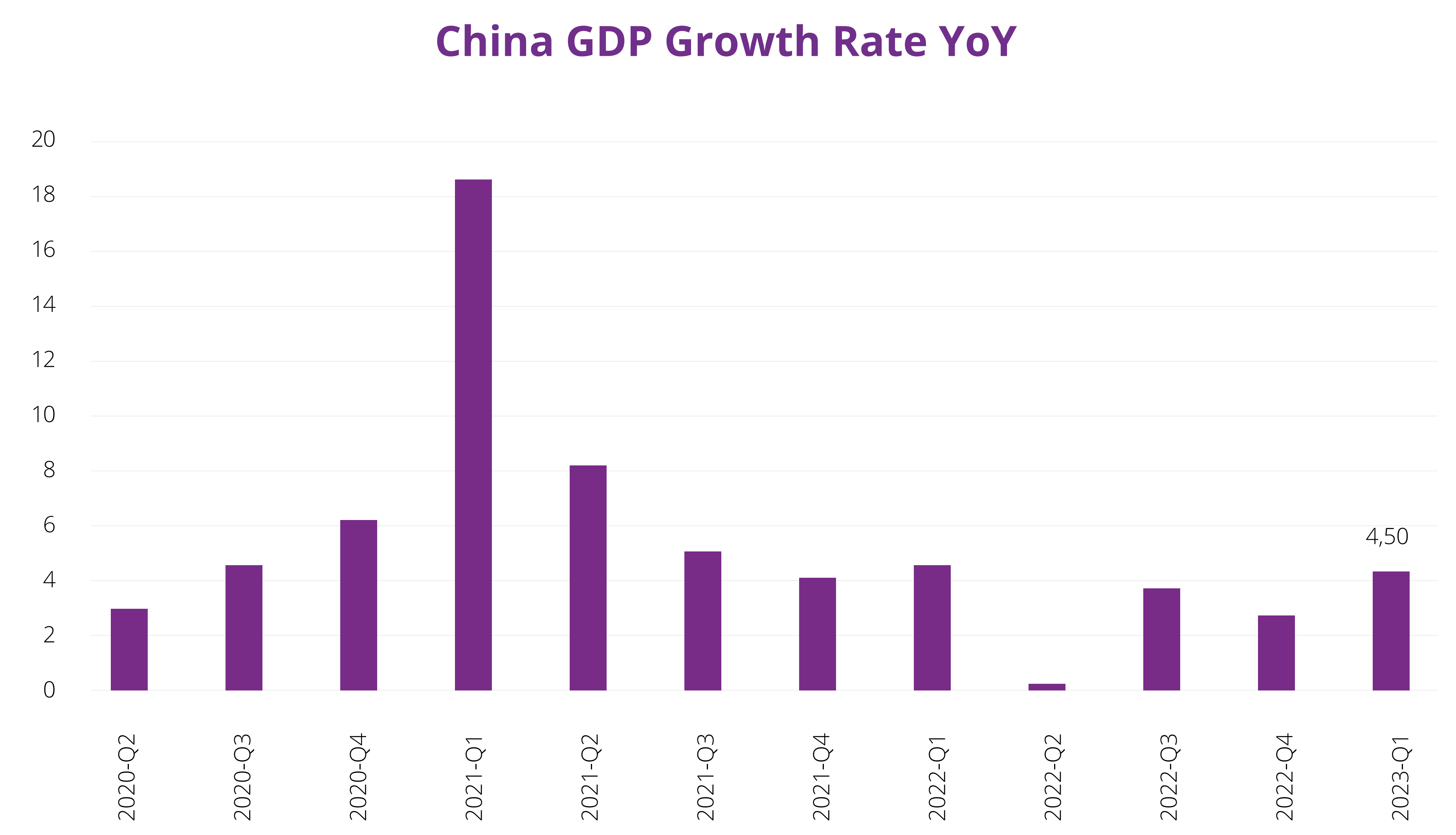
Source: Bloomberg, BIL

CHINA – THE ICE ON THE WING IS DEFROSTING

China's economy is preparing for take-off. Following zero-Covid lockdowns, it's rebound has thus far been a source of disappointment, taking longer than many had expected.

While growth elsewhere slows, China's economy is preparing for take-off. Following zero-Covid lockdowns, its rebound has thus far been a source of disappointment, taking longer than many had expected. Our analysts on the ground explain that after the prolonged pandemic shock, with many businesses shuttered and consumer confidence dented, it makes sense that it will take at least a few quarters before all the cogs of the Chinese economy are turning smoothly again.

Already, China's economy grew by 4.5% in the first quarter compared with the same period last year, following modest growth of 2.9% in Q4 2022. GDP growth should accelerate further in Q2, helped by strong base effects due to the Shanghai lockdown of Q2 last year. Overall, the GDP growth target for the year is around 5%, with leaders emphasising economic stability and the need to revive private consumption. The consensus expectation is that China will surpass this target, with full-year growth of around 5.6%.



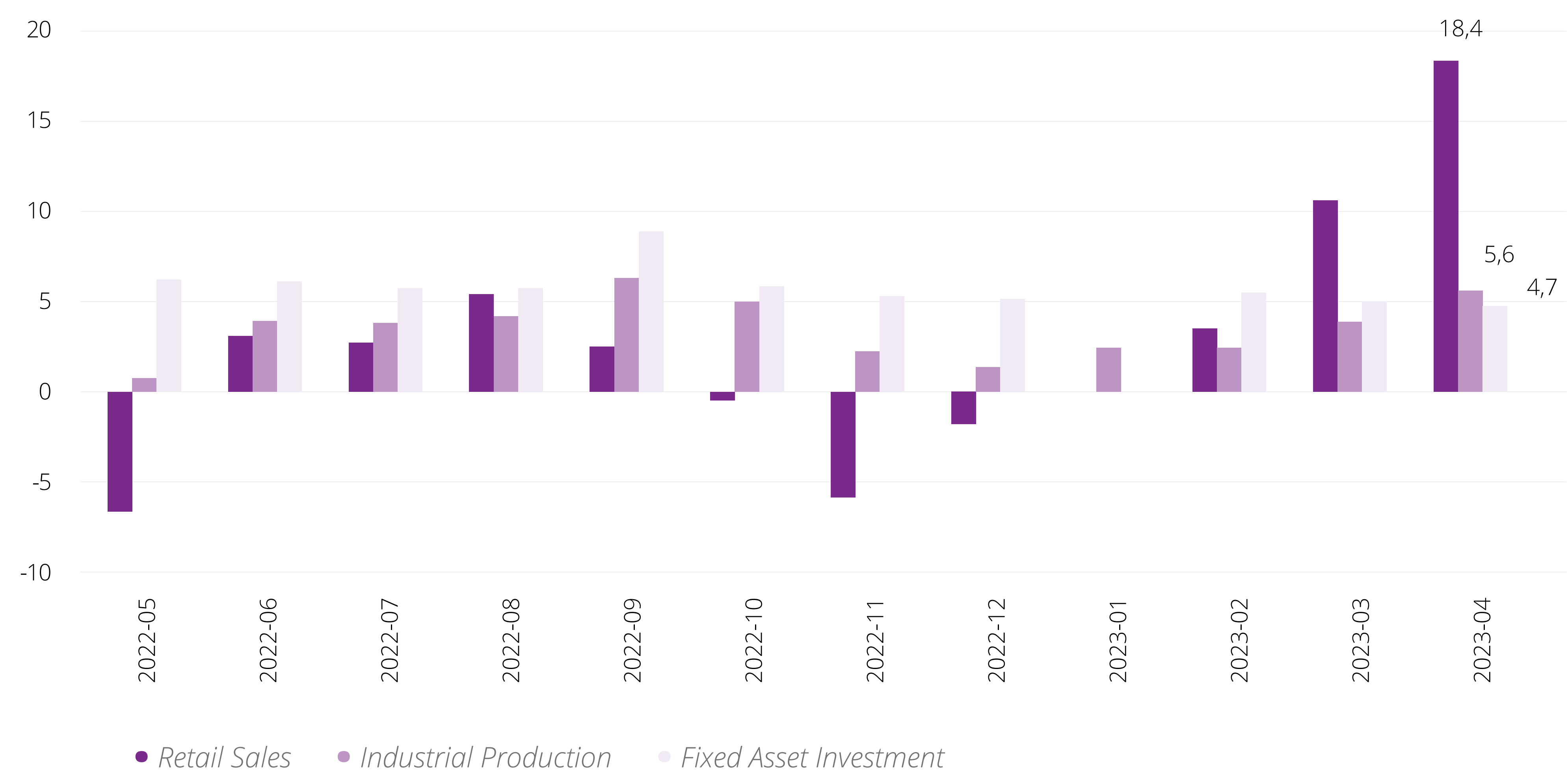
Source: Bloomberg, BIL

...Chinese consumers are beginning to increase their spending.

At present, there are encouraging signs that Chinese consumers are beginning to increase their spending. However, consumer confidence still has a long way to go before reaching the pre-pandemic average. Estimates vary regarding the level of excess savings that households have amassed which are yet to be deployed: Goldman Sachs puts the figure at about CNY 3 trillion (USD 437 billion). Pent-up demand will be released slowly, starting from services and gradually rotating towards goods. All the same, reports from European companies already point to a significant rebound in demand when it comes to luxury goods.

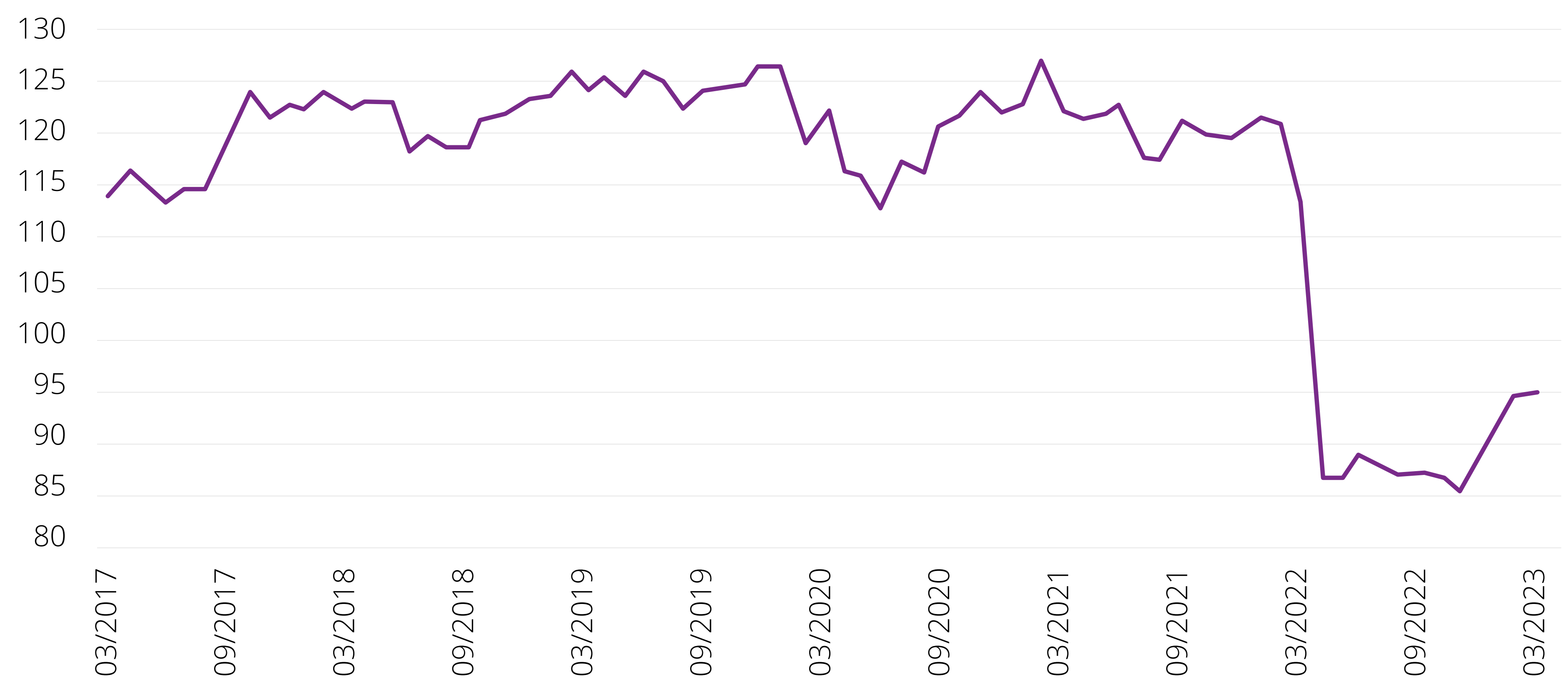
On the corporate side, fixed asset investment is lagging and has even trended negatively in recent months. Steel rebar prices in China hit their lowest level in three years recently, underscoring flagging growth, particularly in its weak property sector, which remains a key risk and potential source of volatility alongside trade tensions and technological decoupling.

Retail Sales and Industrial Production are trending upwards while fixed asset Investment recently softened (*% YoY*)

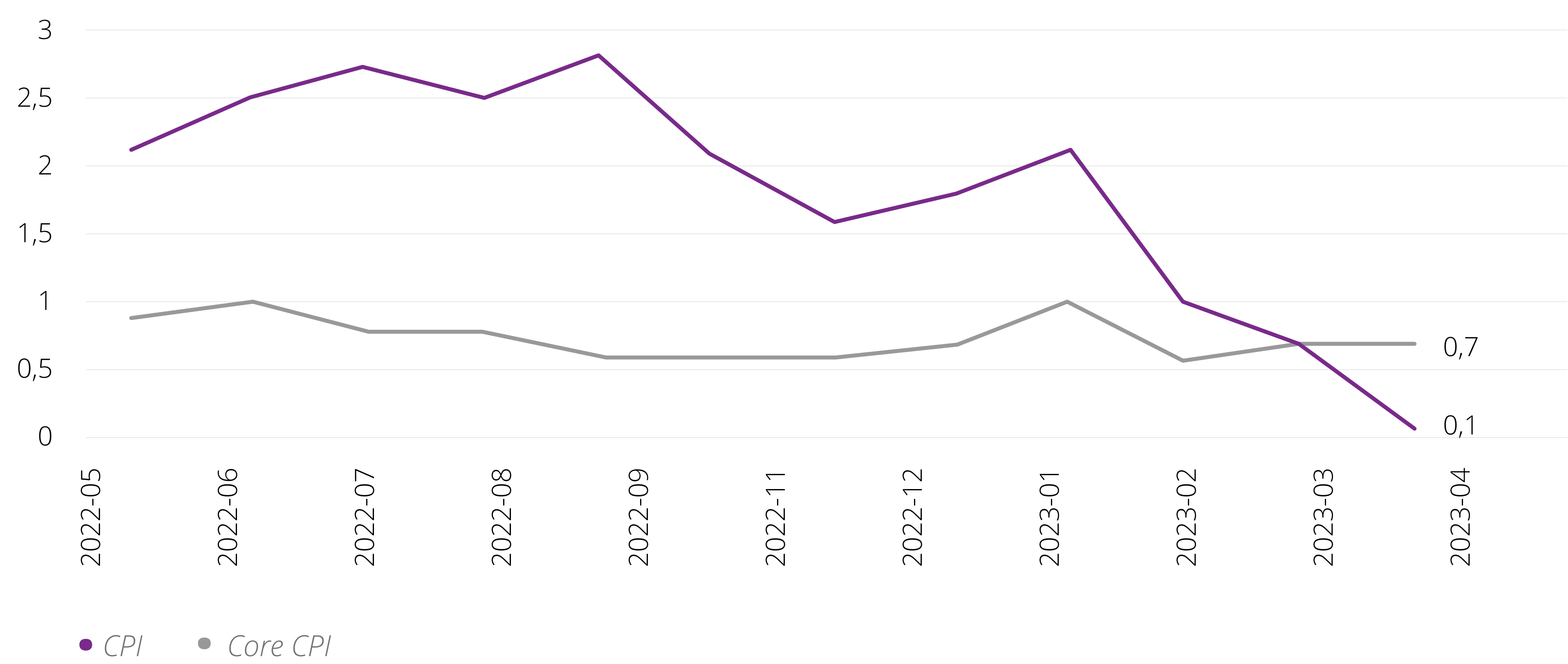


Source: Bloomberg, BIL

China Consumer Confidence Index



CPI & Core CPI *YoY*



Source: NBS, Bloomberg, BIL

The key source of optimism around China stems from the fact that it is an outlier in the global tightening cycle, with inflation running at a meagre 0.1%...

The key source of optimism around China stems from the fact that it is an outlier in the global tightening cycle, with inflation running at a meagre 0.2% versus the target of around 3%. Absent the inflation problem that is plaguing western economies, policymakers have room to manoeuvre in order to boost activity. As of now, the country is enjoying favourable credit conditions (measures implemented to reduce funding costs for lenders and encourage spending such as capping rates on certain deposits) and the People's Bank of China (PBoC) is expected to maintain ample liquidity and accommodative credit conditions in the coming months. The possibility of further monetary policy easing has increased due to weaker-than-expected growth in April and May.

We expect macro policies to remain supportive this year to boost demand and make the recovery more sustainable.

We expect macro policies to remain supportive this year to boost demand and make the recovery more sustainable. The Politburo meeting in late April suggests the government may double down on policies adopted at the March National People's Congress, instead of rolling out new stimulus. The policy focus appears to be fostering the economy's intrinsic momentum by encouraging private investment, creating jobs, stabilising foreign trade and investment, and supporting new growth engines such as new energy vehicles and AI.

BIL INVESTMENT STRATEGY

...we are currently underweight on developed market equities and bonds, with an emphasis on quality and a preference for cash ...

As growth slows and credit conditions tighten in western economies, we believe it is time to hunker down and prepare for some volatile quarters ahead. As such, we are currently underweight on developed market equities and bonds, with an emphasis on quality and a preference for cash (played via cash equivalents, or via investments in companies that are cash rich).

EQUITIES

The trajectory of equity markets in the second half of the year will largely depend on company earnings and profit margins.

Despite tightening financial conditions and a gloomier growth outlook, equities have held up surprisingly well this year. In the US, the equity upturn has been driven by a handful of tech giants (the S&P 500 is becoming more like the S&P 10), as investors shifted toward companies with strong earnings potential and exposure to artificial intelligence, and moved away from economically sensitive, cyclical industries. Defensive and growth sectors have been the big winners while value strategies have underperformed. To illustrate, the S&P Value index is up 3.3% this year, compared with a gain of 11% for the growth equivalent. European equities gave up some of their gains towards the end of May, largely on the back of rumours of a new Covid wave in China as well as concerns over the US debt ceiling. The news flow caused the market's previous darlings (largely found in the luxury sector) to fall out of favour.

The trajectory of equity markets in the second half of the year will largely depend on company earnings and profit margins. With almost all companies now having released their Q1 earnings in the US and Europe, we have more clarity about what to expect moving forward.

The key takeaway is that while earnings have held up better than expected until now, recessionary clouds are gathering overhead.

Investors are clearly not buying the Q1 earnings beat as fear about the remainder of the year dominates.

In Europe, earnings once again came in better than expected due to higher prices and effective cost control. Up to now, companies have managed to raise their prices without losing too much volume, leading to better-than-expected operating margins. Those better-than-expected margins are quite widespread rather than being concentrated in a single sector; the percentage of companies exceeding expectations reached 72%. China's reopening is helping some consumer-related companies especially in the luxury sector, while other China-exposed companies have fallen short of expectations due to weak volumes. The impact is proof of a multi-speed Chinese economic recovery. Banks have offered reassurance on deposit flows and commercial real estate exposure. European companies delivered a stunning EPS growth rate of +15%, versus the -1.3% expected. Financials, Industrials and Utilities were the biggest contributors to the surprise beat. Even though earnings were clearly better in Europe, they were not enough to stimulate gains for the index, which traded within a range of less than 2% from 14 April to 23 May. Investors are clearly not buying the Q1 earnings beat as fear about the remainder of the year dominates.

The same conclusions are also valid for the US. Earnings dropped by 3.39% rather than by the 8% feared. Companies have improved margin levels, while China had a positive impact on some sectors and a negative one on others. As in Europe, better-than-expected earnings had no influence on the price evolution of the S&P 500: from 31 March to 18 May, the index traded in a narrow range of 2%. Hopes of an agreement on the debt ceiling changed this pattern and eventually pushed the index above a closely watched breakout level of 4,200 points.

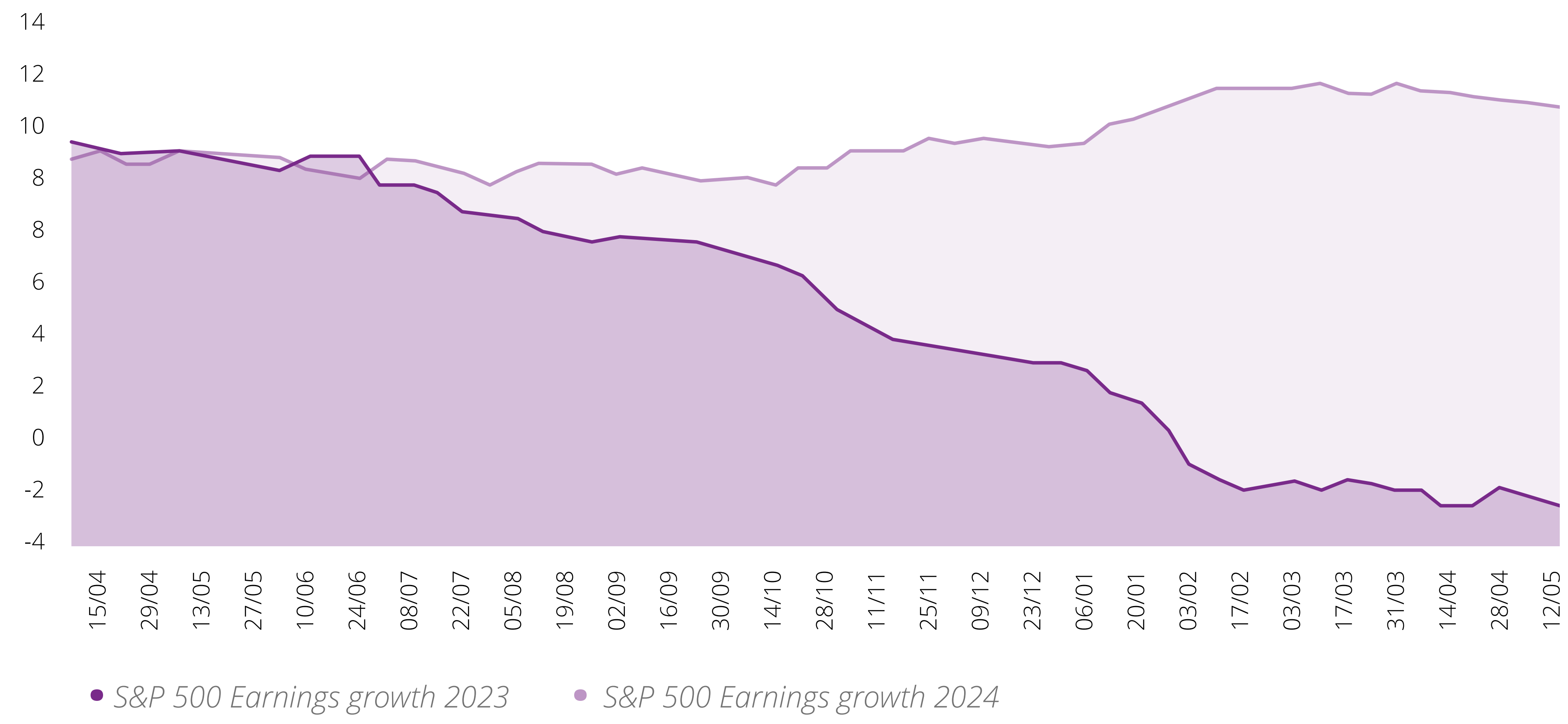
...credit tightening and a potential credit crunch are still playing out. That threatens to further weigh on growth...

Slowing growth is set to become the major theme as we move into the second half of the year: will central banks fight inflation at all costs and thus hurt growth and eventually equities? While the banking turmoil of Q1 seems to have stabilised, credit tightening and a potential credit crunch are still playing out. That threatens to further weigh on growth and fast-forward any possible recession.

Given all this, what do analysts expect regarding earnings for the remainder of 2023? European earnings forecasts improved slightly following decent Q1 results, with the outlook shifting from slightly negative to slightly positive, as can be seen in the graph below. The flipside of this is that the outlook for 2024 has been negatively adjusted. The flat outlook for FY 2023 implies that earnings will grow negatively in the remainder of the year given the strong start in Q1.

Eurostoxx 600 Earnings growth

S&P 500 Earnings Growth



Source: Bloomberg, BIL

EARNINGS AND VALUATIONS

...we have adopted a defensive sector composition, aimed at reducing the cyclicality of our portfolios.

In the US, earnings growth expectations for this year and the next barely budged during the earnings season: expected EPS growth is still negative at -2% for this year, while remaining at +11% for next year.

All things considered, we move into the second half underweight on developed market equities. Where we do have exposure to this asset class, we have adopted a defensive sector composition, aimed at reducing the cyclicality of our portfolios. We favour:

- Consumer Staples - earnings forecasts are relatively stable while the Q1 earnings season has demonstrated that consumer companies are successfully passing on higher prices for now.
- Utilities - the sector is benefiting from banking turbulence as investors adopt a more cautious view and shift into haven stocks; high dividends are the main attraction versus other defensive sectors while stimulus packages are set to provide strong tailwinds on both sides of the Atlantic. Moreover, in response to the US Inflation Reduction Act, a package that includes $369bn of subsidies and tax credits for clean energy technologies, Brussels has cleared the way for EU member states to "match" multi-billion-dollar incentives as they fight to keep projects in Europe.
- European Healthcare – The sector benefitted from banking turmoil and rising recession fears. EPS growth over the next two years should be robust on higher revenues and margin expansion, with pharmaceutical and equipment companies contributing the most.

...the less favourable macro environment compels us to double-down on our thematic bets which focus on secular shifts (and those companies that are strategically positioned to benefit from them), thereby allowing investors to look through the ups and downs of the economic cycle.

Looking beyond sectoral considerations, the less favourable macro environment is compelling us to double-down on our thematic bets, which focus on secular shifts (and those companies that are strategically positioned to benefit from them), thereby allowing investors to look through the ups and downs of the economic cycle. At present, we are focusing on a few key themes that often converge and reinforce each other: the accelerating transition towards a more sustainable economy made possible by the largest technological transformation in human history. We also like biotechnology – a theme that has gained momentum from the pandemic and the race to create vaccines. If the 19th century was characterised by breakthroughs in chemistry, and the 20th century by big leaps forward in physics, we believe that the 21st century will be all about biology, leading to a vast expansion in our ability to reengineer biological systems to meet our needs and address pressing global issues. Needless to say, we think the theme merits consideration within portfolios.

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Looking at equity styles, we have fortified our portfolios with quality stocks – those with strong balance sheets, stable earnings, low debt

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and the financial firepower to weather a downturn in profits. As such, we also remain overweight on IT, where many such companies are found. Earnings releases from industry bellwethers so far confirm that they are making money and have good business momentum.

In terms of regions, we are underweight on the US and Europe, and neutral on Japan. We are slightly overweight on Chinese equities, believing that the economy there has the most promise for the months ahead, with the post-pandemic pick-up yet to play out. As it does, the driver of potential gains will likely rotate from multiple expansion to earnings growth/delivery. Rather than taking bets on specific sectors, our analysts on the ground cherry-pick the names that are poised to benefit from the reopening, as well as those most likely to receive policy tailwinds, for example, in those industries earmarked as strategic.

Sector Preferences

NEGATIVE	Real estate	Industrials				
NEUTRAL	Energy	Communication services	Financials	US Healthcare	Consumer Discratonary	Materials
POSITIVE	European Healthcare	Consumer Staples	IT	Utilities		

FIXED INCOME

...the economic cycle looks to be turning in favour of bonds.

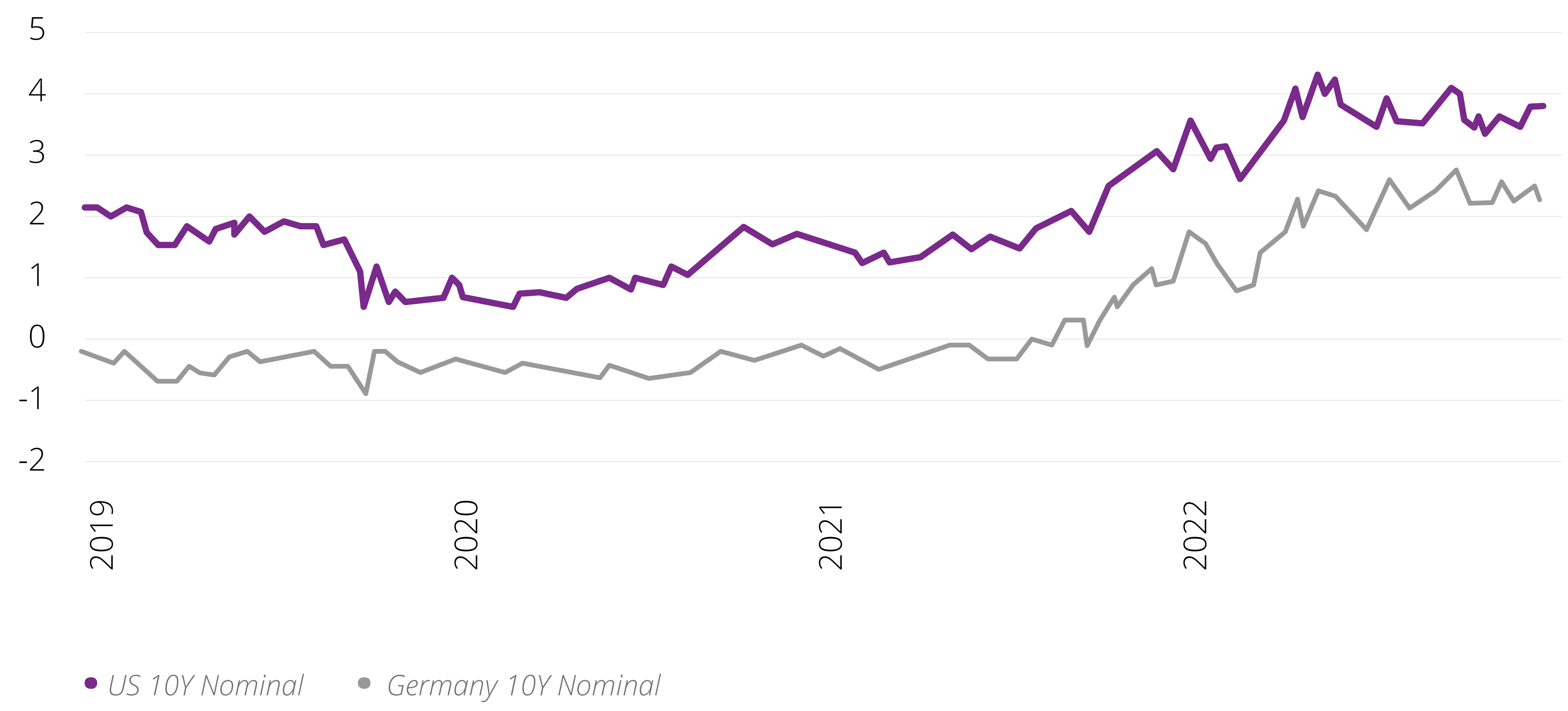
While there might be temporary and sporadic moves higher in rates...

...we believe they will trend lower as the year progresses.

In our 2023 Outlook, we noted that the big battle in 2023 will be the shifting focus between "recession" and the "terminal rate". This battle now seems to be in its final stages: headline inflation is softening, central banks have nearly completed their cycle of aggressive tightening and growth is weakening. In short, the economic cycle looks to be turning in favour of bonds.

While there may be temporary and sporadic moves higher in rates (for example, if certain datapoints come out stronger than expected), we believe they will trend lower as the year progresses. This makes us more constructive on duration: without trying to time the exact peak, we are monitoring for technical entry points to continue reducing our underweight. In the Sovereign space, we have a preference for Treasuries over European equivalents given that the Fed has paused its rate hike cycle, while the ECB is likely to hike by at least another 25 basis points.

10y Yields



Source: Bloomberg, BIL

In the Sovereign space, we have a preference for Treasuries over European equivalents given that the Fed has paused its rate hike cycle...

For now, we have a preference for euro-denominated investment grade (IG) paper. As with equities, we emphasise quality in our selection, with this tranche offering enhanced income levels and improved diversification benefits as the cycle turns. The recent underperformance of US IG has been primarily driven by rate effects as markets reassessed the outlook for Fed policy in the context of better-than-expected macroeconomic data. EUR rates face relatively little pressure on that front as markets are already pricing in a more hawkish central bank. EUR spreads remain relatively wide to dollar equivalents, though more so in IG than in high yield (HY). This view is also confirmed when looking at individual ratings buckets, with little incentive to move down the ratings ladder.

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On that note, we are reluctant to invest in high yield. It seems that markets have become desensitised to the risks of high debt levels because of the extended period of low or zero interest rates since the global financial crisis. Now, with a sea change in the availability and cost of money underway, caution is needed, especially on those bonds at the lower end of the quality spectrum. Where we do hold such instruments, we prefer them to be denominated in EUR: US credit tightening will be especially problematic for smaller firms, which are most prevalent in the US HY space.

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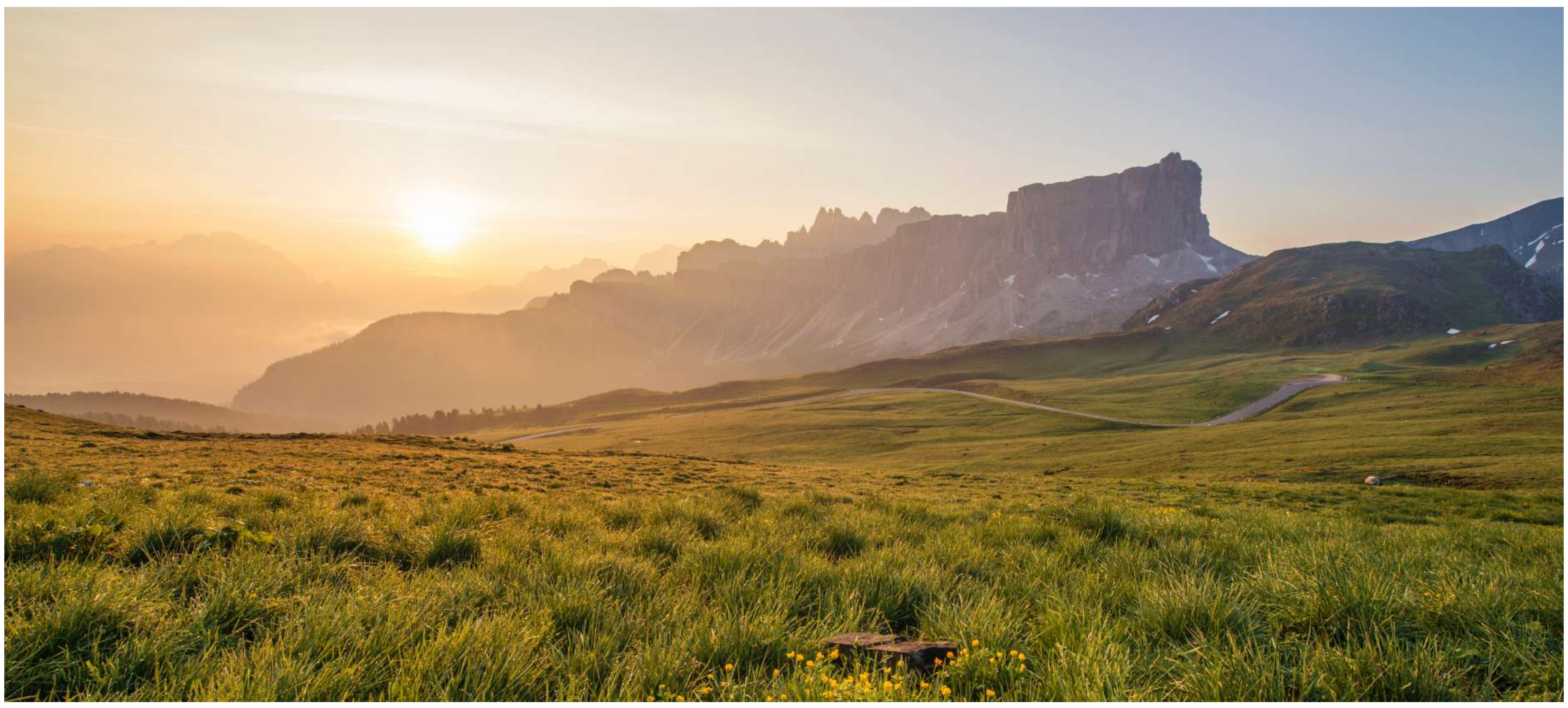
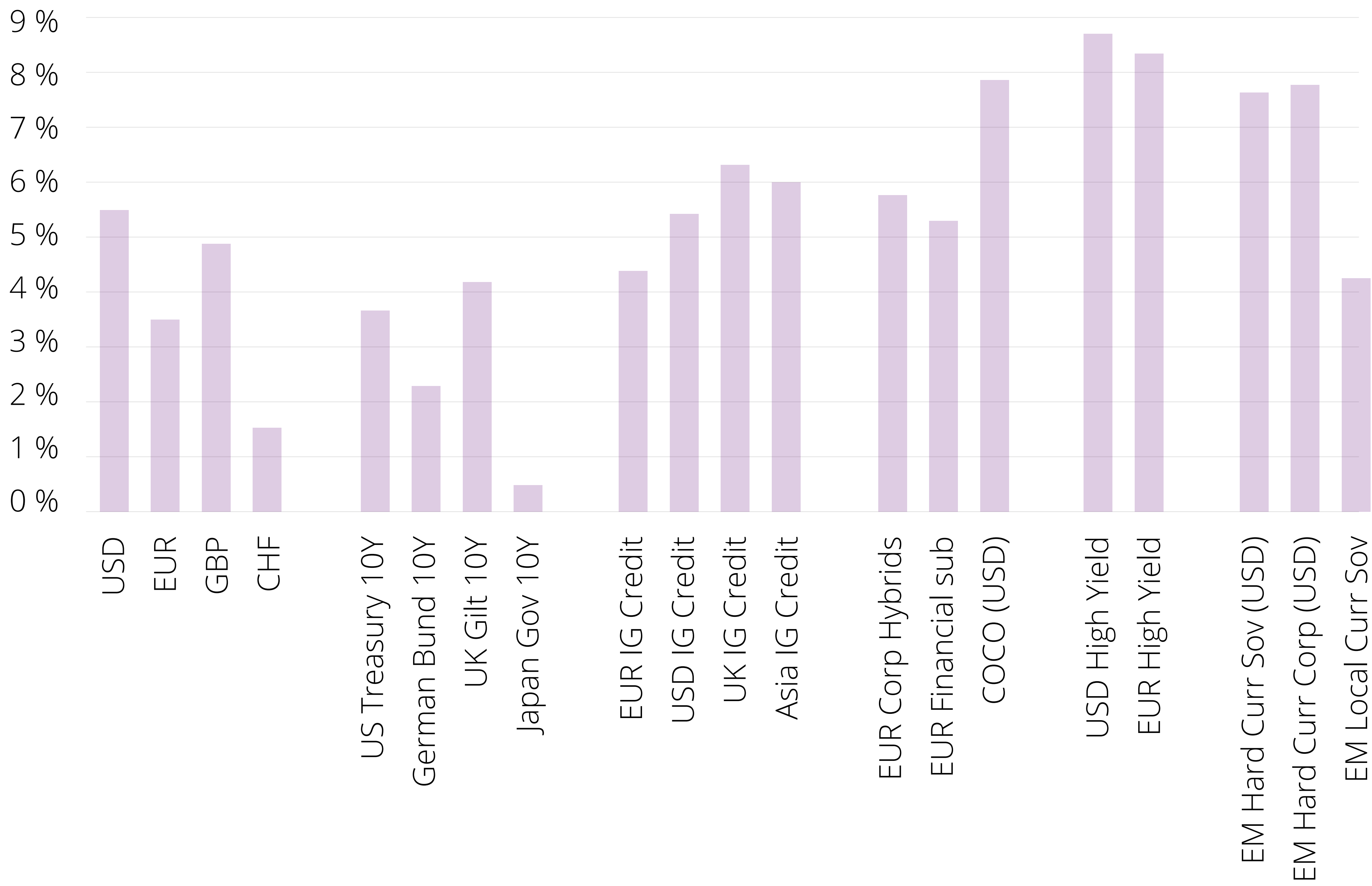
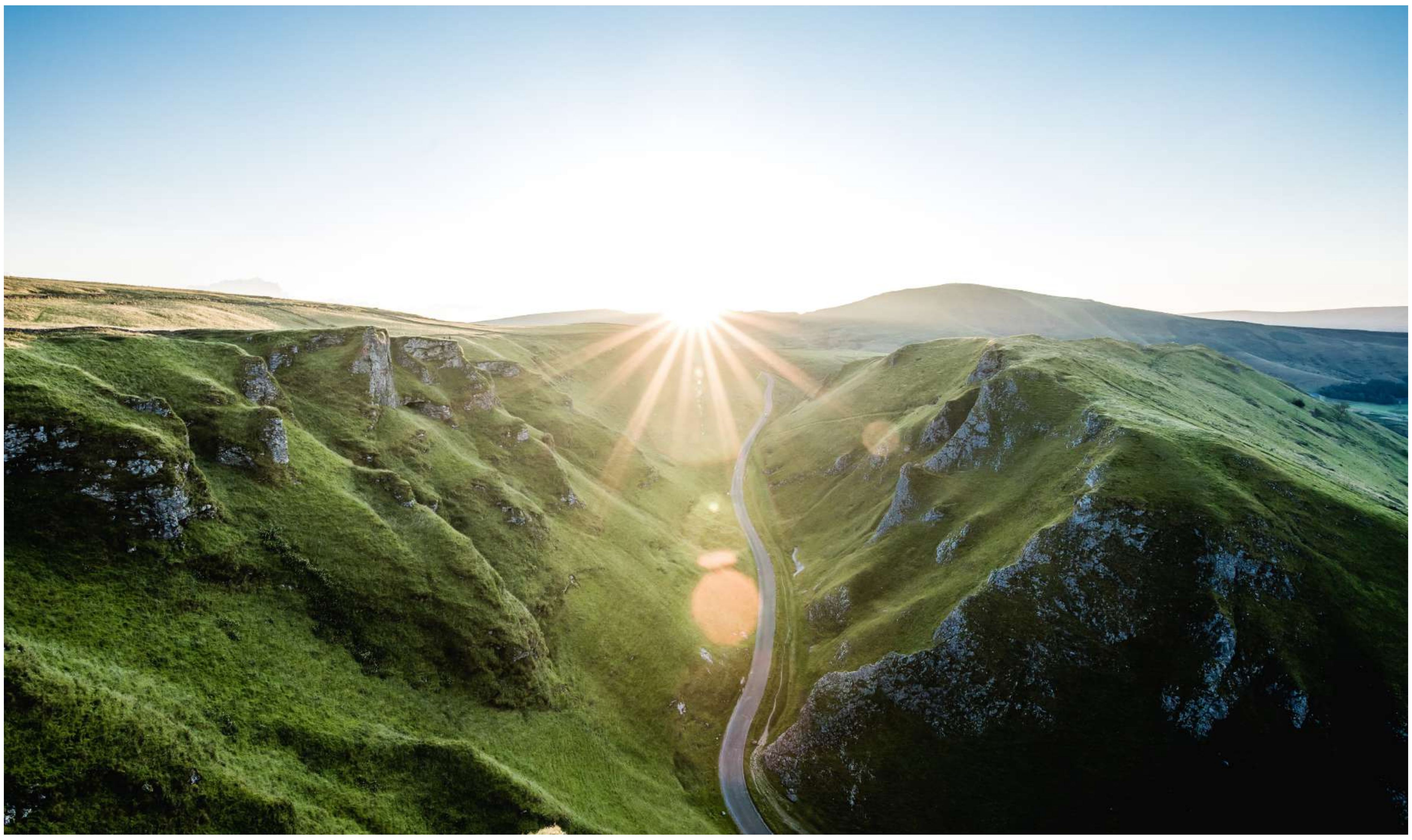
We are also underweight on Emerging Market Debt (EMD). While markets have been preoccupied by the debt ceiling discussion in the US, EMD has faced some country-specific issues too. Elections in Turkey led to wider credit spreads and there is still uncertainty ahead, with geopolitical tensions between South Africa and the US (regarding SA's stance towards Russia) unresolved and weighing on sentiment. Carry remains attractive for EM debt, and the outlook for easier monetary policy – first locally, and later also from the Fed – means that EM yields are likely to have peaked. As always, there are large discrepancies across EM issuers. Asian sovereign spreads appear very tight historically, while there may be better value in EMEA or LATAM, for example.



Yield for a selection of Fixed Income Classes



Source: Bloomberg, BIL



CURRENCY AND COMMODITIES

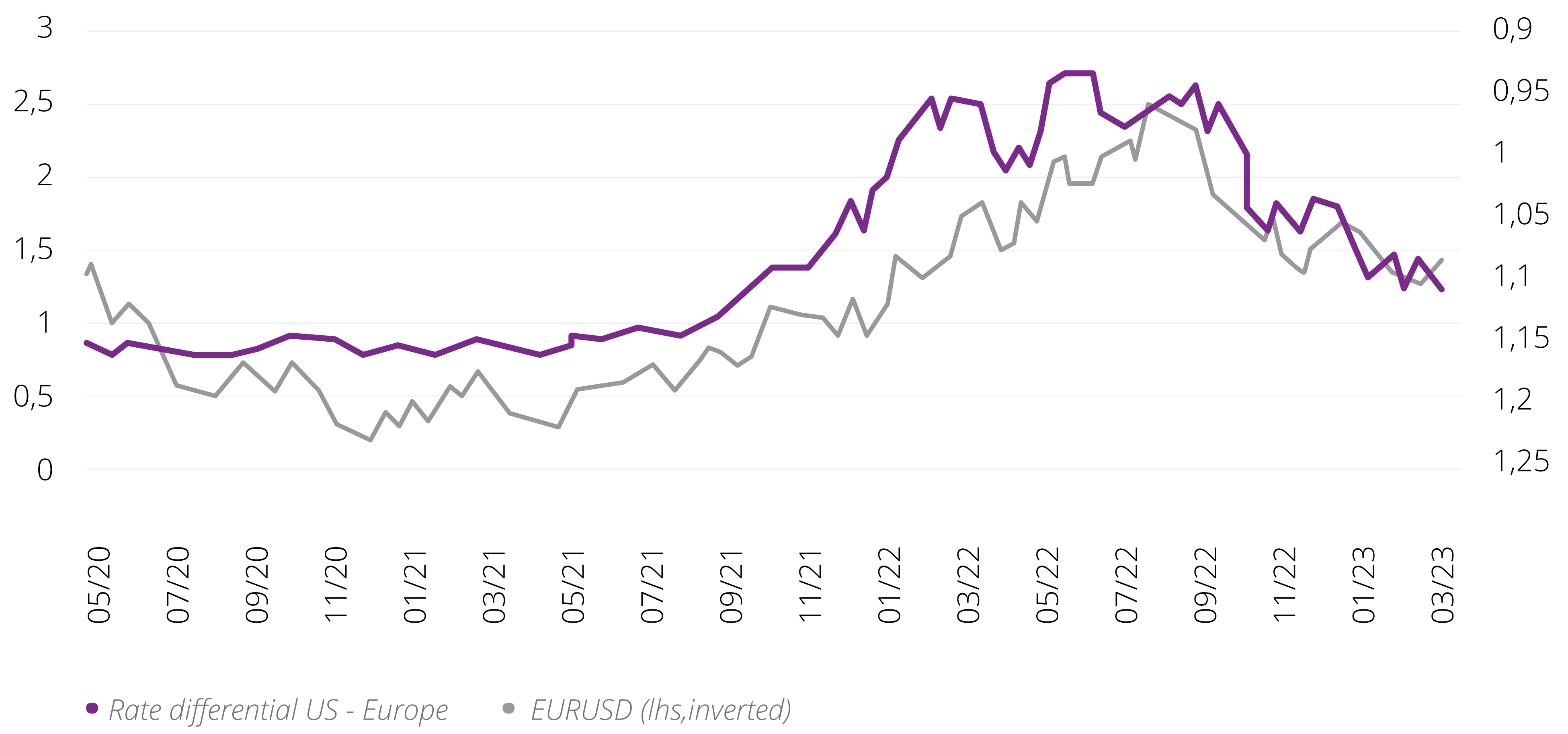
USD

Since the USD peaked against the EUR last September at 0.96, the greenback has been on a weakening trend since, recently crossing the 1.10 mark. In other words, the USD has weakened by around 15% against the euro. The "fall" in the USD has made some investors wonder if the dollar's heydays are over and if the USD is at a turning point.

Some metrics such as purchasing power parity indicate that the USD has been overvalued for some time but valuation alone is not enough to bring it back down. For a long-term decline to set in, there needs to be several catalysts in place.

Interest rate differentials are the first important factor. In the below chart, one can see a clear correlation between the interest differential on 2-year notes between the US and Europe and the trend of the EUR/USD exchange rate.

EUR/USD spot vs. rate differential



Source: Bloomberg, BIL

With a doom-and-gloom scenario now priced out in Europe, the euro has rebounded...

Another element driving the performance of currencies is the economic outlook across various markets. Last year, Europe was faced with a grim outlook on the back of energy supply concerns but now growth prospects in Europe are looking much brighter. The risk of a deep recession in the European economy has fallen. With a doom-and-gloom scenario now priced out in Europe, the euro has rebounded towards our 1.10 forecast.

In the short to medium term, we see the USD/EUR moving...

However, this positive momentum reversed in May because of certain fear factors confirming the historical fact that USD benefits from its status as a safe-haven currency. The major fear factor was the US debt ceiling. It seems contradictory, but fear of the US defaulting on its debt drove investors towards USD. USD was also underpinned by the mixed Chinese manufacturing surveys in May suggesting the outlook for the economy remains uncertain and policymakers may need to do more to spur growth. A weaker Chinese economy does not help the global economy and especially not the European one, which is helping to drive USD up against other major currencies. Finally, lower-than-expected inflation in countries such as Germany (6.3% y-o-y versus the 6.7% expected and down from 7.6%) takes pressure off the ECB to hike rates again, which is also affecting the single currency.

If the world economy manages to avoid a deep recession, the EUR could strengthen again based on fundamental drivers.

In the short to medium term, we see USD/EUR moving in the range of 1.06 to 1.11. Any upside above this level will require negative dollar drivers to kick in. The Fed seems to have ended its hiking cycle and the ECB will most likely continue a little longer, but this has been priced in by the market and will probably not be enough to push the euro much higher. For the euro to rally, it is now much less about the ECB staying hawkish than it is about the Fed enacting a dovish pivot. We believe that the Fed will probably hold on a bit longer and only cut rates towards the very end of the year.

If the world economy manages to avoid a deep recession, EUR could strengthen again based on fundamental drivers. However, given the uncertain economic outlook in the short run, we consider the upward potential to be balanced by the risk and are refraining from taking any aggressive bets on the EUR/USD exchange rate.

GOLD

...we are maintaining a neutral allocation to gold across our portfolios, primarily to cushion them in case of any potential stress periods on markets as credit conditions tighten and growth prospects dim.

Gold has undergone a resurgence since November, underpinned by a record 1,087 tonnes of buying by central banks last year. Despite this rally and profit-taking opportunities, moving into the second half of the year, we are maintaining a neutral allocation to gold across our portfolios, primarily to cushion them in case of any potential stress periods on markets as credit conditions tighten and growth prospects dim. The precious metal has several factors working in its favour: demand has increased on the back of sticky core inflation, we are living through a period of elevated geopolitical risk and headwinds are easing as the US hiking cycle reaches its conclusion.

Demand from central banks looks set to remain supportive, their buying spree having extended into this year, as they picked up a record 228 tonnes of gold in the first quarter. A survey by the World Gold Council, released in May, reveals that 24% of central banks intend to increase their reserves in the next 12 months. 62% said that gold would account for a greater share of total reserves compared with 46% last year.

It is worth noting that Chinese consumers also provided tailwinds as they rushed to buy more jewellery, bars and coins following the end of zero-Covid policies. Chinese consumers bought 198 tonnes of gold jewellery in Q1, 41% of the global total, representing the hottest first quarter for Chinese jewellery demand since 2015. However, with the tendency to save among Chinese consumers receding from historically high levels as the economy normalises, and a greater share of capital is allocated towards things like travel and entertainment, this could become a headwind.

OIL

We recently downgraded our view on oil from positive to neutral (played via equity investments in the energy sector).

...China's recovery will be key (+1.8 mpd YoY potential demand growth).

We recently downgraded our view on oil from positive to neutral (played via equity investments in the energy sector). It seems that the oil price rally in response to OPEC+ production cuts was a false dawn and that, for a sustained rebound, China's recovery will be key (+1.8 mpd YoY potential demand growth). With China's reopening clearly service-led for the time being, and manufacturing PMIs still in the doldrums as growth slows elsewhere, near-term oil market dynamics are unfavourable.

PRIVATE EQUITY

...that "difficult" years often prove to be good vintages: those capable of providing capital when it is more costly and difficult for companies to obtain it have an opportunity to secure better terms and ultimately purchase assets at attractive prices.

Headline inflation is receding, but interest rates remain elevated, catalysing liquidity issues and fuelling fear of recession. At first glance, this might not appear to be a favourable investment landscape, but actually we see fresh opportunities arising in private markets this year as volatility continues and valuations become more attractive.

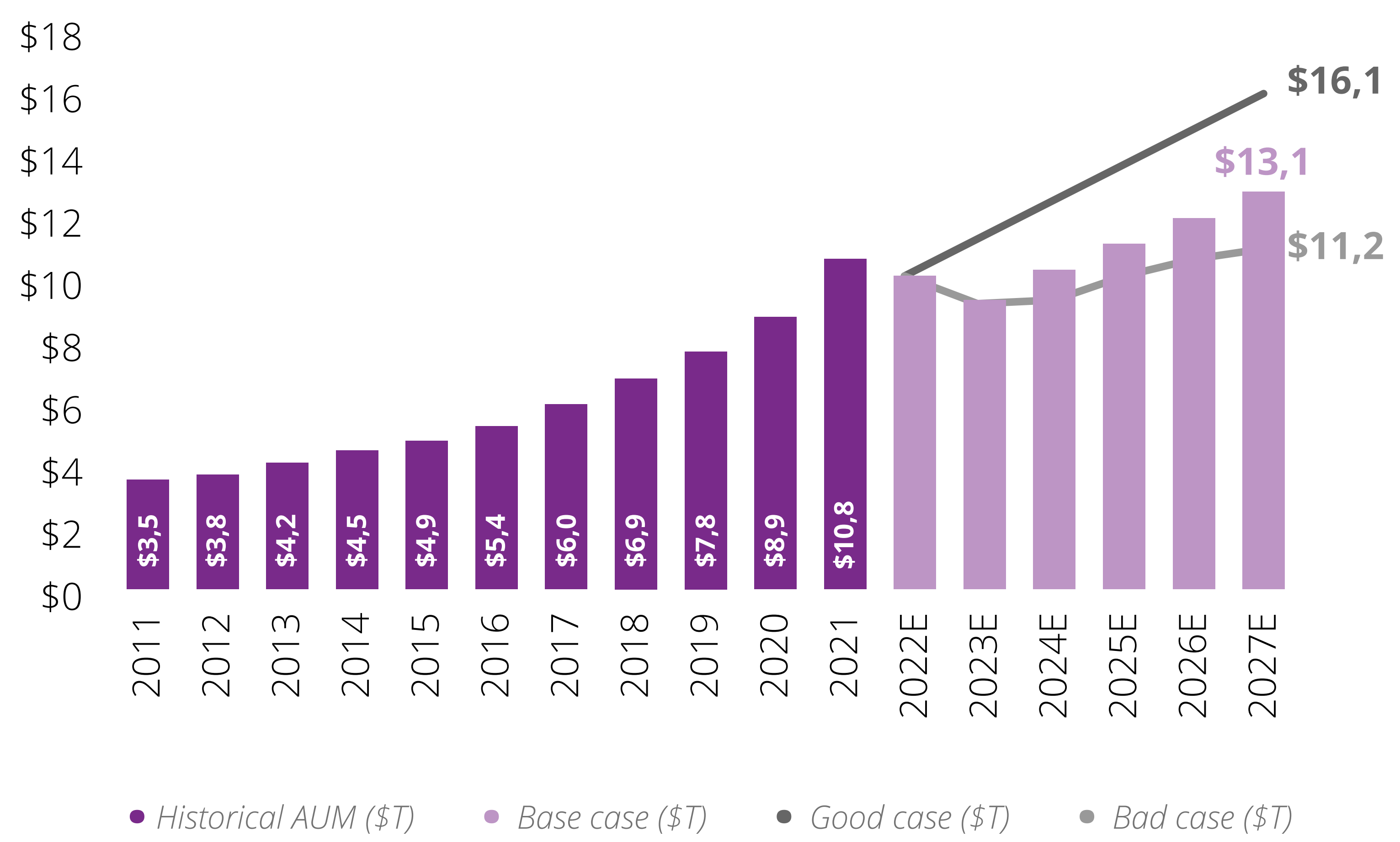
Looking back over time reveals that "difficult" years often prove to be good vintages: those capable of providing capital when it is more costly and difficult for companies to obtain it have an opportunity to secure better terms and ultimately purchase assets at attractive prices.

There are various ways to approach private markets. In our view, the optimal routes at this point in time are via infrastructure investments (with post-Covid government spending packages still percolating into the real economy), buyouts or secondaries.

...selecting an experienced manager with a strong network and proven experience in identifying high-quality assets with significant upside potential is vital.

The latter are interesting because often in times of public equity market downturns institutional investors are left with a private equity stance that is above their target allocation (or they simply might need to sell to meet liquidity needs). For attentive buyers, this can allow them to acquire slices of high-quality existing funds for a discounted price. As with all private market opportunities, but specifically with secondaries, selecting an experienced manager with a strong network and proven experience in identifying high-quality assets with significant upside potential is vital.

Global AUM ($T) in closed-end, private capital funds[1] & Private capital AUM forecast*



Source : Pitchbook. [1] As of December 31st, 2021. Geography : Global. * Forecasts generated on January 5, 2023

CONCLUSION

In the last outlook, our CIO Lionel De Broux quoted the 1995 movie "La Haine": It's not how you fall that matters. It's how you land. Here at the midpoint of the year, the landing process has now begun as the implications of tighter policies start to become apparent.

Though western central banks cannot yet declare victory on inflation, the end of the global rate hike cycle does seem to be in sight. Given that monetary policy takes time to filter through to the real economy, we do not yet know how economies will "land". Have central banks been able to trigger a soft landing, or have they tightened too much – the latter being something we will only know after the fact? Or is it that inflation will require even tighter policy as tight labour markets spur wage growth, especially in Europe?

While these uncertainties remain, what is clear is that the global growth outlook as we enter the second half of the year is worsening. The US, the world's largest economy, is flirting with recession, while Europe faces elevated core inflation, globally unexciting growth prospects and strong heterogeneity, with manufacturing-dependent countries like Germany already struggling. A lot of hope rests on China's reopening – if it goes smoothly, which is far from guaranteed, this should prop up growth amid a slowdown elsewhere.

All this calls for a defensive approach as we move into the second half of 2023. While we do have a larger-than-usual allocation to cash, we do not advocate exiting the market altogether. Time and again, studies have shown that missing just a few good days on markets can have a meaningful adverse impact on performance. No one can predict when those days will be. Rather, it is better to stay systematically invested, while diligently managing risk. This also means investors will already be in the market when an eventual reacceleration takes place (remember that earnings growth is projected to pick up considerably in 2024, at least in the US).

By adopting a defensive and diversified approach, we hope to limit the overall volatility of our portfolios, as well as the downside, should markets conditions take a turn for the worst. We do this by having a conservative exposure to risk assets, an allocation to safe-havens such as gold and some longer-duration govies, a defensive sector selection, and a preference for strong, dividend-paying businesses whose fortunes do not rise and fall with the economy.

CURRENT ASSET ALLOCATION MATRIX

	Strategic Weight	Current Weight	Stance
Equities	50%	44%	
Fixed income	42%	37%	
Cash / Equivalents	0%	5%	
USD	28%	25,5%	
Total return	0%	6%	
EQUITIES			
US	20%	17%	
Europe	20%	17%	
Japan	5%	5%	
China	2%	3,5%	
Emerging Markets Ex-China	3%	1,5%	
FIXED INCOME			
Government Bonds - Developed	20%	16%	
Emerging Market Debt	3%	2%	
Corporate Investment Grade	14%	15%	
Corporate - High Yield	5%	4%	
Oil	0%	0%	
Gold	8%	8%	

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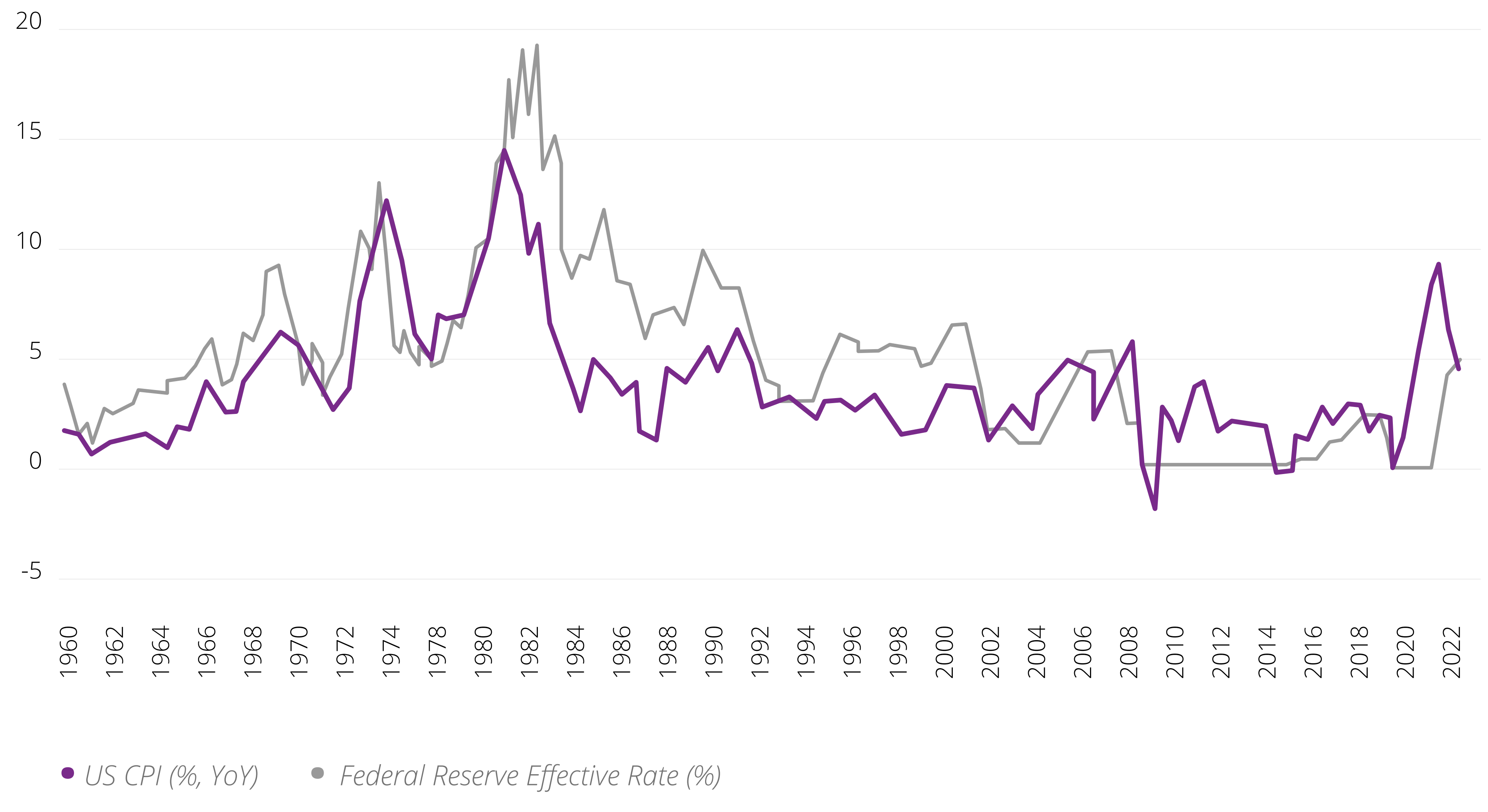
APPENDIX

1.1
APPENDIX

The Fed is eager to avoid a repeat of the Great Inflation of the 1970s



1.2
FISCAL STIMULUS HAS SUPPORTED AMERICAN CONSUMPTION

STIMULUS CHECK FOR THE INDIVIDUALS

APRIL 2020
$1200

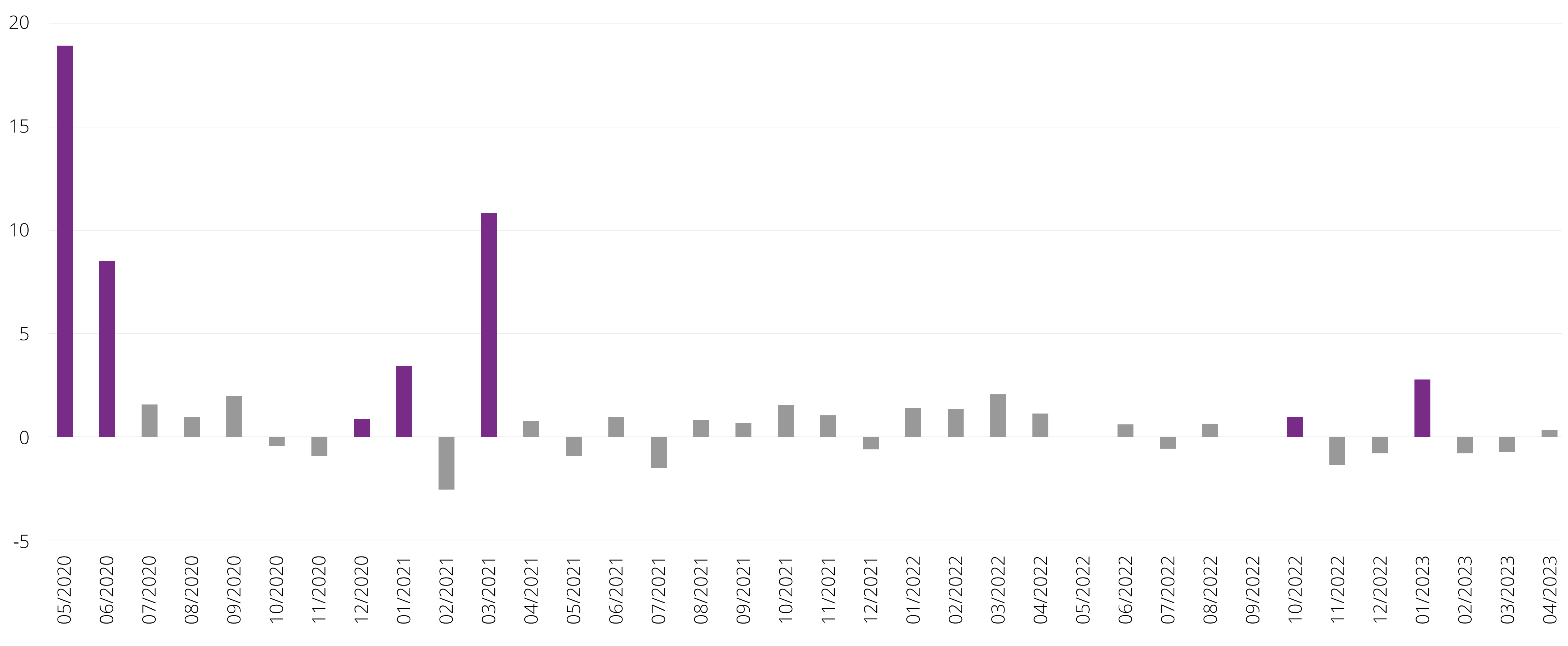
DEC 2020
$600

MARCH 2021
$1400

OCTOBER 2020
20 states, compromising over half of the US population
still enacting fiscal stimulus programs e.g. California
started sending payments of up to $1,050 to 23m residents
In total, these state programs added up to about $31bn = roughly 0.5% of quarterly GDP

JAN 2023
COLA

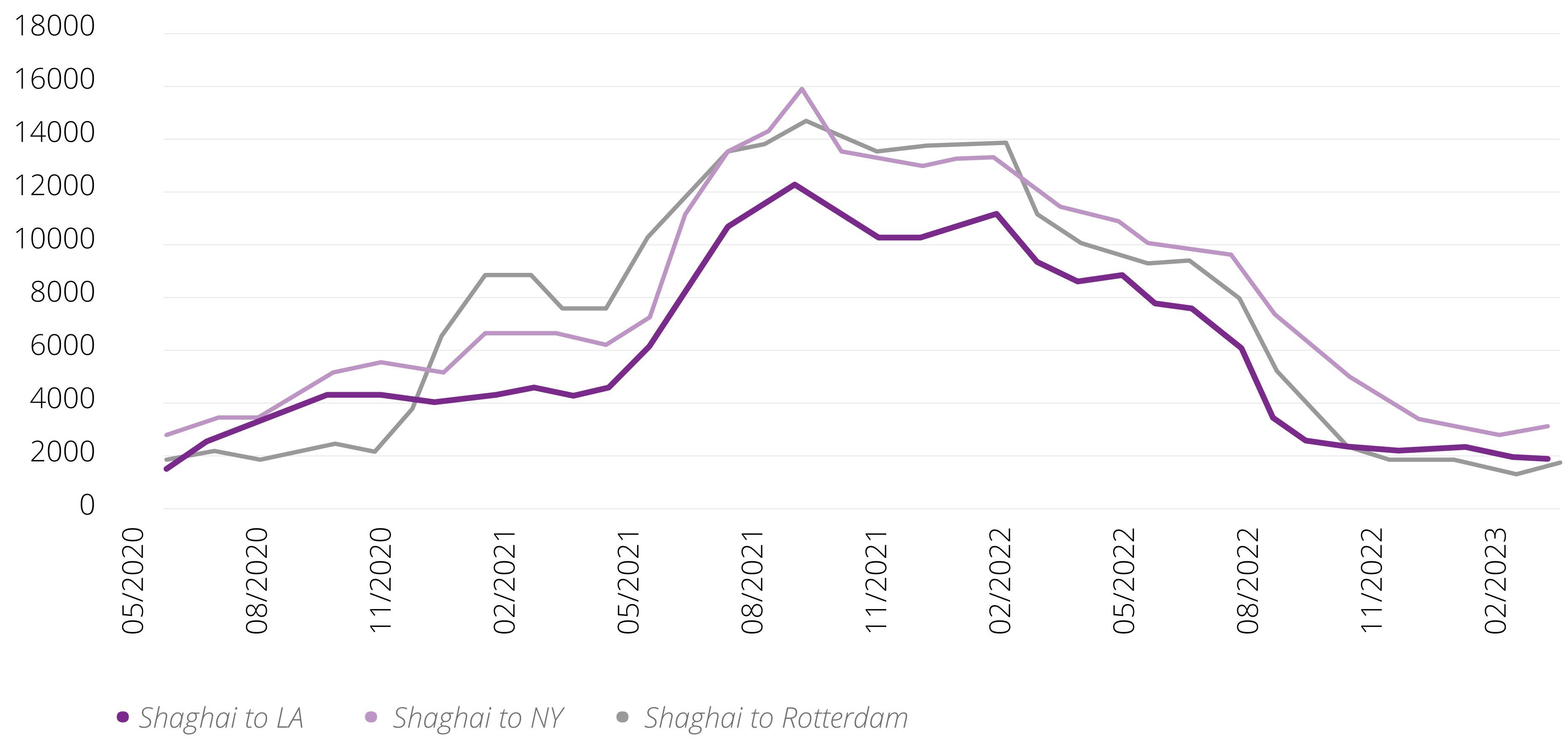
Retail Sales MoM%



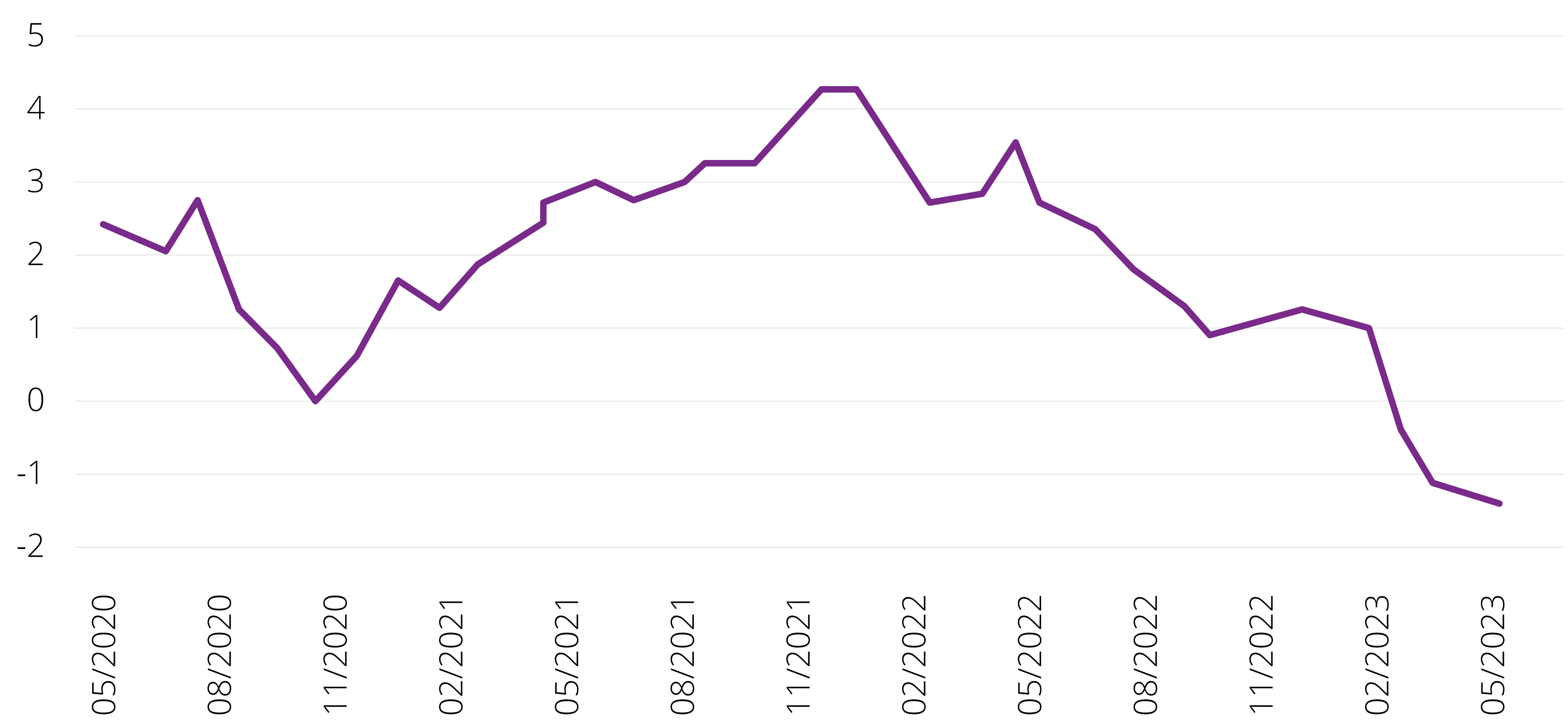
Source: Bloomberg, BIL

1.3
SUPPLY CHAINS HAVE NORMALISED

Shipping costs slump
Cost to send a 40-foot container



NY Fed Global Supply Chain Pressure Index



Source: Bloomberg, BIL

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