HOUSE VIEWS

May 2024

Rate cuts are coming

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Central banks are now set to pivot but will probably be out of sync. The European Central Bank (ECB) could be the first to cut rates at its June meeting, followed by the Bank of England. Inflation continues to fall in Europe and the modest revival in the economy is unlikely to derail this trend. In the United States, inflation has ticked upwards in some components (mainly housing), but recent signs that the economy is finally starting to moderate could be enough for the Fed to follow suit and cut rates, probably starting in the second half of the year, and gradually normalise its policy stance.

We remain Overweight equities in developed economies and have added exposure to emerging markets. Strong economic data and further evidence of upcoming rate cuts persuaded us to maintain our equity Overweight. We remain Overweight European markets, which still look cheap, and US markets, which stand to gain from their strong economy. We nudged up exposure to emerging market equities to cash in on the positive momentum that has emerged over recent weeks in markets that are still (broadly speaking) trading on attractive multiples.

We also continue to favour sovereign and investment grade corporate debt, still posting an interesting carry and offering a sound diversification play in case markets are hit by further turbulence in a deeply unstable geopolitical world. We are remaining Overweight the dollar versus the major European currencies to play a likely time-lag in the rate-cutting cycles of the central banks.

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OUR MAIN CONVICTIONS

Economic trends positive but a mixed global picture

Growth trends in the world's major economies continue to diverge. The United States has shown some modest signs of slowing lately but the economy should remain dynamic. In Europe, falling inflation seems to have nurtured some green shoots of growth, which could be further encouraged if monetary policy is eased as expected. Finally, in China some economic indicators have perked up slightly, even though domestic demand should remain weak for some time yet.

Central banks: heading for desynchronised loosening

Doubts continue to hover over US price trends but in Europe the downward trend in inflation seems firmly entrenched. As a result, the European Central Bank (ECB) should be the first mover in the policy-easing cycle, starting at its June meeting, with the Bank of England (BoE) close behind. The Fed is more likely to hang on until Q3, waiting for a confirmation of a durable taming of inflation. In all three cases, though, we expect only modest reductions in 2024, with three cuts by the ECB and BoE and just two by the Fed.

Overweight on European and US stocks and adding emerging market equities exposure

Corporate America has been posting strong results amid a buoyant economy and we are therefore keeping our Overweight position on US equities. We also retain our Overweight to European and UK markets, which stand to gain from the current economic rebound and their attractive valuations. Everywhere, the prospect of rate cuts will give markets additional support. Finally, we have upgraded emerging market equities to Neutral, mainly on their recent strong momentum and cheap multiples.

Still constructive on sovereign and investment grade corporate debt

Bond markets continue to profit from their attractive carry and looming rate cuts. The sovereign bonds safe-haven status may also play a favourable role in the current geopolitical climate and should recessionary pressures re-emerge. Even so, our economic scenario – sustained growth in the United States and a small bounce-back in Europe with only modest rate cuts – suggests there will be no great squeeze on bond yields. We therefore remain Neutral on fixed-income markets.

Overweight US Dollar versus European currencies

Unless something unexpected happens, the ECB looks set to trim rates in June, followed by the Bank of England in June at the earliest (August at the latest). However, the Fed is likely to hold fire until September at least. The mismatch in the timing and number of rate cuts should bolster the US dollar against European currencies. We are therefore maintaining our Underweight on the EUR/USD and GBP/USD, which means we are Overweight the dollar.

Still Underweight gold

Gold prices, since hitting a historical high in mid-April, have been yo-yoing since. The year-on-year performance however remains excellent thanks in large part to heavy buying by central banks and geopolitical tensions. We nonetheless remain Underweight an asset that pays neither interest nor dividends in a world of high interest rates.

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OUR ASSET ALLOCATION

Summary house views

			UW	Slight UW	N	Slight OW	OW	Variation since previous GIC
EQUITY		GLOBAL EQUITY				■		=
		United States				■		=
		Euro area				■		=
		United Kingdom				■		=
		Japan			■			=
		Emerging			■			+
FIXED INCOME	SOVEREIGN	GLOBAL RATES			■			=
		U.S. Treasuries			■			=
		Bunds			■			=
		Gilts			■			=
		EM Govies ($)		■				=
	CORPORATE	U.S. IG			■			=
		U.S HY		■				=
		EMU IG			■			=
		EMU HY		■				=
		U.K. IG			■			=
FOREX		EURUSD		■				=
		USDJPY			■			=
		GBPUSD		■				=
		EURCHF		■				=
ALT.		Commodities			■			=
		Gold		■				=
		Hedge funds		■				=

Equity markets: Allocation by style	Growth	Value
United States	No Preference	
Euro area	■	
United Kingdom	No Preference	

Fixed income: Allocation by duration	Underw.	Neutral	Overw.
United States		■	
Euro area			■
Unitted Kingdom			■

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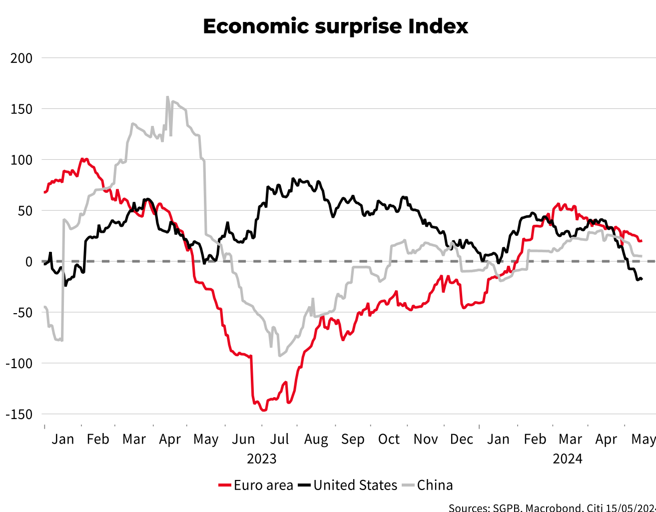
Economic surprises further fuel central banks rate cuts expectations

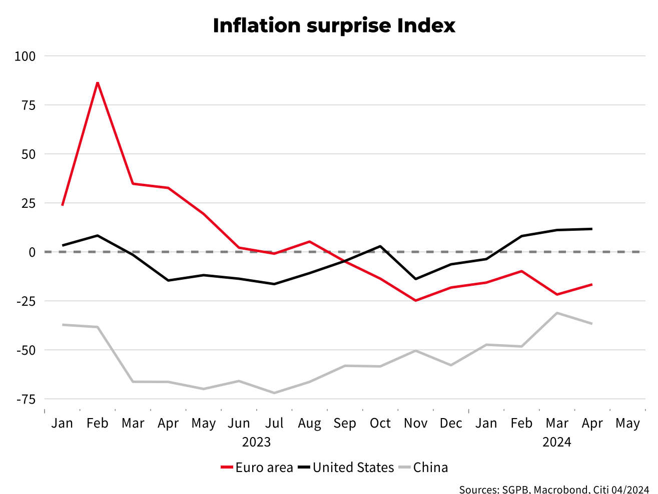
Recent data have supported the view that the world's major central banks will opt for a pivot soon. In Europe, the economy has surprised on the upside, albeit modestly. But the inflation easing appears well-entrenched and will encourage central banks to embark on a rate cut cycle sooner rather than later. In the United States, the economy has slowed slightly, and the latest inflation print is reassuring, suggesting the Federal Reserve (Fed) will likely go ahead with cuts, but these will be later and smaller than its European counterparts. In China, recent data show signs of a pickup but any improvement will be tentative.

Europe. Surprise indexes, which measure how far a given indicator deviates from consensus forecasts on the up- or downside, have been trending positively for the euro area and the United Kingdom. The economy has recovered slightly, thanks largely to past declines in inflation. We expect this improvement to continue, if only through a mechanical effect. European economies were hard hit after the energy crisis, particularly the German industry, and with the energy market now back to normal they should now return to a healthier growth path. Expected cuts in central bank rates should provide a further boost. Even so, growth will remain modest according to our scenario. Meanwhile, inflation has continued to decline, even surprising the consensus on the downside, supporting the European central banks to make their first cuts in June, though further reductions are likely to be gradual given the generally healthy state of the economy.

United States. After a year and a half of positive surprises, economic data proved disappointing last month. However, these downside surprises need to be seen in context. The US economic trends remain strong, with highly accommodative fiscal policy and robust private demand. The stock market surge of recent months has created a wealth effect for American households, who hold much of their savings in stocks. However, as the labour market normalises (in terms of jobs and wage growth) and fiscal stimulus fades, we expect the US economy to slow gradually toward its pre-Covid pace of around 2%. April's inflation figures tend to confirm our scenario of a gradual decline, but after recent unpleasant surprises the Fed will probably tread cautiously in easing policy. We expect two cuts, both in the second half of the year.

China. Economic indicators point to a slight improvement. Industrial output and retail sales have picked up and sentiment surveys confirm this trend. Nevertheless, China's problems have not gone away. The property sector continues to struggle, and the country faces a structural greying of the population.





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EQUITY MARKETS

Overweight on developed market equities, adding exposure to emerging markets.

The global stock markets bounced back last month, particularly in Europe and China. We are maintaining our Overweight to the US and have moved to Neutral on emerging markets given their recent positive momentum.

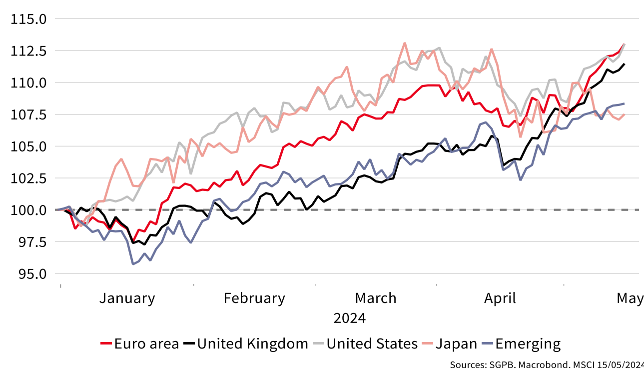
United States. The US equity market slightly lagged the global market last month (up 5% vs. 5.2%) but is still up by more than 10% year-to-date and by 30% year-on-year. The Q1-2024 results season again underlined the health of the US economy and its companies. Earnings rose 5.5% year-on-year with growth in most sectors. Economic figures fell somewhat short of forecasts but not enough to signal any marked slowdown in growth. So, the Fed can afford to wait until inflation returns closer to target, but it will probably, in our view, cut rates twice this year, giving stocks an extra boost. Lastly, the P/E ratio may be high but not at record levels. We therefore remain Overweight US equities.

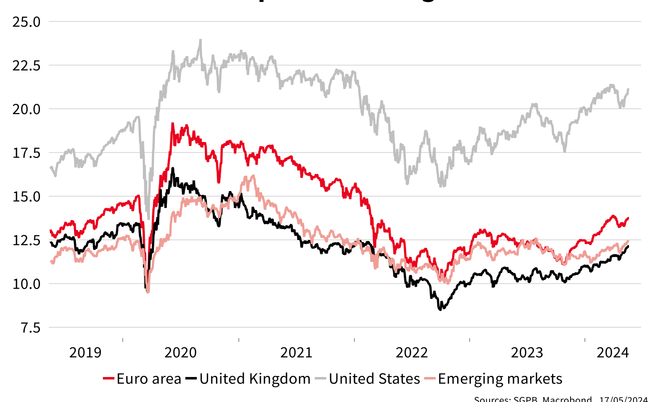
Euro area. European stocks tracked the global trend last month, continuing a healthy performance that leaves them up by 12% year-to-date and 18% year-on-year. A modest improvement in the economy, apparent in the first quarter, coupled with expected rate cuts in June, should continue to buoy the local markets. What is more, while actual results in Q1 may have been unimpressive, the guidance that came with them points to clear improvements in sales and earnings. Lastly, P/E ratios still look attractive while equity risk premia (over bonds) remain cheaper than their US counterparts. We therefore maintain our Overweight on euro area markets and favour growth stocks, which stand to gain most from the factors cited above.

United Kingdom. The UK equities market clearly outperformed its rivals, gaining 7.7% vs. 5.2%, spurred on by several factors. First, it was and remains one of the most attractive markets on multiples and has been through a year-long underperformance. Also, economic growth in Q1 surprised on the upside while inflation continued to fall, raising expectations that the Bank of England will cut rates. Finally, the British market continues to enjoy healthy momentum. For all these reasons, we remain Overweight.

Japan. The Japanese market was the worst performer last month, up 2.4%, but remains the best of the major stock markets year-on-year with a gain of 33%. This has been driven by strong corporate earnings as the country came out of deflation plus improved corporate governance and a resurgence in the popularity of equities as an asset among Japanese households. On the other hand, a volatile and falling yen coupled with uncertainties around monetary policy led us to remain Neutral on the Japanese market.

Emerging markets. Over the last month, emerging market equities have outperformed the global average, led by a rebound in Chinese stocks, which gained 16%. The Chinese revival seems to be, at least in part, a correction after a dismal performance when they were dragged down by the travails of the property market and reluctance of foreign investors to allocate to China. Now, though, Chinese markets are back in favour and could remain so. For one thing, the country's economic data have surprised on the upside lately. For another, momentum indicators for Chinese markets, and hence emerging markets more widely, have turned positive. Lastly, emerging markets are still attractively priced. Given this picture, we have moved from Underweight to Neutral on emerging market equities.





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FIXED INCOME

We remain constructive on bond markets

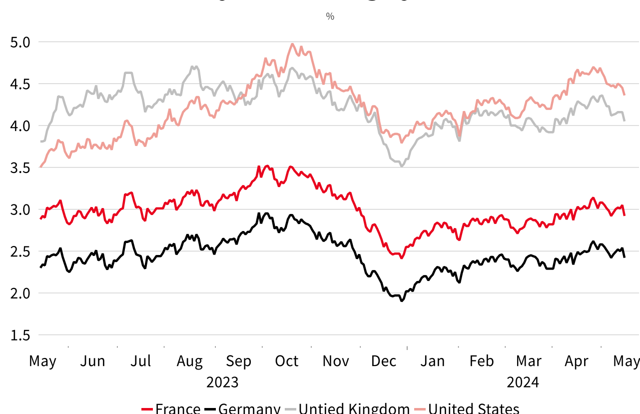
We remain Neutral on fixed income. With inflation easing, sovereign and corporate debt yields remain attractive both in nominal and real terms. Also, though volatility will likely stay high in the short term, the interest rate cuts expected in H2 should boost total returns.

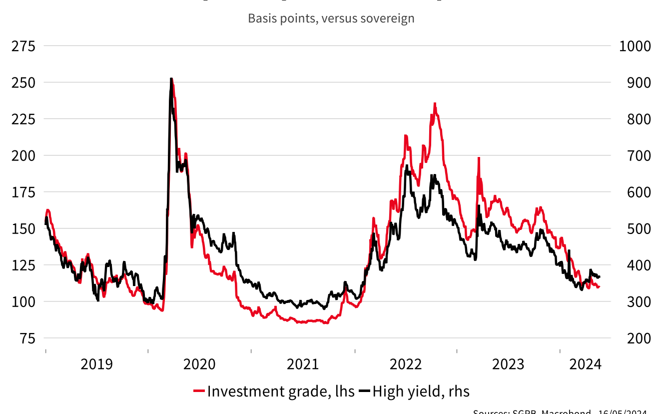
United States. US Treasuries reversed their April rally. Rates on 2-year bills – a proxy for where the market thinks policy rates will be in a year's time – fell from 5% to 4.75% and the yield on 10-year Treasuries fell from 4.7% to 4.3%, taking them both back to their March levels. The market was reacting to recent jobs and inflation data which have soothed fears the US economy could be about to overheat. Net new jobs in April and salary increases slowed towards a figure compatible with 2% inflation. Core inflation also came down, to 3.6% year-on-year, and we expect it to continue its gradual decline. We therefore also expect the Fed to start its rate-cutting cycle in 3Q24 with a second cut to follow in 4Q24. We are staying Neutral on Treasuries, based on attractive carry and our scenario of easing inflation and rate cuts in H2. We also remain Neutral on duration.

Euro area. Like US Treasuries, euro area sovereign yields tightened last month. The 10-year Bund went from 2.6% to 2.4% and the 10-year OAT from 3.1% to 2.9%. Risk premia on peripheral bonds also tightened again, with the spread on Italian debt narrowing to 130 bp. Driving all this is the gradual downward slide in European inflation towards its 2% target – it reached 2.7% year-over-year in April – and signs that the economy has started to tick up. Against this backdrop, the ECB should start reducing rates from their current 4% in June and make two further cuts before year end. We remain Neutral on the euro sovereign debt market for its still attractive carry. We move to Overweight duration in light of falling inflation and the start of the policy loosening cycle.

United Kingdom. Gilt yields also dipped over the past month, from 4.4% to 4%. We remain Neutral on this market. Inflation is continuing to decline and with the economy still comparatively weak, the Bank of England should start reducing rates in June and continue at a similar pace to the ECB.

Developed Credit Markets. We remain Neutral on investment grade credits which offer good carry at 4% and robust corporate balance sheets. We remain Underweight the high yield segment where valuations are very high and risks inevitably greater on these more heavily indebted companies.





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Overweight the US dollar

We remain Underweight the EUR/USD and GBP/USD, and so are Overweight the dollar, which should strengthen against the main European currencies as monetary policy at central banks moves out of sync.

Dollar index. The dollar shed some of its gains against the major developed and emerging market currencies last month, mirroring the decline in long bond yields as investors worried less about US overheating and global risk aversion diminished.

EUR/USD. The euro rallied nearly 2% against the dollar to EUR/USD 1.08 last month. These gains reflect both the improving outlook for growth and inflation in the euro area and the general fall in risk aversion. However, we remain Underweight EUR/USD as central banks are diverging in their easing cycle timing. The ECB is set to start cutting rates in June, but we expect the Fed to hold its fire for some time. The growth gap should also help the dollar against the euro.

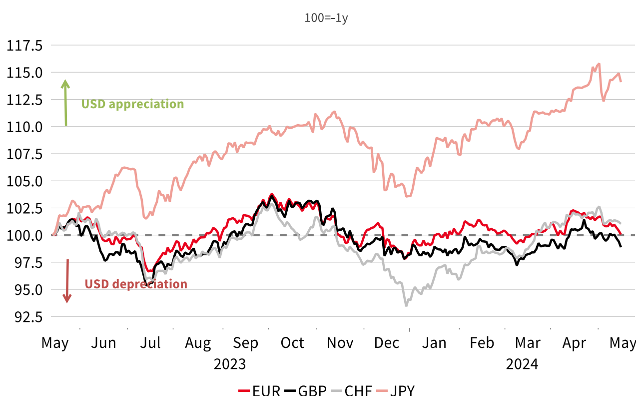
GBP/USD. Like the euro, the pound rose more than 1.7% against the dollar to GBP/USD 1.27. We also expect the Bank of England to begin its monetary loosening cycle before the Fed and we therefore remain Underweight on this cross.

USD/JPY. The yen has been more volatile than any other developed market currency for more than a year now, having lost nearly 12% of its dollar value. Volatility continued last month, with the yen swinging between USD 150 and 158. Globally, the yen's weakness reflects the large interest rate gap between Japan and the rest of the developed world as the Bank of Japan moves at a snail's pace toward policy normalisation (hiking its policy rate to 0.1% and removing the 10-year JGB ceiling). Also, considering the country's foreign reserve position, with important dollar assets and yen-only liabilities, the monetary authorities have intervened only intermittently to smooth volatility. We remain Neutral on USD/JPY based on Japan's robust foreign exchange position and the upcoming Fed policy pivot.

EUR/CHF. The euro continues to claw back some ground against the Swiss franc, rising nearly 1.3% over the month. The Swiss Central Bank was the first to lower policy rates, removing one of the props for its currency. Even so, we remain Underweight the cross as the ECB will shortly follow suit with rate cuts and given the low inflation, strong current account surplus and safe-haven status of the Swiss economy.

EM currencies. Emerging markets currencies gained ground against the dollar last month as markets revised the likely timing of Fed rate cuts and US long bond yields fell. Latin American currencies were the biggest winners, being highly sensitive to dollar rates. The Brazilian real gained 2.9% and the Mexican peso 1.4%. In Asia, the Korea's won enjoyed the largest increase versus the dollar, putting on 2.54% as the authorities intervened.

Exchange rate against USD



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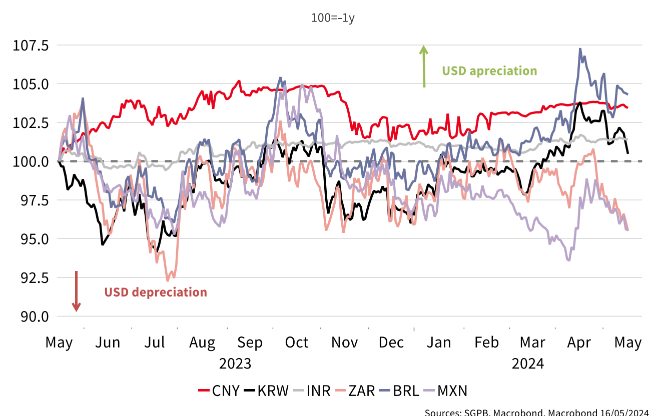

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Keeping our Underweight on gold and hedge funds

High interest rates continue to sap the appeal of Hedge Funds and gold, in our view, despite recent gains. Theme-wise, we are sticking with Artificial Intelligence and Clean Energy as well as re-shoring and European Excellence.

Commodities. The price of Brent crude fell around 5,5% last month to USD 83/barrel on an easing of Israel/Iran tensions, some slowing of the US economy, healthy performances by US equities and strong oil production. OPEC's latest round-up indicates that members are pumping 500,000 bbls/day more than the agreed cap. In Europe, gas prices dropped over 10% on the month as European inventories remain high.

Gold. Geopolitical tensions and pressure on US bond yields made it a volatile month for gold. Having hit a new all-time high above USD 2,400/oz, gold fell back below USD 2,300 before recovering to hover around last month's price and finish unchanged month-on-month but up by near 20% year-on-year.

HF-Long/Short Equity. Funds in this class that follow a non-directional strategy could do well in the current climate of high volatility and dispersion and the current stage of the economic cycle.

HF-Event Driven. High interest rates and a shortage of liquidity continue to discourage firms from embarking on mergers and acquisitions. Funds specialising in such deals look unattractive for now.

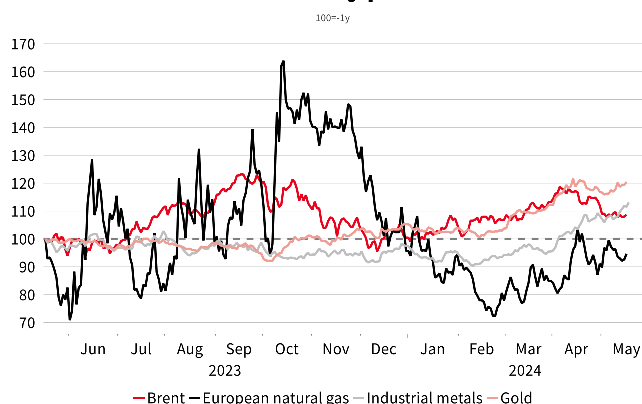
HF-Fixed Income Arbitrage. Some sovereign bond funds could benefit from higher interest rates. We retain our relative interest in funds positioned in the credits segment.

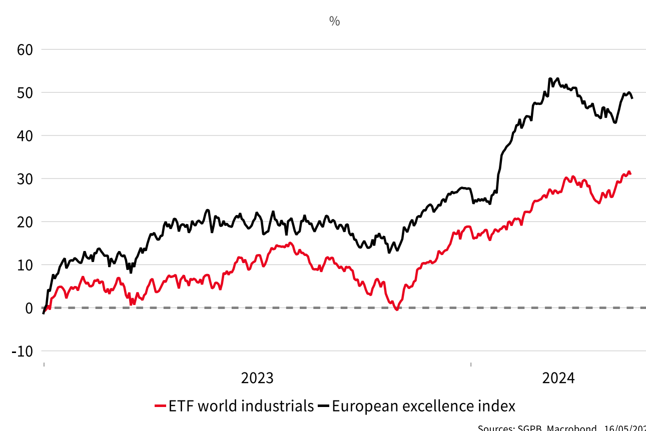
HF-Global Macro/CTA. Commodity trading advisors (CTAs) are generally useful as a way to hedge market volatility. But their recent performance has left them looking insufficiently attractive in our view.

Themes

Reshoring. The Reshoring theme should benefit from resurgent national industrial policies following supply chain disruptions as well as trade and geopolitical tensions. These policies have taken the form of stimulus packages in both the United States (Inflation Reduction Act) and Europe (Next Generation EU). The recent US decision to massively increase its tariffs on some Chinese products is the latest contribution to the reshoring story. The theme has performed well on equity markets. Since end-2022, the index of industrial stocks in developed economies has had a strong momentum, outperforming its benchmark.

European Excellence. After two tough years for the European economy, retreating inflation should not only allow the ECB to start its rate-cutting cycle but should also support household purchasing power and hence activity. Recent data bear out this scenario, which comes amid a rising trend for European equities, which remain attractively priced. To fully benefit from this combination of positive factors, we favour international companies who are leaders of their market segment.





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