

# HOUSE VIEWS

JUNE 2022



## STRIKING THE RIGHT BALANCE

**Bear markets.** Risk aversion has been on the rise all year and the trend has gathered fresh impetus since end-February. Equity and fixed-income indices are sharply down. Interest rates are rising – with spreads now being demanded for riskier debt – and the dollar continues to strengthen across a broad front. Behind these trends, a number of factors are at work: (i) uncertainties over the war, which have eroded confidence and pushed up commodity prices, (ii) the deteriorating health situation in China and its impact on supply chains, and (iii) inflation that remains stubbornly high, leading markets to price in higher rates and worry about recession. Without a serious easing of geopolitical tensions, the global outlook will remain weakened and uncertain. That said, assuming tensions get no worse, the central economic scenario for developed economies remains one of ongoing stable or positive growth. Labour markets are still looking healthy. Company balance sheets are generally robust. And the post-Covid return to business as usual continues to buoy the economy. However, in this situation economic policy choices will remain crucial.

**We are sticking with a prudent investment strategy.** We retain our overall Neutral exposure to equity markets: risks remain high but, in many cases, seem already to be priced in. Meanwhile, high inflation will encourage further hikes to interest rates. That said, a portion of the upward rate cycle is now behind us, and we retain our slight Underweight to sovereign bond markets. Consistent with this, we have reduced our Underweight to investment-grade corporate debt, where companies sitting on solid balance sheets are starting to pay attractive yields. Lastly, we are maintaining our Overweights to hedge funds and gold, both still attractive alternatives in uncertain times.

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Unless otherwise specified, all statistics and figures in this report were taken from Bloomberg and Macrobond on 05/20/2022.

# OUR STRONGEST CONVICTIONS

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## **Growth would remain positive despite high level of uncertainties**

Our central scenario remains that of growing activity in developed markets over the year 2022. According to the regions, emerging economies will suffer from the Chinese slowdown and rising commodity prices.

## **Inflation would only gradually decline, prompting central banks to pursue policy normalisation**

Inflation would have peaked in the United States, but its spread to different categories of goods and services as well as wages will slow down its decline. The Fed, as well as the main central banks, now have a clear priority in their fight against inflation. The ECB could also act faster to raise key interest rates in positive territory.

## **Financial markets already appear to incorporate much of the downside risks to business**

Uncertainties continue to be high but already appear to be largely integrated into markets. We remain cautious in equity markets, with neutrality in the US and euro area markets and an underweight position in Japan and emerging markets.

## **Some of the upward movement in yields seems to have passed, prompting a slight overweight in all bond markets**

After reducing our underexposure to sovereign bond markets, we are reducing our underexposure to the best-rated corporate debt markets. Interest rates are now attractive, with companies with generally healthy balancesheets.

## **Overweight to gold, hedge funds and dollar against other currencies**

The current environment of high uncertainty is conducive to alternative assets and safe havens. Meanwhile, the dollar continues to appreciate, notably due to a rapid tightening of the Federal Reserve.

# OUR ASSET ALLOCATION

The table below presents the latest conclusions of our Global Investment Committee (GIC)

		Summary house views					Variation since last GIC
		UW	Slight UW	N	Slight OW	OW	
EQUITY	GLOBAL EQUITY						
	United States						
	Euro area						
	United Kingdom						
	Japan						
	Emerging						
FIXED INCOME	GLOBAL RATES						
	U.S. Treasuries						
	Bunds						
	Gilts						
	EM Govies (\$)						
	U.S. IG						+
	U.S HY						
	EMU IG						+
	EMU HY						
	U.K. IG						+
FOREX	EURUSD						
	USDJPY						
	GBPUSD						
	EURCHF						
ALT.	Brent						
	Gold						
	Hedge funds						

# ECONOMIC OUTLOOK

## Acceleration of the monetary tightening cycle



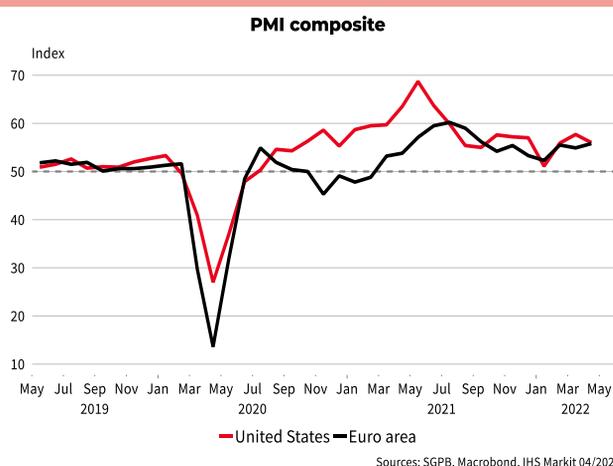
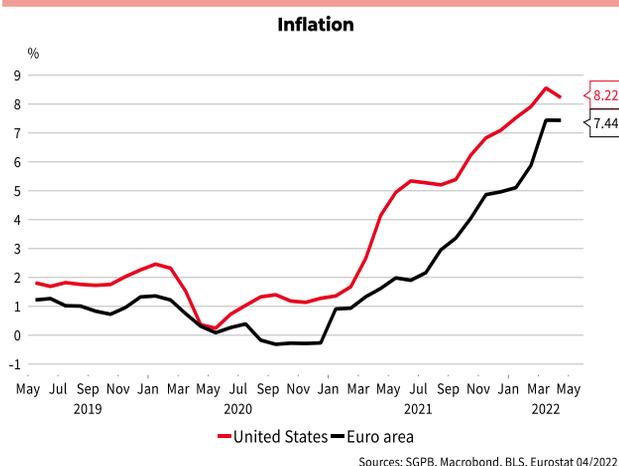
**Despite a still uncertain economic outlook where the balance of risks is tilted toward a slowdown, central banks have decided to go in hard on inflation.**

**Activity has slowed sharply since the turn of the year.** We now have economic activity figures for Q1 2022: +0.3% growth in the euro area, -1.4% in the United States, +0.8% in the United Kingdom, -1% in Japan (quarter-on-quarter). They confirm the economic slowdown in developed economies, a slowdown that is likely to intensify as the impact of the Ukraine war feeds through. In a classic economic cycle, the economic slowdown would automatically ease inflationary pressures by moderating global demand. This is not what we are seeing today. The strong inflationary trend, particularly in Europe, continues to be driven by supply-side disruption (commodities shock and slow renormalization of supply chains) in the face of which it will be some time before any effect from slowing demand can make itself felt. Meanwhile, bottlenecks are back, thanks to the Chinese lockdowns. Households, faced with the prospect of rising prices, have lost confidence, which has slumped to levels last seen near the start of the Covid crisis.

**The outlook remains one of slowing economic activity mitigated by still solid fundamentals.** While the start of 2022 saw consumer confidence fall and company order books shrink, final consumption and companies' trading volumes held up better than expected. This was thanks to a buoyant labour market and healthy growth accrued in 2021 as Covid lockdowns were lifted. Most Q1 results came in ahead of expectations and companies have so far mostly been able to mitigate or pass on rising production costs. Before the Ukraine war, households and companies also reported solid fundamentals in terms of savings and debt. These factors should prevent too sharp a slump in activity and head off any deep recession in the euro area.

**Speeding up monetary tightening.** Inflation may be nearing its peak – at least in the United States – but inflationary pressures will be with us for some time yet and inflation will remain high. The main central banks have looked at the situation and sped up their tightening of monetary policy. The next two rate hikes in the US are likely to be in half-point steps rather than the traditional quarter points. In the euro area, rates are set to rise sooner than initially thought, with the first hike coming in July. Markets expect euro area rates to move back into the black by year-end with a Fed funds rate of 2.75% in the United States.

**For the time being, activity remains resilient in the face of continued high inflation**



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# FIXED INCOME

## Reduction in underweight



**Bond markets have stabilized. Central banks are expected to continue monetary tightening while growth prospects deteriorate. We are moving from Very Underweight to Underweight on IG Corporate Bonds to take advantage of carrying**

## Fixed income

**United States.** US sovereign yields held broadly stable over the month. The 10-year hovered between 2.90% and 3.10%. This relatively stable performance reflects the Federal Reserve's ongoing tightening against a backdrop of fears for global growth and a gradual easing of inflation. As expected, the Federal Reserve increased its policy rate by 50bp to 1%. It also signaled it will continue to hike rates in half-point steps in June and July and by 25bp in September, which will take it to the 2.25% it views as neutral. Looking past this guidance and given the uptrend in the most stubborn components of inflation, such as rents, the Fed will likely have to keep tightening beyond this, ending up at 3% in the first half of 2023, which would tip financial conditions into restrictive territory. This being the state of play, we remain Underweight sovereign debt. At 3%, we think part of the Treasuries correction is now behind us. Also, the environment continues to favour Treasuries as investors seek safe havens in a world still rife with uncertainty.

**Euro area.** In line with US yields, European sovereign yields held generally steady having corrected sharply in April. The 10-year Bund and OAT hovered around 1% and 1.5%, respectively. With inflation still on the rise and underlying inflation running above 3%, the ECB decided to tighten policy significantly sooner than previously planned. It will likely halt net asset purchases in June and is set to start raising rates in July, with the aim of exiting its negative-rate policy. This speeding up of policy tightening has had the effect of widening risk premiums on peripheral countries. Given its options for reinvesting its various asset purchase programmes, we think the ECB still has the dry powder to deal with such pressures. We therefore remain Underweight sovereign bonds. Much of the correction is already done, and downside risks to the scenario are mostly good for sovereign debt.

**United Kingdom.** We remain Underweight Gilts. The Bank of England should continue to tighten rates. Money markets are pricing in a base rate of 2.25% at year-end. Inflation touched 6.2% in April and the monetary authorities are forecasting stagflation for 2022-2023.

## Credit

**United States and Euro area.** We are changing our recommendation on investment grade bonds from Strong Underweight to Underweight. Yields have shifted over recent weeks, making the carry on these assets attractive given the solid balance sheets of the issuing companies. We remain Underweight high-yield corporate bonds.

**Emerging markets.** We remain Underweight emerging market debt. Developed economies are tightening monetary policy, which usually sucks value out of EM assets. Also, further lockdowns in China and decoupling of the PBoC's monetary policy will put downward pressure on Chinese bond values.

### Investment grade corporate bond yield



Sources: SGPB, Macrobond, 19/05/2022

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# EQUITIES

## An overall neutral position

**We are retaining our overall Neutral exposure to equities. Equities have been facing multiple headwinds since the start of the year. Many of these have, however, already been priced in by the market. Also, the outlook for revenue growth remains positive in a context of significant nominal growth.**

**United States.** Equity markets corrected sharply over recent weeks as the Fed tightened policy and real rates turned positive. Tech stocks were hardest hit by the trend in rates, with the Nasdaq posting losses comparable to those seen in March 2020. While the Q1 earnings reported by companies (including those in the Nasdaq) mostly surprised on the upside, revenue risks are on the downside. For one thing, deteriorating households' confidence is likely to translate into softer consumption. For another, rising wages and production cost inflation are putting pressure on company margins. Nonetheless, recession now looks less likely – at least in 2022 – than markets originally feared. The labour market continues to boom, and the near-energy independence of the US economy means it can mitigate the commodities shock. Overall, we remain Neutral.

**Euro area.** Euro area equity markets continue to suffer from the war raging in neighboring Ukraine. Inflationary pressures are mainly coming via energy and food prices. Underlying inflation is lower than in the United States and salary rises much lower. Growth in Q1 2022 was broadly stagnant, as economies fighting their way back from Omicron were hit by the commodities shock. Consumer confidence fell back to the levels seen in March 2020, just as the ECB is bracing to speed up its monetary tightening calendar. A first policy rate rise is now expected in July 2022. In these circumstances, we reckon much of the correction to European equity indices has already happened. Also, the value on offer in equity markets is now looking attractive. Considering these multiples factors, we remain Neutral.

**United Kingdom.** The UK equity market is one of few developed countries to have performed well since the start of the year, thanks to its advantageous sector composition. On the other hand, the British economy itself is skirting recession, with household incomes especially hard hit. Overall, we remain Overweight, as the UK stock market is relatively independent of the country's economy.

**Japan.** The Japanese equity market, in contrast, is at the mercy of growth trends in wider Asia. Ongoing health clampdowns in China are likely to hurt earnings at the leading Japanese groups. Also, the correlation between a weak yen and improving company profits has weakened over recent years. We remain Underweight.

**Emerging markets.** Emerging market equities are currently being hard hit by the shutdown to activity in China. The brutal drop in the Chinese economy is also creating bottlenecks, raising fears of possible supply problems and fresh pressures on inflation, particularly for emerging economies. We therefore remain Underweight.

### Burst of the US technology sector bubble



Sources: SGPB, Macrobond, Nasdaq 18/05/2022

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# FX RATES

## Still Overweight on the dollar

**Strong geopolitical tensions and faster normalization by the Federal Reserve will keep the dollar high against major currencies.**

**Dollar index (DXY).** With risks significantly on the rise, the dollar continues to make gains against main currencies. The Federal Reserve is tightening policy quicker than other big central banks in developed economies and the relatively robust pace of US economic growth combined with a persistence of geopolitical risks over coming weeks, should translate into continued support for the USD.

**EUR/USD.** We remain Overweight the dollar versus the euro, although it has probably already run up most of its rally. Ongoing geopolitical risks, mounting threats to European growth and the Fed's intensified pace of monetary policy tightening will continue to support the USD for the next few months.

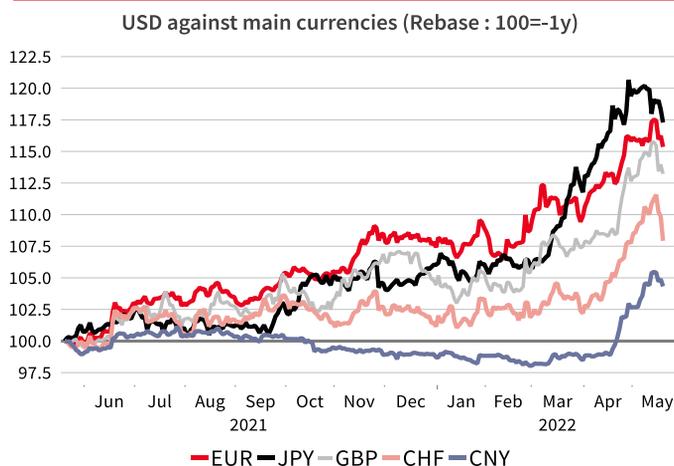
**GBP/EUR.** Sterling is largely unchanged versus the euro at EUR 1.19. We remain Neutral on the cross, as the gap between nominal rates in the two regions is likely to remain stable.

**EUR/JPY.** Downside pressures on the yen remain significant. The Bank of Japan left monetary policy unchanged, continuing to control the yield curve with underlying inflation still running at a negative -1.6% in April, resulting in a significant increase in JGB purchases over recent weeks. Given the discrepancy in monetary policy, we remain Underweight the euro/yen cross.

**EUR/CHF.** The Swiss franc is holding steady against the euro. While geopolitical risks look set to continue for months yet, the still negative Swiss interest rates and the SNB's interventions on currency markets should cap any gains by the CHF. We remain Neutral on the EUR/CHF.

**EM.** Emerging currencies remain on a downward trend. On the one hand, the extension of lockdowns in China have put Asian currencies as well as those of countries exporting mining products at a disadvantage. In addition, the Fed's accelerated tightening adds downward pressure to currencies like the TRY that are dependent on capital flows. The only exception to this downward trend is the BRL, which still benefits from positive real rates.

### Strong appreciation of the US dollar against major currencies



Sources: SGPB, Macrobond, Macrobond 19/05/2022

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# ALTERNATIVES

## An environment still favourable to alternative assets



Since the start of 2022, the economic backdrop of sustained inflation and uncertain growth prospects has been bad for traditional assets but good for alternative investments. We maintain our Overweights to gold and Hedge Funds. We remain Neutral on oil.

### Commodities

**Oil.** Having briefly dipped below USD 100/bbl last month, oil is now trading at USD 110/bbl and looks set to stay high, albeit with plenty of volatility to come. Supply side, exporter countries are capping production and have no plans to raise it. Demand side, the Chinese lockdowns are having their effect. Against this, Europe's plan to cut off its supply from Russia by the end of the year is helping put upward pressure on prices. Overall, we remain Neutral on oil.

**Gold.** The gold price fell over the month to just above USD 1,800/ounce, back where it was before the Ukraine war. The trend is explained by strong gains in the dollar and rising fixed-income yields – both factors that make it less attractive to hold gold. However, at its current price, gold is looking tempting again, particularly compared to fiduciary currencies other than the dollar, which are losing purchasing power, and following the recent plunge in crypto assets. Crypto was sold, like gold, as offering some hedge against inflation. Obviously, though, gold remains the go-to safe-haven asset. As inflation and economic uncertainty look set to last some time yet, we are maintaining our Overweight.

### Hedge Funds

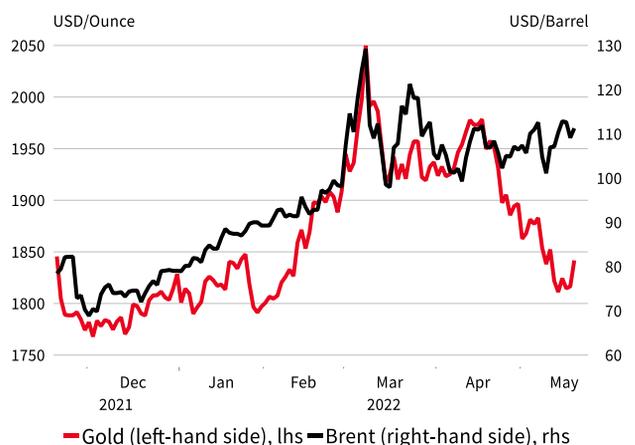
**Long/Short Equity.** Equity funds (L/S Market) are playing a particularly strong “performance protection” role as they are able to manage dispersion, particularly high in the current phase of sector rotation on equity markets.

**Event Driven.** Merger managers will continue to benefit from heavy M&A activity, led by companies that are cash-rich and/or eager to take advantage of still cheap credit in the short term.

**Fixed Income Arbitrage.** We remain cautious on funds taking positions in sovereign debt, given our scenario of a gradual rise in interest rates. We prefer funds positioned on the credit side, which stand to profit from this market where conditions are particularly tight. Such funds also offer protection against rate widening.

**Global Macro / CTA.** Commodity Trading Advisors (CTAs) offer traditional protection against market volatility, which looks set to persist. As for Global Macro funds, managers will have to pick particularly carefully amid ongoing uncertainty about the economic recovery.

#### Gold and oil prices since the beginning of the year



Sources: SGPB, Macrobond, ICE 19/05/2022

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