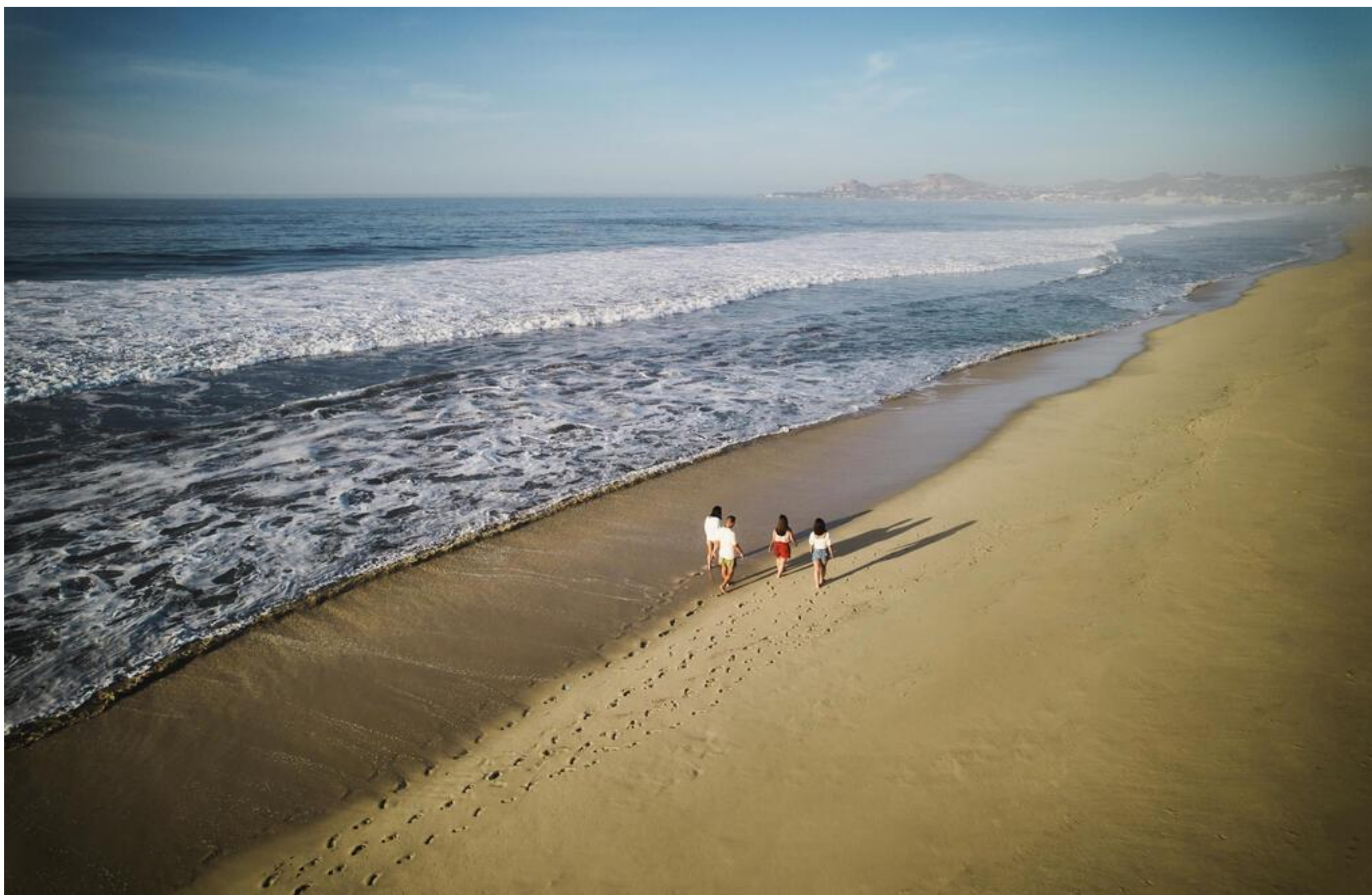
HOUSE VIEWS



July 2024

Central banks into the deep end

In accordance with the regulations in force, we inform the reader that this document is qualified as a promotional document.

Disinflation trend confirmed. With inflation continuing to fall on both shores of the Atlantic, the major central banks could now start scaling down the restrictive nature of their monetary policy. We now expect their next moves to be both gradual and synchronised, with the Federal Reserve (Fed), European Central Bank (ECB) and Bank of England all cutting rates once each quarter until the end of 2025. The economic background should remain favourable. Growth looks set to slow in the United States but only after several quarters of strong economic growth. Europe's economic growth should remain more muted and with a more uncertain pace, helped by falling inflation and the prospect of lower interest rates.

We maintain our equity Overweight and add fixed-income exposure. The prospect of still positive growth and falling interest rates leads us to maintain our Overweight to equity markets in developed economies. US markets continue to ride the robust American economy and European markets still look good value. At the same time, we have tweaked our exposure to bond markets to play the upcoming easing of interest rates, by extending the duration of our sovereign bond positions and adding exposure to high-yield corporate debt, where we have gone from Underweight to Neutral. Finally, we have switched to Neutral on the USD/EUR and USD/GBP currency pairs as our scenario now sees all three central banks easing policy in synch.

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OUR MAIN CONVICTIONS

Economic trends support keeping some risk in our allocation. We retain our Overweight to equity markets.

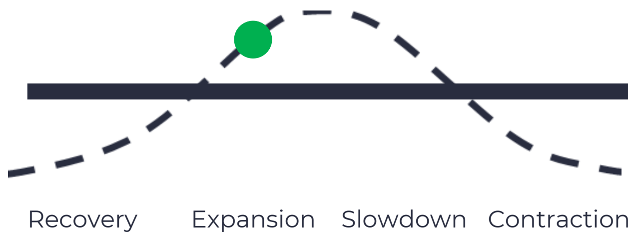
We like the European and US markets, which should benefit from healthy economies and a downward cycle in rates. We are Neutral on Emerging Market equities, despite their attractive multiples, largely because of China, whose economy remains sluggish.

Confirmation of upcoming cuts in policy rates and tempting levels of carry continue to support fixed-income markets. Sovereign debt is seen as a safe haven in the current geopolitical situation and also if recessionary risks emerge. We have increased duration on sovereign portfolios and raised our exposure to the high-yield corporate bond segment to neutral.

We are now Neutral on the dollar's main pairs as we expect the main central banks to cut rates in synch.

The main building blocks of our analytical framework

Economic Scenario



Valuations

Momentum

Sentiment

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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	No Preference	
United Kingdom	No Preference	

Fixed income: Allocation by duration

	Underw.	Neutral	Overw.
United States			■
Euro area			■
Unitted Kingdom			■

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ECONOMIC OUTLOOK

Negative trend in “surprise” indicators: don’t jump to conclusions too quickly

The Surprise Index records, for a large number of economic indicators, the differences between actual and expected outcomes. Over the past few weeks, "surprises" related to economic activity have clearly turned negative in both the United States and the euro area. These surprises mainly reflect the persistence of a disconnect between survey data and hard data, and do not reduce our confidence in our scenario of a supportive economic environment, with moderate but positive growth and continuing decreasing inflation, opening the way for central bank rate cuts.

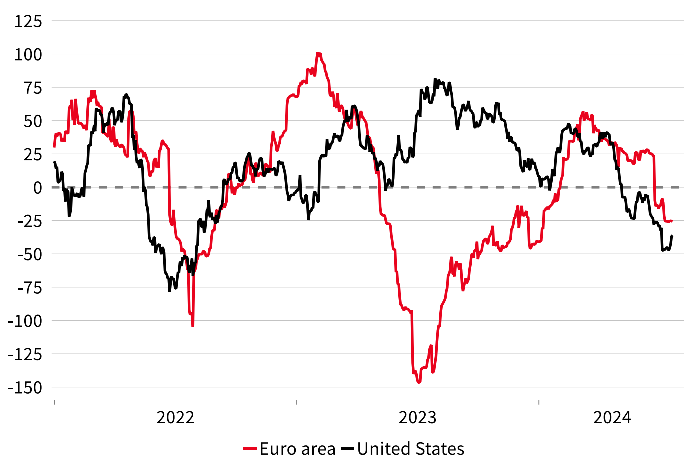
Persistence of a disconnect between survey data and hard data. Since Covid, survey indicators have underestimated the economic activity recovery. The initial explanation was linked to very specific tensions related to the Covid crisis, particularly those linked to supply chain disruptions and bottlenecks. More recently, this disconnect can be explained by increased sensitivity of households and businesses to certain variables - inflation and interest rates in particular, given that developed economies had not experienced a marked inflationary episode in nearly 40 years and high interest rates in over a decade. First, households continue to have a very negative perception of inflation, while it has already significantly decreased. Indeed, households are more affected by the significant increase in prices than by the slowdown in the pace of increase. Moreover, the increase in disposable income is not perceived as sufficient and kept consumer confidence at depressed levels. Similarly, business surveys are still affected by high interest rates.

In the United States, surveys overstate the economic slowdown. After several quarters of very high growth, economic activity is slowing down across the Atlantic, a slowdown that was both expected and desirable. While this slowdown is real, it appears overestimated by survey data. Hard data on activity shows a much more limited slowdown. While household goods consumption and the labour market are slowing, services consumption, industrial production and business investment remain well oriented. Overall, hard data reinforces our scenario of growth stabilising around 2% in the United States, its pre-covid level. With the confirmation of the decline in inflation, this scenario should allow the Federal Reserve to lower interest rates in the coming months.

In the euro area, growth would remain positive but more moderate and uncertain. In the euro area, the context remains different from that of the United States, with a still moderate level of activity. In addition to surveys that still appear soft, hard data gives mixed signals, with industrial activity in particular continuing to disappoint. Hard data and confidence indices still signal a divergence between the robustness of sectors related to business investment (a powerful growth engine in 2022-23) and the weakness of household consumption (especially in durable goods such as automobiles). Nevertheless, the decline in inflation in a context of tight labour market and strong wage growth should boost real disposable income for households and, in the long term, consumption. We continue to expect moderate but positive growth, supported by the decline in inflation and then interest rates in the second half of the year.

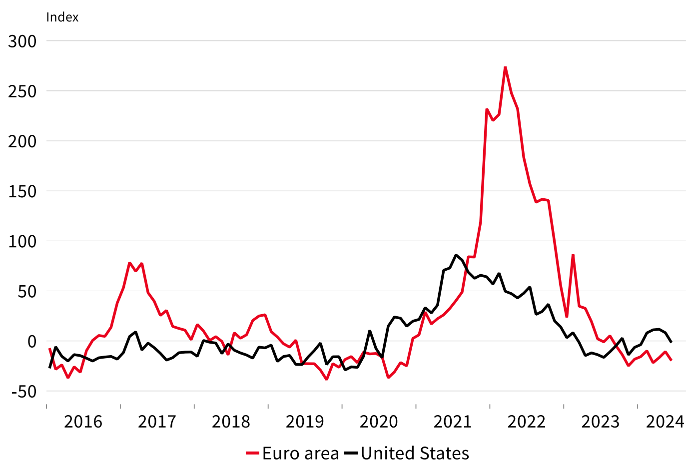
In China, indicators continue to point to modest economic activity. Growth disappointed in Q2, with domestic demand particularly weak. China’s economic difficulties are likely to last, including persistent troubles in the property sector and, longer term, the trend toward an ageing population.

Surprise economic activity index



Sources: SGPB, Macrobond, Citi 18/07/2024

Inflation surprise index



Sources: SGPB, Macrobond, Citi 06/2024

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We maintain our Overweight to developed equity markets

Global equity markets were rocked last month by several factors: political events including French snap elections and the turbulent US Presidential campaign, expectations for Fed rate cuts and, lastly, sector and style rotation by investors. They nonetheless managed a firm performance – up 2.6% month-on-month and 19% year-on-year – albeit with major discrepancies by region and sector. We stand by our Overweight to developed equity markets, based on cheap value in Europe and healthy earnings growth in the United States.

United States. The US stock market continued to rally over the past month (+1.8%, +23% over a year). This strong monthly performance, however, disguises major discrepancies between sectors and styles, particularly since the start of July. Escalating expectations of Fed rate cuts triggered a rotation toward value stocks, small and mid-caps and defensive sectors. Fears of worsening trade relations between the US and China then sent growth stocks tumbling further. We remain Overweight US equity markets which should continue to benefit from healthy – though slightly slowing – growth, the steady decline in inflation and limited rate cuts. Corporate profits and balance sheets are still looking good, justifying the premium priced into company multiples. We remain Neutral on investment style: while falling rates are traditionally good for growth stocks this segment currently looks overpriced.

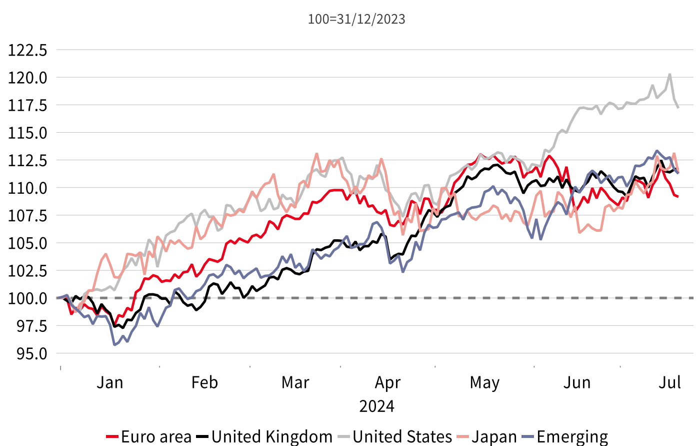
Euro zone. European equities underperformed again last month (0.7%), hit by unexpectedly weak economic data, political uncertainty in France and China/US tensions. Even so, we stand by our Overweight to these markets, with our rationale being that the economy should remain strong, driven by a rebound in real household incomes as inflation retreats and rates fall. Also, private sector investment is likely to be sustained by healthy corporate margins and a catch-up of past underinvestment. Finally, European markets are still cheap in absolute terms and close to their long-term average relative to bond yields. That said, we have shifted to Neutral on style (having previously favoured growth stocks).

United Kingdom. Despite the market's heavy value bias, British stocks slightly underperformed the global index last month. Nevertheless, they can count on several support factors going forward: interest rate cuts, reviving economic growth and the restoration of a degree of political stability. Cheap-looking valuations and improving earnings growth will also be good for the UK market, where we remain Overweight.

Japan. The Japanese equities market, which boasts one of the world's best year-on-year performances, outperformed the global index last month (+6.3%). We remain Neutral on this market, which should get a boost from the end of deflation and gradual exit from the zero-rates policy but could be held back by yen volatility and its heavy weighting toward technology and communication sectors.

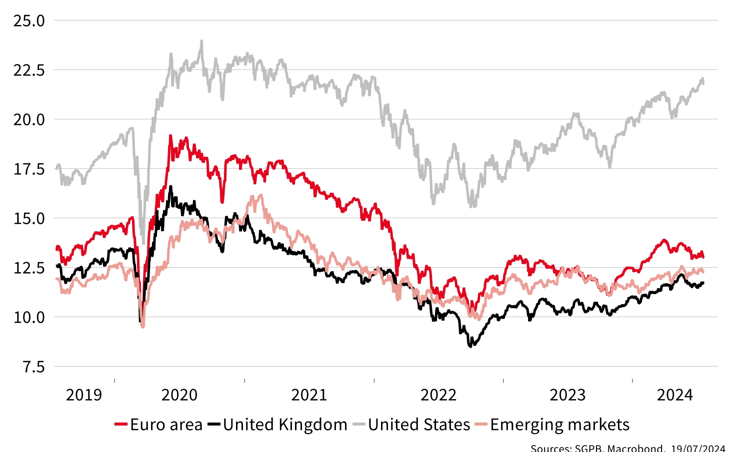
Emerging markets. Emerging markets outperformed the global index over the last month (+3.5%) as the plunge in the Chinese market was offset by rallies elsewhere, notably in Latin America and India. A heavy weighting toward technology stocks, geopolitical risks and the weakness of the Chinese economy make us cautious on these markets. However, we are sticking with our Neutral stance due to the attractive value they offer.

Equity market performances in euro



Sources: SGPB, Macrobond, MSCI 18/07/2024

Equity indices: Price to earnings ratio



Sources: SGPB, Macrobond, 19/07/2024

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FIXED INCOME

Still positive on bonds

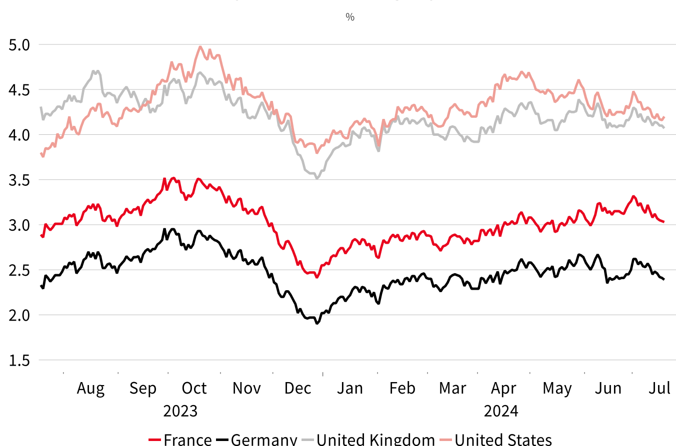
We remain Neutral on fixed income. With inflation easing, sovereign bond and corporate bond yields remain temptingly high in both nominal and real terms. We have increased the duration on our government bond yield exposure and moved to Neutral on high-yield debt to play the attractive carry and still solid balance sheets offered by most issuers in this class.

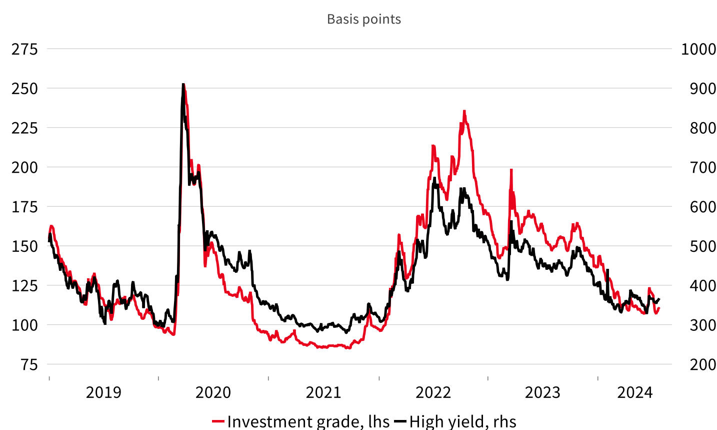
United States. Sovereign yields have narrowed since early June. Yields on the 2-year Treasury bill (proxy for monetary policy one year out) have fallen from 4.7% to under 4.5% and yields on the 10-year T-bond from 4.3% to 4.2%. These falls reflect the market's expectations for Fed rate cuts following good news on inflation and an ongoing rebalancing of the labour market. Inflation continued to slow in June – including, importantly, the price of rent and equivalent rent – bringing it near to the Fed's 2% target. Moreover, while the US economy continues to create lots of jobs, unemployment has edged up to 4.1%, again close to the Fed's "target". In these circumstances, the Fed is likely to start cutting rates in September and cut again at its December meeting taking the Funds rate to 5% at year end. We therefore remain Neutral on Treasuries but with a preference for long duration to play the fall in inflation and the downhill leg of the rate cycle.

Euro zone. Sovereign bond yields in the zone have also fallen substantially over the past month on political risk in France, further falls in inflation and the easing of monetary policy. Yields on the 10-year Bund and OAT dipped around 20 bps to 2.4% and 3.1%, respectively. This still leaves the French risk premium higher than before parliamentary elections were called. Finally, the sovereign yields paid by peripheral economies also fell and their risk premiums are now back to pre-French-election levels. European inflation continues its gradual decline (2.9% year-on-year), helped in large part by sharp falls in durable goods inflation. Wage growth easing should also help take the sting out of services inflation in coming months. In this context, the ECB held its deposit rate at 3.75% at its July meeting and we expect it to make two further rate cuts in 2024 to end the year at 3.25%. We therefore remain Neutral on European sovereign debt but with a preference for long duration to play the fall in inflation and downhill leg of the rate cycle.

United Kingdom. We also remain Neutral on gilts, with a preference for long duration. The 10-year gilt yield fell last month, to 4%, with the Bank of England expected to start cutting rates in September.

Credit. We are moving from Underweight to Neutral on high-yield corporate debt. This asset class has done well this year, up 4% thanks to a resilient growth environment, ongoing declines in inflation and substantial carry of 6.6%. Moreover, companies continue to enjoy solid fundamentals, with a higher proportion of rated BB companies in the index, while the index's short duration limits the risk of total return losses if rates should spike.





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CURRENCIES

Dollar Neutral

We have shifted to Neutral on the EUR/USD and GBP/USD crosses as the Fed and BoE both look likely join the ECB in cutting rates in September. We remain at Neutral on the USD/JPY given the Bank of Japan's snail-like progress toward normalising policy.

Dollar index. The US currency lost ground in its key crosses with developed and emerging market currencies. This drop in the dollar reflects growing expectations that the Fed will start cutting rates in September.

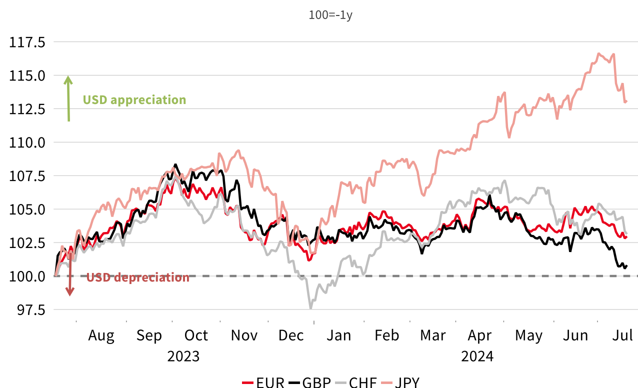
EUR/USD. The single currency gained almost 2% against the dollar last month, rising to USD 1.09. Euro strength mainly reflects growing expectations that the Fed will start cutting rates in September and that the ECB will make its second cut the same month. The narrowing spreads between euro and dollar rates translated into gains for the euro. We have therefore moved to Neutral on the EUR/USD as we expect the two central banks to cut rates at a similar pace.

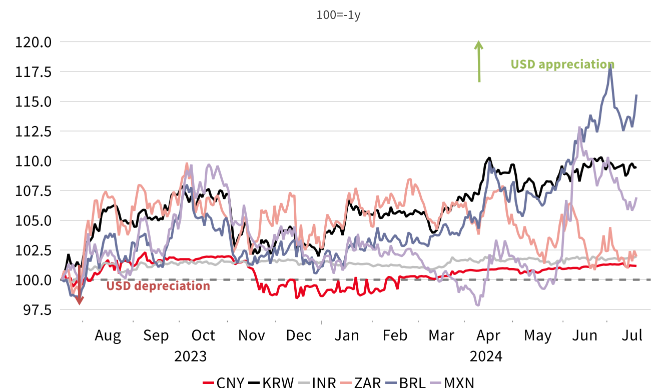
GBP/USD. As with the euro, we have switched to Neutral on the GBP/USD. Sterling gained more than 1% against the dollar, tracking the rise in expectations for Fed rate cuts. We anticipate the Bank of England will start its own series of rate cuts in September (or possibly August), from the current base rate of 5.25%, as core inflation (3.5% year-on-year in June) continues to edge gradually down toward target. This synchronisation in the pace of interest rate cuts should keep sterling’s crosses steady at current exchange rates.

USD/JPY. In a break with the trend of recent quarters, the JPY rose more than 1% against the dollar to 157 USD/JPY. This rally again illustrates the sharp jump in expectations for a September rate cut by the Fed, the US rate spread to Japan being the biggest with any developed economy. It also seems likely that the Japanese monetary authorities stepped in to support the yen. We remain Neutral on the USD/JPY. First, the BoJ will continue to crawl toward a more normal policy stance. We expect two rate hikes in H2-24 while Fed rate cuts are likely to be gradual. Second, the country's balance of payments remains heavily positive, limiting further downward pressure on the yen.

EUR/CHF. The euro fell by around 1% against the Swiss franc to 0.96 EUR/CHF last month. We remain Underweight this cross. Political uncertainties in Europe should be good for the Swiss franc, particularly given the wider political risks in the world. Also, Switzerland's heavy balance of payments surplus coupled with a reduction in the Swiss National Bank's foreign exchange reserves should help the franc.

EM currencies. It has been a mixed story for emerging market currencies in the past month. The Mexican peso made good part of its post-election losses, rising 3.2% against the dollar as monetary policy was kept tight, allaying market concerns. The Chinese yuan continues its slow slide as CNY rates continue to come down.





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We retain our Underweight to gold and hedge funds

High interest rates tarnish the appeal of hedge funds and gold. Theme-wise, we retain our exposure to Artificial Intelligence, Clean Energy, Reshoring and European Excellence, and have added another, Health Innovation.

Commodities. Apart from a short-lived spike to USD 88/bbl in early July, Brent prices traded between USD 84 and USD 86 last month, ending slightly up on the month as a whole. Oil prices were led by greater confidence in growth-friendly rate cuts by the Fed, the fall in US oil stocks and signs of persistent weakness in the Chinese economy.

Gold. Gold touched a new all-time high of USD 2,482/oz last month and ended the month up 5%, helped by the prospect of US rate cuts which would weaken the dollar and the increasing probability that Donald Trump will return to the White House and revive geopolitical tensions with China.

HF- Long/Short Equity. Long/short equity funds, which specialise in non-directional strategies, 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.

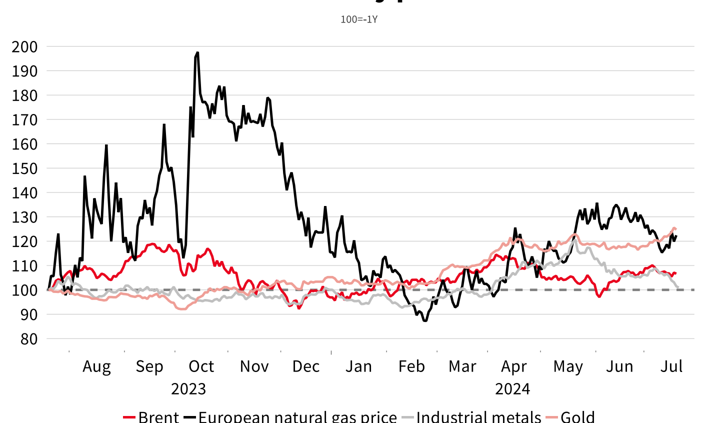
HF- Fixed Income Arbitrage. Some sovereign bond funds could benefit from higher interest rates. We retain our relative interest in funds positioned in the credits segment.

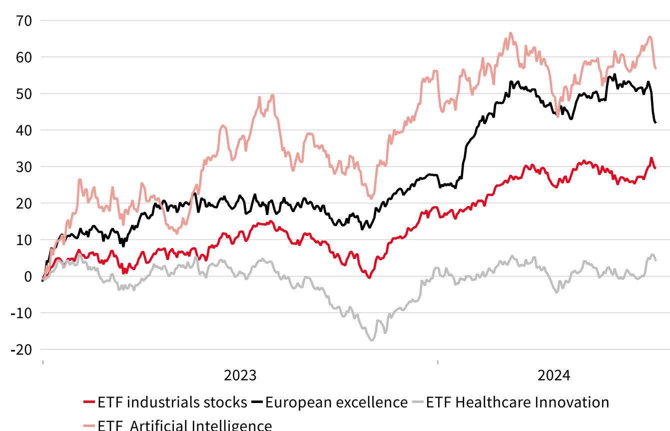
HF- Global Macro/CTA. Commodity trading advisors (CTAs) are generally useful as a way to hedge market volatility. However, their recent performance has left them looking insufficiently attractive in our view.

Themes

Current themes: Artificial Intelligence, Clean Energy, Reshoring and European Excellence. Even after 18 exceptional months, we think Artificial Intelligence stocks will continue to perform well, given the maturity and potential of AI and the strong profit growth of companies in the sector. The Clean Energy theme is a way to invest in winners from the energy transition. The Reshoring theme should benefit from the return of industrial policies and perform strongly on equity markets. Finally, the European Excellence theme is a way to cash in on a combination of positive factors – falling inflation, cuts to ECB rates and attractive valuations – via international companies that are leaders in their respective markets.

New theme: Healthcare Innovation. An ageing population, changing lifestyles with a greater interest in physical fitness, well-being and nutrition, coupled with major technological progress (gene therapies, immunotherapy, personalised medicine, remote health services, etc.) should benefit the health sector as a whole and its innovation component in particular. This theme thus represents an opportunity to invest in cheaper-valued stocks that offer long-term growth.





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