PICTET
Asset Management

BAROMETER OF FINANCIAL MARKETS JUNE OUTLOOK
June 2023

Marketing Material

Barometer: Neutralising risk

China's re-opening has failed to deliver a market rally, US banking sector remains jittery and inflation is proving sticky. We extend our already cautious stance by shifting more positions to neutral.

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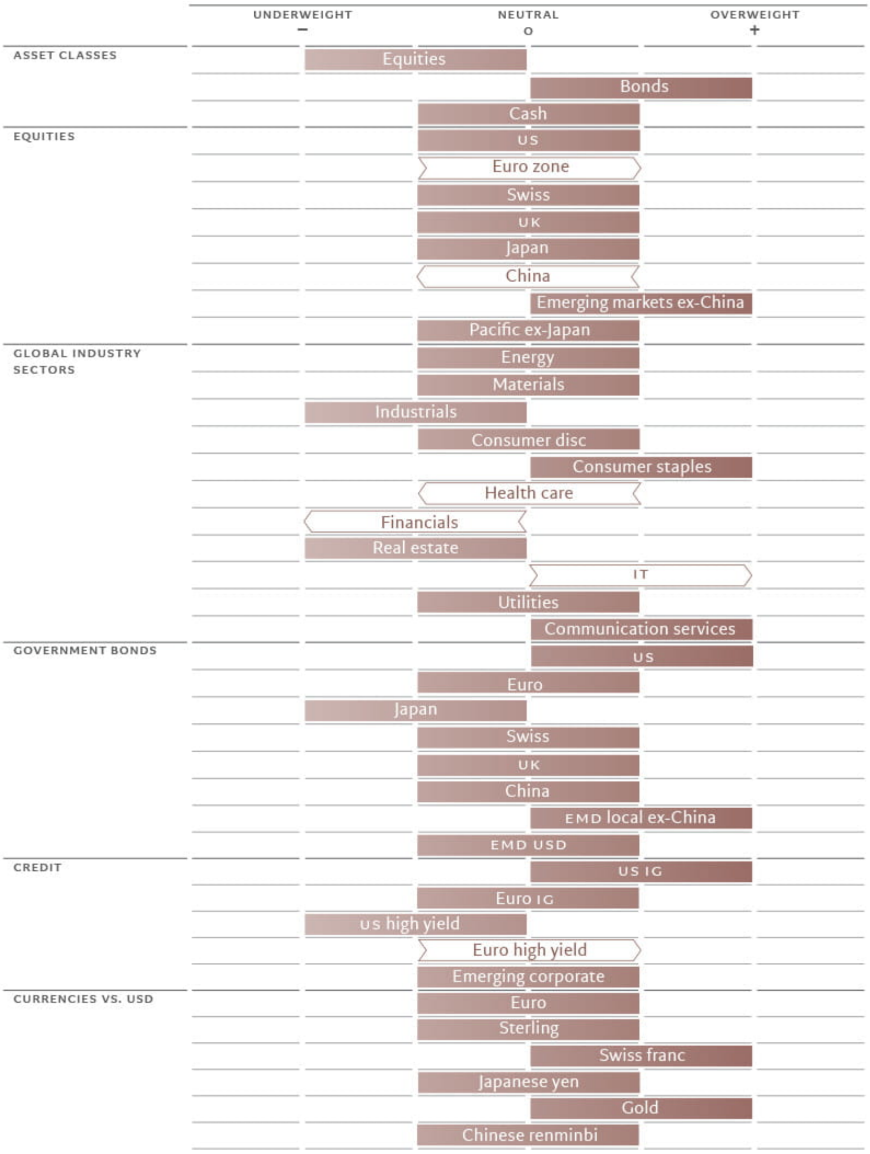
01 Asset allocation: never mind the debt ceiling

The US debt ceiling has filled column inches, but throughout, the markets have been sanguine that a compromise would be struck, limiting the scope for any relief rally in equities.

More pertinent, however, are questions over the direction of the global economy, with the US's outlook worsening in recent weeks, China's post-Covid performance starting to disappoint and Germany wobbling. And as inflation fails to fall as fast as anticipated, investors are reconsidering how quickly central bankers might be prepared to ease monetary policy or how soon rates might peak. That's one reason equities failed to respond more positively to what was a strong first quarter earnings season – the recent past might have been good, but the future's looking increasingly uncertain.

As a result, we remain cautious in our general asset allocation, with an overweight on bonds and underweight on equities.

Figure 1 - Monthly asset allocation grid
June 2023



Source: Pictet Asset Management

Our global **business cycle** indicators show signs of softening momentum in developed markets, but with emerging markets still registering positive growth. We also detect a growing divergence within developed economies. The US Federal Reserve's dramatic series of rate hikes since the start of last year finally seem to be taking a bite out of the US economy. US consumers are responding by increasing their precautionary savings, though the stock of excess savings and relatively low household leverage ratios suggest that while growth will dip below potential, the US shouldn't slide into recession.

By contrast euro zone growth is picking up – though even here the signals aren't all positive. The economy continues to be two paced with a persistent gap between the more buoyant services and a contracting manufacturing sector, according to sentiment indicators, despite German unfilled orders remaining well above trend. Overall, the euro zone's trade balance has rebounded following the energy shock triggered by Russia's invasion of Ukraine which should add to deflationary trends. Meanwhile, Japan is in its own virtuous economic cycle, with GDP growing solidly thanks to healthy domestic demand. The Bank of Japan, might, however, start to temper this if, as we expect, it winds up its ultra-accommodative monetary stance.

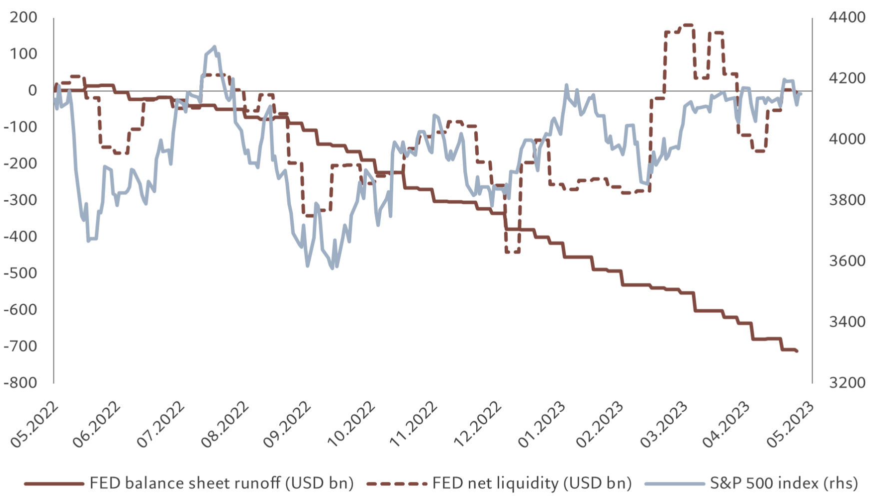
We remain positive on the Chinese economy as post-pandemic pent-up demand is significant and mortgage rates are falling. However, the timing of the recovery appears somewhat uncertain with April activity data clearly weaker than expected. Retail sales are running at 12 per cent below trend, and the real estate sector still struggling.

Our **liquidity** indicators show a desynchronised global cycle, with liquidity contracting in developed economies and expanding in the emerging world. But even in the developed markets, the contraction is less severe than it was at the start of the year, amid moderating inflationary pressures and – in the case of the US – the Treasury in essence injecting liquidity by drawing down its cash pile and the Fed providing emergency assistance to the financial sector.

Though the Fed retains a hawkish bias, we think it's now on pause. That, however, won't necessarily improve liquidity conditions – falling inflation means real rates are going up. At the same time, once the debt ceiling drama is resolved, the Treasury could be expected to rebuild its balances. That will also represent a liquidity squeeze (see Fig. 2). Still, the market is ambitious in its expectations for rates – 170 basis points of cuts over the next 18 months.

Figure 2 - Running dry

US Federal Reserve liquidity change since start of quantitative tightening, vs S&P 500



Source: Refinitive, Pictet Asset Management. Data from 31.05.2022 to 26.05.2023.

Our **valuation** metrics show that most asset classes are priced in broadly neutral territory – though the dispersion of valuation and yields for major asset classes is abnormally low, suggesting an under-pricing of market risk. Emerging market equities look cheap, broadly because of weakness in Chinese equities. Meanwhile, the gains of the past month have taken Japanese equities from cheap to neutral.

Overall, equity multiples have limited upside over the next 12 months on our model. The US market's multiple is 15 per cent above our medium-term fair value, though falling inflation could cause it to overshoot further in the short term. We see corporate earnings staying flat in US and Europe this year, though there's scope for upside surprises in emerging markets.

Our overall **technical** signal remains positive for equities, with momentum firming further in the Japanese and Swiss markets. Seasonality turned negative for European and UK equities, however. Generally, sentiment indicators are neutral, except for Japanese equities, which now look overbought. The bond score was unchanged at neutral, with the US Treasury market upgraded to neutral.

Most investor surveys point to weakening risk appetite, with fund managers stating their bond allocation is at a 14-year high. Equity outflows accelerated during the month, mostly driven by the US. At the same time, money market and government bond flows remained strong.

02 Equities regions and sectors: calling time on China

The man who waits for a roast duck to fly into his mouth will wait a long time. So goes an old Chinese saying. When it comes to Chinese equities, we believe we have waited long enough.

The country's reopening after the pandemic has not translated into positive sentiment on corporate earnings while its economic recovery has not quite lived up to expectations, either. In recent weeks, geopolitical risks have also intensified. All of which means it is time to downgrade to Chinese equities to neutral.

This is a tactical decision.

Valuations for Chinese stocks are still attractive (as a consequence of recent poor performance, China is now the second cheapest region in our model, after Eastern Europe).

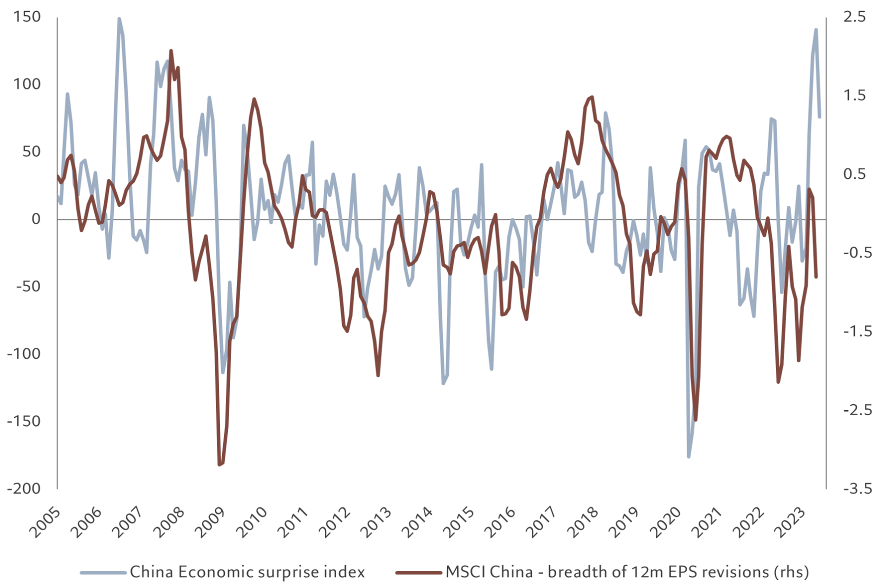
And we might yet see the economic recovery play out, as anticipated by our economics team. Over the medium to long term, we still see strong potential for Chinese assets.

But first Chinese companies have to find more ways of translating GDP growth into earnings growth (see Fig. 3). Until we see evidence of that, we are unlikely to rebuild our exposure.

While Chinese stocks have disappointed, Europe's have done the opposite. Economic growth in the region has proved more resilient that expected (we now see the euro zone economy growing by 0.7 per cent in 2023, compared to 0.2 per cent we forecast six months ago), energy price dynamics are supportive, valuations are neutral, and corporate earnings momentum is positive. We therefore close our underweight on Europe.

Figure 3 - Chinese economy versus earnings

China macro surprise index versus breadth of analysts' earnings revisions



Source: Refinitiv DataStream, Pictet Asset Management. Breadth of EPS revisions is upgrades less downgrades to 12m forward earnings estimates as a % of total estimates. Data covering period 01.01.2005-25.05.2023.

Elsewhere, we maintain an overweight on emerging market (EM) stocks ex-China, where valuations remain attractive. We expect the gap between economic growth in the emerging and the developed world to widen significantly this year – with EM economies growing four times as fast – and to extend further in 2024, to the benefit of EM assets.

Among sectors, our stance is relatively defensive, with a preference for communication services and consumer staples. We've also upgraded technology to overweight as we believe companies operating in the sector will be rewarded for their high profitability and low leverage in an environment of tepid economic growth and rising interest rates. Tech has also delivered the highest share of earnings beats so far, with 89 per cent of companies reporting results above expectations compared to the S&P 500 average of 77 per cent.[1]

Conversely, we have turned less positive on healthcare stocks, downgrading them to neutral. Although traditionally thought of as a haven, this time healthcare has failed to show defensive characteristics, with virtually no gains year-to-date. We believe the weakness is partly a reassessment of the size of the sector's post-Covid prospects. It also reflects the continued fall out from the US government's Inflation Reduction (IRA), which introduced curbs on drug prices, as well as the usual uncertainty over the sector's prospects going into an election cycle.

We also downgrade financials to underweight. The US regional banking crisis continues to rumble on, while the outlook for lenders' net interest margins (NIM) remains challenged by an inverted yield curve.

03 Fixed income and currencies: a quality shield

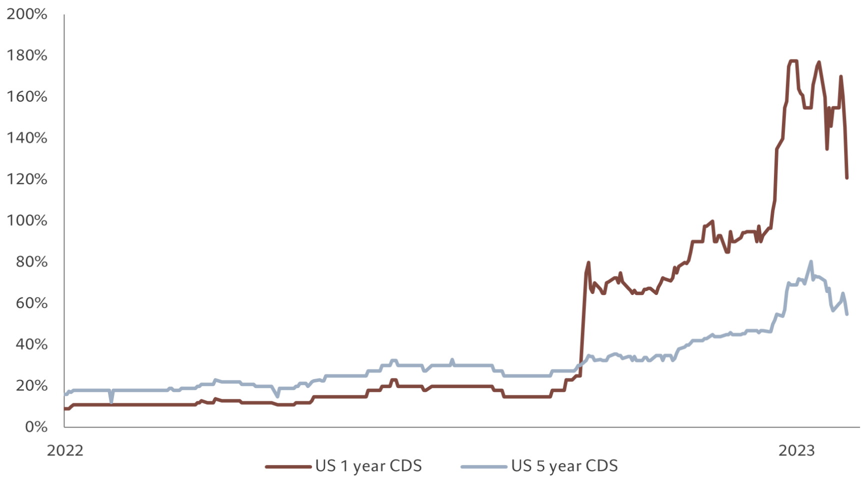
Investors seeking defensive and income-generating assets have a growing number of options.

Many high quality sovereign and corporate bonds are now priced at levels that offer cost-effective insurance against deteriorating economic conditions and corporate earnings.

We remain overweight US government bonds, a safe-haven asset that is also supported by falling price pressures. Consumer prices in the world's biggest economy fell for the 10th month in a row in April, boosting confidence that the Fed is on track to winning its battle against inflation. At the same time, investors appear to have looked past concerns about the US debt ceiling.

Figure 4 - Frenzy over

The cost of insuring against a US government default has eased after a spike on debt ceiling nervousness



Source: Bloomberg, Asset Management, data covering period 26.05.2021 – 26.05.2023

While we think market expectations for an interest rate cut this year are too aggressive, the Fed should at least pause its tightening campaign – which would also support the country's investment grade bonds, in which we also hold an overweight.

Currently yielding 5.5 per cent, US high grade bonds, adjusting for inflation expectations over the next decade, exceed the dividend yield of the S&P500 by a full percentage point – the largest extent since 2010. Elsewhere, we maintain a neutral stance in Europe's government bonds.

Central banks in the euro zone and UK are likely to deliver two more hikes before pausing their tightening campaign as the region lags the Fed's hiking cycle and inflation is proving sticky. Japan is the only developed government bond market in which we hold an underweight.

Inflation, which has hit a 41-year peak in April, is likely to remain at levels that are too high to be justified by the Bank of Japan's ultra-loose monetary policy.

The central bank is likely to prepare the ground for abandoning its policy of controlling the yield curve and keeping interest rates below zero. In credit, we are becoming less pessimistic on the prospects for euro zone high-yield debt, which we upgrade to neutral from underweight.

The asset class should outperform its US counterpart, which is under pressure from the regional banking crisis and tightening lending conditions.

US high yield bonds also face challenges from a tighter regulatory environment – the Fed is poised to present new capital rules in the coming months – and low demand for credit.

Demand for commercial and industrial loans stood at historically low level of -53.3 per cent on a net basis while that for commercial real estate, for example, has hit an all-time low.

We also like emerging market local currency bonds outside China. Inflation is declining across all emerging economies more quickly than in the developed world. This is because prices of goods, which make up a bigger proportion of the EM region's inflation basket, are normalising faster than those of services.

Within currency markets, the dollar should remain under pressure as inflation abates and investors bet on a likelihood that the Fed will cut interest rates by the end of this year.

We retain a defensive bias by remaining underweight the US dollar against gold – which is supported by central bank buying – and the Swiss franc, a safe-haven currency that is also likely to appreciate as the Swiss National Bank raises interest rates.

04 Global markets overview: looking for direction

Question marks over the state of the global economy and how quickly inflation might fall left markets treading water during May. The US debt ceiling circus wasn't taken particularly seriously by investors, but it added to the general state of uncertainty. As a result, equities drifted back by 0.2 per cent and bonds were down 0.8 per cent on the month, both in local currency terms.

Once again, the dollar's safe-haven status came to the fore, with the currency picking up 2.6 per cent on the month, more than reversing losses run up since the start of the year. By the same token, US equities performed relatively well, up 0.7 per cent on the month – though performance was heavily concentrated in tech and communications stocks, with the sectors up 8.5 per cent at 2.6 per cent respectively. There was a broad spread of losing sectors, though real estate, materials and consumer staples all lost more than 5 per cent on the month, while energy dropped 8.4 per cent with a slump in the oil market, which was down 7.5 per cent.

The standout equity market, however, was Japan's, up 4.5 per cent amid signs that the Japanese economy is finally taking off (see Fig. 5). Other markets struggled, with the UK proving the biggest laggard, down 5.2 per cent, amid concerns about how the Bank of England might be forced to respond to persistently sticky inflation.

Figure 5 - Nikkei at 3-decade highs
Nikkei 225 price index

Source: Refinitiv DataStream, Pictet Asset Management. Data covering period 03.04.1950-25.05.2023.

The British bond market was similarly afflicted, with gilts down 3.4 per cent on the month. US Treasury bonds also fared poorly, down 1.6 per cent, as did those in emerging markets, with EM local losing 1.6 per cent and EM hard currency bonds also down.

European corporate credit fared slightly better, though the US market flagged. European high yield was up 0.7 per cent while US investment grade and high yield both fell back, the former down 1.3 per cent and the latter 0.9 per cent.

Commodities dropped 6.1 per cent, which weighed on emerging market currencies and the Australian dollar. Gold also slipped back, down 1 per cent, though it continued to register a healthy 8.6 per cent gain since the start of the year.

05 In brief

BAROMETER MONTH YEAR

Asset allocation

We remain cautious with an overweight in bonds and an underweight in equities.

Equities regions and sectors

We downgrade China to neutral, but remain overweight on other emerging markets thanks to strong growth prospects and attractive valuations.

Fixed income and currencies

We prefer high-quality debt, such as US Treasuries and investment grade bonds.

Written by

Pictet Asset Management Strategy Unit

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