PICTET Asset Management

BAROMETER OF FINANCIAL MARKETS MAY OUTLOOK
May 2024

Marketing Material

Barometer: Stars align for European equities

Economic conditions in Europe are improving while interest rates in the region could soon head lower. This augurs well for European stocks, which we upgrade to overweight.

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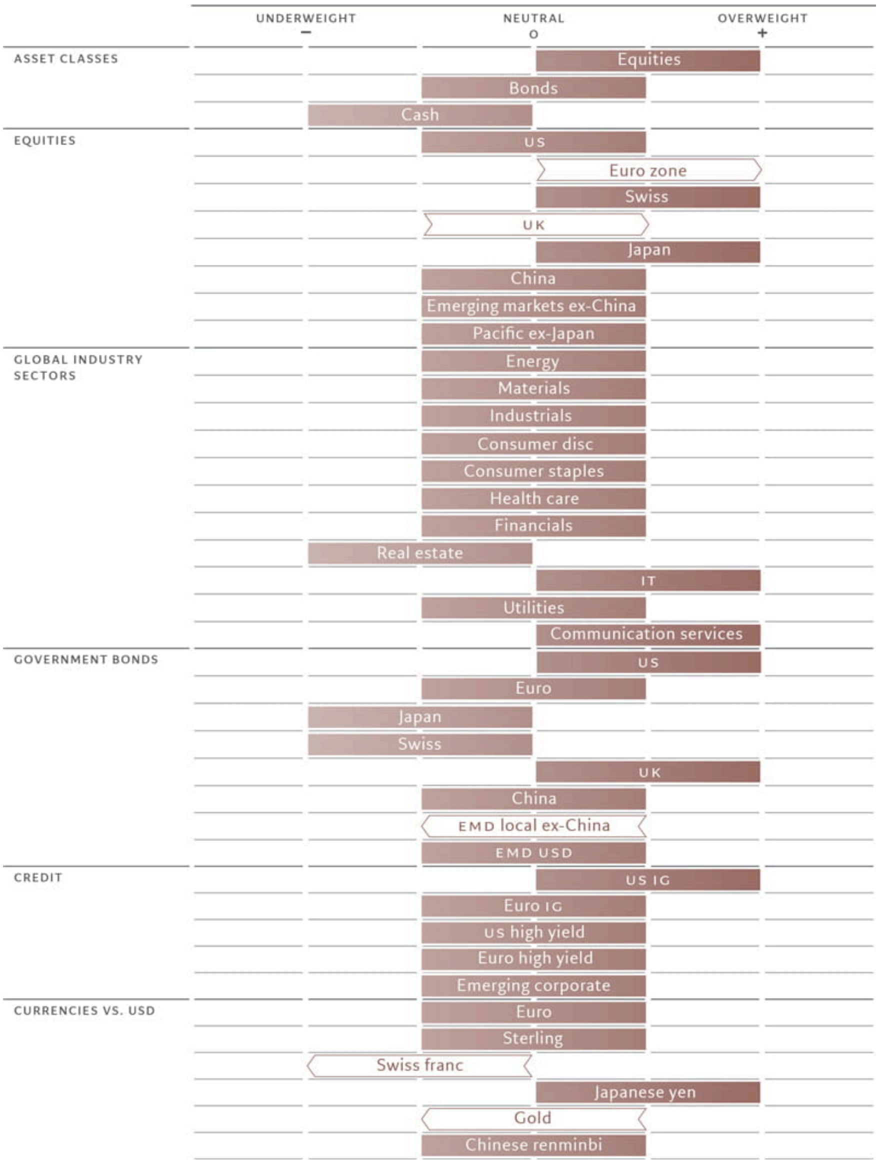
01 Asset allocation: Europe edges ahead

April proved a cruel month for risky assets, but we believe that brighter times are ahead. Valuations for several asset classes now look more appealing while investor positioning in stocks is less bullish, increasing the scope for gains. Economic conditions are also turning more favourable, particularly in Europe, where interest rate cuts look likely and corporate earnings momentum remains strong.
For all these reasons, we retain an overweight stance on equities and a neutral one on bonds.

Within equities, our positioning is increasingly tilted in favour of European countries. Our **business cycle** scores show improving conditions in both the euro zone and the UK. We think that euro zone quarterly GDP growth can reach potential by end of 2024, exceeding 1 per cent annualised. Domestic economic activity is supported by a tight labour market and rising wages while terms of trade are also improving, which bodes well for exports. At the same time, the inflation picture is more stable than in the US, which should enable the European Central Bank to begin cutting interest rates in June.

Fig. 1 - Monthly asset allocation grid

May 2024



Source: Pictet Asset Management

The Bank of England is likely to cut at the same time. Our modified Taylor rule model suggests the central bank has significant room to ease, with scope to deliver as many as four or five cuts by year end. That should provide further support to the UK economy, which now seems to have recovered from recessionary conditions.

In the US, by contrast, rate cuts are likely to be delayed at least until September. The inflation backdrop is mixed, with core goods inflation contracting, but core services inflation moving in the opposite direction – core ex rents inflation increased to 6 per cent year-on-year in March. This reflects the US's GDP growth trajectory, with services propping up the economy while most other sectors display weaker, late-cycle dynamics (for example, retail sales were flat last month while consumption of goods contracted in the first quarter this year). The resilience in services consumption is unlikely to endure if households increase their savings to more normal levels: currently households are saving 3.5 per cent of their disposable income, when the average is usually 7 per cent. Furthermore, excess savings built in the aftermath of pandemic-induced stimulus will be depleted by the end of this month.

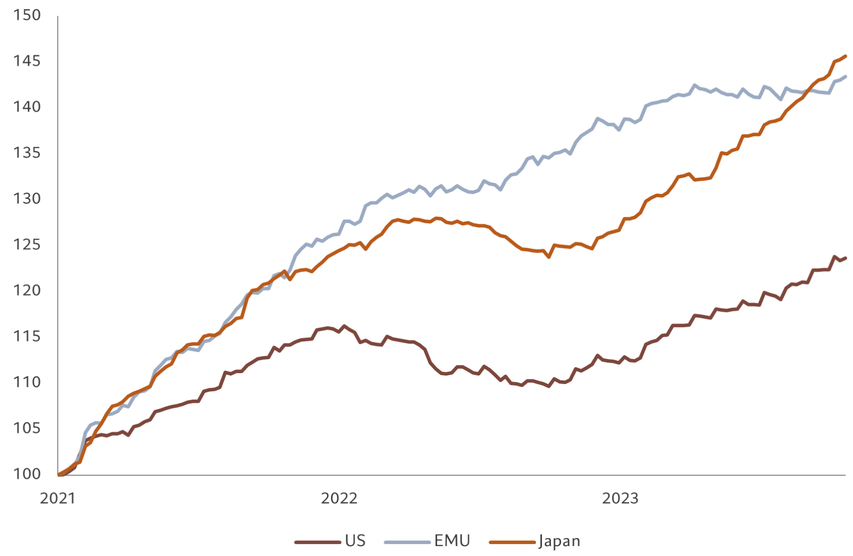
Our **liquidity** indicators are broadly neutral for global risk assets; expectations for an easing of monetary have been recently been pushed further out into the future, nowhere more so than in the US. And while commercial banks in

Europe are increasingly willing and able to lend, demand for credit in the private sector is is unlikely to pick up without an easing of policy.

One exception is China, where a mini easing cycle offers a partial offset to longer-term deleveraging pressures. We expect monetary policy there to remain easy but restrained – irrigating the economy rather than flooding it with broader monetary stimulus.

Fig. 2 - Earning power

12-month forward earnings estimates by country, indexed to 01.07.2021



Source: MSCI, IBES, Refinitiv DataStream, Pictet Asset Management. Data covering period 01.07.2021-18.04.2024.

In terms of **valuations**, global equities are looking slightly more attractive following the market's recent weakness – albeit still expensive relative to their performance range over the past 20 years. Furthermore, corporate earnings momentum remains positive across developed markets (see Fig. 2). Europe, UK and Switzerland are all cheap according to our model, supporting our overweight positions in those regions.

In fixed income, valuations look especially attractive for US Treasuries as short-term rates have climbed back to cyclical peaks.

In contrast, gold has moved further into extremely expensive territory. At a time of easing inflationary pressures and an improving economic outlook, we believe such valuations are no longer justified.

Technical indicators are also flashing red on gold: the market is overbought, positioning is stretched and surveys show that the proportion of investors seeing gold as over-valued is the highest since August 2020.

In contrast, technical indicators are now looking friendlier for equities after the recent pullback – positioning in stocks among investors, for example, is less bullish, increasing the scope for gains.

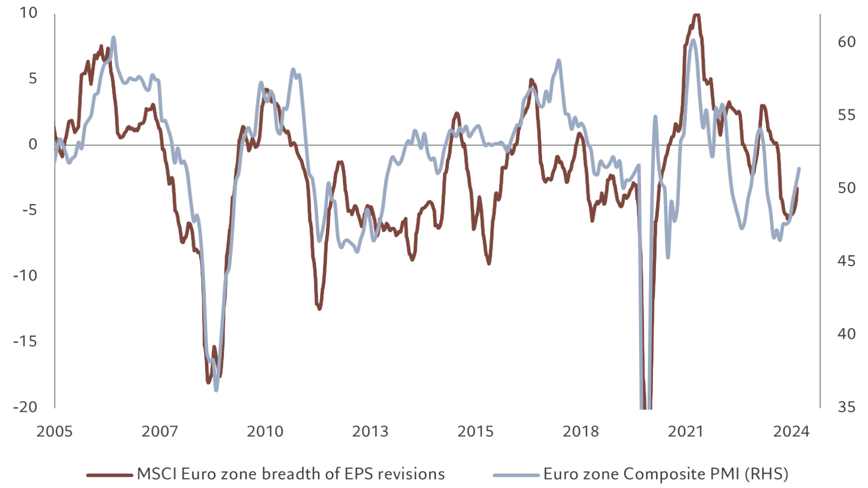
Another positive sign is that gains in equities have recently broadened out across industries and sectors, meaning that outperformance is no longer concentrated in a handful of stocks. This reduces the risk of a sharp pullback.

02 Equities regions and sectors: bright spots in Europe

Our analysis shows that euro zone stocks are becoming more attractive. There are strong reasons to believe corporate earnings could turn out to be stronger than market expectations thanks to a favourable macroeconomic and monetary policy backdrop. As Fig. 3 shows, an acceleration in economic activity – as measured by the purchasing manager surveys – is typically accompanied by analyst upgrades to 12-month earnings estimates. According to our calculations, euro zone companies should see earnings per share increase by just over 4 per cent this year, higher than the consensus forecast for 3.1 per cent. With this in mind, we upgrade European stocks to overweight from neutral.

Fig. 3 - Economy and earnings looking up

Euro zone composite PMI vs breadth of EPS revisions*



* Net upgrades to +12-month EPS estimates as a % of total estimates, 3-month average Source: Refinitiv, Pictet Asset Management. Data covering period 01.01.2005 – 15.04.2024

We also upgrade UK stocks to neutral from underweight. Earnings dynamics for domestic UK-listed companies are supported by expected interest rate cuts by the Bank of England. What is more, the UK equity market offers exposure to cyclical stocks such as mining and energy, which are particularly attractive at this point in the business cycle.

We remain overweight Swiss equities, a market which is home to a disproportionately high number of quality companies.

The Swiss market as whole may have advanced a disappointing 6 per cent this year, held back by a group of three underperformers – food company Nestle and pharmaceutical firms Novartis and Roche -- which make up nearly half of the index and have fallen nearly 10 per cent since last year.

On a market-cap weighted basis, however, the rest of the index is comfortably outperforming, up 25 per cent from its October low. What is more, easier monetary policy from the Swiss National Bank – which cut interest rates well ahead of its peers – should cushion the economy in the coming year.

We also remain overweight Japanese stocks. Strong company earnings and encouraging progress on corporate governance reforms make Japanese equity one of our very strongest convictions.

Elsewhere, we are neutral US stocks. The world's biggest equity market is trading at a high valuation – it is the most expensive on our score card -- while sticky inflation may delay the timing of the Fed's first rate cut.

As the US implied equity risk premium – an estimation of the excess return that investing in the stock market should provide over a risk-free rate – stands at well below the average at 3.3 per cent, we can expect almost no outperformance of stocks over bonds.

That said, we are reluctant to go underweight as the US offers investors exposure to the world's leading technology and communication services companies that are enjoy strong growth.

A "Magnificent Seven" group of megacap US tech companies are likely to lead profit growth on Wall Street, although earnings results have been mixed – blockbuster earnings from Alphabet and Microsoft are contrasting with disappointing reports from Meta and Tesla. Nevertheless, results so far point to higher capital spending on data infrastructure. We continue to be overweight in this sector which is underpinned by attractive secular growth themes such as artificial intelligence.

03 Fixed income and currencies: easing back on gold

With global inflation trends starting to diverge slightly, opportunities within the sovereign debt market are opening up, notwithstanding that we remain neutral on bonds overall. For now, our outlook within bonds is informed by the strength of the US dollar.

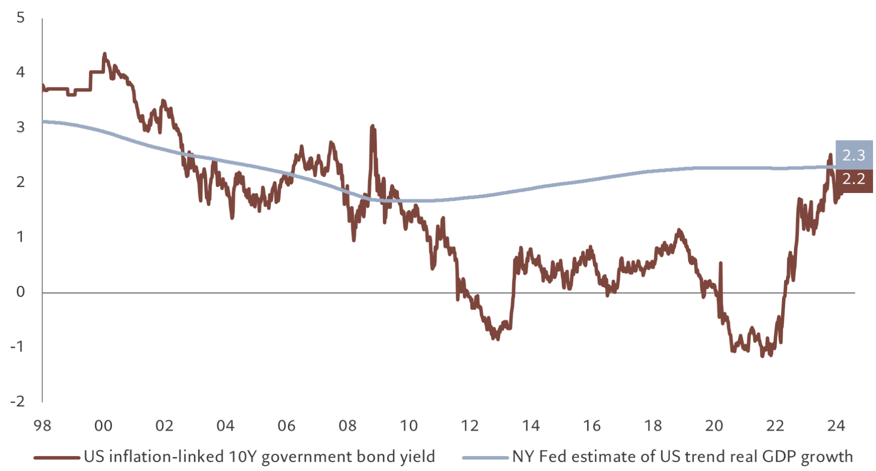
Sticky US inflation, which suggests the Fed might end up having to hold rates at current levels well into the second half of the year, has underpinned the greenback. This, in turn, prompts us to cut our exposure to local currency emerging market (EM) bonds to neutral from overweight. While the yield on EM local bonds is attractive, at 6.6 per cent versus a 10-year average of 4.6 per cent, the US economy’s outperformance is eroding EM's growth advantage.

Elsewhere, and despite the stickiness of US inflation, we see value in US Treasuries, with their valuations now looking more attractive as short-term rates have climbed back to cyclical peaks.

That’s particularly true in US Treasury inflation protected bonds, on which we remain overweight. The yield on TIPs once again more or less matches the trend real GDP growth rate – 2.2 per cent vs 2.3 per cent respectively – for the first time since the global financial crisis (see Fig. 4).

Fig. 4 - Ending financial repression

US Treasury inflation protected bond yield vs US trend real GDP growth, %



Source: Refinitiv, Pictet Asset Management. Data covering period 01.01.1997 - 26.04.2024.

The disinflationary trend looks more established in the UK, prompting us to overweight UK Gilts. By contrast, easy monetary policy has made Swiss and Japanese bonds expensive, which is why we maintain an underweight on those markets.

We remain constructive on US high grade credit which would benefit from a below-potential growth disinflationary backdrop. Short-term high yield credit also looks particularly attractive with excess return potential versus bonds given our limited expectation on duration returns; the level of carry also remains attractive.

Although we believe in the long-term investment case for gold, we have chosen to scale back our exposure to the precious metal as part of a tactical move. While gold is supported by demand among emerging market central banks, we believe its valuation is looking high. We have thus move to a benchmark-weighting from overweight, awaiting a better point to re-enter the market.

We also downgrade the Swiss franc to underweight. We think it is beneficial to have some upside exposure to the dollar, since, for now, the Fed is having to sit on its hands rather than ease policy. It seems sensible to swap some of the Swiss currency for dollars since the Swiss central bank has already started its easing cycle.

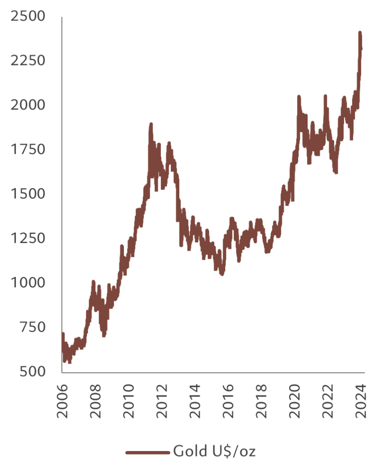
04 Global markets overview: worrying about US inflation

A pick-up in inflationary pressures in the US unsettled investors during April, forcing a re-think about how soon the Fed might start cutting rates. Although goods prices were better behaved, in part thanks to disinflationary pressures coming from China, wage growth was uncomfortably high as were services costs, not least because of the US housing market's strength. At the same time, the conflict in the Middle East is pushing up oil prices.

The inflation shift proved a depressant for US equities, which dropped 4.1 per cent on the month. It also pushed yields up on Treasury bonds, particularly at the short end of the curve – total return on US sovereign bonds dropped 3.3 per cent in April. At the same time, expectations US rates will stay higher for longer meant the dollar made ground against nearly all other currencies, developed and emerging.

Gold however lost steam following its strong run so far this year, up only marginally on the month and down 4.4 per cent from recent all time highs, with the resurgent dollar weighing down on it (see Fig. 5).

Fig. 5 - Golden ascent
Gold price, USD/oz



Source: Refinitiv DataStream, Pictet Asset Management. Data covering period 21.04.2006-24.04.2024.

US equity trends weighed on other markets. Euro zone stocks lost 1.8 per cent in local currency terms on the month, Swiss stocks lost 2.5 per cent and Japanese equities 1.1 per cent. The UK equity market was a prominent outlier, gaining almost 3 per cent – the market is relatively undervalued while investors are also beginning to anticipate Bank of England rate cuts as inflation comes down and economic growth remains soft. Emerging Asian equities also performed well, up 1.8 per cent, with some hopes that the Chinese economy might be poised for a rebound.

Energy was the strongest sector performer, up 1.1 per cent on the month, while real estate dropped 6.1 per cent on fears about the persistence of high rates, while investors took some profits on an inflated IT sector, down 5.2 per cent in local currencies.

Taking their lead from US Treasuries, government bonds fell back across the board, most losing between 1 per cent and 3 per cent on the month. Credit suffered alongside the equity markets, with US investment grade dropping some 2 per cent on the month.

05 In brief

BAROMETER MAY 2024

Asset allocation

We are overweight global equities thanks to attractive valuations and solid earnings prospects. With rate cuts on the cards across much of the developed world, we are neutral on bonds and negative on cash.

Equities regions and sectors

We are becoming more positive on Europe. We upgrade euro zone stocks to overweight and raise UK equity to neutral from underweight.

Fixed income and currencies

We downgrade emerging market local currency debt to neutral from overweight due to the strength of the US dollar. We pare gold back to neutral from overweight on profit taking and cut the Swiss franc to underweight from neutral.

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Written by

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