From recession fears to Goldilocks **confidence?**

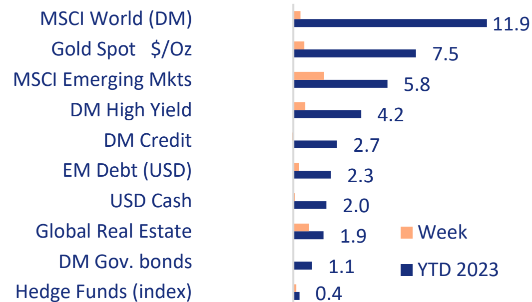
- **Last week was another positive one for most asset classes, with a rotation in favour of previous laggards**
- **The week ahead is very busy with four major central banks meetings as well as CPI and activity numbers**
- **We haven't changed our modestly conservative positioning in June.**

So many traditional early recession indicators have been flashing red for so long that even the most patient bearish investors have started to capitulate. Indeed, recent market action shows that investors are less concerned about recession risk and start to embrace a more favorable outcome, at least for the near-term. Afterall, PMIs continue to display resilience in activity, and the most painful part of monetary tightening is now behind us. Of course, inflation remains a concern (watch the US CPI Tuesday), but central banks are now fine tuning their policies rather than radicalizing them. Confidence prevails: the VIX, index for US stocks implied volatility, is below 14, a level unseen since the Covid outbreak. Most asset classes did well last week, with a rotation favoring the laggards of 2023, from EM stocks and real estate to energy or utilities within DM stocks.

We keep on thinking that the risk of recession, especially in the West, is underpriced by several asset classes. We haven't changed our positioning in June and remain overweight safe bonds and underweight DM stocks. Having said that, should the "Goldilocks interlude" be confirmed, our overweight EM stocks should do well. Markets could worry again at some point, but in the meantime, we are paid to wait with the returns and peace of mind from cash, our largest overweight.

The week ahead will be all about central banks and inflation. We do not expect the Fed to hike but they should guide for their intention to do more. The ECB should increase their policy rate by 25 basis points and also guide for more. The BoJ could continue to prepare the market for a tweak in their yield control on government bonds. We will look at CPI in the US Tuesday and in Europe Friday, as well as at industrial and retail sales for both the US and China on Thursday.

ASSET CLASSES USD % TOT.RETURN, YTD 2023 & LAST WEEK



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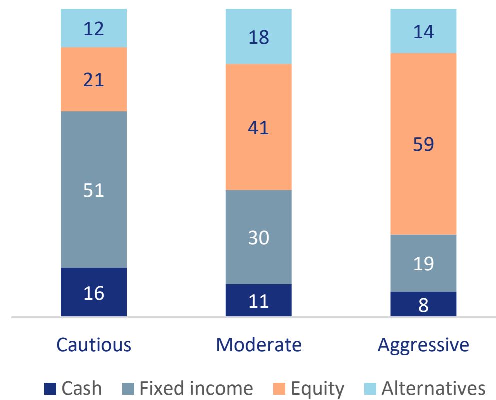
Cross-asset Update

A piece of the ever more scrutinized US labour market puzzle, in the form of sharply rising jobless claims, suggested last week that employment conditions could be starting to loosen in the United States. Yet, consumer discretionary stocks took the reading in their stride, and investors will want to see more evidence that the economy is buckling, before selling their beloved stocks in earnest. Indeed, we already observed that the market has turned more pro-cyclical since the strong May jobs report, and Bank of America US equity strategist Savita Subramanian gave her nod, saying that she sees the rally broadening out to cyclical stocks. After all, with IT mega-caps having led equities higher, the most cyclical chunk of the market still cheap, Quantitative Tightening going on and the economy still showing positive growth, why keep on piling on the same theme when cyclical exposure offers some value? Bottom line, the post jobs-report rotation is likely to continue.

China's inflation remained close to zero in May, with a weakening economic recovery and giving the central bank scope to increase stimulus. The CPI increased 0.2% from a year earlier, while the PPI declined 4.6%. This comes on the back of reports showing contracting manufacturing activity and shrinking exports, overall heightening the risk of deflation. Pressure has been growing on the PBOC to cut rates to support private businesses. A cut might occur very soon, followed some months down the road by a lowering of the reserve requirement ratio for banks. The current Goldilocks interlude marked by positive growth and falling inflation in the West, alongside the prospect for Chinese stimulus should finally be able to boost EM equities.

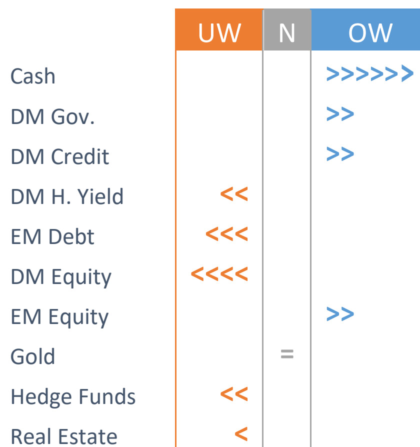
However hard investors try to deflect their attention from the dreaded recession word, there is always some new Cassandra highlighting the inevitable. This time it is the turn of Professor Campbell Harvey, the gifted mind that was first to uncover the link between the yield curve and US recessions. He said that the amount of hiking that has already occurred will make itself felt and eventually crack the economy, an argument we have some sympathy for. And the banking crisis, still simmering and for now just dormant in his view, is simply a symptom of the over-tightening. What investors will like least to hear, is that Harvey has found that the duration of the yield curve inversion is "highly predictive" of the length of a recession. So, no matter how shallow the next contraction could be, it would be long indeed this time. By the way, we would be adding that historically we have been on the verge of a recession each time the yield curve has re-steepened in positive territory, that is when markets have started to discount rate cuts. For now, we may not be even done with the tightening, so maybe we should go back to chasing the fledgling cyclical rotation for a while longer.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING



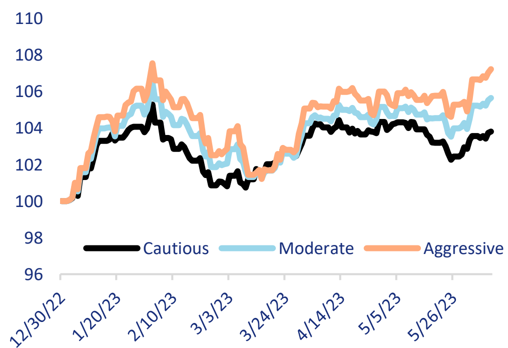
TAA – RELATIVE POSITIONING – MODERATE PROFILE

UW/N/OW:Underweight/Neutral/Overweight



	UW	N	OW
Cash			>>>>>>
DM Gov.			>>
DM Credit			>>
DM H. Yield	<<		
EM Debt	<<<		
DM Equity	<<<<		
EM Equity			>>
Gold		=	
Hedge Funds	<<		
Real Estate	<		

TAA – 2023 INDICATIVE PERFORMANCE



Source: Bloomberg. CIO Office calculation based on TAA applied to market indices, net total return in USD.

Fixed Income Update

We enter a period of heightened central bank activity. After the hawkish jolt from BoC and RBA last week, six central banks from G-10 countries will meet for policy rate decisions in the next few days. This is a very delicate period for rate movement. Both institutions followed the Hike-Pause-Hike instead of the Hike-Pause-Cut customary of Central Banks, blaming the insistent inflation. Heightened bets on Higher for Longer rates lifted the front-end rates while the long-end increased slightly, with 30-year hardly changing on a weekly basis.

The first wave of increased bills sales as the US Treasury rebuilds its cash coffers following Washington's deal to suspend the nation's debt limit was met with healthy demand. Treasury has increased bill auction sizes for the one to six-month tenors, totalling almost $60 billion in larger auction sizes, as well as adding regularly issued 6-week cash management bills with a starting offering size of $45 billion. Bank of America expects bill issuance to amount to $1 trillion from June to August, with the accumulated total rising to $1.4 trillion by year-end.

As many as four central banks from the G-10 meet this week. The Fed is widely expected to pause on Wednesday with crucial inflation data release a day prior, which would make the meeting interesting. As for the dots, we need at least three officials upgrading their terminal rate forecast for the '23 median to move higher. ECB is expected to hike the rates by 25 bps. The next challenge will be dealing with a multi-speed European economy where the advertised wage growth is indeed strong in Germany and France while Italy sees a pullback. BoJ would stay put even though the core CPI forecast for Q4 23 has moved up to 2.05% from 1.2% at the start of the year.

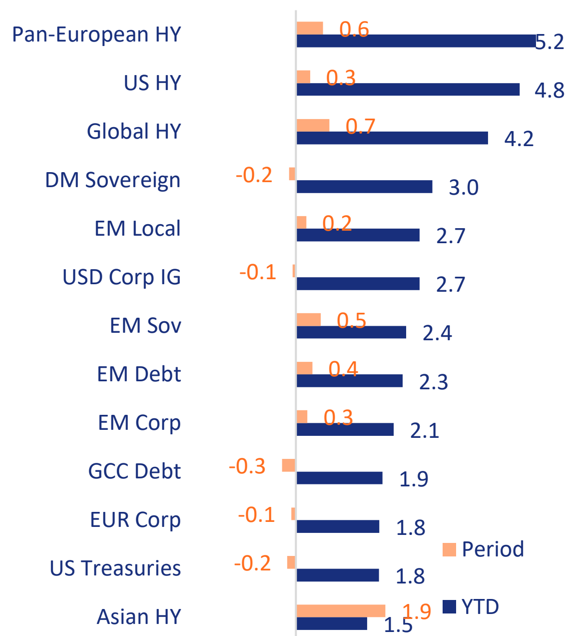
While a Fed rate hike is not our base case, the best in the STIR futures indicate that market players are placing more short positions in the 3, 6, and 9-month horizon for the SOFR futures. Though the positioning for bond futures remains moderately bearish, we haven't seen a significant increase in those short positions. This indicates the market's expectations of a range-bound long-end yield, which should be positive for locking in long-duration carry-in quality credit without significant interest rate risk.

Lastly, while the focus is justifiably on the US CPI release this week, Retail Sales is another data point crucial for the movement of the yields. According to Vanda's research, the high-frequency credit card data indicate something in the 0.2-0.4% MoM range for most of the ex-auto/gas and control figures for May, which is higher than consensus. US consumer spending activity over the past couple of weeks has been solid, with increases in Goods and Services spending. If the retail sales positively surprise this month, Treasury yields would almost certainly rise from current levels but should not break out above 4%.

FIXED INCOME KEY CONVICTIONS

DEVELOPED MARKETS
OW Quality corporates
OW Government Bonds
UW High Yield
EMERGING MARKETS
Overall UW EM Debt
Favor quality and selectivity
OW Selectively Asia,

FIXED INCOME SUB ASSET CLASS RETURNS (YTD, LAST WEEK)



Source: Bloomberg

Equity Update

Positive returns from global equities last week with Japan continuing to outperform, the Russell 2000 playing catch up, regional US banks off their lows and a broad EM rally. Locally, the DFM had a strong week +2.7% whist the ADX ended 0.4% lower. This year the Dubai bourse performance has been stronger, with real estate and banks boosting gains. Higher off plan housing offtake and a vibrant economy are boosting both sectors.

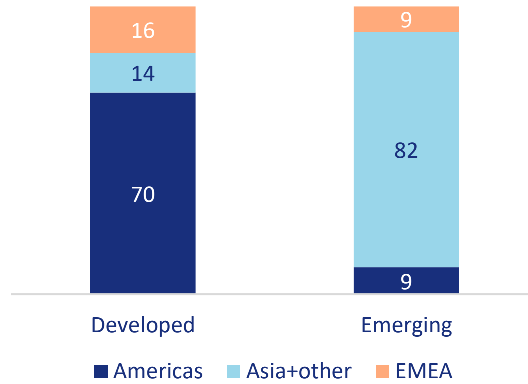
The potential profit boost from AI has provided a tail wind for equities, while risks from recession and hawkish Fed policy remain. This week we get central bank meetings from Europe, Japan and the U.S., along with U.S. inflation data that will influence the Fed's monetary policy path. The US regional bank crisis is behind us, at least for now, and a debt ceiling solution reached without any of the 2011 volatility. Excitement around generative AI has reinforced profitability growth and a supportive macro environment suggest outperformance may continue, with the caveat of some volatility.

If economic growth data is resilient and inflation trends lower, a declining equity risk premium will offset slightly higher interest rates and a higher equity multiple. Equities are currently competing with cash (yielding 5%) and IG credit (5%). While these are less risky asset classes, the VIX at 14.4 is indicative of lower volatility for equities. Also, positive for sentiment is consensus estimates for the S&P 500 for Q2 2023, of earnings growth of -6.4%; revenue growth -0.4% and then a turnaround with Q3, earnings growth of.0.8%; revenue growth 1.2%; Q4, earnings growth pf 8.2%; revenue growth 3.2% and in line with our estimates ending with flat earnings growth for CY2023. For 2024 estimates jump up sharply to earnings growth of 12.3%; revenue growth of 4.9%.

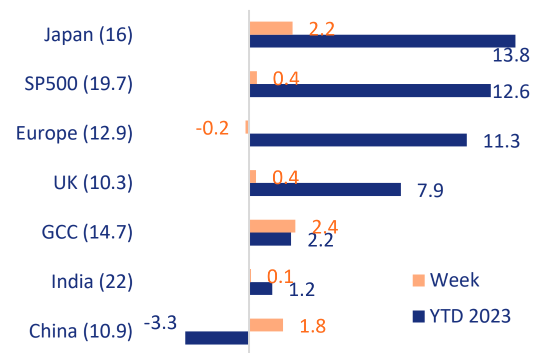
We are neutral US equities. The Nasdaq is +27% YTD as the technology sector has left nearly all other sectors behind. But recommend a broader US positioning as cyclical sectors should play catch up and big tech is trading at 1.5X broader market valuations. The S&P 500 was up 0.4% last week and officially in a bull market (+20% from lows). The S&P 500 +13% YTD, has been driven by gains from big tech, and muted returns for most other stocks. The equal-weighted S&P 500 is in comparison only +3% YTD. with Apple, Nvidia, Microsoft, Amazon. Tesla, Meta and Alphabet up +40% to 170% YTD and now comprising close to one third of S&P 500 market cap. Valuations for the S&P 500 at 19.7 X forward P/E are above our fair value estimate 18.2X which was based on a tightening cycle lower multiple. Slowing inflation, better than expected growth, and elevated market concentration supports the higher multiple. On a similar note, the Euro Stoxx up 15% YTD is also in a narrow rally with mega cap outperforming including the key consumer, luxury, tech stocks: Nestle, Airbus, ASML, BMW, Siemens, Safran, LVMH, et al.

We have retained our overweight EM Asia outlook and expect Chinas consumption recovery (estimated $1 trillion in excess savings) to be driven more by a gradual recovery and initially led by services and middle-to-high-income consumers, before broadening to goods and low-to-middle-income consumers.

EQUITY RECOMMENDED REGIONAL POSITIONING

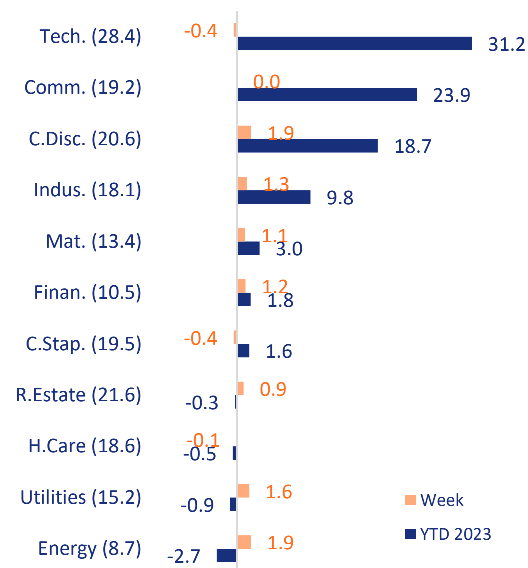


MAJOR INDICES PERFORMANCE (TR, US$) AND 2023PE



Source: Bloomberg consensus. MSCI Indices unless specified.

GLOBAL SECTOR PERFORMANCE (TR, US$) AND 2023PE



Source: Bloomberg consensus. MSCI All Country World sectors US$.

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