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Where has the volatility gone?

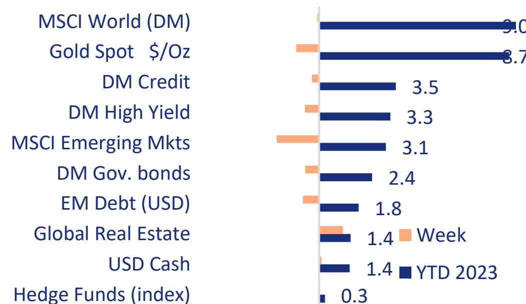
- **Last week was slightly negative across asset classes, though volatility continued to moderate**
- **The global economy was strong in Q1, and momentum remains firm, defying recession predictions**
- **Western Central Banks are on track for more tightening, although with probable nuances**

Last week was modestly positive for global listed real estate and almost flat for stocks from developed markets, but all other asset classes printed negative returns, between -2% for EM stocks and -0.3% for investment grade corporate bonds. Economic data looks increasingly positive, challenging the recent predictions from the IMF, the Fed or the Bank of England who all warned about downside risks ahead. Propelled by a booming China but not derailed by a resilient West, global GDP is on track to print a 4% annualized growth in the first quarter of the year. Very strong indeed.

The logical consequence is that as demand supports inflation, central banks from the developed world still have work to do. The Fed should hike by 25 basis points in early May, but we expect it to be the last one before a pause. Assuming the ECB is as data-driven as it claims, core inflation at 5.7%, a strong flash PMI and improving consumer confidence would suggest a 50bps hike, while the UK is still dealing with a double-digit headline CPI. Even Japan sees supportive economic data and increases in salaries unseen in -literally- decades.

This is overall not negative fundamental news, also confirmed by better than expected corporate earnings so far in Q1. What is more intriguing is to see the steadiness of markets, that usually don't like surprises, especially when they point to more hawkish central banks. Even the US debt ceiling drama, which is not unusual but takes particular color given the current balance of power and election calendar, doesn't seem to unnerve anyone. This is good for our portfolio, though we retain our overweight in cash and neutrality on stocks, with a fundamentally-driven preference for emerging regions. We also definitely favor quality segments within fixed income.

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



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Cross-asset Update

The current consensus view that the banking crisis is over, the odds of a recession are low, the dollar is set to weaken further and the Chinese real estate sector will be a persistent drag to China and the emerging complex seem to us to be bordering on complacency.

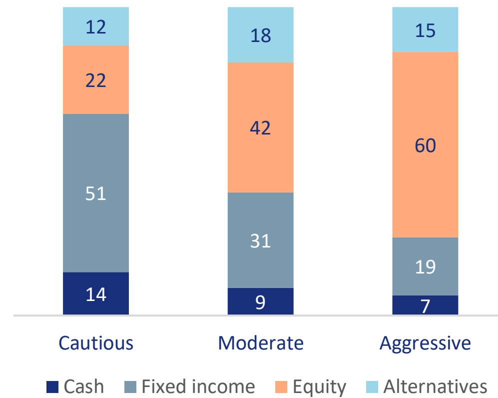
In the United States uncertainty about the depositor base will persist insofar as the arbitrage opportunity of withdrawing money from banks and placing it in significantly higher-yielding money market funds continues to exist. Lenders will gradually adjust accordingly, shrinking credit, that in turn will negatively impact the economy, most likely triggering a vicious circle. At that point further weaker links in the financial system will emerge. For instance, the banks overexposed to commercial real estate, a significant asset in the balance sheet of smaller lenders at risk of falling further in value, could come in the spotlight. And this brings us to the underappreciated odds of the risk of an economic contraction. Latest business confidence prints both in the United States and in Europe seem to be actually encouraging, given their buoyant readings in April. Yet, it seems to us that the Philadelphia Fed survey and the Conference Board Leading Index YoY% are much more reliable than PMIs having leading power versus the ISM indices, and they both remained firmly in contraction territory in the month of March.

As for the dollar, its fall of more than 12% from its September high, justified by expectations non-US growth holding up better than projected and the Fed coming closer the end of the tightening, is now over-discounting tighter policy by other banks versus the Fed going forward. For instance, investors expect the ECB to keep raising rates further, even as Europe remains more vulnerable to the negative effects of a credit crunch, being euro area banks more exposed to commercial real estate. The carry of being long EUR or GBP versus USD is now negative. Leveraged funds two weeks ago went long the US dollar for the first time in over a year against all the major DM currencies, a sign that major investors see limited downside from current levels on the global reserve currency.

There seems to be little conviction on the continuation of the EM equity rally as well, as Chinese real estate is seen as a persistent drag on the economy. But investors may be underestimating the power of the positive money supply growth impulse engineered by the Chinese authorities, that must be contrasted with the negative one in the United States, and the slumping money supply across the other major DM countries. With the Chinese real estate sector already stabilizing, liquidity will go in the direction of lifting it eventually, though maybe only temporarily. And that will compound the positive action of services and consumptions currently underpinning the recovery. Hence, we would tend to see a positive Q2 for Chinese and EM stocks.

In summary, we still think that higher-quality bonds will offer the best risk-adjusted returns for most of 2023

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

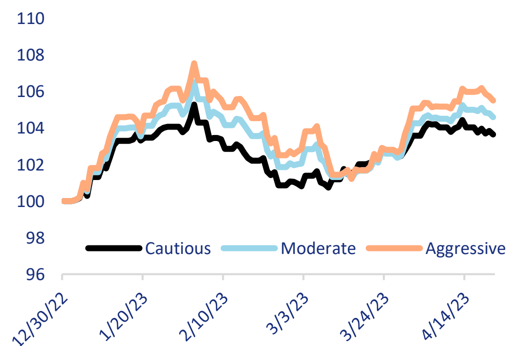


TAA – RELATIVE POSITIONING – MODERATE PROFILE

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.

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Fixed Income Update

There is an eerie calm in the fixed-income markets. The MOVE Index, a gauge of US Treasury volatility, spiked to its highest level since the GFC to 198 barely a month earlier, but has since dipped to 120. Bank earnings have come in generally better than expected allowing credit spreads to stabilize and the Treasury yield curve to bear flatten over the course of the week. However, the recent calm may not last as uncertainty hasn't disappeared. Traders are pricing a 90% chance of a 25 bps in the next week's FOMC decision due on 2nd May. Blackswan events such as the US Debt Limit fight will keep markets on tenterhooks till the deal goes through. Meanwhile, the slowdown in bank lending muddies the waters as US Bankruptcy filings have reached their highest levels since 2010.

Last Friday's trio of PMI data print beats was bearish for treasuries. Moreover, CFTC reported a record short position by hedge funds against 10-year US Treasuries which could be due to basis trade. However, the front-end of the US treasury was range bound as the 2-year hovered in a tight range of five bps. The 10-year meanwhile has bounced back from 3.6% to trade around 3.55%. In this week before the forthcoming FOMC meeting, crucial data points will be released, including the US GDP on Thursday, and the University Of Michigan Sentiment and Core PCE deflator to round up the week on Friday.

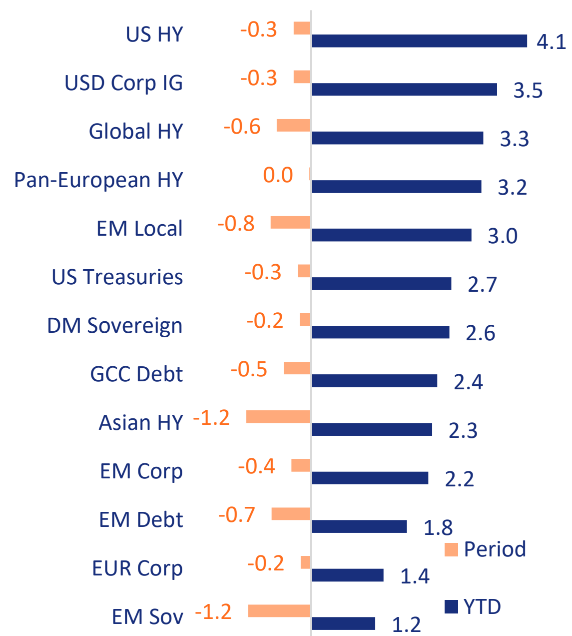
The latest survey from Bloomberg indicates a cautious investor view of the high-yield market. High grade dominates High Yield for 2Q positioning. The valuation of the segment remains very tight. The survey also mentions Investment Grade is the only overweight by rating, with BBs neutral and CCCs and Bs avoided. Communications is the most favoured sector, Cyclicals the least. This positioning aligns with CIO office views as we have an overweight allocation to Investment Grade credit across all our three risk profiles, while we are underweight in High Yield and EM Debt.

GCC Debt has outperformed the broader Emerging Market total returns by 60 bps YTD. However, this makes the asset class spreads equivalent to the developed market IG credit. It makes sense, given that most GCC issuance has been concentrated in the IG space. This also means that further capital appreciation in the shorter duration IG names is limited this year, and most of the returns for investors would be from carry. The situation is different for longer duration A-rated names from the region, which could rally when yields drop in a feat similar to the rally we had seen in 2019.

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, LatAm

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



Source: Bloomberg

Equity Update

Global equities had a flattish week in developed markets, while ending -2% lower in emerging regions. There was a few intraweek swings, but overall the most striking fact is certainly that volatility keeps on abating. The VIX, widest measure of market expectations for volatility on US stocks, actually traded below 17 for the first time in a year. This level is certainly not unusual in history. In times of quiet macro factors, when investors, rightly or not, feel comfortable with high visibility, VIX trades even lower, as it did for most of the decade which preceded the Covid pandemic. The backdrop however doesn't look that comfortable: there are at least three levels of uncertainty, on growth, on inflation, and on central banks' response, not even mentioning the geopolitical tensions or the kick-off of the US debt ceiling drama.

No surprise, then, that Bloomberg reported that hedge funds directional positioning is the most bearish in years, according to open positions on futures contracts. Interestingly, the same applies to US Treasuries, with short positions also at a record level.

These two facts, low volatility and hedge funds shorting both stocks and bonds, certainly illustrate the current state of confusion from market participants. With regards to US stocks, the absolute hegemon of the global asset class, the only, but serious, reason to be cautious is the fact that their valuation multiple corresponds to an ideal scenario of soft landing and rate cuts from the Fed down the road. However, if the multiple is right, then government bond yields are probably too high.

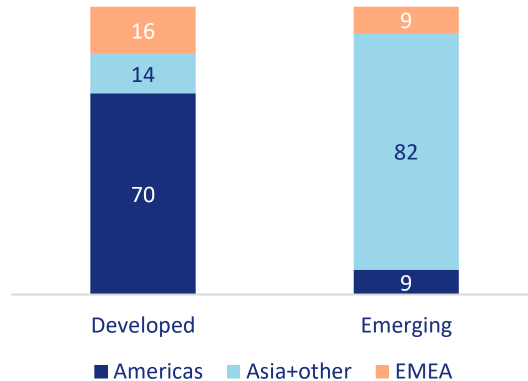
Times of confusion are not supportive of huge risk-taking, especially when there is no clear extreme in either valuations or investor sentiment. Our current positioning is to be neutral at the asset class level. We underweight developed markets, due to their valuations, but also acknowledge that expectations for Q1 corporate earnings may be a bit too pessimistic which, combined with the level of short positions, could prolong the current tactical rebound. Indeed, the early days of the current earnings season show a higher than usual beat at the EPS level. We will have a better picture this week, with big tech being the next to come on tape in particular.

We are overweight on the emerging regions, which by comparison are fundamentally much more compelling. Simply put, faster growth at cheaper valuations.

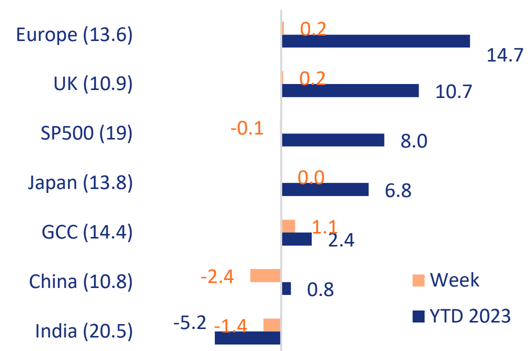
Now looking forward, we think that a spike in volatility, that is a market correction, is certainly much more probable than an acceleration of the current rally, unless we see big positive surprises on inflation or geopolitics. This is why we only cautiously ride the current wave, and would certainly consider any acceleration as a potential opportunity to reduce risk.

The current week will see earnings from Coca Cola today, Microsoft, UBS, General Motors tomorrow, Meta and Boeing Wednesday, followed by Amazon and Intel – among many others.

EQUITY RECOMMENDED REGIONAL POSITIONING

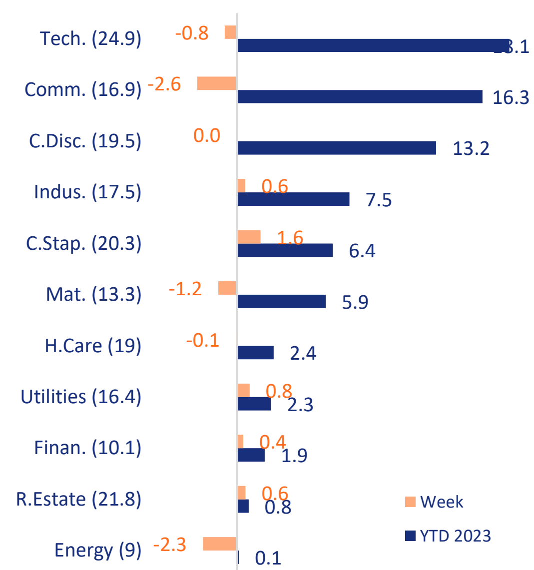


MAJOR INDICES PERFORMANCE (TR, US$) AND 2023PE



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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