MSM House View

Outlook 2023: Core Views

We expect range-bound trading and a bounce in market volatility as we enter the closing weeks of the third quarter and prepare for the upcoming earnings season! We continue to run overweight fixed income and hold equity exposure at neutral.

Volatility across the asset classes has continued to drift down since the Silicon Valley Bank shakeout of March. This is especially true in equity markets as the S&P Volatility (VIX) and the Deutsche Borse Volatility (VDAX) indices are approaching multi-year lows. This should change going geopolitics and earnings come into focus post the summer lull.

While hard data will provide the signals for future market direction, we can't ignore the possibility that global geo-politics (e.g., Ukraine, US-China tensions) and/or the increasing political tensions in the US might trigger bouts of rising volatility. One would have hoped that the US Congress would return with the intent to deliver the fiscal budget for 2024 in a timely manner, but the reality is that there is little agreement on this topic amongst House Republicans' "five families." The latest announcement from Mr. McCarthy portends increasing noise and little action, leading to market volatility but limited direction.

DM central banks take central stage in the closing weeks of September as questions ! We are not yet at the point where divergence may revert to convergence. The ECB opened the show with a 25 basis points increase, taking the Main Refinancing Rate to 4.50% and leaving the door open for more. Concerns about sticky inflation remain the key driver for ECB President Lagarde and her colleagues notwithstanding slowing growth in the European economy. Bund investors ' reaction to the increase was relatively muted, but the Euro was taken down 0.6% and the Euro Stoxx 600 equity gained 1% on the news.

The markets are pricing in better-than-even odds that both the Bank of England and the Swiss National Bank will raise their respective policy rates by 25 basis points, following in the steps of the ECB but for different reasons. Given recent data, the US Fed and Bank of Japan are expected to pause after their July moves. Investors' reaction should be limited as the remaining primary actors on the stage live up to expectations.

Recent data confirm that our long-held views that recession fears for 2023 were overblown and that inflation would continue to trend down! This is proving especially true with respect to the US. After several months of negative surprises, the Citigroup Economic Surprise Indices (CESIs) been improving with the CESI for G-10 economies holding broadly stable since early-August. In other words, the data flow for the G-10 economies has been in line with forecasts. Data releases for the US have continued to outpace forecasts and the CESI China index is trending higher. The same cannot be said for Europe index which is still in negative territory and again trending down since mid-August.

The S&P Global PMI sentiment surveys - a component of the surprise indices - are telling a similar story. The global composite PMI was holding steady between 52-54 up until July. Since then, it began grinding lower as the services components deteriorated across the regions and particularly the Euro Zone. Investors will be focusing on a potential turn in the China PMIs, which remain at expansion levels and surprised on the upside in August.

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The manufacturing PMIs had been trending steadily down since mid-2021 as China's Zero COVID policy and the supply-chain disruption were at their peak. They have begun recovering across the major economies - except for the Euro Zone - since December, and are now approaching the 50 level, indicating renewed expansion. In the US, capital expenditure expectations have bottomed, and manufacturing construction (especially IT-related) is over 70 percent above 2019 levels according to BCA Research data.

Separately, the US home construction industry seems poised to recover. Homebuilders have failed to keep up with household formation for the past 15 years. The homeowner vacancy rate has fallen to a record low while the average age of US homes has risen to 31 years, the highest since 1948. Single-family building permits have been climbing steadily since the beginning of the year.

Shortly, the third quarter earnings season will set the tone for market sentiment. According to the latest estimates compiled by LSEG I/B/E/S, this reporting season is shaping up as an inflection point for US companies but an "earnings recession" for their European peers.

The S&P500 companies are expected to post positive earnings growth of 2% in the third quarter after dropping 2.9% in the second quarter (7.9% above estimates). Excluding the energy sector, earnings would be up 7.4%. Earnings revision have been trending positive over the past weeks which sets up a positive picture for the season. More notably, bottom-up earnings forecasts for the following quarters are pointing to low double-digit growth through 2024. On the revenue front, analysts are estimating flattish growth of +0.6% for the quarter, followed by steady recovery of three to six percent through 2024. Seven of the eleven sectors are forecast to post positive earnings growth, led by the communication services (+34.6%) and consumer discretionary (+22.0%); the laggards remain the energy (-37.4%) and materials (-19.8%) sectors.

Unlike the failed predictions for a US earnings recession in the first quarter of 2023, the Euro Stoxx 600 companies are more likely to meet this definition in the upcoming earnings season. European analysts have been revising earnings and revenue estimates downwards these past weeks.

Earnings are now predicted to drop 10.9% (vs -6.4% the prior week) in the third quarter after falling an estimated 5.6% last quarter. Similarly, revenue estimates have come down to -7.9% growth versus -6.4% the prior week. This negative trend is forecast to continue into the first half of 2024. At a sector level, earnings growth from the energy (-46.9%) and materials (-41.9%) companies are expected to be the major drags, partially offset by the financials (+22.2%) and utilities (+11.0%) sectors.

Update on our focus themes

Our investments in the **Energy and Energy Transition process** remain a key focus.

We have **maintained our overweight to the energy sector** for some time now, driven by the ongoing war in Ukraine, the consistent messaging from OPEC+ that they would cut supplies as needed to keep oil prices stable to higher, and the probability that a China recovery would result in an increment demand for oil.

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The first two assumptions have been proven out. The Ukrainian counter-offensive and the latest comments from Putin give no sign that an off-ramp to a negotiated peace is possible over the coming year. OPEC+ messaging has been followed by concrete actions, most recently last week when both Saudi Arabia and Russia extended the voluntary supply cuts (1.3 million bpd) to year end. As per JP Morgan's equity team, "the cuts reinforce a strong message of OPEC+ unity and the cartel's efforts at maintaining oil prices at a steady and potentially higher level to incentivize more conventional oil production which requires longer investment lead times." More notably, the latest monthly report from the International Energy Agency (IEA) estimates that the cut to supplies means the market is now likely to see a deficit of about 1.1 million barrels a day through the fourth quarter.

China's recovery remains a question mark. After an initial burst of activity, China's post- zero COVID recovery waned under the weight of a lack of broad stimulus and renewed signs of stress in the real estate sector. While concern over China's sluggish recovery builds, there's been only limited measures to reignite growth, prompting forecasters such as JPMorgan Chase & Co., Barclays Plc and Morgan Stanley to downgrade their projections for China's economic growth this year to below the government's 5% target.

We believe that the **Energy Transition process will continue to drive investment flows**, particularly as the drive to increase electrical vehicle (EV) usage creates a super-cycle for critical minerals. The transition from internal combustion engine (ICE) vehicles to EVs is a long-term structural driver of demand for materials like lithium, manganese, graphite, copper, nickeland cobalt. EV requires between 3x and 14x more of these materials than a traditional ICE. As of May 2021, the IEA estimates that EV vehicles use over 200 kg/vehicle versus ICE vehicles' 30-35 kg/vehicle.

Other clean technologies such as solar panels or wind turbines require rare earth minerals to manufacture the products. Assuming the evolution to EVs continues to gather pace, that will drive an increased demand for the industrial metals that are necessary for the storage and distribution of renewable energies.

The International Energy Agency's (IEA) Sustainable Development Scenario estimates that to reach Net Zero by 2050, the demand for Critical Minerals would need to grow six times larger compared to today's levels. Ixios further points out that the war in Ukraine has increased awareness of the strategic importance of energy independence, creating additional demand for renewables . They believe that China's huge push on renewables is driven primarily by this geopolitical consideration.

Artificial Intelligence became the topic of the day since the November 30, 2022, launch of ChatGPT (a.k.a., Chat Generative Pre-trained Transformer) using GPT-3.5. It is - like its competitive brethren - a large language model-based chatbot developed by OpenAI to enable users "to refine and steer a conversation with the application towards a desired length, format, style, level of detail, and language used".

Since its launch as a free research project, the chatbot has captured the imagination of millions (over one million in its first five days in the open) and redefined the standards of artificial intelligence. According to a May 19 Forbes article, OpenAI was valued at $29 billion, and the company has raised

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a total of $11.3B in funding over seven rounds so far. In January, Microsoft expanded its long-term partnership with Open AI and announced a multibillion-dollar investment to accelerate AI breakthroughs worldwide.

The growing interest in AI is reflected in flood of media and research articles on the transformational impact of AI on the global economy. The markets are still in the early stages of understanding the potential implications for markets and society. Like other transformational moments in history, the early stages lead to bursts of enthusiasm, hyperbole, and speculation in markets. Recent strategy papers from NDR and Goldman Sachs, look at the historical parallels (e.g., the California Gold Rush of 1848 and the Internet Bubble of the 1990s) and leave us with a preference for well-capitalized companies that provide the "picks and shovels" to this nascent technology with cross-industry applications. More to follow in the future on this topic.

The **upcoming month may prove trendless but volatile** as the mix of economic data, politics, and earnings set the tone for the final quarter of 2023. Our base case scenario continues to assume no US recession until later in 2024, DM central banks holding policy rates near current levels for the foreseeable future (i.e., approximately six months), and major EM central banks (including China) easing monetary policy ahead of DM peers.

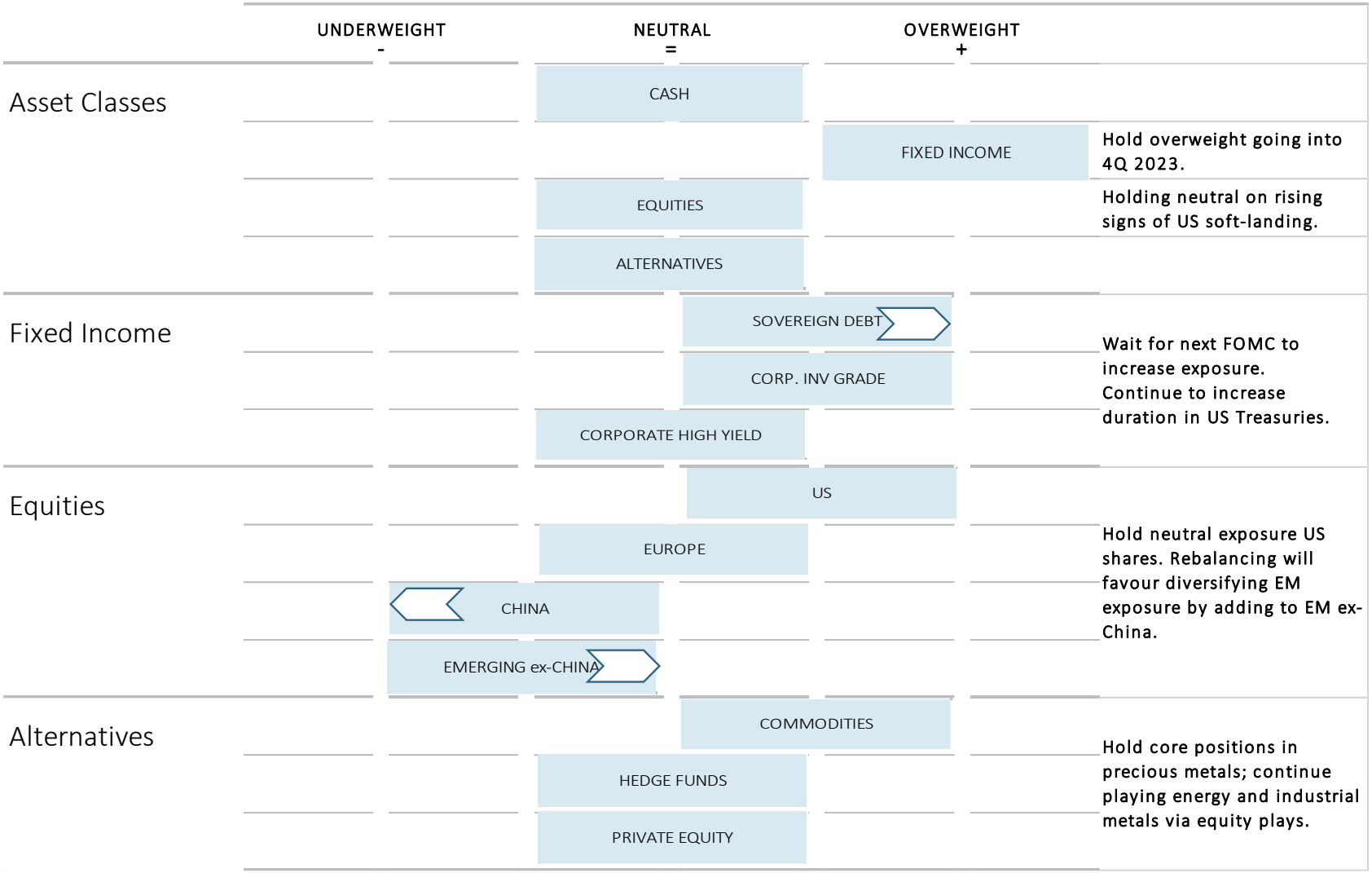
As such, we are **holding our neutral exposure in cash** as it offers attractive returns. US and European central banks remain data dependent and likely to pause in September. Cash returns may grind a touch higher going into the fourth quarter.

We are **holding overweight exposure to global bonds** as yields have risen. Political gridlock amongst Republican Representatives may bring another US government shutdown if they cannot pass the 2024 fiscal year funding bills by end-September or a continuing resolution to kick the can down the road. We continue to run short (2-3.5) duration risk within portfolios with a focus on Investment Grade corporate credits. We look to increase duration risk towards 4.0 should yields increase in the coming weeks. We still favour issuers in recession-resistant sectors (Consumer Staples, Heath Care) and look to for opportunities to increase our allocation to EM local currency issues.

We **retain our neutral exposure to equities** as investors' risk appetite is fed by rising probabilities of a soft-landing in the US. We recommend increasing overweight exposure to Healh Care companies (lagging defensive sector with above-market growth potential). We continue to run a moderate overweight in the Energy, Industrials, Materials, and Real Estate sectors.

Monthly Allocation Grid Across Asset Classes/Market Sectors

September 2023



Outlook 2023: Fixed Income

Final Quarter 2023:-As we approach the final quarter of 2023, we are confronted with a yield curve exhibiting some noteworthy dynamics: an inversion at the short end, bear flattening in the middle, and an unusual bear steepening at the long end. Given this complex backdrop, it is imperative that we strategically position our fixed income portfolio to adapt to these yield curve shifts, market sentiments, and anticipate opportunities driven by expectations in interest rate movements. In response to the atypical yield curve dynamics, our strategy involves implementing a credit barbell approach. This primarily entails taking a bullish position at the short end of the yield curve through investments in corporate investment-grade bonds, with the aim of capitalizing on the yield opportunities presented by the inverted yield curve. Additionally, we are adopting a long position at the long end of the yield curve by investing in US Treasury bonds to capture yields surpassing the 4.25% threshold.

Here are key strategies for the upcoming period:

1. **Overweighting Long-Term U.S. Treasury Bonds:** We maintain an overweight position in long-term U.S. Treasury bonds. This stance is rooted in our belief that the market is undervaluing the potential for future rate cuts, making long-term Treasuries an attractive investment.
2. **Short Duration on U.S. IG Corporate Bonds:** We are adopting a short duration strategy for U.S. Investment-Grade corporate bonds, essentially creating a "credit barbell" strategy. This involves holding short-duration, high-quality corporate bonds alongside longer-duration U.S. Treasury bills. This approach is designed to optimize our risk-adjusted returns while managing credit risk.
3. **Inclusion of Euro Investment Grade & Floating Rate Notes:** Currently, European investment-grade credit spreads are wider than their historical averages, indicating potential future tightening. Our focus is on short-term investments in the financial & energy sectors, offering a 125-bps spread, a 63-bps premium compared to other sectors. The financial sector, known for its stability and resilience, boasts a strong balance sheet. Anticipated interest rate increases are expected to enhance profitability. Additionally, we are incorporating Euro floating rate notes into our portfolio strategy in response to the European Central Bank's hawkish stance and ongoing interest rate hikes in Europe. This aligns with our goal of capitalizing on changing interest rate conditions in Europe.
4. **Overweighting Emerging Market Local Currency Sovereign Debt:** We are favoring an overweight position in Emerging Market Local Currency sovereign debt. This choice is driven by our confidence in the disciplined policies adopted by many EM central banks. These proactive measures are aimed at effectively managing inflation expectations through substantial and timely interest rate increases. Furthermore, select EM economies have demonstrated exceptional prowess in taming inflation during the first half of this year. This success has translated into enticing opportunities, particularly in local bonds, where high real yields are prevalent. This, in turn, bolsters the appeal of investing in these markets, particularly when considering that EM currencies are currently under valued

This undervaluation enhances the attractiveness of high-yield currencies and leverages the FX carry trade, combined with the allure of high real yields. Additionally, certain emerging economies, including Brazil, Chile, Uruguay, and Hungary, have already embarked on interest rate reduction measures. It is widely anticipated that more will join this trend before the year concludes. Consequently, we see merit in reshaping our exposure in these countries, transitioning from short-duration positions to medium and long-duration positions along the local yield curves. This strategic shift offers favorable risk-reward dynamics within the duration spectrum.

5. **On HY markets, moving to a neutral position on US HY and underweighting global HY. This shift is due to several factors:**

US HY Concerns: Some US HY companies have struggled to meet debt obligations due to weakened financial health and slow earnings growth. While we don't expect a surge in defaults, rising borrowing costs for companies geared towards slow growth and low inflation could pose challenges.

Global HY Volatility: Global HY markets have been volatile, driven by mixed economic data and the US Federal Reserve's intention to maintain higher interest rates. Credit ratings in the HY segment have seen more downgrades than upgrades.

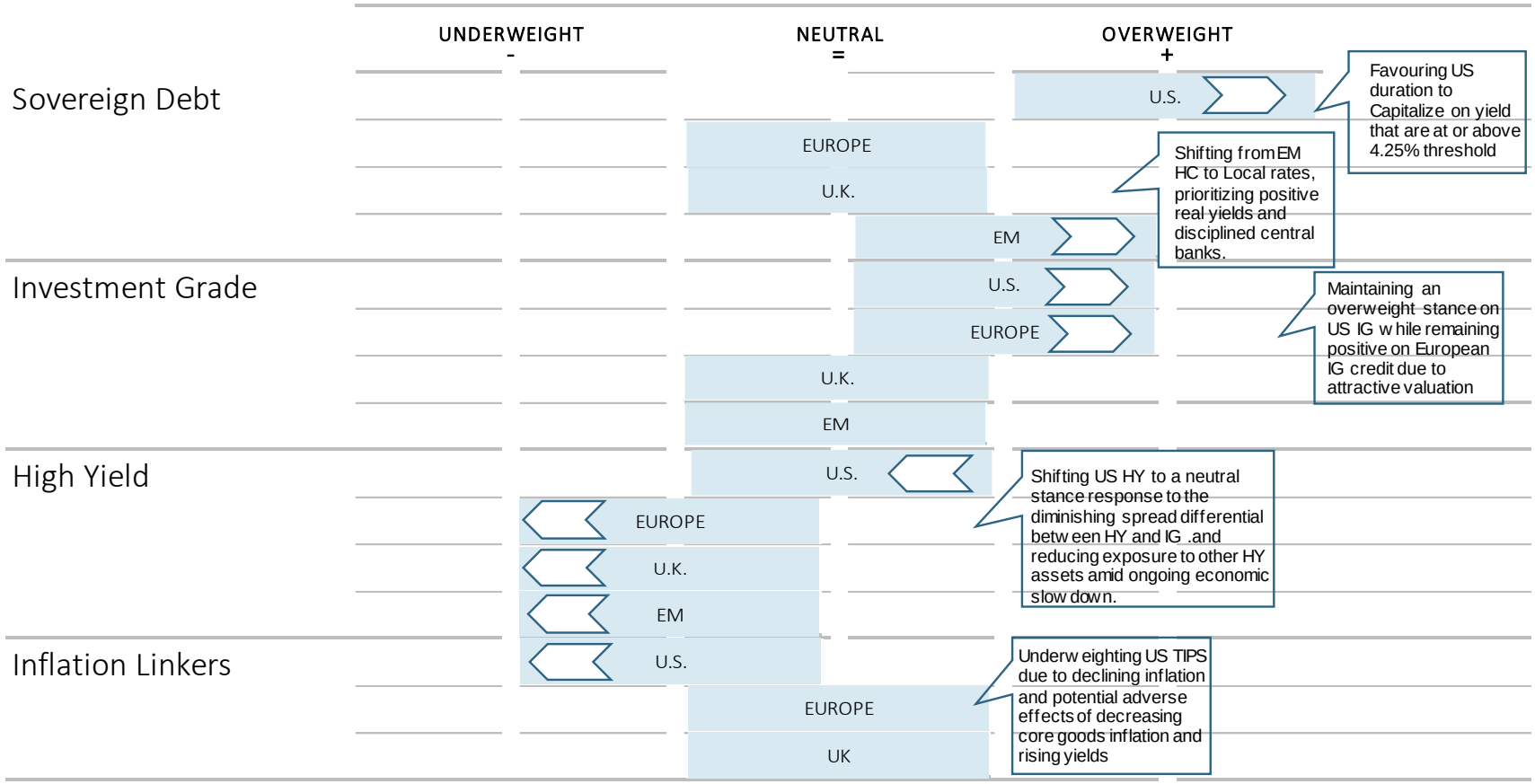
Asian HY Caution: Asian HY bonds have faced difficulties, primarily due to issues in China's property market and weak economic data. This sector is currently less favorable.

European HY Potential: European HY presents potential opportunities with healthy earnings, low defaults, and manageable volatility. While spread levels are not particularly cheap, overall yields and low duration have supported performance.

Unique Economic Cycle: The ongoing economic slowdown is unique because inflation is decreasing. This suggests more resilient growth and flexibility for the Federal Reserve to stimulate the economy. This reduces the risk of a recession following the slowdown and may lead to an expansion or recovery phase.

In light of these prevailing uncertainties, our advisory stance inclines towards a preference for High quality assets. While the historically elevated yields within the HY market continue to offer attractive total returns, our bias is to reduce exposure in the coming months if recession risks in Europe increase.

Monthly Allocation Grid Across Asset Classes/Market Sectors



Outlook 2023: Global Equity

We retain our neutral exposure to equities as investors' risk appetite is fed by rising probabilities of a soft-landing in the US.

As we enter the third quarter, equity investors will again concentrate on the following data flows:

- **3rd quarter earnings season begins mid-October with positive earnings revisions expectations.**
- **Macro-data showing signs of positive reversal in manufacturing spending.**
- **Progress (or lack thereof) in approval of the US 2024 fiscal budget**

At a **sectoral** level, we look to increase our overweight exposure to Health Care companies (lagging defensive sector with above-market growth potential). We continue to run moderate overweight in the Energy, Industrials, Materials, and Real Estate sectors

We continue to run a small underweight to the Financials as we prefer to wait for confirmation that US Fed policy will peak. We will run neutral exposure to five sectors (Communication Services, Consumer Discretionary, Consumer Staples, Information Technology, and Utilities).

Regional exposures will see minor shifts away from the United States. Profit-taking will reduce our US overweight as we look to hold European allocations near current levels. While we continue to hold our China exposure as shoots of a recovery appear, we will be diversifying our underweight emerging equity allocation away from China.

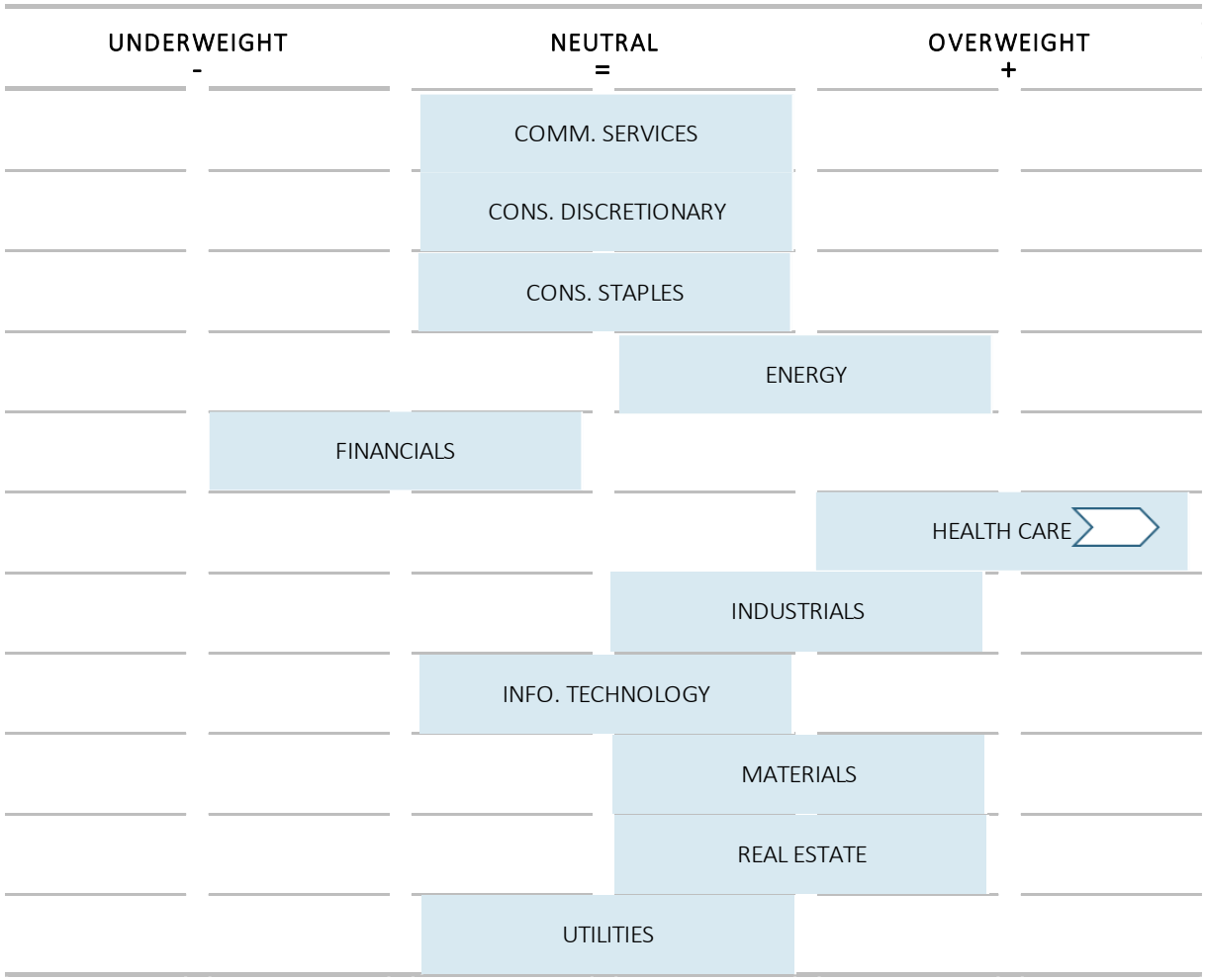
We continue to see better value in non-US shares as valuation metrics remain relatively high for the broad US index versus European and Asian markets. In addition, select emerging markets' valuation levels, central bank policies, and sentiment are improving.

As usual, our direct investments favour companies with high quality balance sheet strength, strong free cashflow, and with product pricing power.

Monthly Sector Views vs MSCI AC World Equity Index

September 2023

Increase overweight to defensive sector with high earnings growth potential.



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