



BAROMETER OF FINANCIAL MARKETS JULY INVESTMENT OUTLOOK
July 2022

Barometer: Cheap, but not cheap enough

Even if the ongoing sell-off in equity markets takes valuations to levels that are at odds with fundamentals, there are good reasons to remain underweight stocks and high yield bonds.

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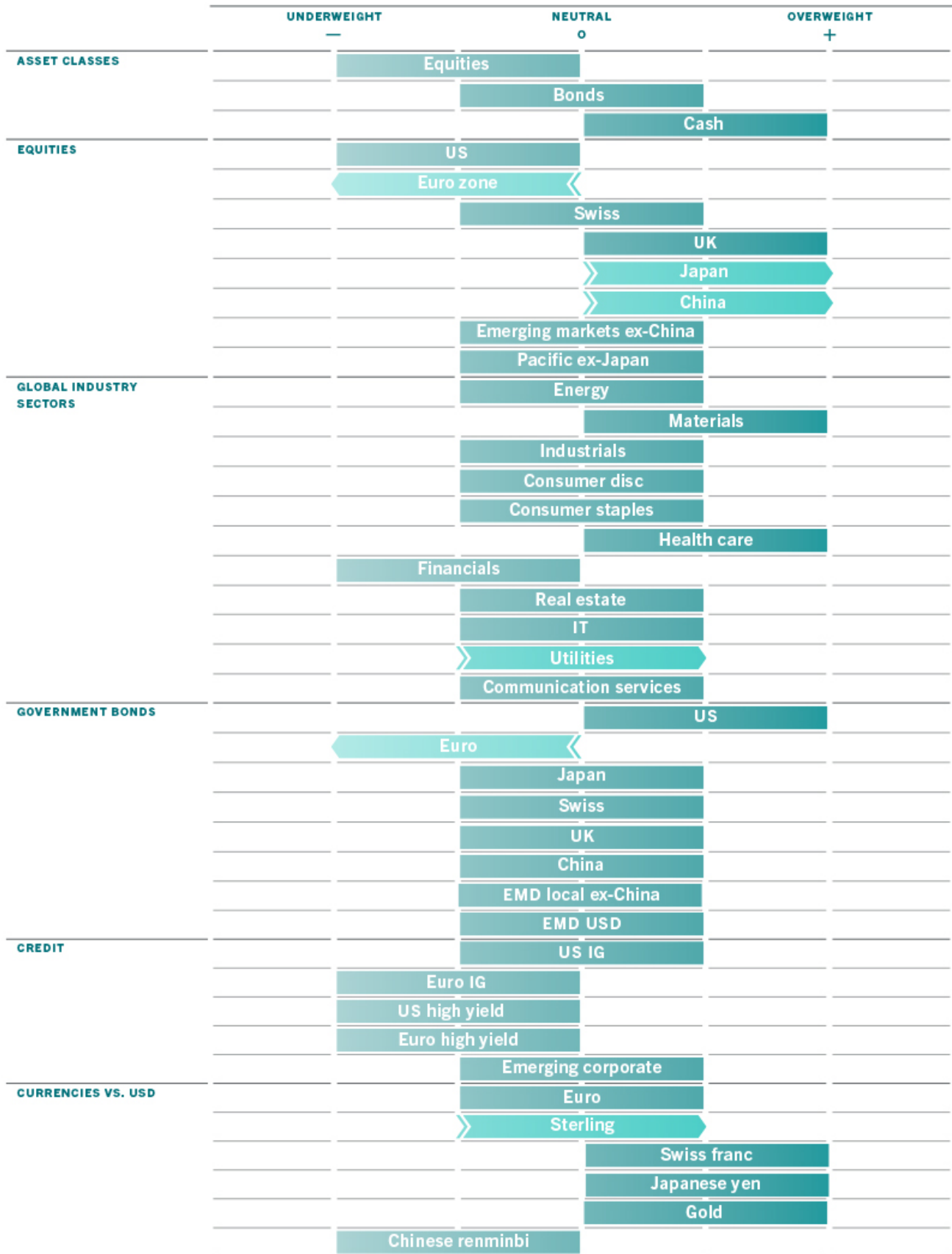
Asset allocation: no recession panic (yet)

The risk of a recession is rising as central banks put the squeeze on monetary conditions across much of the world. That and the fact that valuations aren't yet sufficiently cheap despite this year's steep selloff, mean that we maintain our underweight on equities.

Indeed, with the exception of commodities, assets of all stripes have suffered hefty losses since the start of the year, largely to the same order of magnitude, generally down some 10 per cent to 15 per cent making it exceptionally difficult for investors to avoid being caught in the general riptide. A portfolio composed equally of US stocks and bonds has lost more in the first six months of the year than at any point since the Great Depression.

Economic conditions, however, are managing to remain resilient for now, so we keep a neutral stance on bonds overall – our leading indicators suggest central banks won't tip major economies into recession this year as they seek to control inflation.

Fig. 1 - Monthly asset allocation grid
July 2022



Source: Pictet Asset Management

The question for the markets now will be whether central banks relent on rate hikes before they have inflation fully under control. So far they appear to be fixed on their policy course. But with signs that inflation has peaked, some of the pressure on them to make ever more extreme moves is easing, reducing the risk of a policy mistake.

Our **business cycle** indicators suggest the world economy will expand at a modest 2.9 per cent in 2022. Within that broad forecast, we have trimmed our expectations for the euro zone and Australian economies while upgrading our expectations for emerging markets, thanks to strength in both India and Russia. Emerging Asia's recovery looks particularly encouraging, thanks in part to China's resurgence.

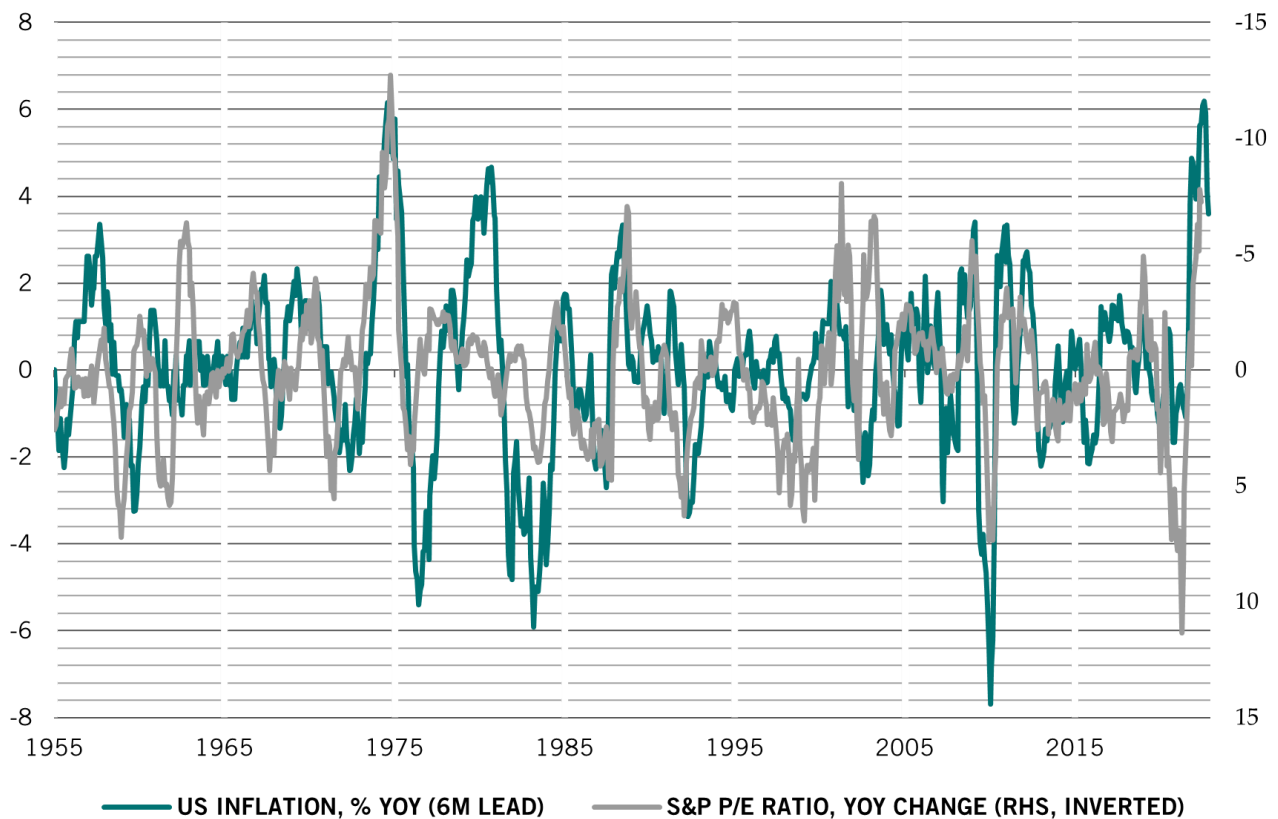
Notwithstanding the US economy's marked slowdown, we believe the risk of a full-blown recession for this year is overstated, though the odds are high for 2023. Excess household savings amount to USD2.3 trillion, some 12 per cent of income, and, together with a solid jobs market and the post-Covid recovery, should be enough to offset a squeeze on consumers from rising prices and interest rates. One worry, however, is the downturn in housing: construction activity is down some 30 per cent, with surveys suggesting more to come.

Our **liquidity** indicators show a continued squeeze on monetary conditions outside of Asia. Financial markets are pricing in some 200 basis points of cumulative interest rate hikes from the major central banks over the coming 12 months. What is more, some central banks – with the Bank of England in the lead – are poised to launch quantitative tightening. That's to say they are not only going to be allowing existing bonds in their portfolios to mature but will also actively sell their holdings. In all, central banks are removing close to USD1.5 trillion in liquidity per quarter, our calculations show.

Partially offsetting this tightening is the People's Bank of China, which is now easing on all fronts, while the Bank of Japan is sticking to its yield curve control strategy, which has forced it to step up bond purchases.

Fig. 2 - Price pressure

US inflation rate and S&P 500 price/earnings ratio, year-on-year change, %



Source: Refinitiv Datastream, Pictet Asset Management. Data covering period 15.01.1955-15.06.2022.

After the heavy losses bonds and equities have suffered, **valuations** are starting to flash green again. But they are not close to being cheap enough to encourage investors to ignore fundamentals. Among sovereign bonds, UK gilts look particularly attractive. Wider spreads and hefty drawdowns leave US high yield and European investment grade credit looking attractive. On the flip side, index-linked bonds are looking expensive – investors are paying a lofty premium for inflation protection.

Our **technical** indicators show that the trend signals are negative for equities and even more so for bonds. However, seasonal trends should prove supportive for bonds over the coming two months. Sentiment indicators no longer flash panic, though remain depressed – risk appetite appears to have troughed for now and investors have trimmed their cash and defensive positions. At the same time, positioning on S&P 500 futures was net short for the first time since 2016.

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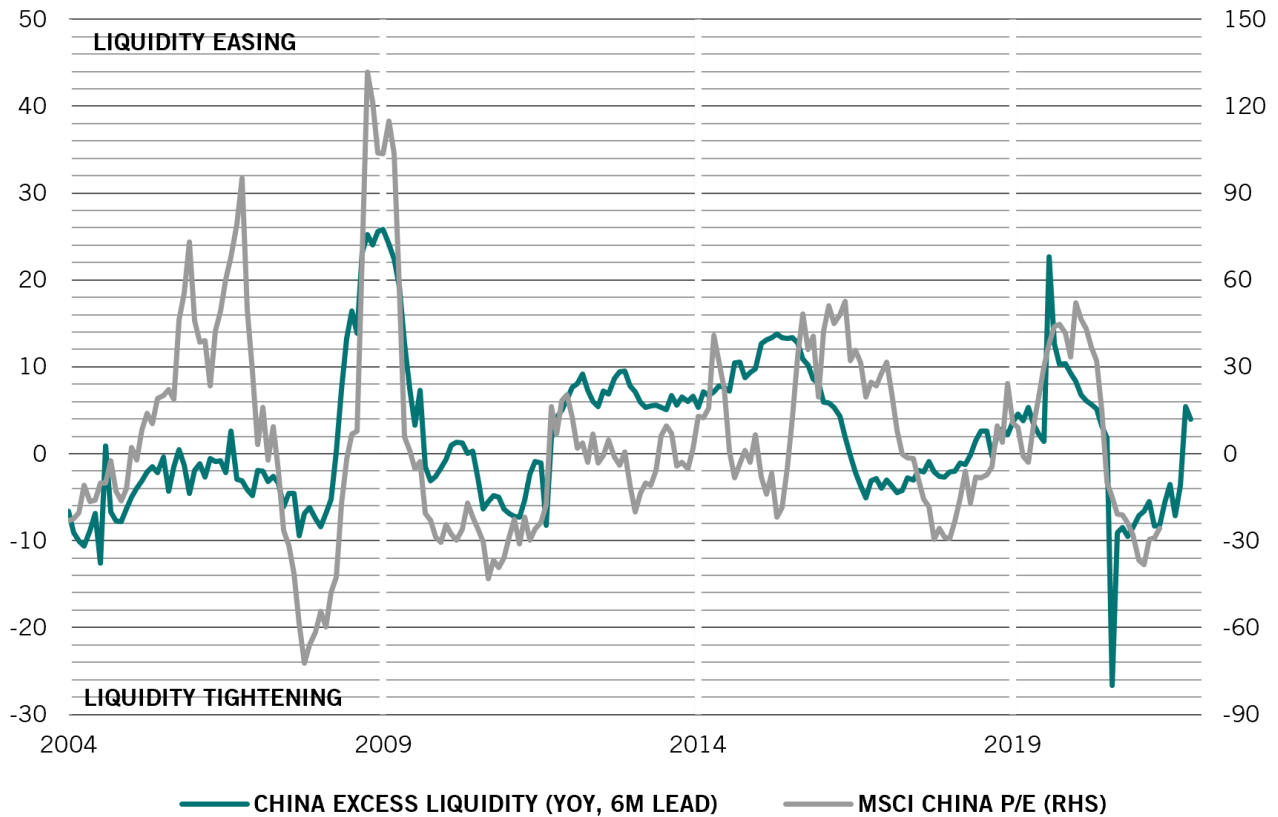
Equities regions and sectors: cheaper but not cheap enough

As the S&P 500 index slips into a technical bear market, equities are approaching fair value. But not quite cheap enough for investors to ignore fundamentals and the ongoing threats corporations face. The risks continue to be skewed to the downside, especially when it comes to US earnings growth. That said, if inflation declines faster than expected, it would trigger a rebound in US stocks' price-to-earnings ratios.

US equities have de-rated sharply. While world stocks' 12-month forward price to earnings ratios have declined by more than 30 per cent since September 2020, the US ratio has fallen to some 30 per cent below the long term trend, the sharpest contraction since 1974. Assuming inflation has peaked, our models suggest multiples will expand some 5 to 10 per cent over the coming 12 months. On balance, taking into account existing multiples and earnings prospects, we remain underweight US equities.

We also downgrade euro zone stocks to underweight. The region is most at risk of a recession, as the energy squeeze caused by sanctions on Russia feed through to the wider economy. At the same time, the European Central Bank is a laggard when it comes to monetary tightening and could find itself being forced to play catch-up if inflationary pressures don't relent. While European stocks' valuations are attractive they have not reached levels that sufficiently compensate investors for their risks.

Fig. 3 - Chinese stocks out of Covid's shadow
China's excess liquidity (year-on-year, 6M lead) vs MSCI China P/E ratio



Source: Refinitiv Datastream, Pictet Asset Management. Excess liquidity calculated as broad money minus value of domestic industrial production growth. Data covering period 15.12.2004-15.05.2022.

We upgrade Chinese equities to overweight in response to the economy's strong rebound, following the easing of Covid-related restrictions that were responsible for an economic contraction during the second quarter. Monetary conditions are supportive and valuations remain attractive despite the market's rally. Moreover, the uncertainty surrounding tech regulation appears to be abating. We also upgrade Japanese equities on grounds of better economic momentum, lower inflation risks and a more optimistic consumer than elsewhere. Monetary policy remains supportive of the market. At the same time, the yen is extremely cheap after its heavy losses this year, making Japanese stocks all the more attractive to foreign buyers.

Within sectors, we continue to prefer health care as a solid defensive play and have upgraded utilities for similar reasons. At the same time, however, we maintain our positive stance on materials as such stocks could benefit from what we see as an improvement in China's economic prospects.

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Fixed income and currencies: cautious on Europe

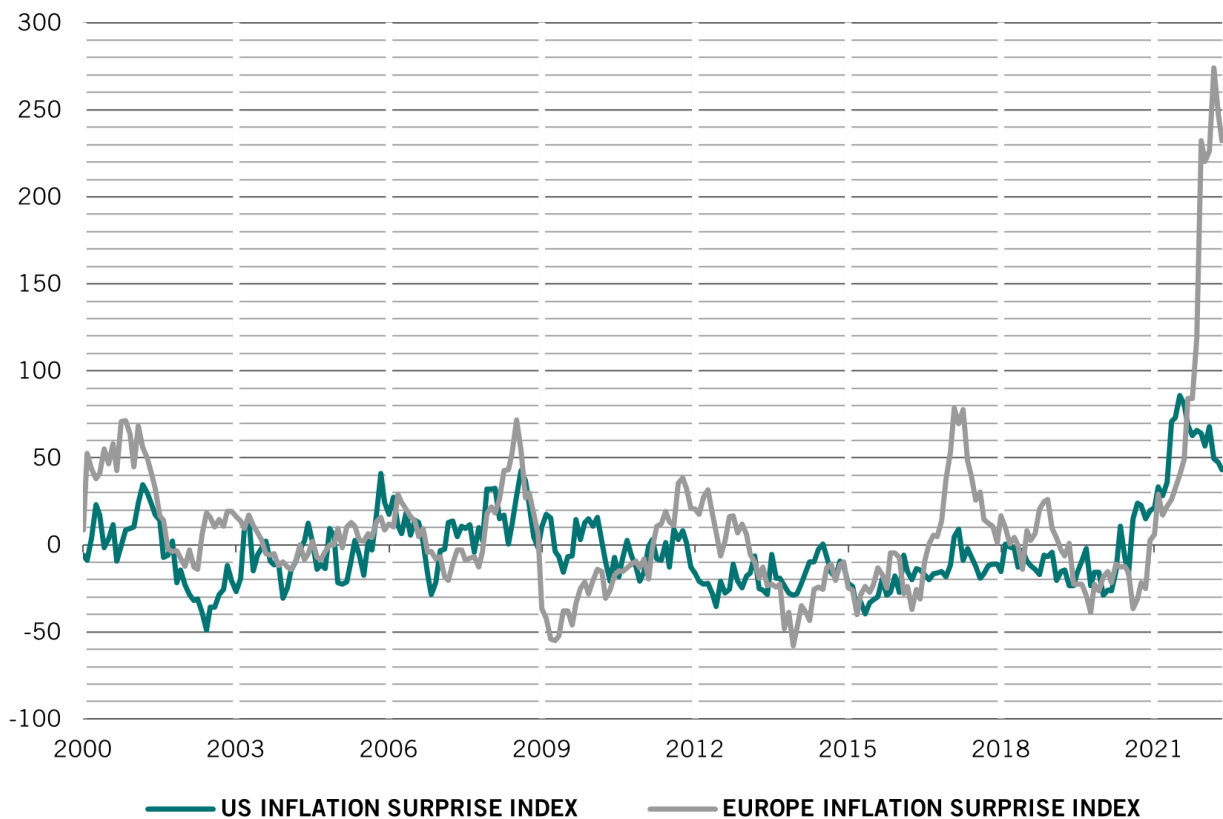
Thanks to the recent rout, bond valuations are looking increasingly attractive. While risks remain, we believe there are a few areas in the fixed income market where the risk-reward balance looks attractive.

One of them is US government debt. Our liquidity models suggest that the Fed is 60-65 per cent through its tightening cycle. Core inflation appears to have peaked, helped by the stronger US dollar, while the market's interest rate expectations seem excessive (pricing in a Fed funds rate peak close to 3.5 per cent, while we forecast 3 per cent). Our fair value for the 10-year Treasury yield is 2.8 per cent, compared to the end-June level of 3 per cent. We therefore maintain an overweight stance on US Treasuries.

Prospects for European sovereign debt look weak by comparison. The ECB risks being caught behind the curve in its battle against inflation. Inflation indicators are coming through much stronger in the euro zone than elsewhere (see Fig. 4) while the second round effects of higher prices are now showing up in wages and wage demands. The war in Ukraine and uncertainty over the region's energy supplies add further risks. Taking all this into account, we have chosen to downgrade euro zone sovereign bonds to underweight.

Fig. 4 - Beware inflation

Inflation surprise indices, US vs Europe



Source: Refinitiv Datastream, Pictet Asset Management. Data covering period 31.01.2000-31.05.2022.

We also maintain our bearish view of corporate bonds in developed markets. The prospect of more monetary tightening and cuts to company earnings forecasts do not bode well. Spreads, meanwhile, are not abnormally high and could rise further if recession risks increase. However, we acknowledge that, after the biggest sell-off in decades, valuations are becoming more attractive.

Among currencies, we reiterate our view that the dollar is approaching what we consider to be a peak in its valuation. But the key precondition for a turn in the dollar's fortunes – an easing of US inflationary pressures – has yet to fully materialise.

Our preference remains for defensive assets such as gold and the Swiss franc, which has appreciated further following a surprise 50 basis point rate hike in Switzerland.

We are also overweight the yen, which ranks as extremely cheap on our valuation model. The currency should also benefit from Japan's positive economic outlook. Capital expenditure and tourism are strong, consumers are more optimistic than elsewhere, and inflation is rising but still at a very low level.

With a UK recession now largely priced in – and following a 11 per cent drop in sterling year to date – we close our underweight in the currency.

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Global markets overview: more losses

June was another tough month for global markets.

Every major equity market and every sector finished in the red. In aggregate, global equities were down around 6 per cent in local currency terms. The latest drop means that in the first half of the year 2021's gains have been erased.

US stocks were among the laggards, as the S&P 500 index suffered its worst first half year since 1970. Futures positioning on the index, meanwhile, turned net short for the first time since 2016.

With the Fed raising rates by 75 basis points in June – the biggest hike in nearly three decades – investors received clear proof that the current focus for policymakers is very much on fighting inflation, even if that means weaker economic growth.

European stocks also fared badly, due to the region's close geographical and economic links with Russia and Ukraine.

Losses were more modest across stock markets in emerging Asia and Japan, thanks to relatively stronger economic prospects, lower inflation and the end of Covid lockdowns in China.

Among sectors, energy and materials stocks lost about 11 per cent in local currency terms, ending a trend of outperformance. The falls reflected concerns about how demand will hold up during a period of weakening economic growth.

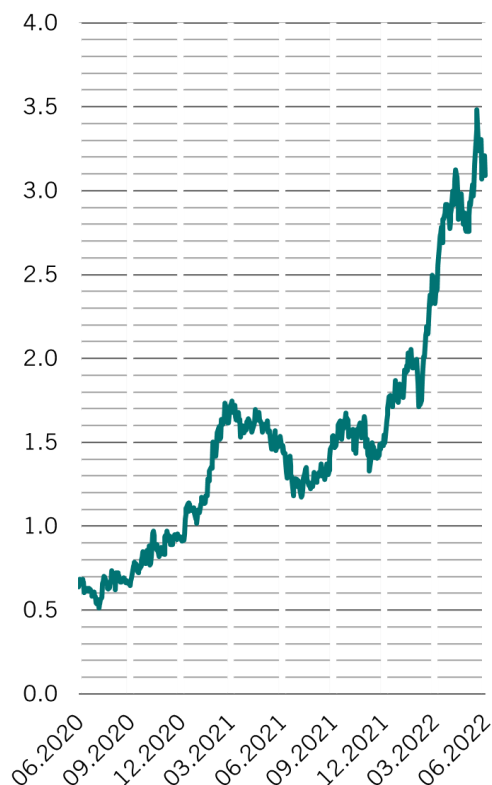
Traditionally defensive healthcare and consumer staples stocks fared the best, though even they too sustained losses.

In fixed income markets there was also a defensive tilt, with the riskier asset classes underperforming. European and US high yield bonds both lost around 6 per cent, hit by concerns about possible defaults. Emerging market government bonds also suffered.

Yields on benchmark 10-year US Treasuries peaked at around 3.5 per cent during June, before retreating to finish the month at 3 per cent (see Fig.5).

The prospect of Fed hikes lifted the dollar, which gained 3 per cent versus a basket of currencies.

Fig. 5 - Yield peak?
US Treasury 10 year yields



Source: Refinitiv Datastream, Pictet Asset Management. Data covering period 29.06.2020-29.06.2022.

05 In brief

BAROMETER JULY 2022

Asset allocation

We maintain our negative stance on equities and remain neutral on bonds.

Equities regions and sectors

We reduce euro zone equities to underweight from neutral amid concerns about the economy. We raise Chinese and Japanese equities to overweight from neutral as both are seeing support from domestic monetary policy. We raise utilities to neutral from underweight as part of a defensive rebalancing.

Fixed income and currencies

We downgrade European government bonds to negative due to concerns about rising inflation, slowing growth and ongoing war in Ukraine.

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Written by



Pictet Asset Management Strategy Unit

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