

BAROMETER OF FINANCIAL MARKETS APRIL INVESTMENT OUTLOOK MAY 2022
May 2022

Barometer: A cruel April could mark the trough

Stocks suffered a brutal sell-off in April but there are signs that investor positioning is overly bearish.

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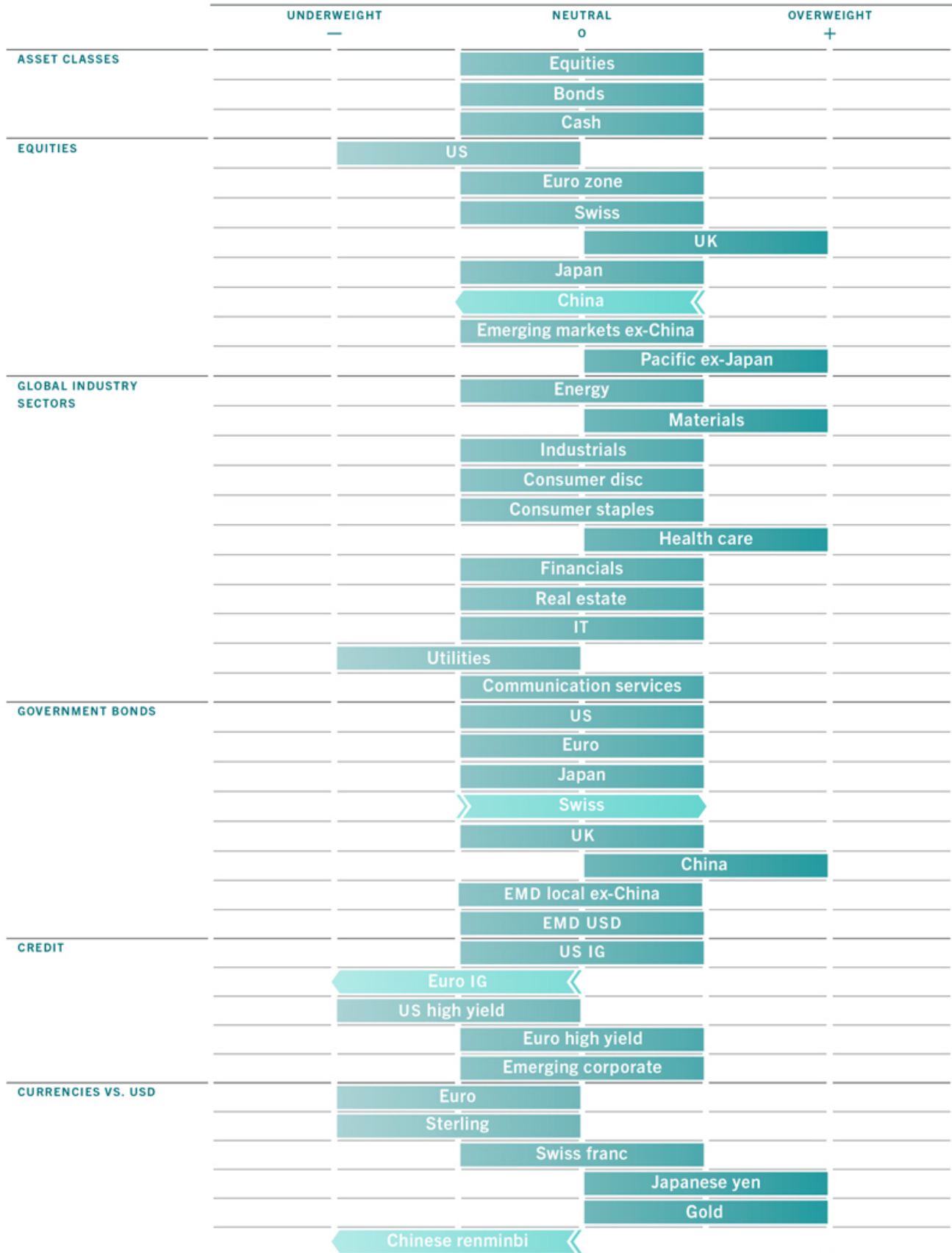
Asset allocation: technical indicators suggest calmer times ahead

The investment climate appears to be getting harsher. Global economic growth is slowing, inflation is rising, no resolution appears in sight for Russia's invasion of Ukraine and new Covid-related lockdowns are sweeping through China, impeding growth.

Faced with these challenges, investors could be forgiven for adopting a defensive stance.

Yet we prefer to remain neutral rather than underweight equities. And that is largely because investor positioning has become excessively bearish, reducing the scope for further market declines in the near term.

Fig. 1 - Monthly asset allocation grid
May 2022



Source: Pictet Asset Management

Indeed, the picture emerging from our technical indicators shows that both positioning and sentiment among investors is unusually pessimistic, discounting a significant loss of economic momentum in the months ahead. Yet history tells us that shorting equities in a bull market, even during the later phase of the cycle, when sentiment is very depressed is always very dangerous.

That said, we have tweaked our positions to adopt a slightly more cautious stance, but – for now – have decided to keep an overall neutral weighting on both global equities and global bonds.

While government bonds are looking increasingly good value after steep sell offs, we would prefer to wait until US inflation and inflation expectations have peaked before upgrading them.

Our **business cycle** indicators support our broad asset allocation stance. Although we have, yet again, reduced our economic growth forecast for 2021 to 3.4 per cent - from 3.5 per cent a month ago and 4.8 per cent at the start of the year – our estimate remains above both the long-term trend and the market consensus.

The US economy, in particular, continues to look solid: US real GDP contracted in the first quarter but final demand continues to gather strength thanks to an exceptionally strong labour market and positive trends in investment spending. Our US leading indicator is rising at a stable pace and remains in line with its historical average. In Asia, meanwhile, Japan and some of the region's emerging economies are seeing improvements in activity and in consumer confidence.

Things look more problematic in the euro zone – not least due to its closer economic and geographic ties to Russia and Ukraine. A technical recession is a real risk, especially in Germany where consumer confidence has fallen to all-time lows.

The Chinese economy is also struggling. Purchasing manager indices are falling below 50, while exports are peaking. Authorities are offering some stimulus, but, so far, not aggressively enough to offset the weakness in the property sector and the consequences of the strict Covid lockdown in some major cities.

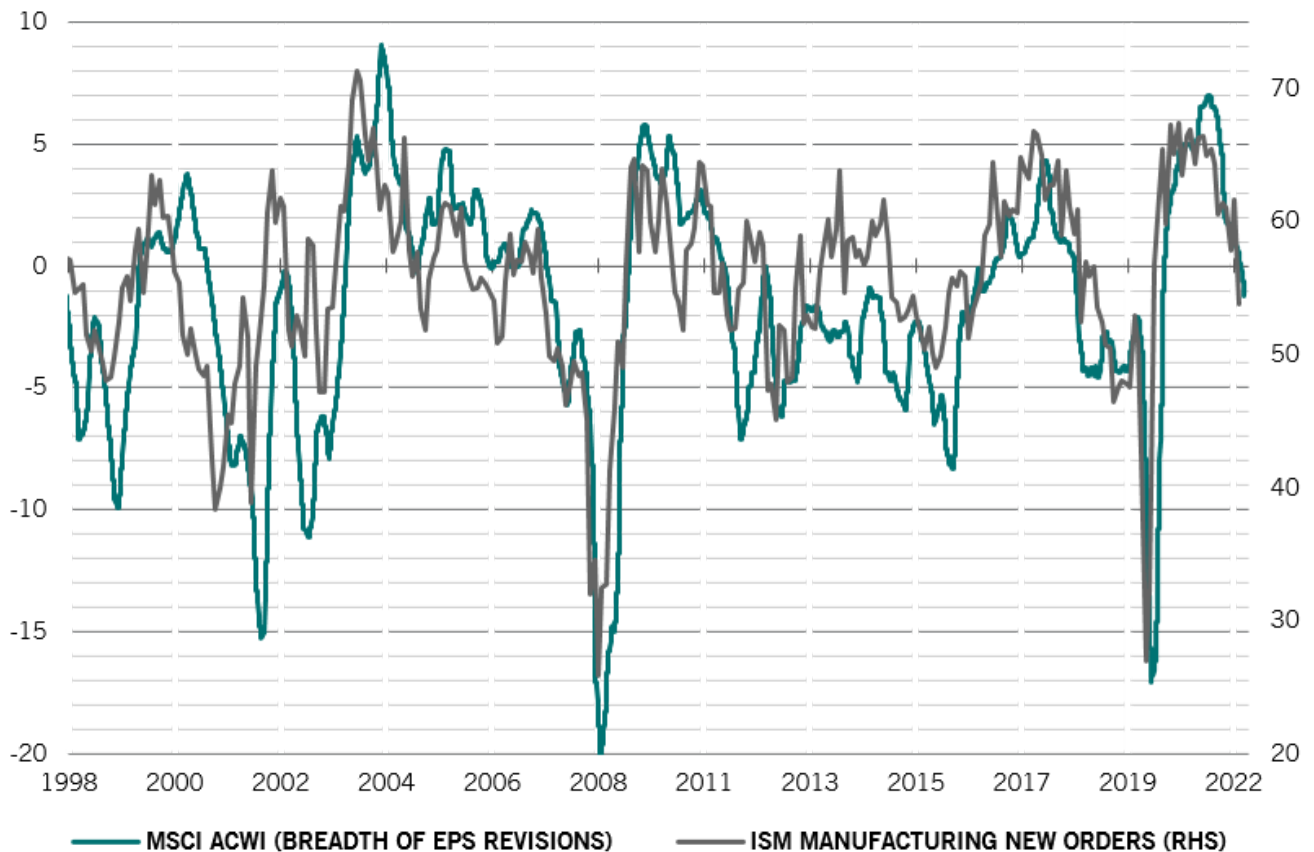
Our **liquidity** indicators show that China is easing policy much more slowly than US is tightening. Yield differentials between US and Chinese government securities suggest that the renminbi could fall to around 7 per dollar over the coming months.

Valuations look particularly concerning for euro zone investment grade bonds; US investment grade bonds appear more attractively priced by comparison.

For equities, valuations are generally looking more attractive, with the 12-month price-to-earnings ratio on MSCI All Country World Index having dropped to 15.5 times – roughly in line with the average of the past 20 years.

Fig. 2 - Weaker earnings

Global earnings revisions (upgrades minus downgrades) and US ISM Manufacturing New Orders index



Source: Refinitiv, MSCI, Pictet Asset Management. Data covering period 01.01.1997-27.04.2022.

However, this looks less attractive when considered in the context of rising bond yields and a deteriorating outlook for corporate earnings. Globally, analyst earning downgrades now outnumber upgrades for the first time since August 2020. This reflects economic reality, as the trend mirrors a decline in the ISM New Orders Index (see Fig. 2).

Looking at **technical** indicators, the equity put/call ratio - a measure of bearish equity positions relative to bullish ones - has risen to near top of historical range, signalling that positioning on stocks is exceptionally negative. This is also reflected in sentiment indicators, with the American Association of Individual Investors investor sentiment survey's bull share near 30-year lows. In such an environment, any market gains could provoke a wave of position adjustments, further fuelling the rally.

02

Equities regions and sectors: China in a bind

Clouds are gathering over China's economy.

Shanghai's four-week-long lockdown has forced most of the city's 26 million residents indoors, with some even struggling to secure food and other essentials while worries mount over the possible imposition of similar measures in Beijing.

The country's worst Covid outbreaks in two years is causing serious disruption to the world's second largest economy.

Illustrating the scale of the impact, China's industrial activity indicator recently fell below the growth threshold of 50, hitting the lowest level since August.

China is the worst-performing equity market this year with a decline of more than 24 per cent since January. Investors are increasingly worried about the extent of an economic slowdown at a time when the People's Bank of China appears reluctant to deliver large-scale monetary easing.

The sell-off has sent valuations for Chinese stocks to levels that now look attractive from a historical perspective and relative to peers. The market trades at 12-month price earnings multiples of below 10, compared with the historical average of around 15-16 and a 40 per cent discount to world stocks measured by MSCI All Country World Index.

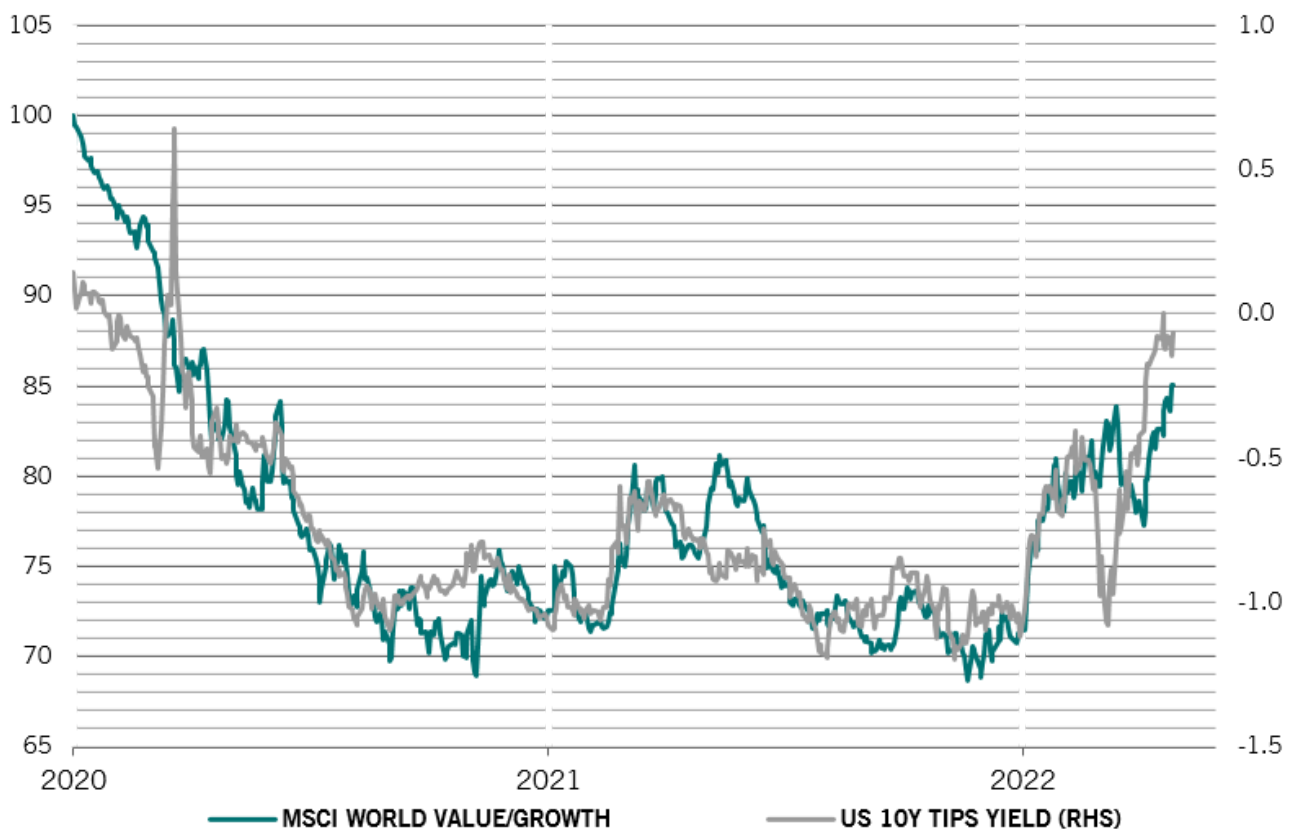
Yet we believe this is not compelling enough to fully compensate for risks stemming from Beijing's zero-Covid policy, a lingering impact from last year's regulatory crackdown and the lack of aggressive monetary stimulus.

Capital outflows from China, which the Institute of International Finance estimate to be as much as USD500 million on a three-month moving average basis since late February, also reflect anxiety over possible secondary sanctions from the US on China from the Russia-Ukraine crisis.

Against this backdrop, we are cutting Chinese equities to neutral from overweight – a move that is reinforced by our simultaneous downgrade in the renminbi currency to underweight.

Fig. 3 - Value in the lead

MSCI All Country World Index Value vs Growth (01.01.2020=100) and US 10Y TIPS yield (bps)



Source: Refinitiv Datastream, MSCI, Pictet Asset Management. Data covering period 01.01.2020 - 27.04.2022.

In contrast, we continue to be optimistic on the prospects for UK equities.

Possessing an attractive sector composition of commodity exporters and quality defensive companies, the UK market should outperform its peers despite a slowdown in the economy.

We remain underweight US equities. Unattractive valuations, a Fed intent on aggressively raising interest rates and a strong US dollar all augur badly for American markets, which have a relatively high exposure to growth-sensitive stocks.

What is more, the risks to 2022 earnings growth for US companies are skewed significantly to the downside.

Wage inflation, which is accelerating to as much as 7 per cent on certain measures, points to downward pressure on corporate margins.

Given the prevailing bearishness, we are positioned to benefit from any turnaround in investor sentiment, preferring value stocks over sectors sensitive to interest rates and

economic cycles in our regional and sector allocation. As Fig. 3, shows value stocks outpace growth stocks when US real yields are tracking higher.

We continue to like materials – which has one of the most attractive valuations in our scorecard. We maintain our overweight stance in pharmaceuticals, a defensive, USD-based sector with reasonable valuation.

03

Fixed income and currencies: cutting back on renminbi

After a brutal first quarter, there are signs that value is beginning to emerge in global bonds. While it is still too early to upgrade our stance from neutral, that stance might soon change as we expect to see a peak in inflation and inflation expectations over the coming months.

Markets have seen the sharpest peak-to-trough fall in in US bonds for half a century. And with 10-year US Treasuries down 17 per cent from their highs, they look increasingly attractive. However, we believe that it is better to wait until US inflation and inflation expectations peak. At that point, the Fed will probably be at its most hawkish, real bond yields will have risen to above 0.5 per cent and the implied Fed funds rate to above 3 per cent. We believe that a US 10-year yield in a 3-2.25 per cent range would attract significant demand from investors.

For now, we restrict ourselves to upgrading Swiss bonds to neutral from underweight. We close our short position in Swiss bonds as yields approach 1 per cent and the Swiss economy slows and its lead indicators are in negative territory for the first time since 2020. Inflation is still manageable, we expect it to average 2.5 per cent this year.

We remain more cautious on European credit however. We downgrade euro denominated investment grade bonds to underweight from neutral. A spread of 145 basis points on such bonds is still not high enough to compensate for the risk of a recession in the region and of European Central Bank tightening in the second half of the year. The surge in energy prices and the risk that Russian gas supplies will be cut across ever more of Europe leaves a number of the region's economies teetering on the lip of a downturn.

Fig. 4 - Under pressure

US dollar-renminbi exchange rate vs US-Chinese bond yield differential



Source: Refinitiv, Pictet Asset Management. Data covering period 01.01.2010 to 27.04.2022.

In foreign exchange, we downgrade the renminbi to underweight. Momentum has turned significantly against the currency and, given the weakness of China's economy and low inflation rates, China's authorities may welcome a depreciation. Meanwhile, recent capital outflows may amplify the move (see Fig. 4). On the other hand, the currency is being supported by China's strong trade surplus and the fact that outbound travel is limited.

We are underweight the euro and sterling as the UK and euro zone's growth differential with the US remains wide. At the same time, the yen is now at a 20 year low against the dollar, and some 20 to 30 per cent undervalued on a purchasing power parity basis. We think the US dollar is experiencing a cyclical overshoot that isn't sustainable over the medium to long term.

04

Global markets overview: April a cruel month for tech

Stocks suffered a sharp sell-off in April, with US technology companies dragging markets lower as lacklustre corporate earnings, rising inflationary pressures and

fears of sustained interest rate hikes rattled investors.

The Nasdaq fell some 13 per cent on the month – its worst monthly decline since the 2008 global financial crisis - following disappointing quarterly results from some of world's largest tech firms, including Apple, Amazon and Netflix.

The index is down more than 20 per cent since the beginning of the year while the S&P 500 Index has witnessed its worst start to the year for more than 80 years.

More broadly, the MSCI World Growth Index ended the month some 22 per cent below its peak, which it hit in November last year, its steepest peak-to-trough fall since 2008.

Fig. 5 - Deep drawdown

US 10-year Treasury (Total Return Index, 100=30.12.2016)



Source: Refinitiv, Pictet Asset Management. Data covering period 30.12.2016-27.04.2022.

The decline in stock markets came as Fed officials continued to press the case for further interest rate hikes to battle inflation, which in April hit a 40-year high. Markets now expect US borrowing costs to be hiked by 50 basis points at the US central bank's May meeting. Bond markets sold off in response to the increasingly hawkish rhetoric, with yields on the US 10-year inflation-linked bond moving into

positive territory for the first time since 2020 and the 10-year nominal bond yield threatening to break through the key 3 per cent mark.

In the foreign exchange markets, the Chinese renminbi saw its steepest ever monthly decline as the country saw the imposition of severe lockdowns in response to renewed Covid outbreaks. The currency fell more than 4 per cent against the greenback in April – closing in on 7 against the dollar – in a decline that was sharper than the one it suffered as a result of its one-off devaluation in August 2015.

Also falling precipitously against the dollar was the Japanese yen, which has suffered as the Bank of Japan has controversially pursued an ultra-loose monetary policy in the face of rising inflation. The yen has fallen below 130 against the dollar.

05

In brief

BAROMETER MAY 2022

Asset allocation

We retain a neutral headline stance on both equities and bonds, while tweaking positions within each to reduce risk.

Equities regions and sectors

We downgrade Chinese equities to neutral as economic outlook deteriorates.

Fixed income and currencies

We upgrade Swiss bonds to neutral from underweight, downgrade euro denominated investment grade credit to underweight from neutral and downgrade the renminbi to underweight.

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Written by



Pictet Asset Management Strategy Unit

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