PICTET
Asset Management

BAROMETER OF FINANCIAL MARKETS OCTOBER OUTLOOK

Marketing Material

October 2022

Barometer: Equities remain unattractive but bonds merit a closer look

As the economic clouds have yet to clear, equities can be expected to see further declines. Bonds are beginning to look attractive, however.

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01 Asset allocation: more pain to come

The global economic outlook is darkening again as tighter monetary policy around the world and surging energy prices continue to undermine consumer confidence and corporate earnings growth.

Major economies are flirting with a recession. Europe is feeling the chill more than most other regions as the soaring cost of living and energy shortages force consumers to tighten their belts, banks to slow lending and companies to delay capital spending plans.

All of this augurs badly for corporate earnings in the coming months.

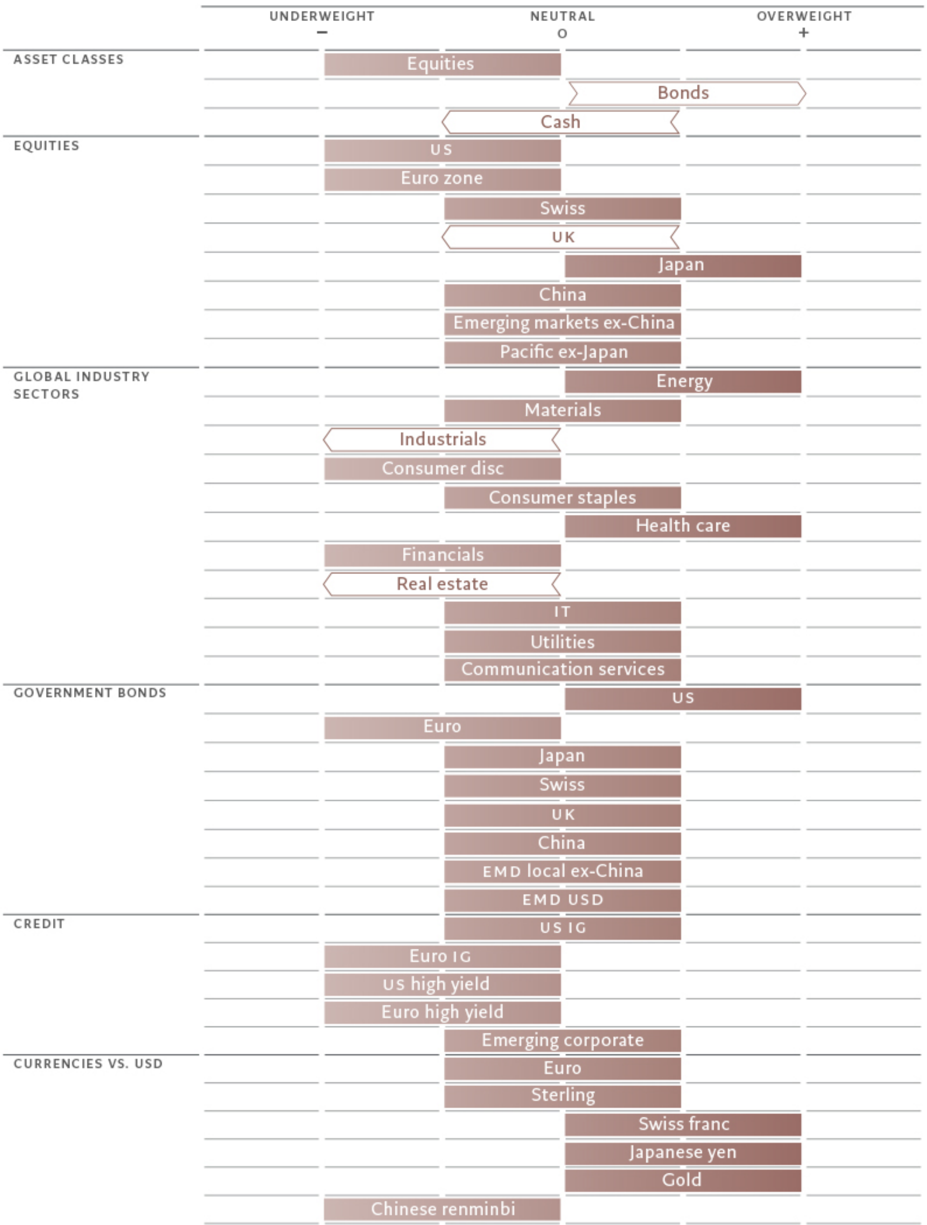
While the equity market sell-off this year has driven investor risk appetite to record lows – a point where stocks and other risky asset classes tend to stage a rebound - we see risks of a further correction. This is why we maintain our underweight position in equities.

We're unlikely to change this stance until we see stabilisation in corporate earnings revisions, a steeper yield curve and a further cheapening of cyclical stocks.

By comparison, some areas of the bond market are beginning to look attractive, however, as yields are climbing to levels that are increasingly at odds with economic fundamentals. Headline inflation has likely peaked in the US, with inflation expectations also having slipped in recent months. The New York Federal Reserve's monthly survey shows that consumers in August saw inflation at 5.75 per cent over the next 12 months, the lowest since October 2021. Against this backdrop, we upgrade bonds to overweight, with a preference for US Treasuries – a haven in times of turbulence. We also cut cash to neutral.

Fig. 1 Monthly asset allocation grid

October 2022



Source: Pictet Asset Management

Our **business cycle** indicators show a clear slowdown in global economic growth. As Fig. 2 shows, rising borrowing costs tend to exact a heavy toll on global business conditions.

The outlook has deteriorated in the euro zone in particular, where consumer confidence has plunged to an all-time low and energy rationing poses further risk to industrial sectors. With the euro zone economy expected to contract towards the end of this year, we have cut our 2023 real GDP forecast to 0.2 per cent from 1 per cent.

The growth outlook is also weak in the US, although there are some positive signs that testify to the resilience of the world's largest economy. The US labour market remains tight with jobless claims now trending down. Consumer confidence, meanwhile, has improved for the second consecutive month thanks to easing inflation worries.

That said, surveys also show companies remain reluctant to boost their capital spending while the housing market is confronting a slump in construction activity, pointing to a further 10 per cent decline in property prices over the next six months.

What's more, typical mortgage payments as a proportion of income stand at their highest levels since the 1980s.

We're becoming cautious on Japan's economy whose leading indicators have slowed down. Manufacturing activity is contracting and weak global demand is pressuring the export sector.

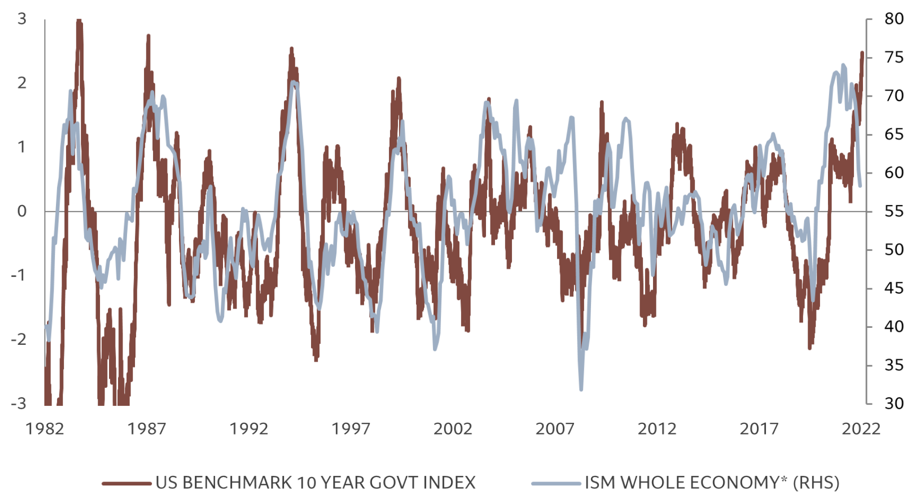
The prospects for the UK economy remain weak, too.

The government's plans to deliver the biggest tax cut since 1972 and ramp up borrowing at a time when the country's consumer price index hovers close to a 40-year high has led investors to question the country's fiscal credibility, giving rise to a sharp sell-off in sterling and gilts.

Consumer confidence stands at an all-time low with inflation-adjusted wages expected to contract 5 per cent. We expect the UK economy to fall into recession from the fourth quarter of this year with full-year growth to be at zero next year.

Fig. 2 Activity cooling

Treasury yields and global business conditions



* Average of output and price paid. Source: Refinitiv, data covering period 15.09.1982 – 28.09.2022

Our **liquidity** indicators show tighter conditions in major economies, especially in the US and UK, as central banks continue to reverse pandemic-era monetary stimulus.

At the same time, bank credit, which has until recently partially offset the effect of central bank tightening, is finally slowing down, in line with leading indications from credit standards.

China is the only country showing easier liquidity. The People's Bank of China is lowering funding costs and offering targeted easing measures to revive credit demand.

Our **valuation** model backs up our positive stance on bonds.

Global bond yields are now at the highest since mid-2011 following a recent sell-off.

Equities are on the verge of becoming cheap for the first time since April 2020 after a 9-per cent decline in world stocks in September alone – which was driven entirely by a contraction in earnings multiples.

As a result, the global 12-month price earnings ratio has fallen to 13 times, below the low seen in June.

What is more, the pace of contraction is consistent with a sell-off typically seen during a recession.

Our models suggest a rebound in multiples of 5-10 per cent over the next 12 months, assuming that 10-year yield on US Treasury Inflation Protected Securities (TIPS) falls to 0.75 per cent.

Our 2022 global earnings growth forecast, meanwhile, stands at 2 per cent, significantly below market consensus.

Within equities, we're becoming more cautious on cyclical sectors that are growth-sensitive, such as industrials and real estate.

Our **technical** indicators show investor risk appetite close to record low levels, with equity funds losing USD25 billion in flows in the past four weeks.

While a technical rebound cannot be ruled out at this depressed sentiment level, our negative trend score suggests taking an underweight equity position over our investment horizon.

02 Equities regions and sectors: bashing Britain

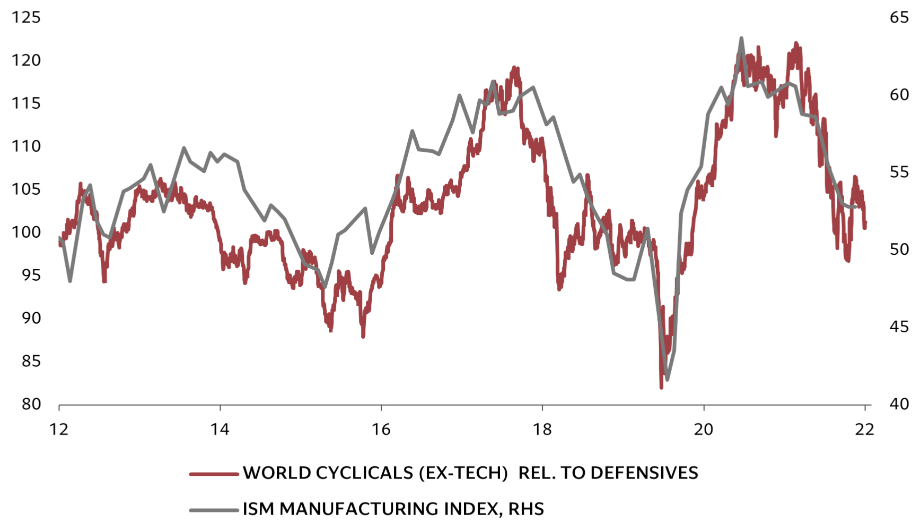
Upward pressure on global real rates have cast a cloud over equities generally. We therefore maintain an underweight position in equities and we continue to dial down down risk within our equity allocations by reducing the UK market to neutral from overweight.

UK equities have become particularly vulnerable given heightened uncertainty on the economic policy mix and fiscal credibility. Expectations are growing that the Bank of England will have to raise interest rates dramatically in order to regain control of a sliding pound and inflationary pressures. We expect heightened volatility for British assets generally and as a result we downgrade UK equities to a neutral stance from overweight.

Meanwhile, we maintain our underweights in US and European equities, which leaves Japanese equities as our only overweight.

Fig. 3 - Cyclically expensive

World cyclicals (ex technology stocks) relative to defensives and ISM manufacturing index



Source: Refinitiv Datastream, Pictet Asset Management. Data from 27.09.2012 to 28.09.2022.

Within sectors, we are particularly cautious on industrials and real estate. We downgrade industrials to underweight from neutral on a number of grounds. Above all, the global economic backdrop is challenging for capital expenditure, with surveys of chief executives showing a lack of appetite to reinvest what have otherwise been robust earnings. US capacity utilisation is only back to pre-Covid levels and doesn't show signs of rising. Capital goods earnings growth expectations for this year and next are much higher than they are for the wider market, making them a high hurdle and, in this environment, at risk of leaving investors disappointed (see Fig. 3). And it's the most expensive cyclical sector, compounding the vulnerability. Finally, there's the China effect. China's investment cycle remains uncertain and, in any case, Chinese companies in the sector trade on high valuation premiums.

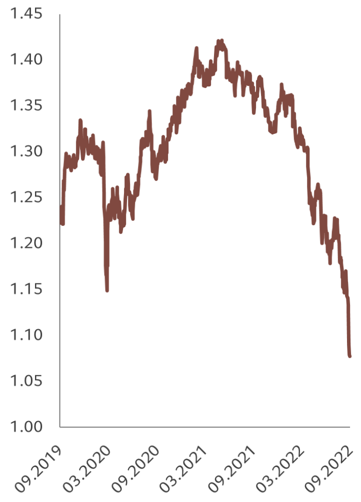
We also downgrade listed real estate to underweight from neutral. The housing sector has been contracting, not least in the US, with housing activity lead indicators collapsing recently. This makes real estate investment trusts (REITs) particularly vulnerable to correction. Meanwhile, the post-Covid recovery in US office and retail occupancy has stalled. And earnings revisions are worse than they have been for the wider market, with no sign that price momentum is undershooting earnings sentiment, unlike in some other cyclical sectors. Finally, given the risks associated with the sector, there is no compelling valuation case to buy -- valuations in the sector are still only neutral.

03 Fixed income and currencies: value in Treasuries

The brutal sell-off in fixed income markets has taken valuations for US government bonds to the cheapest they've been in over a decade – and we believe this represents an attractive opportunity. Yields on benchmark 10-year paper touched the 4 per cent level for the first time since mid-2010. This is well above our fair-value estimate of 3.2 per cent, which factors in quantitative tightening of over USD1.5 trillion from the Fed, our long-term inflation expectations and a softening near-term growth momentum.

Strengthening inflows into US bonds suggest such value may not last. And the investment case is all the more compelling given that Treasuries offer protection in case of any further deterioration in economic momentum. Our macroeconomic assessment on the world's largest economy remains negative. Although there have been some positive surprises in recent data, downside risks persist with the housing market already in recession. While rents are expected to remain strong (for at least the next 9-12 months), prices increases for the rest of the "core inflation basket" are forecast to slow down sharply as demand drops off and US Federal Reserve hikes take rates firmly into restrictive territory.

Fig. 4 - Sinking sterling
Sterling vs US dollar exchange rate



Source: Refinitiv Datastream, Pictet Asset Management. Data covering 28.09.2019-27.09.2022.

Our overweight position in Treasuries contrasts with an underweight in euro zone government bonds. While inflation seems to have peaked in the US, it is still accelerating and broadening in Europe. Negotiated wages are rising. The European Central Bank is behind the curve compared to the Fed and its capacity to curb inflation is constrained by the ongoing energy supply crisis.

We are also cautious on high yield credit on both sides of the Atlantic. Economic weakness will hit corporate earnings at a time when rising input costs are already biting into margins and financing costs are set to increase further. Lower quality corporate bonds also tend to be particularly badly affected by volatility in interest rate expectations, which is likely to persist – at least in the short term.

Among currencies, the dollar is hitting multi-decade highs, with its strength particularly pronounced versus sterling (see Fig. 4). Although we remain negative on the UK economy – forecasting zero growth in 2023 – we believe sterling may be near the bottom. Investor positioning was very short the currency. The Bank of England's moves to calm the markets with bond purchases and the prospect of more rate hikes should help put a floor under the currency.

We retain our overweight positions on the Swiss franc and gold, valuing their defensive characteristics in this period of economic and geopolitical uncertainty.

04 Global markets overview: another twin slump

Stocks and bonds ended sharply lower in September as central banks worldwide, led by the Fed, continued to raise interest rates in a bid to contain inflation that remains at its highest levels since the 1980s. The month's declines in US Treasuries and the S&P 500 equity index took their year-to-date losses to some 17 per cent and 25 per cent respectively.

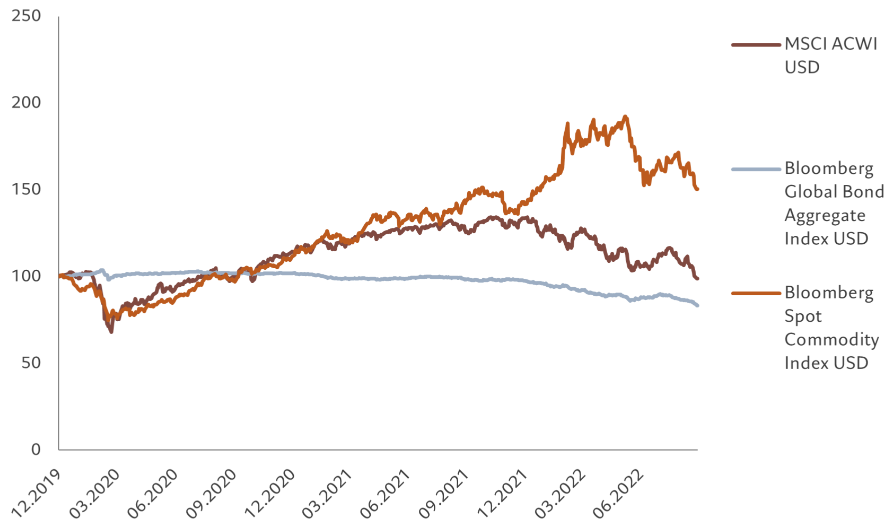
Such falls, our analysis shows, leaves a balanced portfolio split evenly between US stocks and bonds nursing its heaviest loss in more than a century, a fall of some 21 per cent year-to-date.

September's twin sell-offs came as inflationary pressures remained high across Europe and the US, central banks including the Fed, the Bank of England, and ECB raised interest rates, and as analysts continued to pare back corporate earnings forecasts.

Data from Factset showed analysts cut quarterly profit forecasts for S&P 500 companies by an average of 6.6 per cent as a jump in input costs continued to squeeze margins.

Fig. 5: Havens in short supply

Bonds, stocks and commodities. Market moves since 01.01.2020 in USD.



Source: Refinitiv Datastream, Pictet Asset Management. Data covering 01.01.2020-27.09.2022.

Globally, bond markets suffered as monetary policy continued to tighten, with the yield on the benchmark US 10-year note rising at one point to as high as 4 per cent, the first time it has breached that level since 2010.

The most volatile fixed income market by some distance was UK gilts, which saw yields swing by as almost as much as 100 basis points across two trading days as investors balked at the government's plan to fund new income tax cuts with extra borrowing. The yield on the 30-year at one point hit a 30-year high of above 5 per cent, prompting the central bank to launch an emergency bond purchase operation.

In the currency markets, the US dollar continued it ascent, registering particularly strong gains against both sterling and the Japanese yen. The UK currency hit an all-time low against the greenback in late September before recovering slightly while the yen's precipitous fall prompted the Bank of Japan to sell some of its dollar reserves in the currency markets in a bid to stem the decline.

05 In brief

BAROMETER OCTOBER 2022

Asset allocation

We stick to underweight equities given economic uncertainty. We upgrade bonds with a preference in safe-haven US Treasuries.

Equities regions and sectors

We reduce UK equities to neutral from overweight, and, within sectors, industrials and real estate to underweight from neutral.

Fixed income and currencies

We see attractive value in US Treasuries, but remain cautious on euro zone government bonds in the face of rising inflation.

Information, opinions and estimates contained in this document reflect a judgement at the original date of publication and are subject to risks and uncertainties that could cause actual results to differ materially from those presented herein.

Written by

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