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Asset Management

BAROMETER OF FINANCIAL MARKETS NOVEMBER OUTLOOK

Marketing Material

November 2022

Barometer: The skies darken

Prospects for riskier asset classes look weaker as interest rate hikes continue to curtail economic growth worldwide.

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01 Asset allocation: the value of bonds

Prospects are darkening for the world economy. As central banks raise interest rates to combat inflation, GDP growth will slow further, raising the probability of a worldwide recession.

With global liquidity conditions continuing to worsen at the same time, we retain our underweight on equities, whose valuations are even more difficult to justify after the recent market rally. We hold our overweight on bonds; US Treasuries in particular are trading at levels that offer inexpensive protection from ongoing weakness in the economy.

Figure 1 - Monthly asset allocation grid

November 2022

	UNDERWEIGHT –	NEUTRAL 0	OVERWEIGHT +
ASSET CLASSES	Equities		
			Bonds
		Cash	
EQUITIES	US		
	Euro zone		
		Swiss	
		UK	
			Japan
		China	
		Emerging markets ex-China	
		Pacific ex-Japan	
GLOBAL INDUSTRY SECTORS			Energy
		Materials	
	Industrials		
	Consumer disc		
		Consumer staples	
			Health care
	Financials		
	Real estate		
		IT	
		Utilities	
		Communication services	
GOVERNMENT BONDS			US
	Euro		
		Japan	
		Swiss	
		UK	
		China	
		EMD local ex-China	
		EMD USD	
CREDIT		US IG	
	Euro IG		
	US high yield		
	Euro high yield		
		Emerging corporate	
CURRENCIES VS. USD		Euro	
		Sterling	
			Swiss franc
			Japanese yen
			Gold
	Chinese renminbi		

Source: Pictet Asset Management

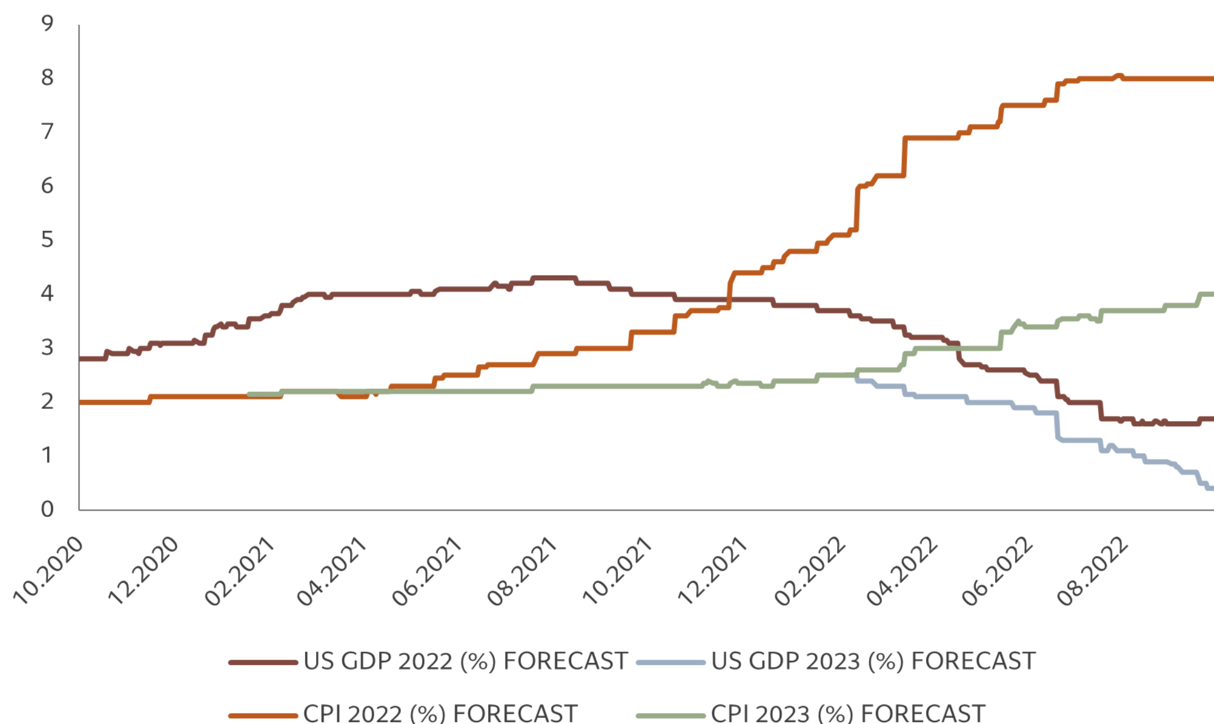
To turn more positive on stocks, we would need to see corporate earnings forecasts stabilise, a steeper yield curve and better relative valuations for cyclical equity sectors.

Our **business cycle** indicators show that momentum in the US is negative and deteriorating, as reflected in analyst forecasts (see Fig. 2). There is increasing evidence of weakness in the housing market, construction activity has collapsed and domestic demand has stalled.

Looking ahead, we expect US GDP growth to slow to well below trend for the next three quarters (at an annualised 0.4 per cent quarter-on-quarter) before a tepid recovery emerges in the second half of next year. Even if price expectations appear stable – a silver lining of sorts – there is still a risk of persistently sticky inflation. This, in turn, would trigger additional monetary tightening and tip the US economy into recession.

Figure 2 - Growth vs inflation

Consensus forecasts for annual US real GDP & CPI, %



Source: Bloomberg. Data covering period 26.10.2020 - 25.10.2022.

For the euro zone, a recession looks even more likely and, indeed, is our base case scenario. One positive is the improvement in energy security dynamics thanks to increased gas storage levels (with a number of countries at full capacity) and a corresponding fall in gas prices. Nevertheless energy rationing

beyond the winter months is still a possibility, which poses a risk for industrial production.

Elsewhere, in the wake of President Xi Jinping's consolidation of power in China, we are reassessing both the near- and medium-term prospects for the Chinese economy. The annual Central Economic Work Conference due to take place in December should offer further clarity on the direction of economic policy.

Our **liquidity** indicators show that excess money – which we measure as broad money minus domestic industrial production growth – is shrinking rapidly. Some USD8 trillion of post-pandemic monetary stimulus has been withdrawn by central banks since March. At the current pace, it would take another five months to reclaim pre-pandemic trends and fully purge monetary inflation. The effects of quantitative tightening - the selling of bonds held by the US central bank - have been amplified by the actions of both commercial banks and central banks in the emerging world, which have also been shedding holdings of US bonds.

We expect that liquidity conditions will remain negative for riskier asset classes heading into the start of the new year, and quite possibly longer, which would normally put pressure on stocks' earnings multiples.

The main change in our **valuation** models is that fixed income offers increasingly good value, with global bond yields now at their highest levels since mid-2011. Notably, 10-year US Treasury yields have surged to 4.3 per cent, far exceeding our fair value estimate of 3.5 per cent.

Although stocks have suffered a sharp sell-off – the MSCI World index is down 22 per cent year-to-date – they are not yet cheap enough to account for possible further deterioration in economic growth and corporate earnings prospects. We see global earnings per share staying flat over the coming 12 months, well below the analyst consensus of 6 per cent growth. Even our forecast could prove optimistic.

Technical indicators support our underweight stance on equities. Trend signals remain weak across regions. Investor positioning in riskier assets is relatively cautious, especially among institutional investors. Net long positions on S&P 500 futures are at a record low, pricing in a significant deceleration in growth momentum, which could be consistent with the US ISM index falling to 45 (compared to September's level of 50.9).

02 Equities regions and sectors: defending the defensive stance

Global equities may have lost a quarter of their value since late 2021 but we are reluctant to shift from a defensive stance that sees us hold neutral or underweight positions in all markets and sectors bar Japanese, health care and energy stocks.[1]

The outlook for the world economy remains uncertain while central banks around the world are still withdrawing Covid-era monetary stimulus at a time when rising input costs are biting into corporate profit margins.

What is more, there is no end in sight to the downward shift in analysts' corporate earnings forecasts.

We therefore stick to our underweight stance on US stocks. Early signals from US third-quarter corporate earnings point to waning corporate pricing power and weaker-than-expected revenues. US tech companies are in an especially weak position, with a slew of disappointing results from Meta to Amazon triggering a sell-off that wiped around USD800 billion off the sector's market value.

We forecast a 12 per cent fall in S&P500 corporate earnings. Profits will likely trough in the first half of next year before recovering modestly to end-2023. Taking all of this into account, we expect the S&P 500 index to hit 3600 by the end of the year, falling to around 3000 early next year 2023. All of which reinforces our underweight in US equities.

Our neutral stance on China is unchanged. President Xi Jinping's consolidation of power and the imposition of tighter US restrictions on Chinese semiconductor exports – a key strategic sector for both economies – may have worried investors in the short-term.

But it is too early to determine the medium to long-term economic implications of either the shift in China's power balance or the deterioration in Sino-US trade relations.

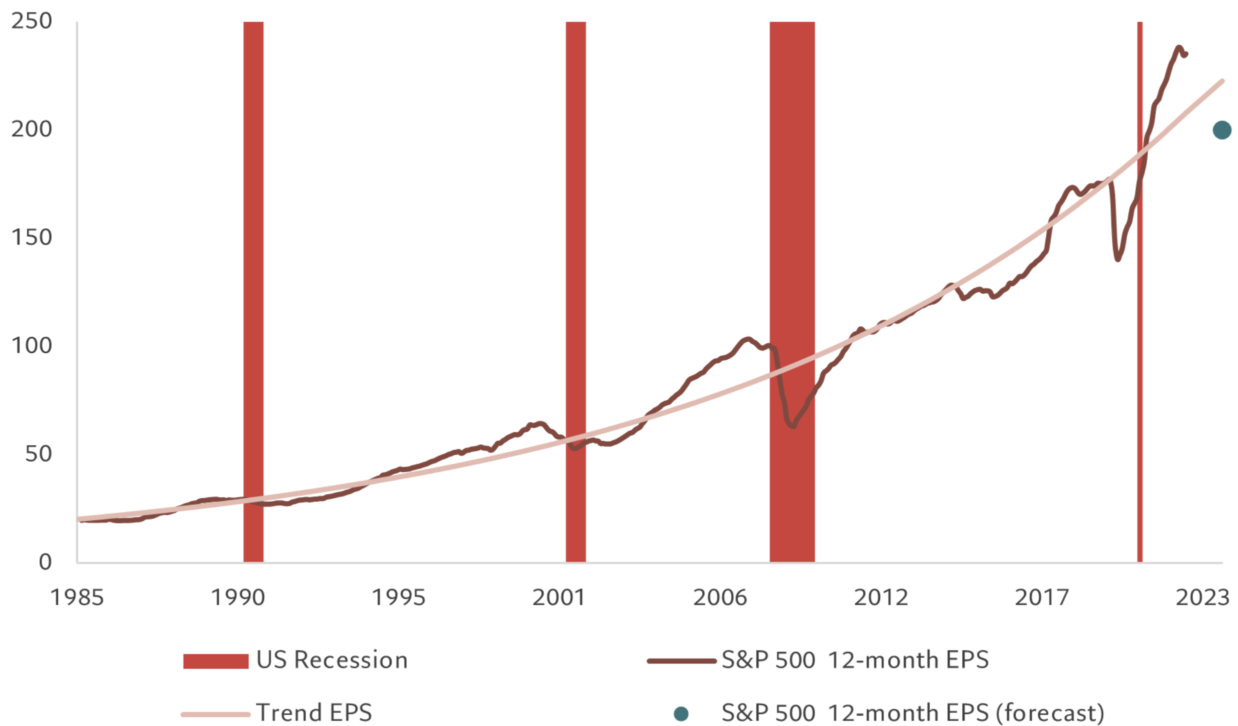
In the near term we see encouraging signs for the world's second largest economy, thanks to buoyant industrial production and manufacturing investment. Since mid-year, the government has ramped up spending, especially in infrastructure.

What is more, our model shows China is among the emerging market economies least vulnerable to rising US interest rates.

Nevertheless, we are reluctant to alter our stance on Chinese stocks at this juncture – we have been neutral since September and we will remain so until we get a clearer sense of the government's immediate priorities, which should emerge in the coming months.

Figure 3 - Underwhelming

S&P500 trailing earnings per share and Pictet AM forecast for end-2023, in US dollars



Source: Refinitiv, data covering period 01.01.1985 – 31.12.2023 (forecast)

Japan is our only overweight region with a weak yen supporting its export sector.

The country benefits from a post-Covid pick-up in consumer demand, benign inflation dynamics, accommodative monetary policy and better energy security with policy support to restart nuclear plants.

Our defensive stance is also reflected in our choice of stock sectors.

We remain underweight real estate. Even though such stocks are trading at favourable valuations, the outlook for property remains grim with housing market and construction activity shows pronounced weakness, especially in the US. Our composite lead indicator of residential investment activity has collapsed to levels last seen during the 2008 global financial crisis. This augurs very poorly for home prices.

Elsewhere, we stick to our underweight stance in industrial, consumer discretionary and financials. We are overweight healthcare, which we believe should deliver defensive growth, as well as energy, which has seen its 2023 earnings estimate constantly upgraded in the past six months.

[1] MSCI All Country World Index 16.11.2021 – 27.10.2022

03 Fixed income and currencies: back in bonds

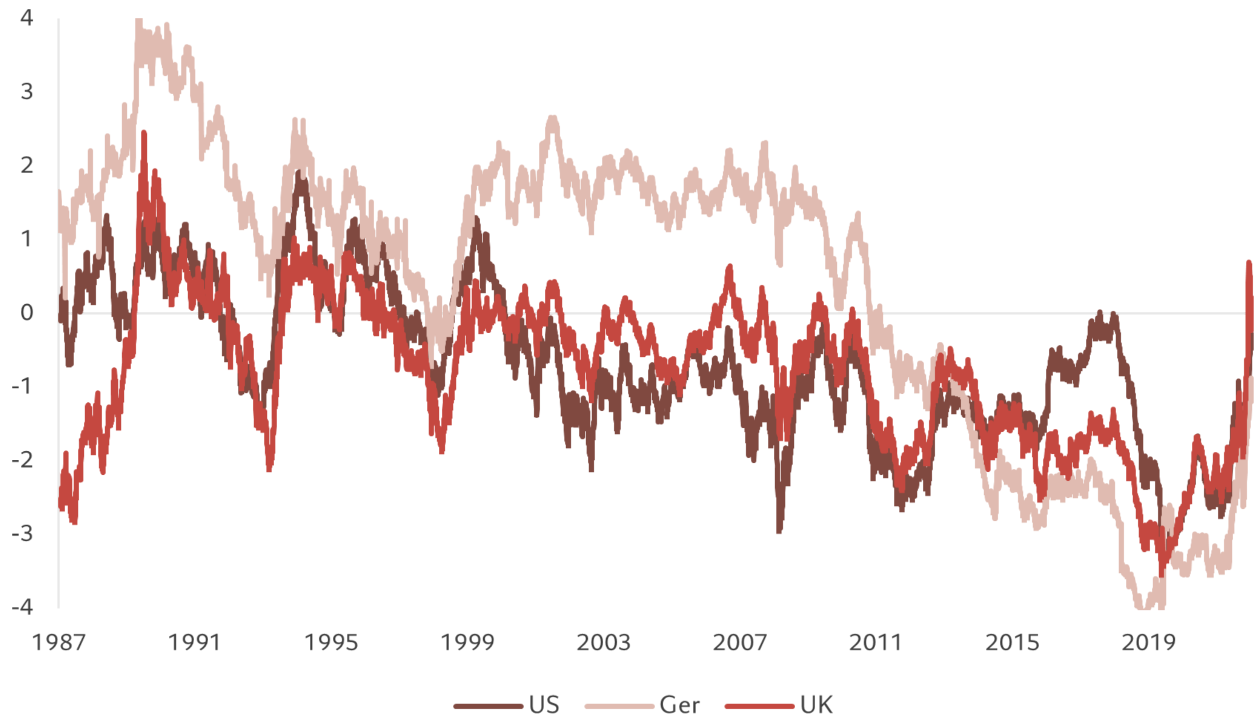
After this year's unprecedented sell-off across more or less the whole of the fixed income market, real yields are starting to look more compelling than they have done in at least a decade. Globally, bond yields are now the highest since mid-2011. In fact here is now considerable margin of safety over breakeven rates – so much so that investors purchasing bonds at current levels could sustain significant declines in their capital value and still generate positive returns thanks to coupon payments.

US 10-year bond yields have surged to 4.3 per cent, which is above our fair value estimate of 3.5 per cent. As a result, investors have turned the most bullish on longer dated bonds since the global financial crisis, with flows back into bonds, particularly US government bonds, though classes such as emerging market debt suffered from ever heavier outflows.

With the Fed well ahead of other G10 central banks in the tightening cycle, we remain positive on US Treasury bonds. By contrast, the European Central Bank seems to be lagging – inflation rates there continue to climb across the continent, with Italian consumer prices running at a near-13 per cent rate – so we maintain our negative stance on European sovereign bonds.

Figure 4 - Positive again

10-year government bond yield minus 10-year average nominal GDP growth, %



Source: Refinitiv, Pictet Asset Management. Data from 26.10.1987 to 27.10.2022

With corporate earnings and margins yet to feel the full effect of rising inflation and higher debt financing costs, and with question marks over consumer demand, we remain negative on riskier credit, particularly European and US high yield securities. By contrast, US and emerging market investment grade corporate bonds continue to show relatively robust fundamentals, so we retain a neutral stance on them.

We remain positive on gold, which still represents a hedge against rising inflation and, alternatively, should benefit as US interest rates reach their peak and the dollar's overvaluation starts to correct. The Swiss franc remains a haven, too, while the yen looks cheap after hitting multi-decade lows against the dollar, so we retain an overweight on both. By contrast, China's 20th party congress reinforces concerns about political risks, which keeps us negative on the currency.

04 Global markets overview:

Global equity markets rebounded in October, gaining around 6 per cent. However, they still remain deeply in the red for the year so far, with losses of

some 17 per cent in local currency terms.

A glimmer of central bank dovishness and, technology firms aside, a reasonable start to the earnings season, was behind the bounce.

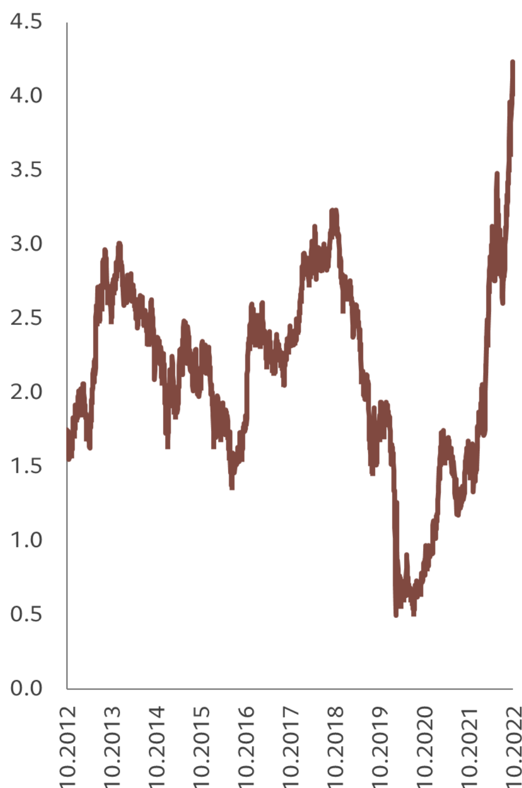
US stocks were among the top performers, snapping a two month-long losing streak on expectations that the Fed may slow the pace of its rate hikes after a widely anticipated 75 basis point move in November.

European equities fared similarly well, with the STOXX 600 index climbing to a six-week high. Earnings in Europe have been particularly resilient thanks to a strong exchange rate tailwind, commodity exposure and favourable base effects.

In contrast, emerging markets bucked the rising trend, dragged down by a weak performance in Asia. Chinese stocks lost ground in the wake of the Communist Party congress, slipping to 3-1/2 year lows.

Figure 5 - Yield surge

10-year US Treasury yields, %



Source: Refintiv. Data covering period 26.10.2012-26.10.2022.

Among sectors, performance was largely dictated by the earnings season. The energy sector saw the biggest gains thanks to very strong results. In the US, for example, energy companies who have already reported third quarter results have beaten expectations by 45 per cent on revenues and by 135 per cent on earnings, according to Refinitiv data.

Industrials were in second place – both in terms of profit beats and in terms of monthly market gains. Both sectors were also helped by strong oil and commodity prices.

Conversely, earnings from the communication services companies have undershot expectations, leaving the sector in the red for October. That followed disappointing results from the likes of Facebook owner meta and Google parent Alphabet.

In fixed income, yields on benchmark 10-year Treasuries climbed to around 4.3 per cent – their highest since 2007 – before retreating in the final days of

the month as expectations of rate hikes were scaled back a little (see Fig. 5).

The US dollar weakened slightly versus a trade-weighted basket of currencies. In particular, it lost ground versus sterling (which rebounded with the reversal of the mini-budget and appointment of a new prime minister) and the euro in developer markets, and versus the Mexican peso and Brazilian real in emerging ones.

05 In brief

BAROMETER NOVEMBER 2022

Asset allocation

The threat of a recession, falling corporate earnings and high real rates all support our preference for bonds over equities.

Equities regions and sectors

Our defensive stance remains unchanged where we hold neutral or underweight positions in all markets and sectors bar Japanese, health care and energy stocks.

Fixed income and currencies

We remain overweight US Treasury bonds as the Fed takes a grip on inflation, but remain underweight European bonds as the ECB falls behind the curve. We are underweight risky credit and overweight gold amid expectations the dollar's run is coming to an end.

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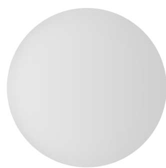
Written by



Pictet Asset Management Strategy Unit.

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