BRUELLAN PANORAMA

Q2/2023

QUARTERLY OUTLOOK / APRIL / MAY / JUNE 2023

STAYING THE COURSE: NAVIGATING THROUGH THE TIGHTENING CYCLE AND MARKET TURMOIL

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EDITORIAL

STAYING THE COURSE: NAVIGATING THROUGH THE TIGHTENING CYCLE AND MARKET TURMOIL

FLORIAN MARINI, CFA, CMT / CHIEF INVESTMENT OFFICER

In 2023, inflation – and its impact on interest rates – is the key factor to monitor. The worry being that positive economic news may not be considered as such, if it implies that inflation is not abating and central banks have to keep interest rates higher for longer. Fortunately, significant tail risks such as the energy crisis in Europe, the lockdowns in China and spiralling inflation have been averted.

Following a sharp slowdown in 2022, China should post a solid rebound this year owing to its post-Covid reopening. Since January, 2023 GDP growth expectations for the country have already been revised up from 4.8% to 5.3%. Unlike many other major economies, China has been successful in keeping its inflation rate under control, providing policymakers with greater room for fiscal and monetary policy stimulus measures, which have boosted consumer spending and investment.

The global economy is indeed displaying encouraging signs of improvement. In October 2022, only 24% of countries had manufacturing PMI readings that were in expansionary territory. As of the end of February, this ratio had increased to 45%. The services sector, which has proved a crucial contributor to the economy in the post-Covid phase, experienced a slight deceleration last year but has rebounded strongly since January, with 88% of countries now reporting a services PMI in expansionary territory. As such, after five months of contraction, both the global manufacturing and services PMI indices are back into expansion territory, lowering the risk of a global recession in 2023.

Inflationary pressures peaked in June 2022 and, despite some mitigating factors, we expect this deceleration to persist. The European energy crisis has eased somewhat, with a consistent supply of liquefied natural gas (LNG), resulting in a significant decline in gas prices. Additionally, the pullback in crude oil prices has helped lower gasoline prices. We anticipate a higher supply of grains in 2023, which should lead to lower food inflation during the coming months. Services inflation, which is primarily driven by shelter inflation and wages, admittedly continues to rise, but we foresee a reversal of this trend.

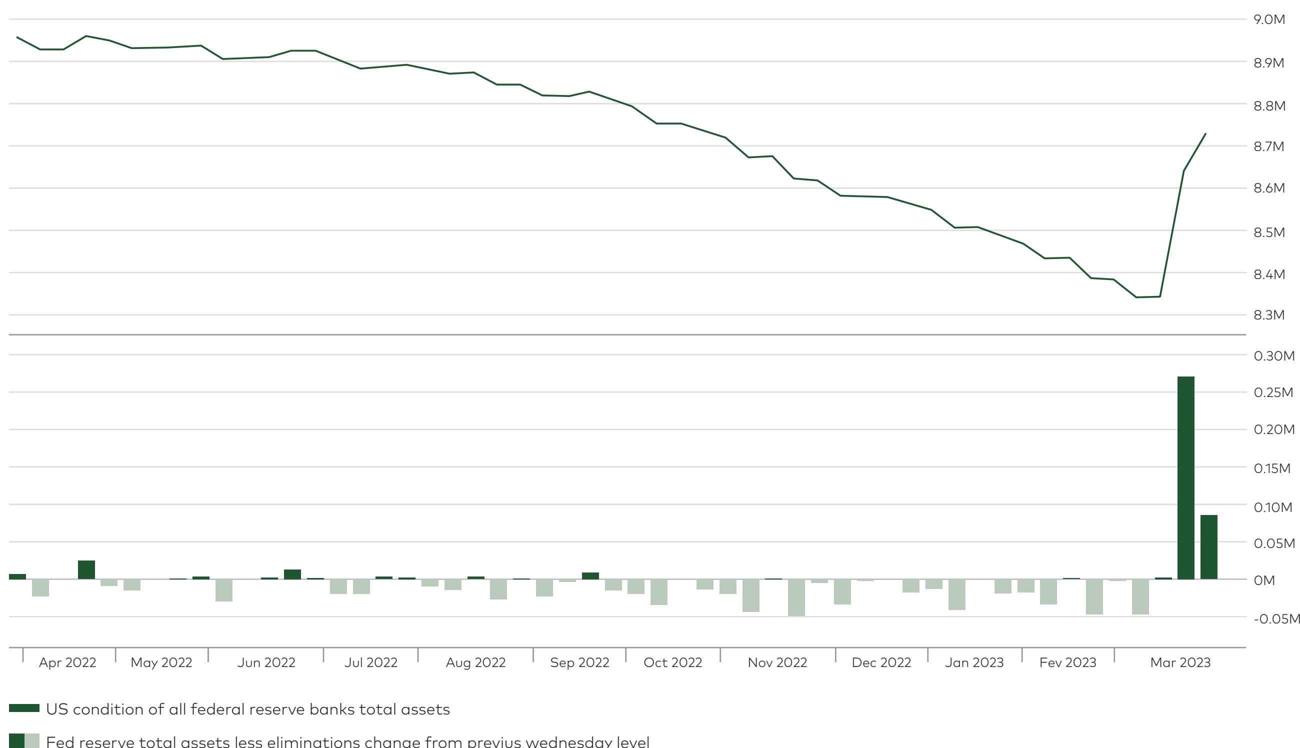
As inflation trends downward, it is likely that the Federal Reserve (FED) will take on a more accommodative tone. The European Central Bank (ECB), having been relatively slow to address inflationary pressures in the region, can be expected to follow suit but with a few months lag. In contrast, central banks in emerging markets, such as the People's Bank of China (PBoC), do not face pronounced inflationary pressures and could implement economic stimulus measures.

With regards to the recent bank failures, our take is the following: the tightening cycle may continue to put pressure on banks, but the current situation is not comparable to that of 2008. First, it is important to note that the issue does not pertain to excessive leverage and risky investments as was the case in 2008. The problem today lies in client withdrawals of their money, forcing the banks to sell their high-quality bonds at a loss before maturity – turning a liquidity shortage into a solvency problem. Secondly, it is worth acknowledging that regulators and the Federal Reserve have taken prompt action to address the liquidity problem and restore confidence in the financial system. Third, since the Global Financial Crisis, new regulations have been imposed to improve bank capitalisations, reduce leverage and increase transparency in financial transactions. The equity capital and disclosed reserves to total risk-weighted assets ratio (Tier one ratio) of European banks has for instance risen from 8% in 2008 to 16.8% today.

Turning to corporate earnings growth, it should come under pressure this year, following the strong 2022 vintage, because of margin erosion. Forward earnings expectations have already dropped 5% since their peak of Q4 2022 and further downward revisions are likely. From their currently more attractive levels, valuation multiples are thus likely to expand under the combined effect of rising stock prices and poor earnings growth.

In conclusion, while tightening cycles always cause some stress, we do not believe that we are at the onset of another financial crisis. Most economies are recovering from their 2022 slowdown and improving. Our scenario of

From quantitative tightening to quantitative easing:
The impact on the Fed balance sheet of the new liquidity facility, allowing banks to borrow against their bond portfolio



receding inflationary pressures is unfolding, which should lead to a more dovish shift in central bank rhetoric and interest rate cuts (especially considering the recent stress in the banking system). Risky assets such as equities should thus remain attractive in 2023. On a longer horizon (2024-2025), however, a second wave of inflation and central bank tightening could occur. Indeed, while the first wave of inflation may have peaked, the shock from the 2020 pandemic is likely to create ripples for several years before the system fully stabilises – putting central banks at risk of mistakes.

As regards regional allocation, we maintain a neutral stance despite European equity valuations seemingly more attractive than those of their US peers. We lack sufficient visibility as to the depth and length of the recession to take an overweight stance on the region at this point in time.

In terms of sector allocation, we continue to adopt a barbell approach. We have, however, reduced our energy exposure from overweight to neutral, given current market conditions. And we continue to underweight Consumer staples, which look overly expensive. We remain optimistic regarding opportunities in the more cyclical parts of the economy, specifically in the Industrial, Consumer Discretionary and IT sectors, all the more so following the February-March correction.

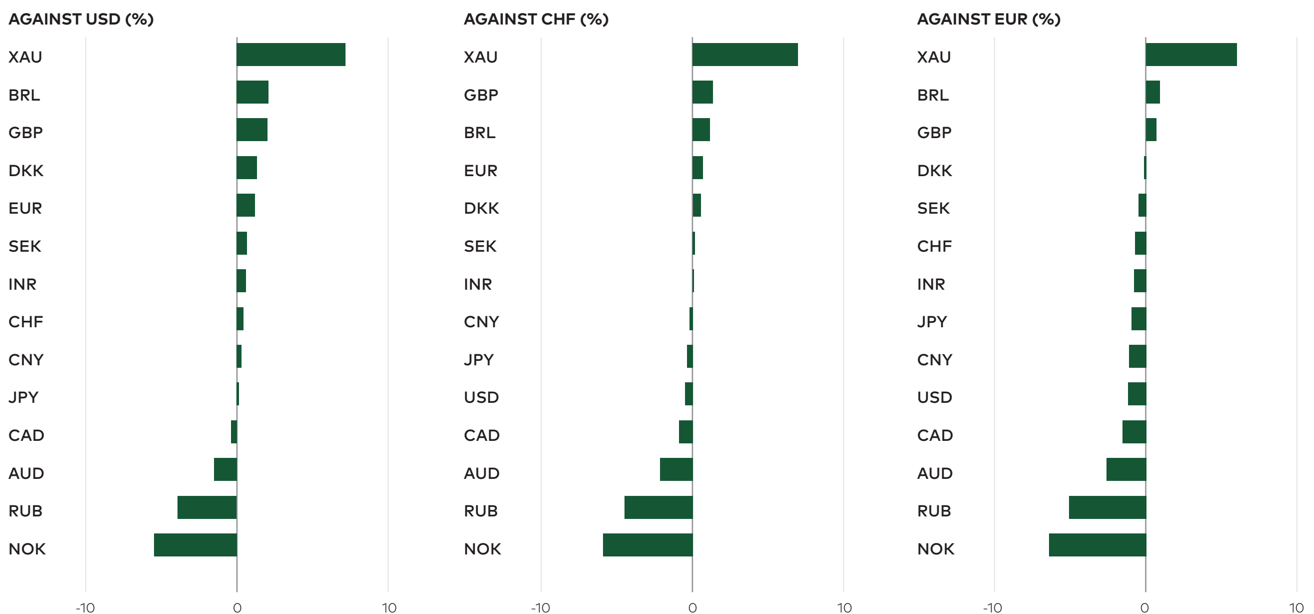
From a thematic perspective, we consider Aerospace & Defence to be interesting, owing to the significant investments expected over the next decade. And we view sectors associated with the "green" energy transition as highly attractive.

MARKETS PERFORMANCE

Economic Indicators (from 31.12.2022 au 28.03.2023)

	Real GDP %		Inflation %		PMI	Debt % GDP	Current Account % GDP	Budget % GDP	Unemploy-ment %	Interest rates	
	2021	2022	2021	2022	Current	Current	Current	Current	Current	3 Months	10 Years
USA	5,7	2.1	4.7	8.0	47.3	79,2	-3.6	-5.5	3.6	4.6%	3.6%
Euro Area	5,2	3.5	2.6	8.4	48.5	95,6	-0.7	-2.6	6.7	2.6%	2.3%
Switzerland	3,6	2.0	0.6	2.8	48.9	42,8	10.1	0.3	2.0	1.4%	1.2%
UK	7,2	4.0	2.6	9.1	49.3	101,0	-4.2	-5.0	3.7	4.2%	3.5%
Asia ex Japon	7,0	3.2	1.1	2.7	-	4,1	2.4	-4.8	3.8	4.4%	3.5%
Japan	1,7	1.1	-0.2	2.3	47.7	236,4	2.1	-8.5	2.5	-0.3%	0.3%
Brazil	4,7	2.9	8.3	9.3	49.2	57,0	-2.9	-5.0	8.4	-	12.9%
Russia	4,2	-2.4	6.7	13.7	53.6	17,4	10.1	-0.6	3.8	7.8%	9.7%
India	-7,5	8.7	6.2	5.4	55.3	70,2	-2.7	-6.9	8.5	7.4%	7.3%
China	8,1	3.0	0.9	2.0	51.6	308,0	2.5	-4.7	4.0	1.8%	2.9%
World	5,8	3.1	4.0	7.6	-	-	0.6	-	7.1	-	-

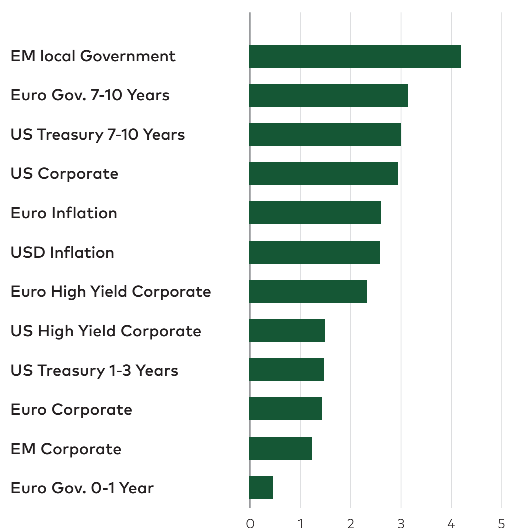
Market Performance (from 31.12.2022 au 28.03.2023)
Exchange-Rates



Stock Markets / Total Return & Valuation

	USD	EUR	CHF	GPB	Forward PE	
					Médiane LT	Current
S&P 500	3,9%	2,6%	3,6%	1,8%	17,9	18,1
Eurostoxx	11,6%	10,3%	11,3%	9,4%	14,5	12,4
Swiss Perf. Index	3,5%	2,2%	3,2%	1,4%	17,4	18,2
FTSE100	3,5%	2,3%	3,3%	1,5%	15,2	10,3
MSCI Asian Ex-Jpn	2,0%	0,8%	1,7%	0,0%	14,6	13,3
Nikkei225	5,6%	4,3%	5,3%	3,5%	20,5	16,9
Brazil Bovespa	-5,5%	-6,9%	-5,8%	-7,6%	14,9	6,9
MSCI Russia	-	-	-	-	6,2	-
India SENSEX	-8,6%	-9,7%	-8,8%	-10,4%	20,0	19,0
China CSI 300	3,7%	2,4%	3,4%	1,6%	15,8	13,8
MSCI World	4,3%	3,0%	4,0%	2,2%	17,4	16,2

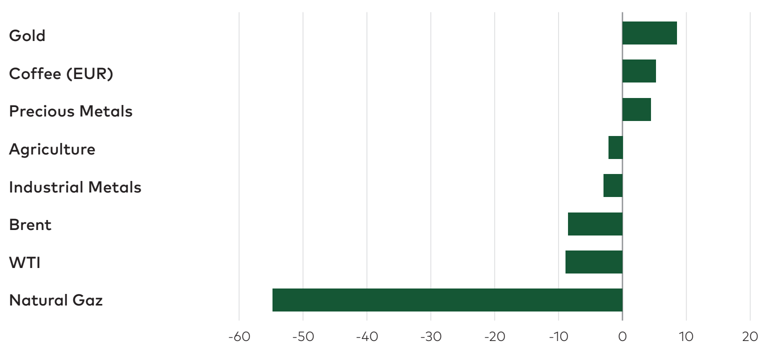
Bond Market



Sectors / Returns & Valuation (Forward PE)

	USA	Europe	World	USA		Europe		World	
				LT Median	Current	LT Median	Current	LT Median	Current
Cons discr.	10,0%	15,0%	10,8%	21,6	23,8	15,1	14,0	18,8	19,2
Cons. Staples	-1,4%	4,2%	1,3%	19,2	20,6	18,8	18,2	19,2	19,6
Financials	-7,6%	0,7%	-4,5%	14,3	11,6	12,4	8,1	13,8	10,2
Energy	-8,0%	-3,9%	-6,4%	14,9	7,1	11,6	6,0	14,0	8,4
Industrials	0,5%	8,8%	3,8%	18,4	19,6	19,1	17,7	18,4	17,6
Technology	15,6%	13,7%	15,5%	22,4	25,0	26,0	22,6	23,1	24,7
Materials	0,1%	-0,2%	1,9%	17,5	16,5	15,0	12,2	16,5	13,6
Utilities	-6,6%	4,1%	-2,8%	16,5	17,5	14,4	13,7	16,5	15,8
Health Care	-6,2%	1,6%	-3,9%	19,5	17,5	20,3	17,0	20,3	17,6
Telecom	15,8%	12,7%	14,1%	17,3	16,4	16,3	14,3	18,0	16,2
Real Estate	-4,4%	-13,7%	-4,4%	43,1	33,3	23,3	10,4	27,4	23,0

Commodities



ALLOCATION GRIDS

Global Asset Classes

	Overweight	Marketweight	Underweight	Main Drivers	Risks
Stocks	●			Further rate hikes lie on the horizon but a less hawkish monetary policy stance in H2 should make for a supportive backdrop for equity markets.	Global hard landing. Global spillover of the banking confidence crisis.
Bonds	●			Global bonds will likely benefit from receding inflation, slower growth and better hedging characteristics.	Stickier-than-usual inflation and central bank overtightening.
Gold	●			The downward repricing of real interest rates makes gold an attractive investment option.	Rising real interest rates.
Cash			●		

Equities

	Overweight	Marketweight	Underweight	Main Drivers	Risks
US		●		Household balance sheets are strong and the labour market remains tight for now.	Monetary tightening that suppresses activity excessively or causes stability issues.
Europe		●		Core inflation is receding thanks to stable wage and energy inflation. Economic activity is moderate but still expanding, potentially helped by the Chinese recovery.	Global spillover of the banking confidence crisis. ECB monetary policy missteps.
Switzerland		●		After several months of gains, volatility has made a comeback in the Swiss equity market. There are opportunities but, in this difficult environment, one need be selective in picking stocks.	The market continues to focus on central bank decisions and hopes the tightening cycle will soon come to an end. If Swiss inflation does not abate, the risk of a sharp correction in risky assets is material.
Asia Pacific ex-Japan		●		Valuations are low and growth is rebounding following last year's stagnation.	Persistent structural issues, technological isolation.
Japan		●		Policy stimulus must be continued for the time being.	Slow recovery due to a drop in business capex and weak household spending.

Bonds

	Overweight	Marketweight	Underweight	Main Drivers	Risks
Developed Sovereigns	●			The recent turmoil in financial markets showcased the regained value of sovereign bonds.	Further monetary policy tightening because of sticky inflation.
Corporates (IG)	●			High quality corporates offer a good mix of yield and spreads.	Widening credit spreads, due to a tightening of monetary policy in the face of financial fragilities.
High-Yield			●	Caution is warranted, given the likely deceleration in economic activity. Prefer short-dated high yielding bonds.	Deepening financial turmoil, high-yield bonds being at greater risk.
Emerging		●		Relative valuations are attractive, owing to resilient economic fundamentals, stronger Chinese growth and a weaker USD.	Global recession, USD appreciation or significant drop in commodities prices.

Currencies

	Overweight	Marketweight	Underweight	
EUR vs USD	●			The EUR is poised to appreciate against the USD, owing to the latter's stretched valuation and to the monetary policy lag between the Fed and the ECB.
EUR vs CHF			●	The CHF's potential for appreciation is limited due to the significant interest rate differential in favour of the EUR.
USD vs CHF			●	Neutral stance.
EUR vs GBP	●			The current account deficit and a central bank that has fallen behind the curve argue for further GBP depreciation.
EUR vs JPY			●	Although the JPY is currently undervalued against the EUR, its bullish potential is offset by the interest rate differential in favour of the EUR.
USD vs GBP	●			The current account deficit and a central bank that has fallen behind the curve argue for further GBP depreciation.

SWITERLAND
A FRAGILE CONTEXT, BUT...

ANICK BAUD / SENIOR FUND MANAGER

Covid, the war in Ukraine, geopolitical instabilities, the return of inflation, rising interest rates, fears of recession and now a banking crisis: the market has had its fair share of turmoil over the past three years. Despite all these headwinds, with still very manifest consequences, our view on Switzerland remains constructive.

No recession in view:
Although economic activity slowed down during the winter, as evidenced by a flat 4th quarter 2022 GDP and the manufacturing PMI's drop below the expansion threshold in January and February, Switzerland should nonetheless not undergo a recession this year. This thanks to an improved international environment, with European countries less impacted by the energy crisis than feared, China having reopened and the US economy still buoyant. Moreover, with unemployment at a 20-year low, consumption should continue to boost the Swiss economy, as it has done for several quarters now. In addition, the construction sector, that weighed on growth for several years, is beginning to show the first signs of a slow recovery. According to the latest KOF survey, a majority of companies in this sector expect their business to improve during the first half of 2023. The odds of a recession in Switzerland now stand around 20%, compared to over 30% just a few months ago.

The odds of a recession in Switzerland now stand around 20%

Still vibrant private consumption:
While the manufacturing PMI is showing signs of weakness, this is not the case for the services PMI. Indeed, consumers appear in good shape, notwithstanding persistent inflation and the prevailing pessimism. The main reason for this sound consumption is the strength of the labour market and historically low unemployment rate. The slight slowdown in growth should not have too great an impact on unemployment, with only 6% of companies currently planning to reduce their workforce – while over a quarter are looking to expand it. The number of open and unfilled positions is also on the rise, reflecting this strength and companies' persistent difficulties in finding qualified employees. This should enable private consumption to continue to serve as a support for demand, by upholding household incomes and consumer morale. Assuming, however, that UBS's recent takeover of Credit Suisse does not lead to an overly large wave of redundancies in the banking sector. According to the BAK Economics research institute, the rationalisation process following the merger of the two big banks will lead to a loss of around 10,000-12,000 jobs, or 0.3% of the total number of jobs in Switzerland, but over a period of several years.

The number of job openings is on the rise again

Persistent but manageable inflation:
The latest Swiss consumer price inflation (CPI) number clearly came as a surprise. While a higher rate was expected for January (+3.3%), due to the upmove in electricity prices (+25%) that are adjusted once a year and added 0.5% to the CPI, no one expected such a high number for February (+3.4%). The main contributors to this increase were food, travel (including airfares) and rents, but inflation does seem to have become more widespread with over 40% of the goods in the consumer basket having seen their prices rise by more than 2%. For the time being, the reference interest rate for lease contracts has not changed (1.25%). But if it were to rise next quarter, which is very likely, then rents would follow, making for a strong negative effect insofar as they have a 20% weight in the CPI computation. The process of decelerating price increases is likely to take longer than initially believed and 2023 expectations are now clearly above the Swiss National Bank's (SNB) target range. Still, the rate hiking cycle, that began almost a year ago, should gradually deploy its effects and thus allow inflation to recede starting in the latter half of the year, supported by a sharp drop in energy costs.

The SNB at play:
the beginning of the spring season has proved busy for Swiss monetary authorities. In addition to its price stabilisation mandate, the SNB had to come to the rescue of a beleaguered banking system by becoming the lender of last resort. A delicate mission indeed, that requires striking the right balance between the fight against inflation and the upholding of fragile confidence. The latest 50 basis point rate hike confirms that the fight against stickier and more lasting inflation is indeed a core concern and that it will do everything, including accelerating the pace of currency sales to strengthen the Swiss franc, in order to achieve this.

Companies down but not out:
"cautiously optimistic" were the words of Swiss companies upon reporting their 2022 results. Although they have logically been affected by the normalisation, or even deceleration, of demand following the post-Covid euphoria, none foresees a recession. According to the latest Purchasing Managers' Survey (PMI), only one in five companies is signalling lower production volumes, and the number seeing their order book contract has even moved down. The majority of companies also expect a more dynamic second half to the year. Rising costs and supply issues have, admittedly, left their mark on profit margins, but this is a temporary situation that should disappear over time and thanks to the various measures implemented. One need also remember that most Swiss companies have little or no debt, with some of the small- and mid-caps having in fact carried out a major balance sheet clean-up since 2008, which protects them from the devastating effects of rising interest rates.

In what nonetheless remains an uncertain environment, whose fragile balance could be challenge at any moment, as made obvious by the recent banking sector crisis, it is more necessary than ever to invest in companies that have a coherent vision, a stable strategy and a management that focuses on the long term rather than aiming for short-term profit. In this respect, family businesses are particularly interesting: the interests of the various stakeholders are aligned, which is the only means to ensure company stability.

EUROPE

CLIMBING A THIN RIDGE LINE

MALEK DAHMANI / FUND MANAGER

After nearly six months of relative outperformance, European equities have come to a turning point – amid worries regarding one of the recently most successful sectors, the financial industry. The upcoming quarter will prove full of cliff-hangers, between hope of receding inflation, increasing risks of failure of the financial system and geopolitical tensions. Against this backdrop, brave equity investors should gear up, prepare adequately and trust their plan if they want to ascend even further.

Imagine yourself, at an altitude of over 3,000m, climbing a thin ridge line. When looking up, you can clearly see the path to the summit, your potential new high record. The air is crisp, the sky blue, the silence almost melodious. On your left lies a slippery and dangerous descent. Anyone tripping over will slide down to the bottom of the valley, 2,000m lower. On your right: absolute emptiness. Anyone falling over will certainly... never be found. And a few steps ahead of you stands your guide, the lead climber, in whom you have to put your full trust. For some, the challenge is not worth it. For others, it is the only "raison d'être".

As an investor in European equities, going into the 2nd quarter of 2023, you may currently be experiencing this scenario. There is a path towards new highs, but to get there each step must be both carefully thought out and bravely taken – so as to avoid either sliding into an economic descent, induced by the inflation spiral, or falling into the unknown of a financial system failure. Who is your climb leader, might you ask? Well, the ECB!

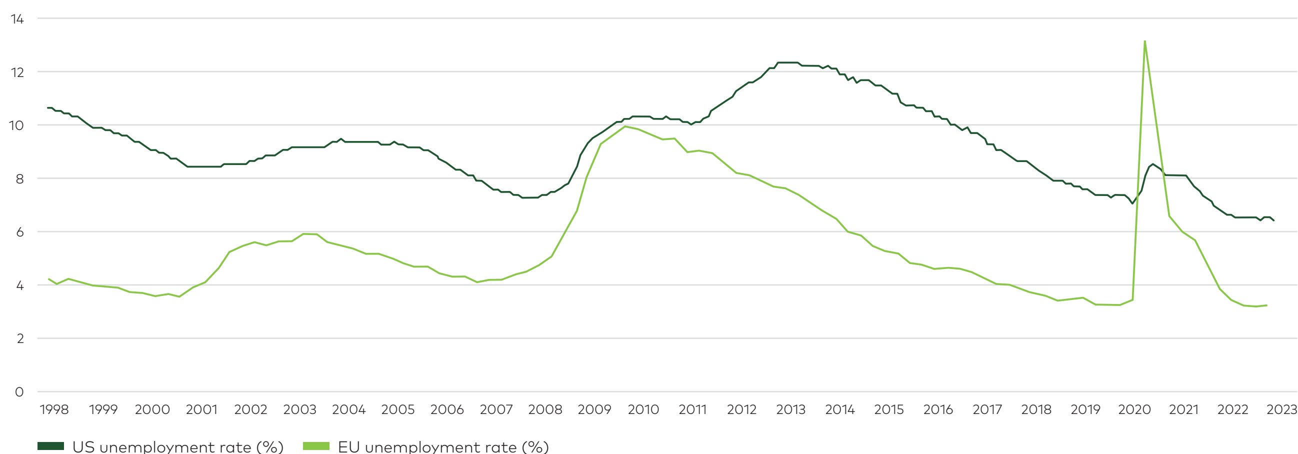
The path to success involves (a) receding inflation thanks to a drop in energy-related prices as well as more manageable wage increases; (b) continued economic growth, even at a slowing pace; and (c) no misstep by ECB, be it by extending the hike too far or forgetting to take a break. While this is indeed a demanding bucket list (too much so?), let us do a little more digging, so as to shape any decision.

Core inflation finally backing down?

This quarter's key topic in Europe, in our opinion, remains core inflation. While the broader CPI has come down from its late 2022 peak, the core CPI continues to climb. Why so? Mainly because of two key factors: wage inflation and energy-related items. As a reminder, the drop in energy prices has not yet impacted the core CPI as it is not part of its components. Items such as transport and utilities, that have obvious links to energy prices, are included, however – making for a usual 6- to 9-month lagged impact of energy price swings on the core CPI. As such, we can expect the past months' drop in energy prices to be reflected in the core CPI

Eurozone wage inflation still stable and below core inflation

Europe still far from full employment, unlike the US



during this and the next quarter. Meanwhile, wage increases, the most important inflation component given their weight in production costs, have remained stable below 3%, and well below the core CPI.

Inflation is stickier when it is driven by wage growth, owing to a very tight labour market that gives workers powerful bargaining power. This is indeed what the US are currently experiencing. In Europe, some specific sectors (e.g. IT) or geographies (e.g. Germany) are also experiencing such tightness. The rest of the region is, however, far from full employment, with a jobless rate topping 6.6%.

For these reasons, we are quite confident that core inflation will subside during the coming quarter.

Growth slowing, but recession to be avoided?

Next on our pre-climb checklist is the growth scenario. At this point in time, both the market and the ECB are expecting growth in 2023. PMI indicators, whether manufacturing or services, are rebounding from their lows of last fall. While operating margins are expected to come under pressure due to inflation, they have still proven incredibly resilient thus far. Some comments heard from private equity peers also confirm this trend. Growth in earnings this year, albeit subdued, thus now seems less unrealistic than a few months ago. Worth noting, however, is the fact that the banking sector was perceived as a strong driver of 2023 earnings growth, at least for the first part of the year, fuelled by higher net interest income. Given how fast the sector has turned from driving European equities' recent outperformance to being the ailing sector, the coming quarter will be key in validating the earnings growth scenario for 2023.

ECB missteps?

The crucial leadership remains to be tested. In our analogy, we reckon that investor courage and cautiousness will be useless if the leader of the climb fails at its task. In a sense, the Credit Suisse woes have drastically reduced the risk of the ECB going a step too far in monetary policy tightening. While the most recent hike was a large 50 bp one, the ECB has (finally!) dropped its hawkish guidance of future hikes, now relying on "data" to guide its next decision. The market changed its perspective almost immediately and now believes that the terminal interest rate (3%) has been reached. Ironically, the first signs of a banking crisis may be positive for stocks. This will, however, only be the case if things remain this way. Meaning that they do not turn into a full-fledged once-in-a-century financial disaster. As such, the ECB has the incredibly tough task of keeping inflation under control while not causing further cracks in the financial system. Easier said than done.

For the daring, we thus believe that there is a path upward in European equities. But it requires an adequate portfolio positioning: a barbell strategy, a constantly good balance across market caps, sectors, styles and risk profiles, in order to have the stamina to climb but also an adequate airbag. And avalanche beacons must not be forgotten.

UNITED STATES
IS THE CYCLE ABOUT TO TURN?

PETTERI PIHLAJA / ADVISOR // **ANTTI TILKANEN** / ADVISOR

Banking sector turbulence has been in the spotlight, with the rapid run-up in interest rates having exposed some cracks. The focus remains on the disinflationary trend which is unfolding, as evidenced by initial signs of a softening in the labour market and investment demand. We will see towards the end of the year how the cycle starts to turn, and it is likely that monetary policy will follow suit – albeit behind the curve. That said, the building blocks for a very severe recession are not present.

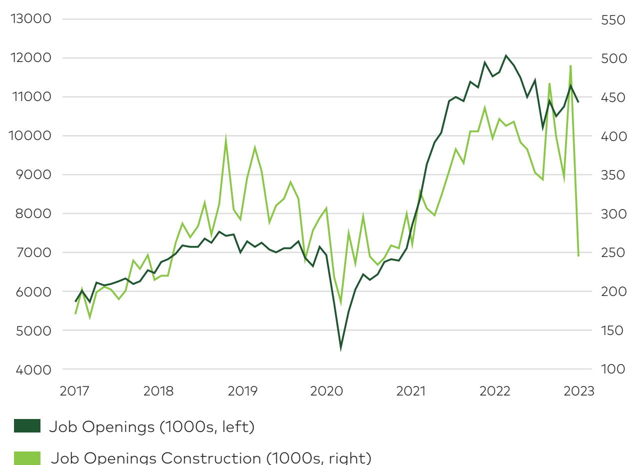
Silicon Valley Bank's mid-March collapse was the most significant lender failure since Washington Mutual in 2008. Understandably, it prompted many questions with regards not only to the financing of startups but also the stability of the banking sector more generally. It would be simple to take 2008 as a comparison, note that bank balance sheets and regulation are now in a much better shape, and conclude that nothing systemically severe is likely to occur. The situation is indeed considerably better today, but the rapid change in monetary conditions still caused significant mark-to-market losses. The Fed is in a precarious position, its actions having been both too slow and too quick: the pace of monetary tightening has been too slow to suppress inflation, but quick enough to expose cracks in the stability of the financial system. Walking this tightrope will have to continue for some time still.

In other aspects, the restrictive monetary policy is working as intended, although the economy remains very resilient, and inflation is receding only gradually. Since core PCE inflation peaked a year ago, it has come down to 4.7% – still a far cry from the 2% target. The cost of shelter, which tends to be rather sticky, now accounts for most of the inflation, with other categories having already settled lower. Shorter-term supply chain disruptions are to a large extent, though not completely, a thing of the past.

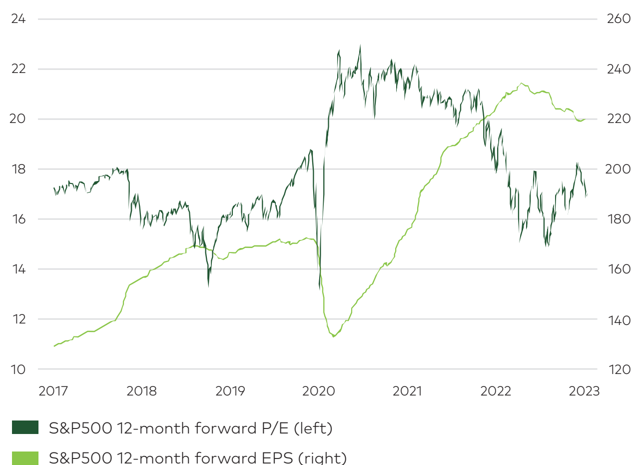
The secularly tight labour market is softening, but only very slightly. The housing market is very slow, which is causing initial signs of weakness in construction jobs. According to leading indicators such as employers' hiring plans, payroll growth is about to slow down during the spring months towards more sustainable levels. Job openings are also drifting down from very high levels. And the participation rate continues to climb. These three factors are promising with respect to wage growth, which continues to slow – and indeed must do so in order for inflation to come under control on a longer-term perspective. Over the past three months, year-on-year wage growth has been below 4%, which is already a very acceptable level.

Hourly earnings growth and participation rate

Job openings



S&P500 forward earnings and P/E



The softening of the labour market is very gradual and, at the same time, household finances are in good shape. This is supportive of the same old "higher for longer" rates thesis, which is largely based on the healthy households and record-tight labour market. Still, with monetary changes having been abnormally rapid, there is a risk that these trajectories could change abnormally rapidly. The economy is clearly being restricted by monetary policy, and taking the foot off the brake is historically very difficult to time well. The Fed is relying on incoming data. As this is always somewhat lagged, some form of overshoot is likely.

Business capex plans are weakening significantly, and capital goods orders slowing, though not quite yet coming to a standstill.

To see if this scenario starts to unfold, both household and corporate indicators will be interesting to watch during the coming months. Households have been dipping into savings to offset declining purchasing power, a trend that cannot go on forever. Corporate investment is another important indicator with regards to a turn in the cycle: business capex plans are weakening significantly, and capital goods orders slowing, though not quite yet coming to a standstill.

The banking sector turbulence has not rattled stock markets excessively, the large US nonfinancial businesses generally not being very sensitive to interest rates. Earnings expectations have, however, continued to decline.

The S&P500 index is presently trading at 17x 12-month forward earnings. The earnings yield is slightly above the 5.6% 20-year median, while the 10-year treasury yield (3.6%) is about one percentage point higher than its historical median. In relative terms, equity valuations are somewhat elevated, but not that meaningfully.

It is quite possible, though far from certain, that there will be further signs of economic slowdown towards the end of this year. For now, the prospect of lower discount rates has overshadowed recession concerns – which admittedly still lie a little further down the road.

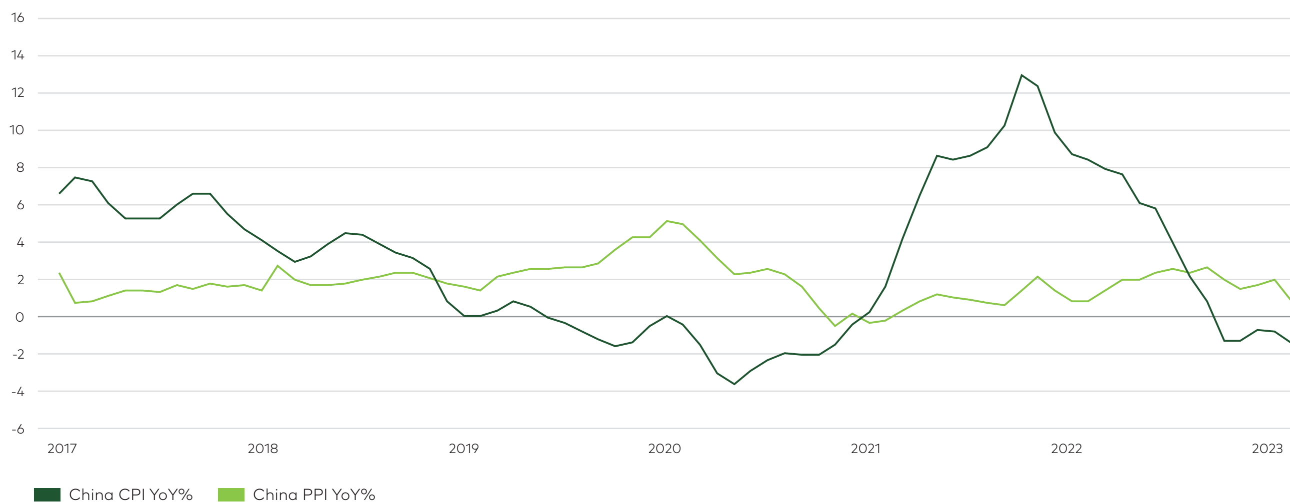
ASIE

HOW IS THE CHINESE ECONOMIC REOPENING GOING?

PETTERI PIHLAJA / ADVISOR // **ANTTI TILKANEN** / ADVISOR

After a number of harsh Covid lockdowns, China is back in business. Thus far, economic data has proved mixed at best, although the skies are clearing.

Chinese CPI and PPI



The 4th quarter of 2022 marked the end of the Covid lockdowns, making for economic data that has been at best mixed. Chinese-style lockdowns were absolute and most businesses had a difficult time operating at normal levels. Consumer-related segments were hit particularly hard, while state-owned enterprises fared better. The focus now is obviously on how the Chinese economy will rebound during the 1st quarter of 2023 and beyond.

Unlike the Western world, China does not have a problem with inflation. The official consumer price index (CPI) was up only 1% year-on-year in February, while producer prices fell by 1.4%. The pricing weakness in China is broad-based and no single specific sub-item stands out. Core consumer inflation, excluding food & energy, is barely higher (+0.6%) than last year. And food prices are also stagnant, up only 2.6% year-on-year.

The outlook is turning positive, with both the manufacturing and services PMI having rebounded sharply. The official February number for the manufacturing PMI was 52.6, in expansionary territory. Expectations have improved quite significantly over just the past two months, from a December figure of 47.0 (signalling contraction). The non-manufacturing PMI's rebound has been even stronger, reaching 56.3 in February vs. 41.6 last December. The services industry reacts very rapidly to restrictions on people's movements. With no further lockdowns in view, the outlook has turned positive. Moderate strength, at the very least, in inflation data is to be expected during the coming quarters.

The outlook is turning positive, with both the manufacturing and services PMI having rebounded sharply

Like inflation figures, both total retail sales and online sales were weak in the latter part of 2022. Online sales growth has been steady at a mid-single-digit pace for almost a year now, which is very low compared to the prior hyper growth era. This data is quite reliable, being aligned with what the Chinese e-commerce giants have been reporting. Total Chinese retail sales have been weaker and even declined during the final months of 2022. On a positive note, they seem to have bottomed in November already and positive growth is likely either in January or

Chinese retail sales and online sales

Chinese disposable income and personal consumption

February. The data makes very clear the immediate impact of government restrictions during the past few years. Each time the situation was normalised, a strong rebound was observed. This will be the case again this time round. The optimal outcome would be to see a return to high-single-digit growth rates sometime in late 2023, which would be in-line with the long-term trend.

Quarterly disposable income and personal consumption data also proved very volatile during the Covid era. Here too, we expect a rebound and subsequent stabilisation of growth rates sometime during this year. Data for the final quarter of 2022 was particularly weak: disposable income grew a mere 2.9% year-on-year, while personal consumption fell slightly (-0.2%). A stabilisation of the growth rate around 5% seems probable, but a pace significantly higher than GDP growth or investments is unlikely. The post-pandemic GDP growth drivers are the usual ones, namely investments in infrastructure and manufacturing. And, thus far, there is no indication that government policies will significantly alter this course.

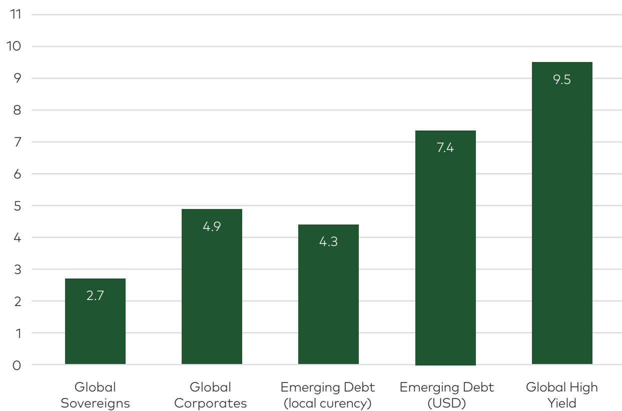
In summary, the Chinese economy is stabilising as one would expect, but the usual structural issues remain. Relations with the US are also not improving, with further restrictions on technology transfers in the making. This renders China's economic transformation even more challenging. The US is putting pressure on the semiconductor industry to exclude China completely. The Chinese government has very limited options in this respect and must build its own semiconductor manufacturing capabilities. If nothing dramatic happens in the US-China relationship, this same isolationist path can be extrapolated to other industries as well. Which, of course, would put a serious constraint on China's potential GDP growth.

FIXED INCOME

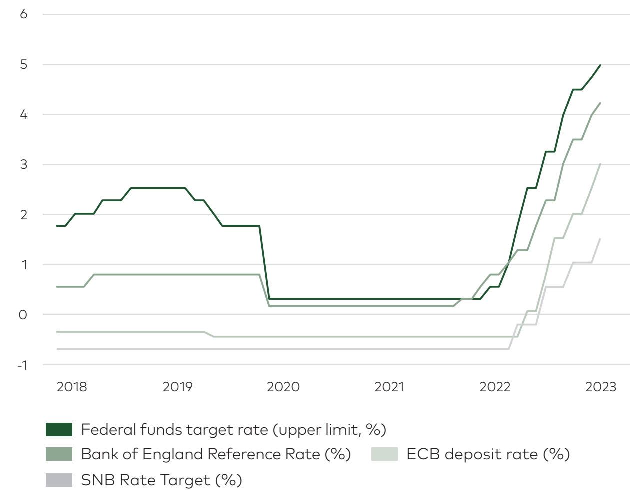
MANUEL STREIFF / ADVISOR

Central banks have reached a critical point in their tightening cycle. Persistently high inflation forced them to continue hiking policy rates and to signal further upward action. Such rapid pace of monetary tightening has triggered financial stress in different parts of the system: cryptocurrency platforms, US regional banks and a top Swiss bank. Major central banks have now had to moderate their hawkish guidance while they observe the full transmission of their recent actions. The bond market rally should continue through 2023.

Global yield by segment: government, corporates (investment grade & high yield) and emerging (USD & local currency)



Federal Reserve balance sheet and federal funds target rate



DEVELOPED MARKET SOVEREIGNS

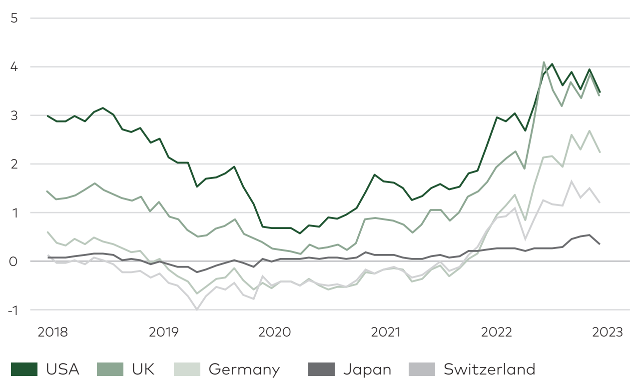
Inflation is persistent, but financial stress triggered the bond rally

The global economy has proved resilient, helped by China's reopening, strong consumers across the globe and lower energy prices. The Fed moderated the pace of its rate hikes and signalled that it is now close to the peak for this cycle. While it went to great lengths to communicate its intention to keep policy rates at a high level at least until 2024, the March banking turmoil has led investors to challenge that view and price in rate cuts already in the latter half of 2023.

Having been slower to tighten its monetary policy, the ECB pursued a rapid pace of rate hikes through March while removing guidance for the next few months.

The recent stress on banks in the US and Europe results from the rapid rise in policy rates. Central banks wanted to slow demand in order to moderate inflation. Banks will now tighten their credit standards and constrain the corporate sector. Investments and employment are likely to suffer, justifying a stabilisation in bond yields.

Selected 10-year nominal government bond yields



We favour mid-maturity bonds in the US and Europe, as central banks reach the end of their rate hikes. Inflation-protected bonds are attractive too, the higher level of real yields being at odds with a slowing economy and the final stages of the tightening cycle. Our research also indicates that inflation expectations reflected in these instruments are low.

DEVELOPED MARKET CORPORATES

Moving towards a more constructive stance, though spread volatility should stay elevated with recession risks high

High-quality corporate bonds continue to offer attractive yields, thanks to the widening in credit spreads. The path to a moderate recession will put pressure on companies. Investors will demand wider spreads for lower quality names, to offset the likely increase in defaults.

The drying up of liquidity will make it more challenging to refinance existing debt. Attractive opportunities will eventually appear in the high yield universe, but we prefer to wait for greater clarity regarding the shape of the recession.

Short-term high-yielding debt issued by companies with manageable financing profiles remains attractive. Given the high US policy rate, investors receive a high total yield. These bonds should prove resilient, even during phases of contracting economic activity.

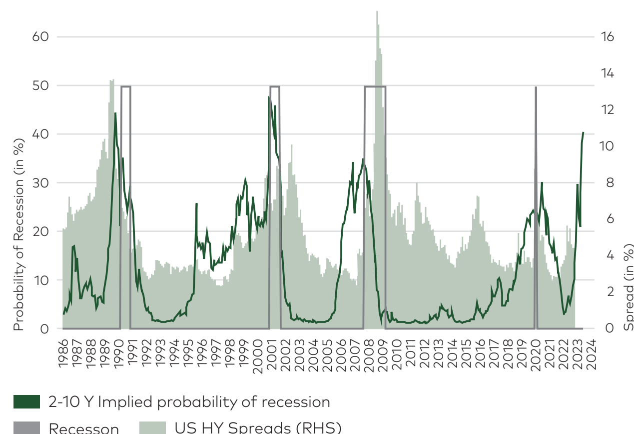
US and pan-European corporateoption-adjusted spreads

HARD CURRENCY EMERGING MARKET DEBT

Wider spreads make for attractive entry points

The recent widening of emerging market (EM) debt spreads provides investors with good entry levels. The March banking stress has resulted in wider EM hard currency spreads, even as we expect the positive fundamentals from China's reopening, a weaker US dollar and moderating inflation to reassert themselves. A moderate recession will not damage EM credit.

US and pan-European high yield option-adjusted spreads

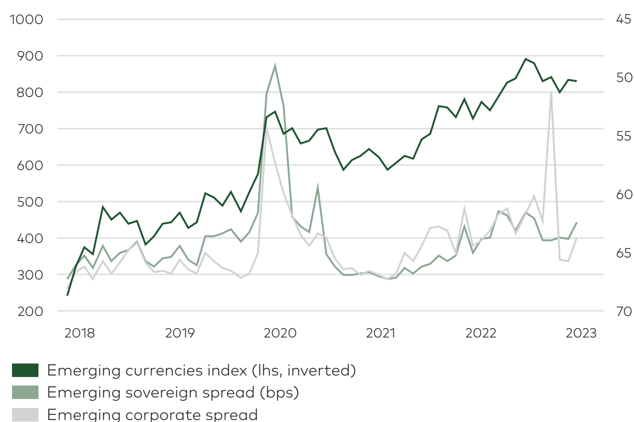


LOCAL CURRENCY EMERGING MARKET DEBT

Emerging currencies and bonds offer attractive potential returns

A weakening US dollar is beneficial for emerging economies whose financial conditions are closely tied to US monetary policy – and its transmission through currencies. Most EM central banks are at or close to peak policy rates, which has already helped bond performance. We remain cautious on Chinese local bonds as the country is in the early stages of its reopening, which could lead to an important bounce in growth, and yields are still low. We continue to like Mexican Bonos and Brazilian local debt, including inflation-protected bonds.

Barclays emerging spreads & local yield



BRUELLAN FIXED INCOME PROJECTION

Segments	Yeld (%)			Return View (12m horizon)
	USD	EUR	CHF	
Cash	5.10	3.00	1.26	↘
Short-Term High-Yielding	6.36	5.00	3.90	↗
10y Government Bonds	3.55	2.27	1.11	↗
10y Government Inflation-Linkers	1.27	-0.04	n.a.	↗

Segments	Spread over Sovereigns (bps)	Return View (12m horizon)
Developed Corporates	273	↗
Corporate Hybrids	501	↗
Developed High Yield	515	→
Emerging Sovereigns	360	↗
Emerging Corporates	563	↗
Emerging Local-Currency Debt	n.s.	↗

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