Diverging global monetary policy stances and a historical shift in Japan

Group Investment Strategy

Monthly Outlook

April 2024

UniCredit

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Summary

The Last Samurai

USA

The US economy is expected to experience a “Soft Landing” in 2024, with an overall growth rate of around 2%. A strong private consumption led to a 4% annualized rate in the second half of last year. However, this trend will not last, as private households’ excess savings will deplete and defaults on consumer loans are likely to increase. Wage growth remains above 4%, but labor demand is expected to ease. Small companies’ hiring intentions have fallen to their lowest level since May 2020, and job losses indicators have risen. Fiscal policy, which contributed to GDP growth last year, is expected to have a neutral to negative impact this year. The US Federal Reserve (Fed) has maintained a cautious stance, with the key interest rate at 5.50% and left unchanged the pace of balance sheet reduction.

EURO AREA

We confirm our slightly positive growth forecast for the eurozone, with a 0.5% growth rate for the current year. The labour market remains resilient, particularly in the public sector and construction, despite a year and a half of economic stagnation. The unemployment rate remains at a record low, and job vacancy data suggest a slow easing. The healthy labour market helps contain downside risks to the economy and allows the ECB to assess the sustainability of the decline in inflation. The ECB’s easing cycle is expected to progress slowly, possibly at a pace of 25 bps per quarter to 3.25% for the deposit rate by the end of 2024. The risks to this scenario are balanced. On the one side, the ECB might reduce interest rates less than anticipated if geopolitical tensions cause energy price spikes, supply chain disruptions, or the introduction of extensive tariffs. Conversely, a notable worsening of the job market without economic recovery could prompt a shift towards a more dovish stance.

CHINA

The Chinese economy experienced a moderate recovery in March, with the services sector showing improvement. However, further government support is needed to achieve the government’s growth target of around 5% this year. The economy has not fully recovered, reflected in poor consumer sentiment since 2022. Inflation rates have slightly increased, possibly due to holiday-related demand. The People’s Bank of China has only taken moderate monetary policy measures, with most support coming from the issue of ear-marked bonds for infrastructure purposes. No comprehensive stimulus measures are expected unless a major macroeconomic shock occurs, while the government should shift to a more consumption-led growth model.

FINANCIAL MARKETS

Positive investor sentiment across financial markets has been bolstered by solid economic data and the prospect of a “soft landing” for the US and Eurozone. The S&P 500 and Euro Stoxx 50 continued upward trends until early April, while fixed-interest securities faced more challenging times. Oil prices, driven by supply shortage and Middle East geopolitical tensions, reached their highest levels since October 2023. Gold prices also rose, reaching new highs, driven by high demand from private investors, gold-rich regions like China and India, and central banks. However, the rapid rise indicates high speculation, increasing the risk of a correction. The EUR-USD exchange rate weakened slightly due to rising US yields and earlier expected interest rate cuts.

CIO’s Letter

The Last Samurai

2024 got off to a surprising start with astonishingly strong economic performance in the first quarter. While many market participants had expected economic activity, particularly in the US, to cool down significantly after last year’s strong fourth quarter, the US economy is showing hardly any signs of weakness despite persistently high interest rates and inflation. This can be seen most clearly in the labour market data, with the US economy adding almost 830,000 jobs in the first quarter. This is more than the average of 640,000 new jobs created in the third and fourth quarters of last year – and also significantly more than the 600,000 jobs that had been expected.

In the US, the strong demand for labour and the associated rise in wage costs have been a key driver of inflation in recent years. Monthly inflation in the US has accelerated unexpectedly in recent weeks, while inflation in the eurozone has recently continued its downward trend. This development, together with the strong economic data from the US, has led to a noticeable rise in US bond yields. This is because the date expected by market participants for the presumed first interest rate cut by the US central bank, the Federal Reserve (Fed), is gradually being pushed back further and further. While the market was still assuming last autumn that the first interest rate cut by the Fed could take place as early as March 2024, this expectation has since shifted to June. Following the latest US inflation data, however, the futures markets are now not expecting the first rate cut until September. The Fed, which is aiming for an early return to the 2% inflation target, is likely to be encouraged in its wait-and-see stance and not feel pressure to cut interest rates (too) quickly. Meanwhile, the Japanese central bank wrote a piece of economic history: with the first interest rate hike in 17 years, it is the last of the major central banks to abandon its policy of negative interest rates (see “In focus” section).

The fact that the Fed’s September meeting is currently seen as the most likely time for an initial rate cut is naturally not without consequences for financial markets. Yields on longer-dated US government bonds have recently risen significantly. They are now trading at a level last seen in November 2023. Elevated US yields are also making investments in the US dollar area more attractive. As a result, the US dollar has gained significantly against almost all currencies in recent weeks. These developments are weighing on emerging markets, as governments and companies there are borrowing more frequently in US dollars – and both high US rates and a strong US dollar are making debt servicing more expensive. After the prospect of an interest rate turnaround, particularly in the US, was accompanied by rising share prices worldwide in recent months, rising US yields, in conjunction with the increased geopolitical risks due to the crisis in the Middle East, have recently weighed on stock markets again.

However, when assessing the situation, it is important to remember that the reason for this development is the robust US economy, which is fundamentally good for equities, as a strong economy generally means rising corporate profits. Should the rise in yields come to a halt, the favourable economic situation should therefore once again take centre stage. Although the situation in Europe is somewhat different – the European Central Bank (ECB) is likely to cut rates for the first time in the summer – the strong demand from the US, the world’s growth engine, should have a positive economic impact on Europe. The first signs of a positive trend can be seen in the latest data. For example, industrial production in Germany grew surprisingly strongly in the first two months of the year.

Nevertheless, it comes as no surprise that stock markets are taking a breather after the strong start to the year and are apparently entering a somewhat more volatile sideways phase.

In the coming months, investors will be focussing on the data that is likely to influence monetary policy decisions of the major Western central banks (i.e. inflation and its drivers such as wage trends and energy prices), as well as on the economy and the development of corporate profits.

With regard to the performance potential of European equities, there is another important factor to consider: The heavyweights in the European share indices in have a multinational rather than a domestic business profile. This means that the somewhat weaker economic development in Europe compared to the US does not necessarily mean that the earnings potential of European equities is significantly lower than that of comparable US stocks.

Looking at German equities, for example, the consensus among analysts still expects rather moderate growth in corporate profits of 4% for 2024. In 2025 and 2026, however, the consensus estimates should see double-digit growth rates on average – earnings growth of the same order of magnitude as that expected for US companies in the same period. This is remarkable, especially in light of the fact that expectations regarding economic growth are quite different. Growth rates in the region of 2% are expected for the US over the next two years, but only around half that for Germany. However, if the global economy grows in the wake of a strong US economy, German companies should also benefit thanks to their international business profile.

The consequences for the investment strategy in a balanced portfolio are clear. Both basic asset classes – equities and bonds – offer interesting potential returns. Against this background, a significant shift in our current investment allocation does not appear advisable at present. Looking in more detail, US dollar bonds are currently offering high yields and harbour potential price gains if yields fall sharply (although this is less likely at present). In Europe, bonds carry lower current yields than in the US, but potential price gains in the wake of potentially faster interest rate cuts by the ECB should not be ignored. However, if interest rates remain high for much longer than expected or even rise again (which we do not currently assume in our base scenario), rising yields and thus price losses on bonds cannot be ruled out.

Meanwhile, we believe that global equities, with a balanced weighting, remain strategically interesting. Possible setbacks in the course of a potential volatile sideways movement cannot be ruled out. However, investors with an affinity for risk could also see this as an opportunity to consider selective purchases. For a broad upward movement, particularly in cyclical segments, we would currently still like to see confirmation of the soft landing scenario. Should such a scenario become clearer, investors with an affinity for risk could consider switching from bonds to equities with upside potential.

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In Focus

Historic turnaround: Bank of Japan ends negative interest rate policy

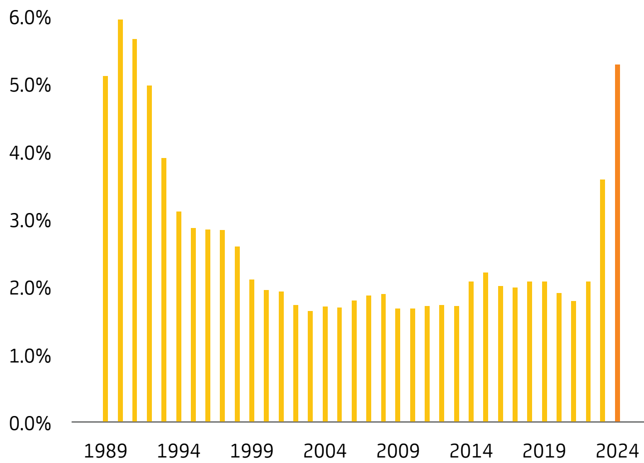
In mid-March, the Bank of Japan (BoJ) surprised the market and raised interest rates for the first time since 2007 – a move that had been expected by most market participants, but in April at the earliest. It thus became the last major central bank worldwide to turn interest rates upwards by raising its key interest rate to a target range of 0% to 0.1%, after it had lowered it to -0.1% in 2016 (see chart 1). According to Japan's central bank president Kazuo Ueda, the measures taken so far had "fulfilled their role" in achieving a "good cycle of rising wages and prices". At the same time, the BoJ decided to end its yield curve control after limiting yields on 10-year government bonds to 1% for several years. Purchases of exchange-traded equity funds (ETFs) and **J-REITs**[1] will also be stopped, while purchases of short-term debt securities and corporate bonds will be gradually reduced over the coming year.

The recent wage settlements are likely to have tipped the balance in favour of the decision. The results of the preliminary wage rounds of the Shunto, the so-called spring labour dispute, far exceeded expectations. Rengo, a trade union umbrella organisation that had demanded a 5.8% wage increase from large companies, was able to achieve an average increase of 5.3% – the biggest jump in 33 years (see chart 1). Even more important, however, is that the basic wage is to rise by 3.7%. This increase would be significantly higher than the inflation rate of just over 2% forecast by the BoJ. Whether the employees of small and medium-sized enterprises (SMEs) will also receive higher real wages remains to be seen. Many SMEs do not have the financial resources to fulfil wage demands of a similar magnitude, and employees with part-time contracts generally lack bargaining power. In the first wage round, SMEs announced that they would pay their employees 4.4% more, including a 2.7% increase in basic wages.

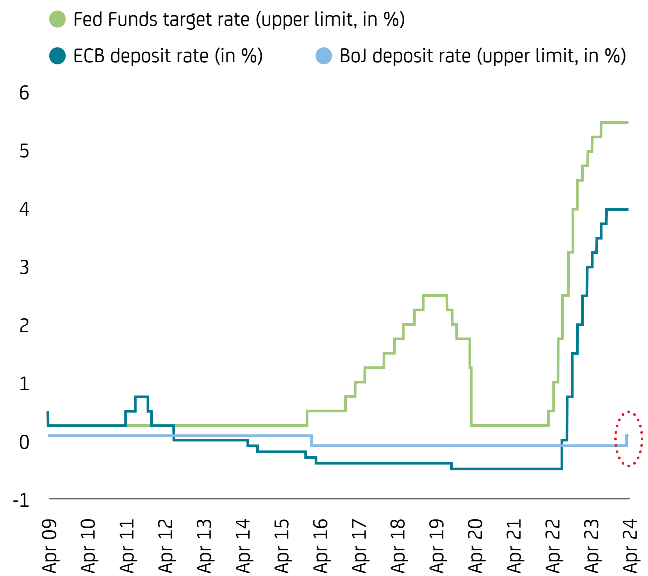
[1] There are two kinds of Real Estate Investment Trusts (REITs) in Japan, one is a Public REIT which is listed on the stock exchange, and the other is a Private REIT. When referring to 'J-REIT', it commonly means the former in Japan.

1. BOJ HERALDS NEW ERA OF MONETARY POLICY WITH INTEREST RATE HIKE

HIGHEST SHUNTO WAGE SETTLEMENT IN JAPAN FOR 33 YEARS



FIRST BOJ INTEREST RATE HIKE IN MORE THAN 25 YEARS



Source: Rengo, Bloomberg, UniCredit Group Investment Strategy
Observation period (right chart): 12.04.2009-12.04.2024

The decision to raise interest rates was not unanimous. Two of the nine voting members of the central bank committee wanted to leave the key interest rate unchanged. In any case, despite the rate hike, the BoJ's message was rather **dovish**[2]. For the time being, it intends to maintain its fundamentally accommodative monetary policy conditions: The central bank announced that it would continue its purchases of government bonds totalling around JPY6 trillion on a monthly basis (approx. EUR36 billion) and to adjust them depending on economic developments. Having successively expanded its government bond portfolio since the introduction of the negative interest rate policy and yield curve control in 2016, the BoJ now holds around half of all Japanese government bonds. It will also not aggressively sell off the large holdings of ETFs, which the BoJ has bought up on a massive scale in recent years, for the time being.

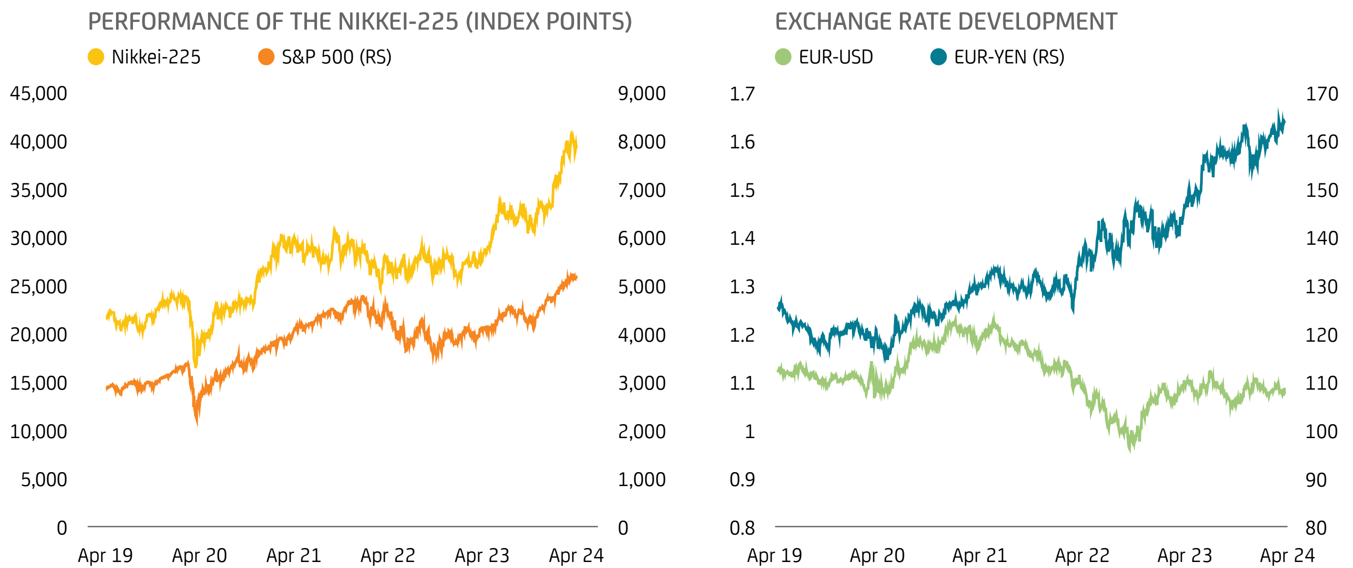
[2]Dovish describes a monetary policy stance that is more concerned with stimulating economic growth than controlling inflation. The opposite is hawkish.

SERIES OF FURTHER RAPID INTEREST RATE HIKES BY THE BOJ APPEARS UNLIKELY

After 25 years characterised by the fight against deflation, the BoJ has now ushered in a new era of monetary policy. However, the Japanese economy is not growing as dynamically as hoped. It remains to be seen whether the "virtuous circle" between wages, prices and growth has been restored, as indicated by Ueda – especially if production activity and consumption remain weak. In February, private household spending fell by 2.7% (adjusted for the additional leap day) following the significant slump of 6.3% in January. In fact, a sharp rise in consumption is unlikely despite the results of the negotiations in the preliminary Shunto wage rounds and recent unexpectedly good retail sales. Accordingly, a series of further rapid interest rate hikes by the BoJ seems unlikely.

The global financial markets appear to have taken a positive view of the BoJ's move. The upturn in the broad Japanese stock market was not slowed down by the central bank's move – which the timing of came as a surprise to many – while the Nikkei-225 reached a new record high at the end of March (see chart 2), before falling back a little recently. The downer for foreign investors is that the ongoing accommodative monetary policy appears to be continuing to weigh on the Japanese yen. Despite the BoJ's exit from its negative interest rate policy, the yen has recently weakened further and in March fell to its lowest level since 2008 (against the euro, see chart 2). Accordingly, Finance Minister Shunichi Suzuki recently felt compelled to point out that the authorities would be able to intervene if the yen were to weaken further. In the short and medium term, the future direction of the yen and Japanese government bond yields is likely to depend primarily on how the US economy develops and what monetary policy course the Fed will take. Both the Fed and the ECB are aiming for an initial rate cut this year (see Macro & Markets section).

2. WHILE THE NIKKEI-225 CONTINUES TO SOAR IN THE FIRST QUARTER, THE YEN REMAINS UNDER PRESSURE



Note: The Nikkei-225 is a price-weighted average of the 225 best valued Japanese companies (source: Bloomberg). Past performance, simulations and forecasts are not a reliable indicator of future performance. The indices cannot be purchased and therefore do not include any costs. When investing in securities, costs are incurred which reduce the performance. When investing in foreign currencies, the return may also rise or fall as a result of currency fluctuations. Acquisition costs incurred when investing in currencies are not taken into account.
Source: Bloomberg, UniCredit Group Investment Strategy
Observation period: 12.04.2019-12.04.2024

Even though the signal for an exit from ultra-loose monetary policy in Japan seems to have been given, monetary policy is likely to remain accommodative for the time being – unless the BoJ sees the risk of significant upward pressure on underlying inflation. In view of the weak yen, which makes imports to Japan more expensive and thus drives up costs, it could be forced to act later in the year. Signals to this effect came recently from central bank chief Ueda, who warned that the generous tariff increases could fuel inflation from “summer to autumn”. According to Ueda, however, the BoJ is ready to react to this with its monetary policy: “If there is a risk that wages and inflation could rise more than expected and push **trend inflation**[3] above 2%, then we might have to consider changing monetary policy.” Nevertheless, interest rates are likely to remain below the inflation rate for the time being and the real interest rate will remain negative despite slowing inflation. The focus is now on the upcoming BoJ outlook at the end of April, which should provide clues as to which path the bank could take in normalising its policy.

[3]According to Ueda, trend inflation is a measure of the development of inflation that does not take into account the effects of one-off factors.

The fact that the BoJ was able to end years of yield curve control without upsetting the markets should make central bankers and economists around the world sit up and take notice. For around 10 years, the mantra has been that the unconventional monetary policy measures, in particular the control of the yield curve, but also the extensive bond purchases by central banks (quantitative easing or QE), harbour major risks that threaten to materialise if they are ended or reduced. This fear seems unjustified. For one thing, it was not just QE that was ended. On the contrary, the central banks have started to gradually reduce their bond holdings (admittedly only to a small extent for the time being). Secondly, the end of yield curve control in Japan also appears to be taking place without market distortions – even if a final judgement in this regard seems premature.

Macro & Markets

Central bank monetary policy approaches a turning point

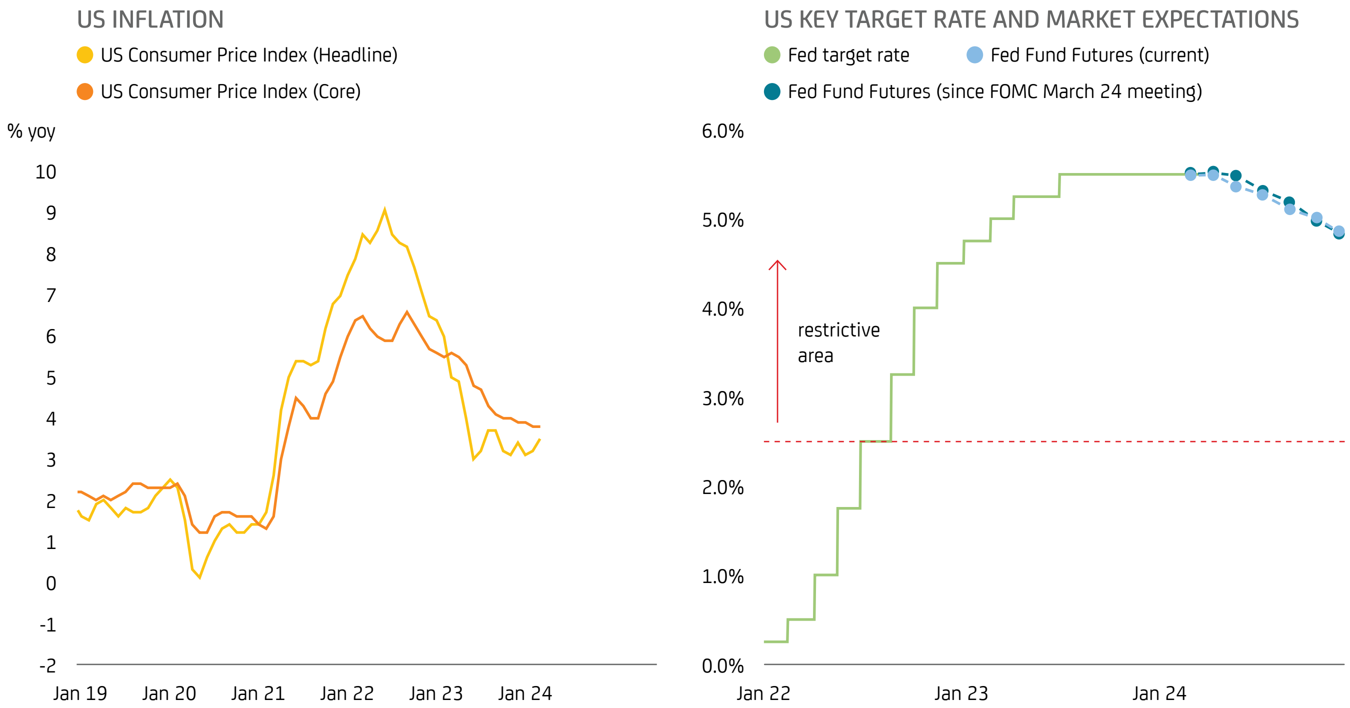
US ECONOMY PROVES ROBUST, FED MAINTAINS INTEREST RATE OUTLOOK FOR 2024

According to the latest economic data, we continue to expect a **"Soft Landing"**[4] of the US economy in 2024 with an overall economic growth rate of around 2%. In the second half of last year, the US economy grew at an annualised rate of 4%, twice as fast as its trend growth, which was mainly due to private consumption. However, this development will not last, as the excess savings of private households will continue to be depleted and defaults on consumer loans are likely to increase. While wage growth remains stubbornly above 4%, there should be an easing trend in labour demand. Small companies' hiring intentions for the next three months have fallen to their lowest level since May 2020 and indicators for job losses have risen. Fiscal policy, which made a positive contribution to GDP growth last year, is also likely to have a neutral to negative impact this year. The disinflation process for the US inflation rate has recently continued to prove tough, with a moderate rise in the overall rate to 3.5% in March (from 3.2% in February) and a stagnating core rate of 3.8%. Nevertheless, we expect the overall inflation rate to fall to just over 2% by the end of 2024, while core inflation will follow one quarter later (see chart 3).

[4]In economics, a "soft landing" usually refers to a cyclical economic downturn that does not lead to a recession.

At its meeting in March, the US Federal Reserve (Fed) left the key interest rate unchanged at 5.50% (upper end of the target range) and maintained the pace of balance sheet reduction. In the press conference, Fed Chairman Powell said that the latest inflation figures justified the Fed's continued cautious stance and reiterated that more data was needed to be confident enough to cut rates. However, he also said that higher inflation in January and February had not changed the Fed's fundamental assessment of the inflation outlook and that rate cuts were likely to be appropriate "at some point" this year. In addition, the Fed has revised its growth forecast significantly and its forecast for core inflation slightly upwards this year. Accordingly, the **"dot plot"**[5] of interest rate forecasts has shifted slightly upwards, but the median value of the plot still points to rate cuts of 75 basis points (bps) this year (which equates to three rate cuts), which is what the markets have largely swung to (see chart 3). Finally, Powell stated that the Fed is likely to slow the pace of the central bank's balance sheet reduction "fairly soon". We continue to believe that the Fed will start cutting rates in the summer and expect an announcement on slowing the pace of balance sheet reduction at the next meeting in May, which should start in June this year.

[5]The so-called "dot plot" is a graphical representation of the individual interest rate forecasts of the 18 members of the Federal Open Market Committee (FOMC).



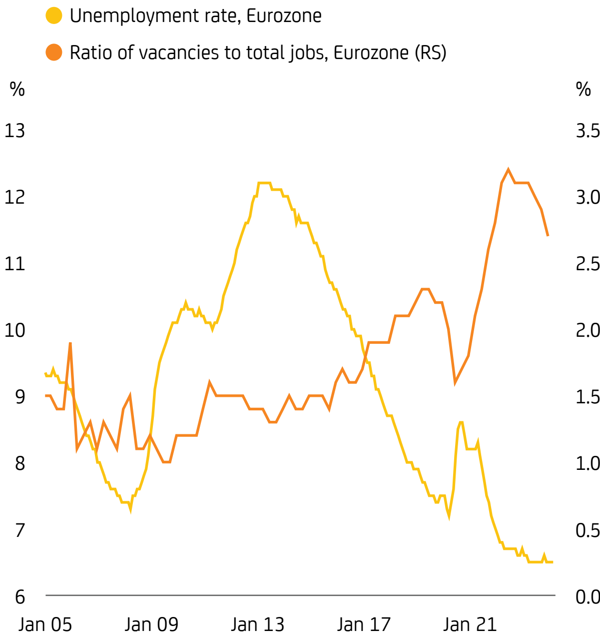
ECONOMY IN EURO AREA RECOVERS, ECB HINTS AT END OF RESTRICTIVE MONETARY POLICY

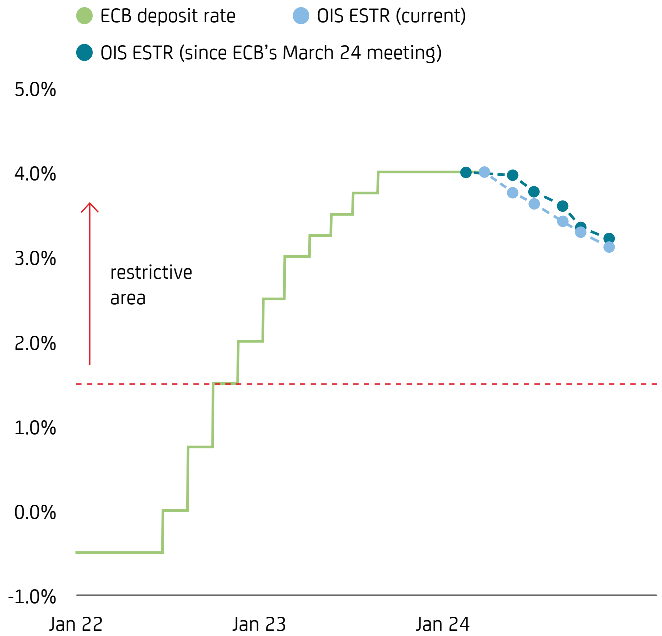
Based on the most recently published economic indicators, we confirm our growth forecast for the eurozone, which envisages slightly positive growth of around 0.5% for the current year. The purchasing managers' indices for March now more clearly indicate that the economy has bottomed out and should gradually recover. Despite a year and a half of economic stagnation, the labour market remains resilient due to new hiring, particularly in the public sector and construction, where employment was particularly high in relation to economic activity (in contrast to market services). Although employment growth appears to be slowing, the unemployment rate remains at a record low (see chart 4) and job vacancy data point to a slow easing in the labour market. The healthy labour market plays a key role in containing the downside risks to the economy and gives the European Central Bank (ECB) time to assess the sustainability of the decline in inflation. However, concerns about strong wage pressures and high unit labour costs appear to be exaggerated.

At its meeting in April, the ECB left its monetary policy unchanged, but paved the way for an interest rate cut at the meeting in June, when new growth and inflation forecasts will also be available. The central bank did not want to send out any signals about the interest rate path beyond the date of the first rate cut. However, given the uncertainties regarding the pace of disinflation in the services sector, the geopolitical environment and the Fed's monetary policy stance, we continue to assume that the ECB's easing cycle will progress slowly, probably at a pace of 25 bps per quarter to 3.25% for the deposit rate by the end of 2024. The market has also broadly converged on this scenario (see chart 4). We consider the risks to our scenario to be balanced. On the one hand, the ECB could cut interest rates less sharply than we expect if an escalation in geopolitical tensions were to lead to a sharp rise in energy prices, a disruption in the supply chain or the introduction of extensive tariffs. On the other hand, a significant deterioration in the labour market in the absence of a recovery in economic activity would be an obvious trigger for a **dovish**[6] change of course. The ECB has also made it clear that its monetary policy is independent of that of the Fed. Firstly, because inflation in the US is different from inflation in the eurozone. Secondly, the exchange rate is not the only channel that needs to be monitored. The extent to which the Fed's interest rate path could influence monetary policy in the euro area also depends on broader financial conditions. For example, if market expectations of Fed rate cuts were to decline further, this could weaken the EUR-USD exchange rate and lead to an easing of financial conditions. It is currently difficult to say in advance how financial conditions will ultimately behave and whether this would lead to a weaker cycle of interest rate cuts by the ECB.

[6] The term "dovish" refers to a supportive stance on the part of the central bank, which aims to keep interest rates low in order to promote economic growth.

4. LABOUR MARKET IN THE EUROZONE IN GOOD SHAPE, ECB ANNOUNCES FIRST INTEREST RATE CUT IN JUNE



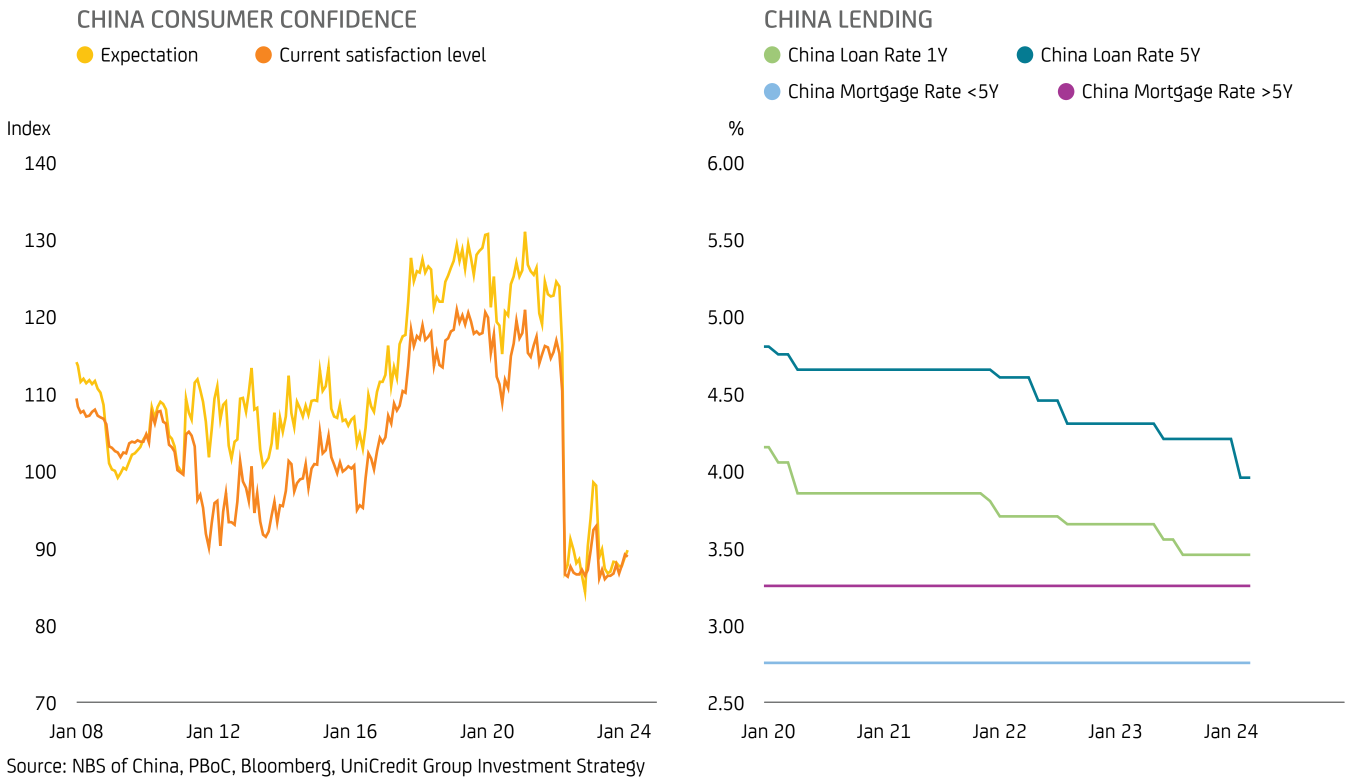


Note: OIS ESTR: Overnight Index Swap Euro Short-Term Rate.
Source: Eurostat, Bloomberg, ECB, UniCredit Group Investment Strategy

CHINA: MODERATE RECOVERY CONTINUES, BUT STILL LITTLE STIMULUS

The leading indicators continue to point to a moderate recovery in the Chinese economy in March, with the purchasing managers' indices for the services sector improving in particular. This means that the economic recovery is continuing beyond the special effect of the Chinese New Year, which we see as positive for further economic development. Nevertheless, we continue to assume that further government support will be needed to achieve the Chinese government's growth target of around 5% this year. The fact that the economy has not yet really recovered is also reflected in the persistently poor sentiment among Chinese consumers (see chart 5). The latter had slumped significantly in 2022, as waves of closures in the wake of the coronavirus pandemic (zero Covid strategy) and concerns about the property market had noticeably shaken consumer confidence. The mood has not improved sustainably since then. On the inflation front, a slight rise in inflation rates was recently observed after inflation rose by a moderate 0.7% year-on-year in February. However, this increase is likely to be largely attributable to holiday-related demand around the New Year. Until recently, there was no significant inflationary pressure in China; instead, the economy had been characterised by months of deflation since October last year.

In terms of monetary policy, there have only been moderate government support measures to date. The People's Bank of China (PBoC), for example, has not taken any major stimulus measures and has only slightly adjusted the interest rates of various credit facilities (see chart 5). On the fiscal side, the majority of government support is likely to come from the issue of earmarked bonds for infrastructure purposes. So far, no comprehensive stimulus measures are expected unless there is a major macroeconomic shock, while the government is trying to shift to a more consumption-led growth model and downsize the property market.



POSITIVE SENTIMENT ACROSS FINANCIAL MARKETS – BUT WITH SLIGHT SETBACKS

Solid economic data also ensured positive investor sentiment in recent weeks, as there were increasing signs of a "soft landing" for the economy not only in the US, but also in the eurozone. Against this backdrop, in recent weeks the S&P 500 continued the upward trend that began at the start of the year, although momentum has slowed more and more recently, as the prospect of a later interest rate cut by the Fed had a negative impact. The Euro Stoxx 50 followed this trend. While equity investors were able to enjoy good economic data, times were more difficult for investors in fixed-interest securities. More stable US inflation data, a robust economy and the prospect of interest rate cuts by the Fed later this year led to rising yields on US bonds. Yields on 10-year US government bonds rose by a good 35 bps between the beginning of March and mid-April. Yields on 10-year German government bonds were not quite able to escape this trend, but only rose by just under 5 bps (as at 12 April, see table).

The oil price has continued its upward trend on the commodity markets in recent weeks, with the ongoing supply shortage on the part of OPEC countries and geopolitical tensions in the Middle East being the main drivers of this development. At times, the price of oil reached USD92 per barrel, its highest level since October 2023. The price of gold also continued to rise in recent weeks, reaching new highs. At its peak, the precious metal cost just under USD2,400 per troy ounce. We believe that the main drivers of the recent rally are the continued high demand from private investors (asset managers and hedge funds) due to increased geopolitical uncertainty, the ongoing demand for physical gold from precious metal-rich regions such as China and India and the demand from central banks to diversify their reserves. In our opinion, however, the rapid rise in recent weeks also indicates a high level of speculation in the market, which increases the risk of a correction. The EUR-USD exchange rate weakened slightly in the reporting period, which was mainly due to the rise in US yields and the pricing out of early interest rate cuts in the US.

Asset Allocation – How we manage our portfolio mandate

Slightly better growth prospects and falling inflation confirm our global asset allocation

Asset		Investment Universe	Investment View		
			Underweight	Neutral	Overweight
Main Asset Classes		Global Equities	○	●	○
		Global Bonds	○	○	●
		Money Markets	●	○	○
		Alternatives	○	●	○
Main Asset Classes in Detail	Equities	US	○	●	○
		Europe	○	●	○
		Pacific (DM[1])	○	○	●
		Emerging Markets	○	●	○
	Bonds	EMU Government Bonds	○	●	○
		Non-EMU Government Bonds	○	●	○
		EUR IG Corporate Bonds	○	○	●
		HY Corporate Bonds	●	○	○
		Emerging Market Bonds (Hard Currency)	○	●	○
		Emerging Market Bonds (Local Currency)	○	○	●
	Commodities	Oil	○	●	○
		Gold	○	●	○

[1]DM= Developed Markets (Australia, Japan, Hong Kong, New Zealand, Singapore)

UniCredit Group Investment Strategy – Asset Allocation Stances

NEUTRAL GLOBAL EQUITIES

Supported by prospects of resilient growth and of more accommodative central banks.

NEUTRAL EUROPEAN EQUITIES

The economy is stagnating but with signs of improvements. The job market is solid, while falling inflation will increase real income. ECB is on track to start easing rates in June. European equities offer good opportunities for value and quality investors.

NEUTRAL US EQUITIES

Above trend GDP growth, but sticky inflation is increasing uncertainty around the timing and size of the Fed's easing cycle. Valuations are high and the concentration of mega caps in the S&P 500 is extreme.

NEUTRAL EMERGING MARKET EQUITIES

In Asia we remain prudent on Chinese equities, however, cheap valuations may favour a limited catch-up on the back of fiscal and monetary rescue packages. In Latin America, a more hawkish Fed may limit the size of the Brazil's easing cycle. Geopolitical risk is increasing due to the Middle East tensions. Overall, valuations are cheap for EM equities. Countries and sectors selectivity among EMs is strongly recommended.

OVERWEIGHT ON PACIFIC EQUITIES

Wage growth is a positive factor for Japan, which is emerging from a long phase of deflation. In addition, the increase in corporate profits and the reform of the Tokyo Stock Exchange are encouraging intense share buyback activity. The Bank of Japan (BoJ) ended the negative rates era and dropped the Yield Curve Control Policy; however, these moves have been well received as BoJ governor Ueda highlighted that the BoJ intends to be data-dependent and is in no rush to further normalise monetary policy. Despite the recent performances, equities valuations are not expensive.

OVERWEIGHT ON GLOBAL BONDS

They present an attractive risk-reward profile, given their current yields and expectations of rate cuts from the major central banks. In detail, we reiterate our strategic preference for "high quality bonds", such as Euro investment grade corporate and Euro government bonds.

OVERWEIGHT ON EURO INVESTMENT GRADE CORPORATE BONDS

Tighter spreads but they continue to be supported by the resilience of the economic cycle and the persistent search for yield by investors.

UNDERWEIGHT ON HIGH YIELD CORPORATE BONDS

Their spreads, especially for lower quality bonds, do not yet fully discount the risk of a material economic slowdown. Also, the asset class is relatively less liquid.

NEUTRAL EMU GOVERNMENT BONDS

Supported by falling inflation and by an ECB well on track to start easing rates in June.

NEUTRAL NON-EMU GOVERNMENT BONDS

Sticky US inflation increases the risk of a delay / size reduction of the Fed easing cycle.

NEUTRAL ON EMERGING MARKET BONDS IN HARD CURRENCY

Interesting carry but we prefer focusing on "high quality bonds". We stay defensive and selective.

OVERWEIGHT ON EMERGING MARKET BONDS IN LOCAL CURRENCY

Falling inflation, especially in Latin America, and attractive carry. However, they might be affected in the short term by a more hawkish Fed / stronger USD.

UNDERWEIGHT ON MONEY MARKETS

Interesting yields, but we prefer to invest in fixed income asset classes such as government bonds and Euro corporate IG given expectations of Fed and ECB rates cuts.

NEUTRAL ALTERNATIVES

They offer portfolios opportunities for decorrelation, while real assets benefit from their inflation-hedging role.

NEUTRAL COMMODITIES

Low oil inventories, OPEC+ production cuts, geopolitical tensions and higher economic growth have reversed the trend in oil prices. The IEA now estimates that improved demand is pushing global oil markets into a slight supply deficit. In addition, the recovery in manufacturing explains the price increases in industrial metals, with the exception of iron ore.

NEUTRAL GOLD

Gold is benefiting from increased central bank purchases – particularly by the People's Bank of China after the freezing of Russia's central Bank foreign reserves as decided by US and the EU – as well as expectations of lower rates and geopolitical uncertainties.

CURRENCIES

Superior US growth and a patient Fed willing to avoid backtracking given the stickier inflation should continue to support the US dollar in the second quarter.

How to invest

Investment ideas in the current scenario

EQUITY INVESTMENTS

OUR IDEA: WORLD BANKS

It's no secret that billionaire investor Warren Buffett loves bank stocks and has owned them for several decades. Banks meet many of the "Buffett must-haves" – they serve important societal needs, their core business model is relatively simple to understand and, despite the asset quality and structure of many banks having improved dramatically since the 2008 financial crisis, the sector is still trading at a bargain.

This third point couldn't be more accurate today: in P/E 1-year forward terms, the sector trades on 9.4x, a 47% discount to the market, compared to a 15-30% discount in the last 25 years, outside times of stress. European banks are even cheaper than the average, trading on 7.5x P/E, an approximate 35% discount to US banks. When evaluating banks' potential, another key indicator to look at is the evolution of the Price-to-Book (P/B) ratio relative to the Return on Equity (ROE), as there is a medium-term correlation between the two. Ideally ROE and P/B move in tandem – when a bank achieves a higher ROE, investors are likely willing to pay a higher price relative to the book value, leading to a higher P/B ratio. For EU banks, consensus estimates currently expect the average ROE to reach 11.2% by the end of 2024, and with a current P/B ratio of 0.86x, there is a constructive view on their potential to get closer to a 1.0x P/B valuation this year.

Overall, in a positive rate environment, with banks better capitalized than ever before, we see these undemanding valuations offering an exciting re-rating potential.

Coming out of the pandemic, central banks have taken aggressive inflation-taming actions, notably the Fed's rapid rate hikes of 525 basis points (bps) in two years, making it the fastest tightening cycle in decades and boosting banks' net interest income (NII), a measure of the difference between the interest that banks earn on loans and that which they pay out on deposits. Walking into 2024, investors expected a reversal of the cycle, with the start of a rapid easing phase – however, stickier inflation and a solid labour market partially delayed rate cuts to 2025. Thus, banks remain beneficiaries of the macro environment and their revenue trajectory is likely better than factored into their guidance, leaving room for positive reviews in the upcoming earnings reporting season. On top of NII strength, early signs of lending activity recovering, fee growth expectations rising, and lower perceived tail risks related to asset quality, especially in commercial real estate, are further fostering investors' optimism, with Stoxx Europe 600 Banks up 17.7% year to date (as of April 10th) on a total return basis and S&P 500 Banks +15.2% versus the broader market up around 10.1%.

But it's not all about valuations and macro. Historically, financials have been full of dividend payers, and few companies have delivered more consistent dividends than banks. In the last two years, on the back of turbocharged profits coming from NII, the total return spiked as executives turned to dividends and buybacks to deploy their excess capital. Even though the market expects overall capital returns to drop back from record highs, the total return consensus estimates remain high for both 2024 and 2025, with an expected 6.9% and 7.4%, respectively, dividend yield for European banks, compared to the broader market at 2.2% and 2.4%, respectively, with roughly an additional 5% cash to shareholders distributed through buybacks per year.

As we approach a new monetary easing cycle, interest rate sensitivity becomes a key factor to watch. For this reason, the most interesting opportunities can be found in banks with lower interest rate sensitivity and diversified revenue streams, particularly asset management and corporate & investment banking fees, that are likely to ensure top-line resilience, organic capital generation and attractive shareholder distributions in the medium term.

BOND INVESTMENTS

OUR IDEA: STRONG US GROWTH REWARDS RISKIEST ASSET CLASSES

During the first quarter of the year, the bond market has been recording a clear dichotomy between the performance of government bonds and other fixed income asset classes.

In particular, government bonds of "core" countries, such as the US and Germany, recorded a negative performance due to a stronger-than-expected rebound in inflation and the economy. This was particularly true for the US, which cast doubt on the start of the rate cutting cycle, effectively postponing cuts from June onwards. The yield on the 10-year Treasury rose from 3.88% at the beginning of the year to 4.20% at the end of March. The 10-year Bund rate rose 30 bps to end the quarter at 2.30%.

On the contrary, the strength of the US economy has supported other fixed income asset classes. In particular, corporate bonds, thanks to the strong balance sheets published by companies in both Europe and the US, recorded positive returns in the quarter: European high yield securities, a proxy of equity markets, returned 1.60% while investment grade bonds were up 0.40%. Emerging market bonds, thanks to the strengthening of the US dollar on the currency markets and important inflows from professional investors, also achieved an extremely positive result of a 4.40% increase since the beginning of the year. As a result, spreads versus government bonds in these asset classes have continued to tighten, falling below long-term historical averages.

The outlook for bond markets remains moderately positive in the coming months. In particular, we note that since the beginning of the year, the correlation between "core" government bonds and equity markets has reversed. Specifically, in recent years both asset classes have been rising or falling at the same time, but since January the rally in equity markets has not been followed by government bonds. In this context, government bonds, in balanced mandates, are once again a stabilizing factor for portfolios, thanks to a positive yield to maturity and coupon flows, and a safe haven asset in case of growing volatility in equity markets.

In the corporate bonds universe, we maintain a positive stance on investment grade credit, whose risk-adjusted yields are still attractive, despite a below-average level of spread versus government bonds. High quality bond valuations may appear tight, but companies have strong fundamentals and high earnings that justify these levels and will allow them to navigate any future market volatility.

Technical factors are also supportive of credit. Inflows into the asset class continue to be very strong, and the increase in the supply of new issuance has so far been easily absorbed thanks to a favourable environment. Many of the new 2024 issues were brought forward to the first months of the year and were well received by the market. As such, we expect the modest levels of future security supply will be a supportive factor for the remainder of 2024.

Finally, historically, the end of a rate hike cycle is a good time to invest in high quality corporate bonds. In previous hiking cycles, after peak rates, investment grade corporate bonds have generated positive returns in the following one to three years. Even if this year's planned rate cuts are delayed beyond current expectations, any corporate bond decline, in our view, is likely to be temporary and at the end, interest rates will be lower than they are now, with attractive potential returns for investors.

DEVELOPMENT OF SELECTED FINANCIAL MARKET INDICES

From	**12.04.23**	12.04.19	12.04.20	12.04.21	12.04.22	12.04.23	12.04.19	**01.01.24**
To	**12.04.24**	12.04.20	12.04.21	12.04.22	12.04.23	12.04.24	12.04.24	**12.04.24**
Stock market indices (total return, in %)								
MSCI World (in USD)	**20.9**	-5.9	50.4	3.7	-3.5	20.9	72.4	**6.3**
MSCI Emerging Markets (in USD)	**7.7**	-15.8	52.5	-13.9	-7.4	7.7	10.4	**2.4**
MSCI US (in USD)	**26.0**	-1.6	53.4	6.3	-6.1	26.0	91.2	**7.7**
MSCI Europe (in EUR)	**12.3**	-11.9	33.2	9.0	5.2	12.3	51.5	**6.5**
MSCI AC Asia Pacific (in USD)	**10.5**	-10.1	48.4	-13.9	-3.1	10.5	23.4	**4.2**
STOXX Europe 600 (in EUR)	**12.5**	-11.4	34.6	8.0	4.4	12.5	51.6	**6.4**
DAX 40 (Germany in EUR)	**14.0**	-11.5	44.0	-7.2	11.2	14.0	49.4	**7.0**
MSCI Italy (in EUR)	**31.1**	-17.7	39.0	4.0	16.9	31.1	80.8	**13.1**
ATX (Austria, in EUR)	**16.4**	-28.7	49.7	4.5	4.6	16.4	34.0	**5.0**
SMI (Switzerland, in CHF)	**4.0**	2.6	22.0	14.5	-6.9	4.0	40.1	**4.0**
S&P 500 (USA, in USD)	**25.5**	-1.5	50.5	8.0	-5.3	25.5	91.6	**7.9**
Nikkei (Japan, in JPY)	**43.0**	-8.2	53.9	-9.1	9.1	43.0	99.4	**19.0**
CSI 300 (China, in Yuan)	**-12.5**	-3.6	34.0	-14.0	0.3	-12.5	-2.9	**1.3**
Bond market indices (total return, in %)								
US Government Bonds 10Y (in USD)	**-4.9**	21.9	-6.7	-7.1	-2.9	-4.9	-2.5	**-4.0**
US Government Bonds (ICE BofA, in USD)	**-2.2**	14.4	-4.6	-6.0	-2.1	-2.2	-1.7	**-2.6**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**2.7**	6.9	7.8	-7.8	-1.7	2.7	7.2	**-1.6**
German Bunds 10Y (in EUR)	**2.7**	3.6	-0.2	-9.2	-11.0	2.7	-13.7	**-1.9**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**4.2**	3.6	2.6	-8.2	-10.2	4.2	-8.3	**-0.8**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**6.6**	-2.4	7.7	-7.1	-6.5	6.6	-2.4	**0.4**
Bond yields (change in basis points = 0.01 percentage points)								
US Government Bonds 10Y (in USD)	**107**	-178	95	105	68	107	196	**65**
US Government Bonds (ICE BofA, in USD)	**96**	-189	43	162	112	96	222	**62**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**45**	-37	-111	169	124	45	190	**47**
German Bunds 10Y (in EUR)	**-3**	-34	1	109	161	-3	228	**34**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**-12**	-32	-26	107	174	-12	207	**25**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**-54**	67	-123	156	213	-54	254	**14**
Spreads on government bonds (credit spreads, change in basis points)								
US Corporate Bonds (ICE BofA US Corporate Master)	**-50**	141	-167	31	18	-50	-26	**-12**
US Corporate Bonds (ICE BofA US High Yield)	**-124**	417	-472	51	87	-124	-43	**-9**
Euro Corporate bonds (ICE BofA Euro Corporate AAA-A)	**-39**	76	-93	36	29	-39	10	**-20**
Euro Corporate Bonds (ICE BofA Euro High Yield)	**-97**	293	-358	111	57	-97	11	**-27**
Money market rates (change in basis points)								
Libor (USD, 3 months)	**33**	-138	-103	85	421	33	299	**0**
Euribor (EUR, 3 months)	**75**	9	-32	11	356	75	423	**1**
Euro exchange rates (change in %)								
US Dollar (EUR-USD)	**-3.3**	-3.5	9.5	-8.8	0.6	-3.3	-5.9	**-3.6**
British Pound (EUR-GBP)	**-3.0**	1.6	-1.2	-3.5	5.5	-3.0	-1.0	**-1.7**
Swiss Franc (EUR-SFR)	**-0.9**	-6.6	4.2	-7.9	-2.7	-0.9	-14.2	**4.9**
Japanese Yen (EUR-JPY)	**11.1**	-5.6	10.0	4.7	7.2	11.1	28.7	**4.4**
Commodities (change in %)								
Commodity Index (GSCI, in USD)	**14.9**	34.6	-4.0	13.3	1.6	14.9	73.3	**14.1**
Industrial metals (GSCI, in USD)	**1.1**	-21.4	58.5	35.9	-22.8	1.1	33.2	**7.7**
Gold (in USD per fine ounce)	**18.4**	29.8	3.1	13.9	1.6	18.4	86.7	**16.8**
Crude oil (Brent, in USD per barrel)	**6.4**	-55.6	99.8	65.2	-16.6	6.4	27.7	**17.9**

Please note: Past values and forecasts are not a reliable indicator of future performance. Indices cannot be purchased and therefore do not include costs. When investing in securities, costs are incurred which reduce the performance. The return on investments in foreign currencies may also rise or fall as a result of currency fluctuations. So-called synthetic bonds are calculated to reflect the performance of government bonds in a fixed maturity range. In each case, the most "suitable" real federal bond at the relevant time is used as a reference for the yield opportunity of the synthetic bond. The development of the expected yield to maturity is shown under the following conditions: servicing of interest payments and redemption in accordance with the terms and conditions and holding until maturity. In this respect, it is a yield opportunity. The yield opportunities reflect the different risk assessments of the investors for the respective products or countries (higher yield opportunity=higher risk assessment). The synthetic bonds cannot be purchased and therefore do not include any costs. In the case of currencies and commodities, acquisition and/or custody costs incurred are not included. Source: Refinitiv Datastream. Data as at 12.04.2024.

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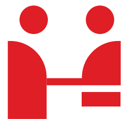

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