October 2023

Asset Allocation

US RECESSION DELAYED

Andrea Cicione

MULTI ASSET The US economy's march towards contraction has come to a halt. The recession process is still under way, but a possible downturn is a concern for 2024, not this year.

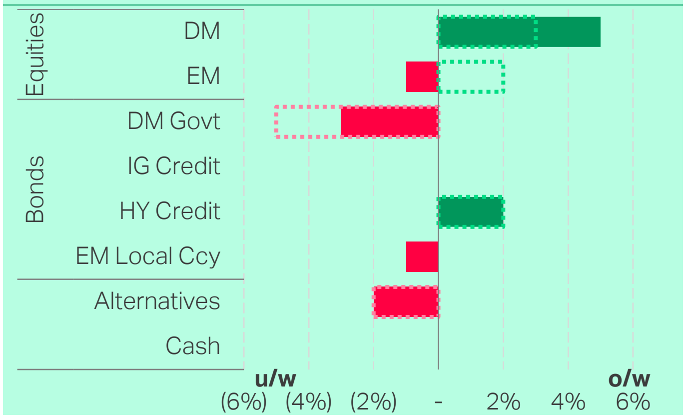
Surging UST yields have impacted equity valuations, but we expect the momentum to ease as they are close to fair value and the Fed is eyeing a pause.

Our DCF model suggests that since July, equity valuations, though still expensive, have cheapened more than higher yields warrant. No recession for now means EPS growth should resume.

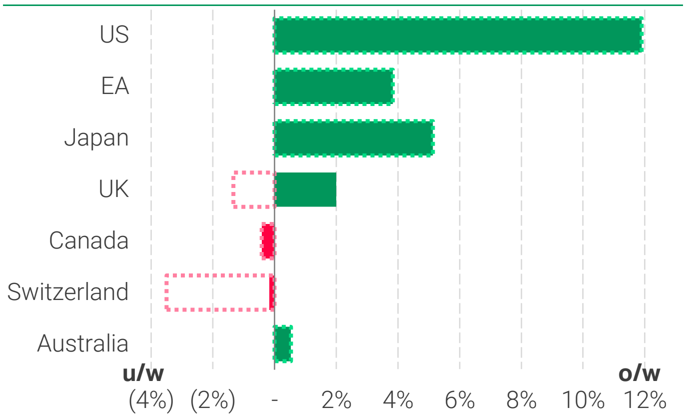
ASSET ALLOCATION We stay overweight Equities but rotate partly into Bond as higher yields make Fixed Income more appealing. We also rotate from EM to DM assets, in both stocks and bonds, going underweight EMs. We stay overweight HY and underweight Alternatives. **Our portfolio beta increases somewhat to 1.03 from 1.00.**

MACRO OUTLOOK Bear-steepening curves and rising term premia tell the story of a market that is rushing to price in a transition to a higher interest-rate environment. The longer simultaneous strength in bond yields, USD and oil persists, the greater the chances that "something breaks", precipitating a deeper economic slowdown.

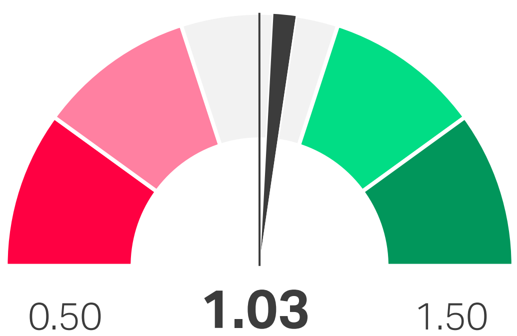
Global asset allocation*



DM Equities asset allocation*

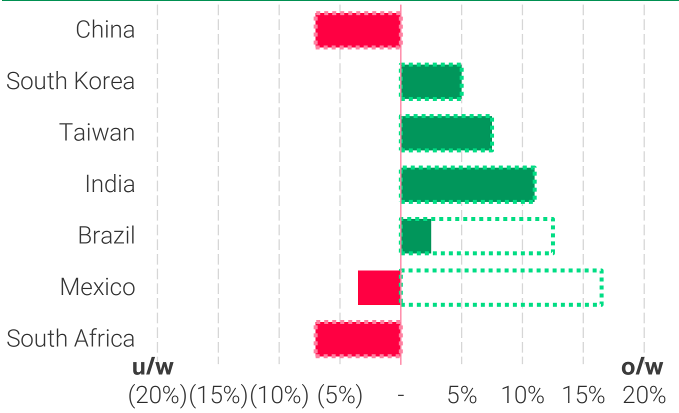


Model portfolio beta vs benchmark



Thin line represents last month's beta

EM Equities asset allocation*



(*) Dotted lines represent last month's allocation

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ASSET ALLOCATION

3 to 6-month view. Previous ratings in brackets. Monetary policy outlook changes in bold. Rationale on next page.

	Equities	Govt Bonds	FX vs. USD	Monetary policy
Developed Markets				
North America				
US	+1	0		No hikes, but no cuts either unless recession
Canada	0	0	+1	Cuts in 2024
Developed Europe				
UK	0 (-1)	+1	0	**Pause in November, active QT**
Switzerland	0 (-1)		-1	**Long pause**
Euro Area			-1 (0)	End of hiking cycle; QT @ 30bn/month
Germany	0	+1 (0)		
France	0	+1 (0)		
Italy	0	0 (+1)		
Spain	0	0 (+1)		
Asia Pacific				
Japan	+1	-1	0	Policy normalization under Ueda
Australia	0	0	+1	Higher for longer
Emerging Markets				
Asia				
China	0	0	0 (-1)	10bp cut to rate corridor
India	+1	0 (-1)	0 (-1)	Extended pause at 6.50%
Korea	+1	0	-1	Unchanged
Taiwan	+1	0	0	Unchanged
Latin America				
Brazil	0 (+1)	0 (+1)	0 (+1)	50bp cut in Sep, 11.50% end-2023
Mexico	-1 (+1)	-1 (+1)	0 (+1)	**On hold till Q1 2024**
Europe & Africa				
South Africa	-1	-1 (0)	-1 (0)	On hold

Alternative Assets	
Real Estate	-1
Energy Commodities	+1
Industrial Metals	0
Precious Metals	0

Corporate Bonds	IG	HY
US	+1	+1
UK	+1	
Euro Area	+1	+1

Key to recommendations

+2 = strongly positive **+1** = positive **0** = neutral **-1** = negative **-2** = strongly negative

Recommendations based on expectations of **normalized local-currency total returns**. FX returns include **carry**.
Model portfolio on p. 11.

Summary of key recommendation changes

	From	To	Rationale
United Kingdom and Switzerland Equities	-1	0	Europe's cycle is still in Slowdown. We turn more positive on defensive markets, especially as the momentum in yields is likely to moderate.
Brazil Equities	+1	0	Accelerating global EM equity outflows increase the pressure on investors with profitable positions in Brazil to cut exposure.
Mexico Equities	+1	-1	Anti-business measures, growing fiscal fragilities and dollar appreciation undermine an otherwise positive nearshoring outlook. Resilient growth in H1 2023 will lose momentum.
German & France Government Bonds	0	+1	The EU economy is stagnating, forcing the ECB to turn dovish and making the EU core into a global safe haven.
Italy & Spain Government Bonds	+1	0	European stagnation amid returning fiscal worries will put continued pressure on the periphery.
India Government Bonds	+1	0	Index inclusion => portfolio inflows, reduces borrowing costs, and incentivizes RBI stabilization & fiscal prudence.
Brazil Government Bonds	+1	0	Challenging external conditions have raised the bar for deep policy-rate cuts.
Mexico Government Bonds	+1	-1	There is a growing trend to fiscal sustainability, while the central bank has a resurgent inflation problem to deal with.
South Africa Government Bonds	0	-1	The SARB remains hawkish as the economy faces continued upward pressure on inflation.
EUR vs USD	0	-1	Geopolitical tensions and a higher energy price floor are negative for importers; European stagnation => ECB dovishness and the periphery is a problem once again.
CNY vs USD	-1	0	The PBoC has made it clear that defending the 7.3 level is a policy priority, while the cost of intervention has been small.
INR vs USD	-1	0	Index inclusion, ample FX reserves and an extended pause in policy rates are all positives.
BRL vs USD	+1	0	A bumpy external backdrop and an easing Banco Central are weighing on the currency.
MXN vs USD	+1	0	There is a growing trend to fiscal sustainability, while resilient growth will lose momentum into 2024.
ZAR vs USD	0	-1	The current account is vulnerable to a higher oil price and the growth outlook is weak.

Summary of model portfolio changes

	1-month chg	O/W (U/W)	Comments
DM Equities	+2%	5%	We add 1% each to the UK and Switzerland.
EM Equities	-3%	(1%)	We reduce Mexico by 2% and Brazil by 1%.
Government Bonds	+2%	(3%)	We add to US, Canada, the UK & France; cut Italy & Spain.
EM Bonds	-1%	(1%)	We add to China & India, reduce Mexico & Brazil.

Full model portfolio composition and performance from p. 11.

Contents

MULTI ASSET

Andrea Cicione

- No recession, Fed on hold and slower UST issuance all point to equity upside in Q4
- UST yields levels consistent with the Fed dot plot suggests stabilization in bonds
- We rotate from EM to DM in both stocks and bonds; portfolio beta up to 1.03 from 1.00

Go to Asset Allocation and portfolio changes

No recession – for now. Since sometime in the second quarter, the US economy's momentum towards contraction came to a halt. A solid job market and signs of life in manufacturing activity suggest that a recession this side of yearend is unlikely. We think that a "recession process" is still under way, but the timing of a possible downturn is such that it will be a concern for 2024, not this year.

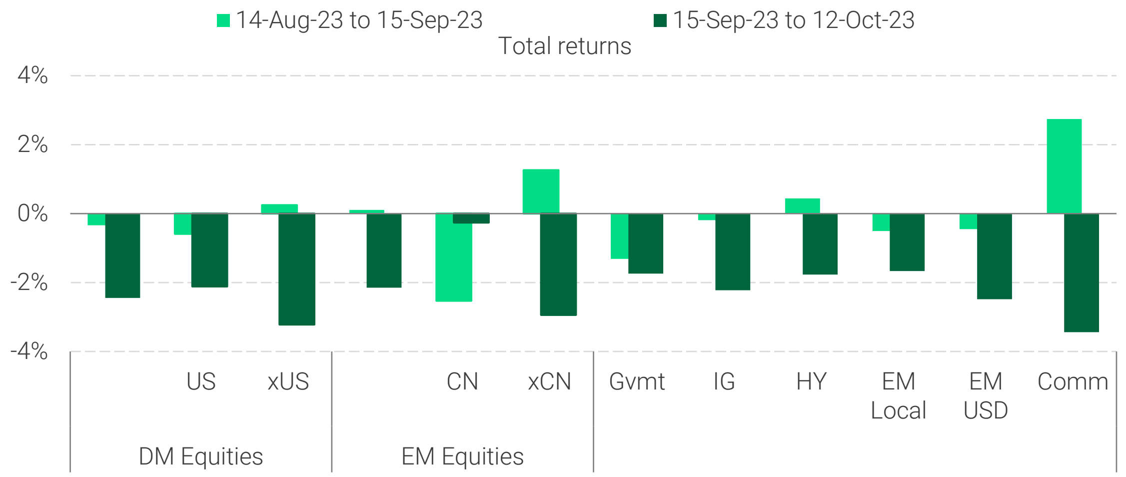
Disinflation to continue. Despite hottish prints for US CPI and PPI in September, disinflationary pressures persist. A sharp increase in oil prices threatened this trend last month, but it now appears to have stalled, despite concerns that the conflict in Israel/Gaza could lead to broader tensions in the Middle East.

Fed on hold; elsewhere the global tightening cycle has peaked. The Fed believes that policy is sufficiently tight. With inflation decelerating, it can afford to be patient and wait for the economy to respond without any immediate need for further tightening. Elsewhere, global central banks will take their cue from the Fed and turn more dovish (if they have not already done so).

Bond yield momentum to ease. US Treasury yields have reached levels that are consistent with the FOMC views expressed in the dot plot. Issuance is likely to slow in Q4 2023; and since investors are very short and the market oversold, we expect yields to stabilize.

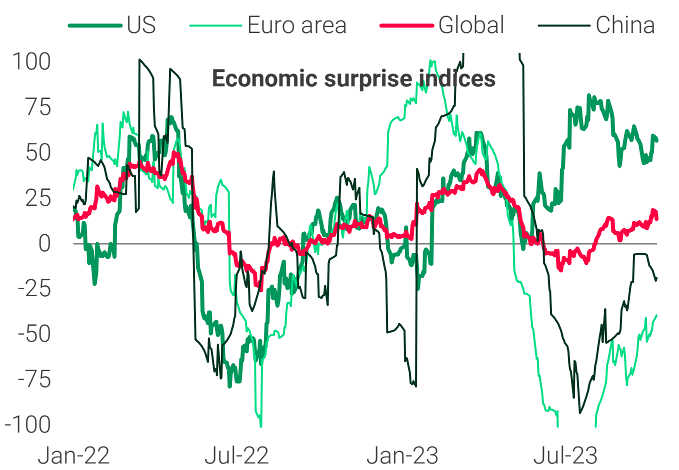
We rotate more into DM assets. We add to DM Government Bonds and DM Equities at the expense of EM assets. **Our portfolio beta climbs to 1.03 from 1.00**.

Negative returns across the board in the past month



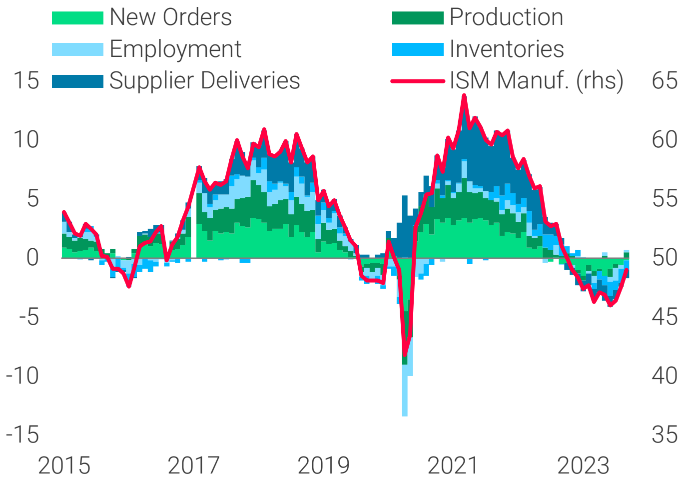
Sources: Bloomberg, GlobalData TS Lombard.

Chinese surprises are turning less negative



Sources: Citi, Bloomberg.

US Manufacturing showing signs of life



Sources: Bloomberg, GlobalData TS Lombard.

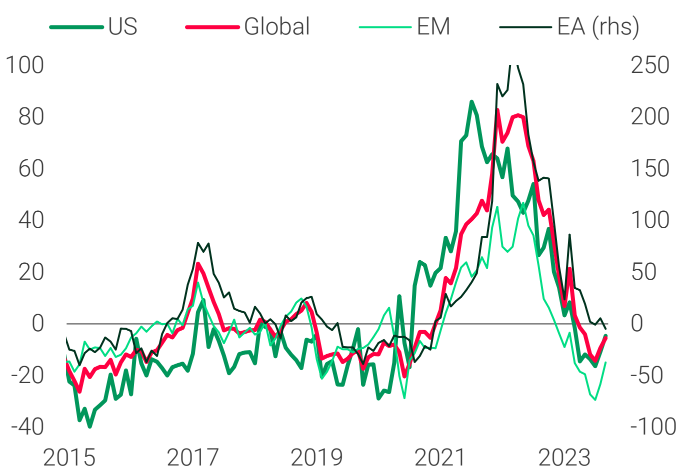
No US recession – for now

No US recession in 2023. US data continue to show remarkable resilience. Cyclical indicators have improved have carried on improving and the labour market remains solid. There are many reasons why the downswing has stopped: the Fed slowing the pace of tightening; high liquidity and excess savings; low overall debt levels, sustained employment along with improving real wage gains, to name just a few.

Disinflationary trends persist. US inflation data for September were somewhat hotter than expected, although that was mostly an issue at the headline level owing to by higher energy prices. Core CPI remains too high for the Fed's comfort, but the trend is in the right direction. Inflation surprises are still negative in the US and most other major economies, and leading indicators – such as ISM Manufacturing Prices – suggest they will likely remain so.

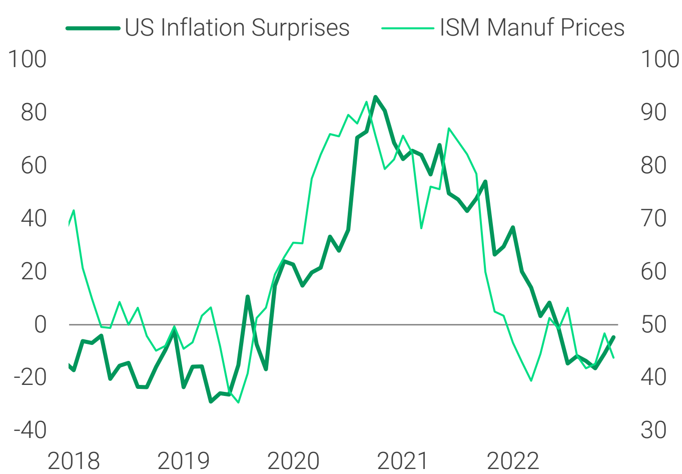
The Fed can afford to be patient. The long duration of US debt means that it takes a while for the effect of higher rates to be felt. Easing inflation allows the Fed to stop and wait for the economy to respond. However, if that response does not come sufficiently quickly, prices may reaccelerate, forcing the FOMC to resume hiking, which would eventually induce a recession. But that is a concern for 2024, not this year.

Inflation surprise remain negative



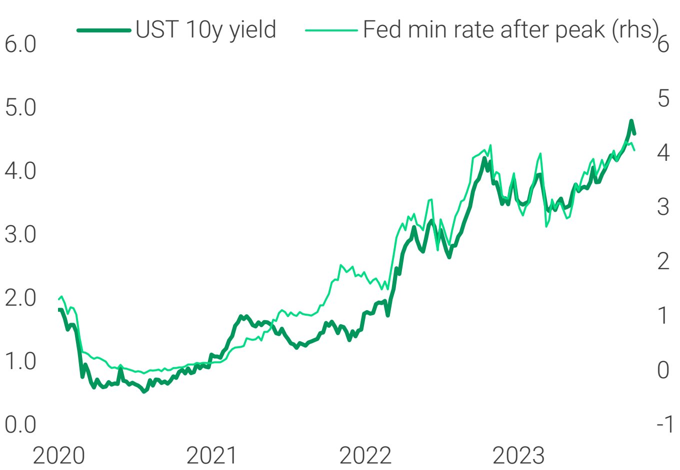
Source: Bloomberg.

Disinflationary pressures to persist in US



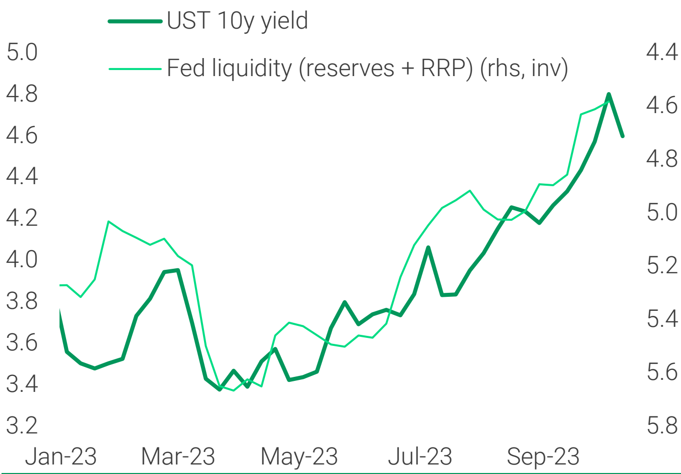
Source: Bloomberg.

UST 10y tracking Fed policy expectations



Sources: OECD, Bloomberg, GlobalData TS Lombard.

Tighter liquidity also weighing on yields



Sources: Bloomberg, GlobalData TS Lombard.

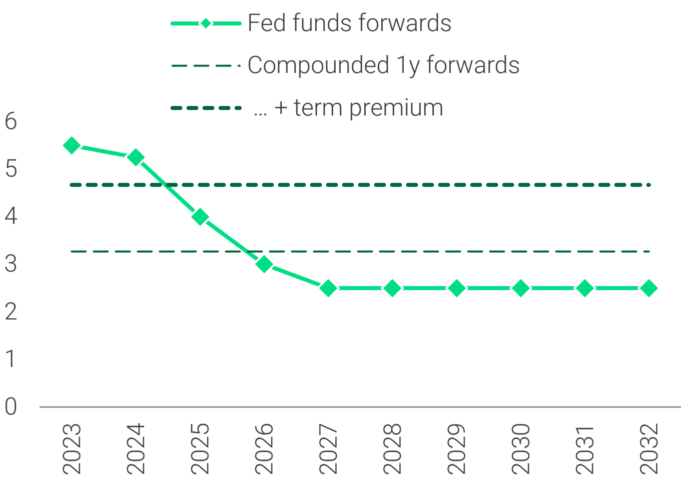
UST yields close to fair value

UST 10y yield of 4.75% seems fair… UST yields surged again in the past month, rekindling the risks that we had flagged in August but which had seemed to ease in September. We feel more confident this time around that yields are approximately at the level they should be. As we showed in a recent Macro Strategy, by compounding the median rates of the Fed dot plot and adding a term premium, we get an estimate of the 10y UST yield at about 4.75%.

…but 6.5% is certainly possible. To be sure, Fed officials have been constantly pushing up their estimates in recent months, and they may continue to do so. Using the more hawkish forecasts in the dot plot, it is easy to come up with 10y yields as high as 6.5%. As Steve Blitz argues, this is a distinct possibility if inflation starts accelerating again in 2024.

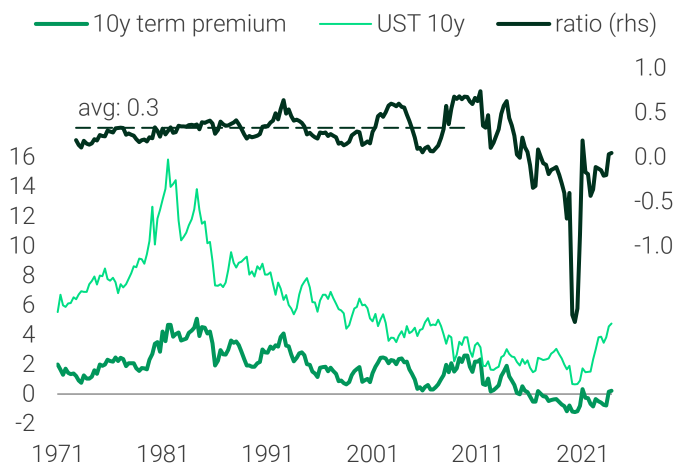
High hurdle for further yield rises. On balance, we think that yields will likely stabilize from here – for a number of reasons. First, the Fed hinted strongly that they are done hiking and intend to wait and see. Second, Q4 2023 is likely to be much more benign than Q3 was in terms of UST issuance, thanks to smaller projected deficit and TGA-related issuance. Finally, investors are very short 10y Notes futures, creating a high hurdle for further rises in yield.

Central case based on Fed dot-plot median



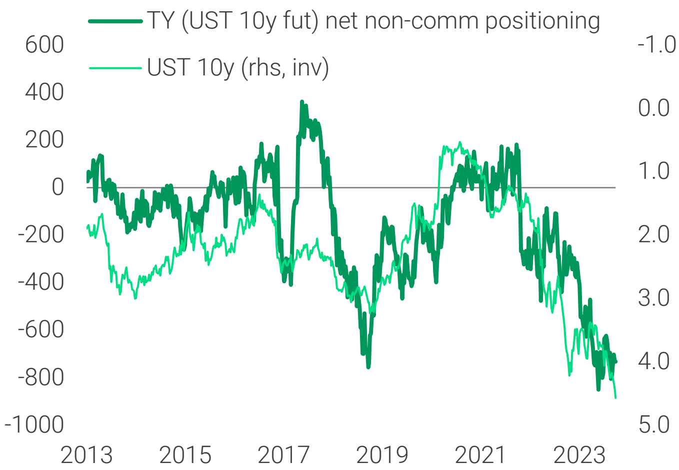
Sources: GlobalData TS Lombard, Bloomberg.

Historical pre-GFC term premium: ~30% of yield



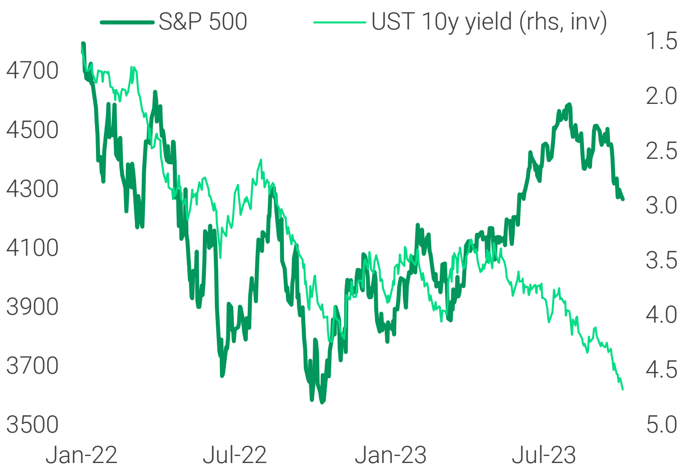
Sources: GlobalData TS Lombard, Bloomberg.

Investors are very short US Treasuries



Source: Bloomberg.

Stocks diverged from yields – but no longer



Sources: Bloomberg, GlobalData TS Lombard.

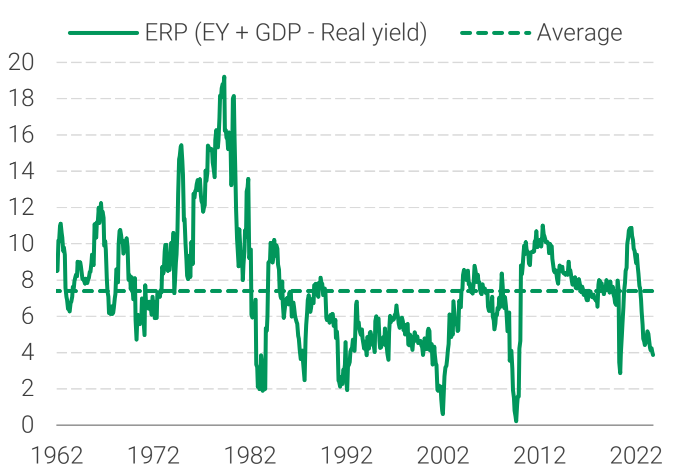
Equity valuations to stabilize if bond yields do

The correlation between stocks and bonds keeps flipping. When bond yields rise to reflect stronger growth expectations, equities tend to perform well. As a result, the correlation between equities and bonds is negative. But when bond yields jump because of higher policy rate expectations that are not driven by an improving growth outlook, equities tend to fall, leading to positive correlation.

Stable yields to support equities. In recent months, markets have experienced both regimes, with positive correlation dominating in the past few weeks. As we argued above, we feel confident that yields should stabilize close to current levels. If that happens, we expect equity valuations to stabilize, too. And since falling valuations have been the only reason for stocks' poor performance (earnings expectations have risen), this would support equities.

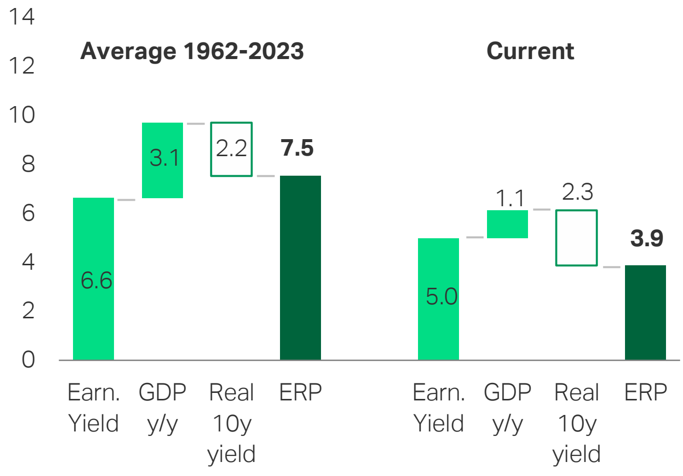
Equity risk premium close to non-crisis lows. This does not mean that headwinds for equities have disappeared entirely. As the charts below show, out favourite macro-based measure of equity risk premium is at historically low levels, suggesting that risk compensation is higher in bonds than stocks. .

ERP at lowest non-crisis levels since 1990s



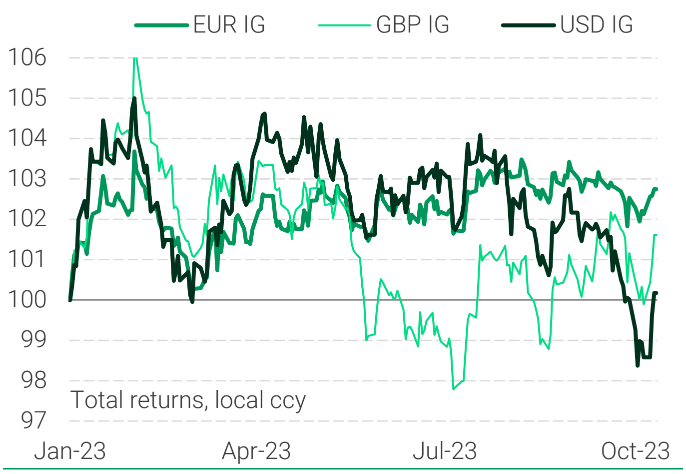
Sources: Bloomberg, GlobalData TS Lombard.

ERP of 3.9% compares poorly with 7.5% average



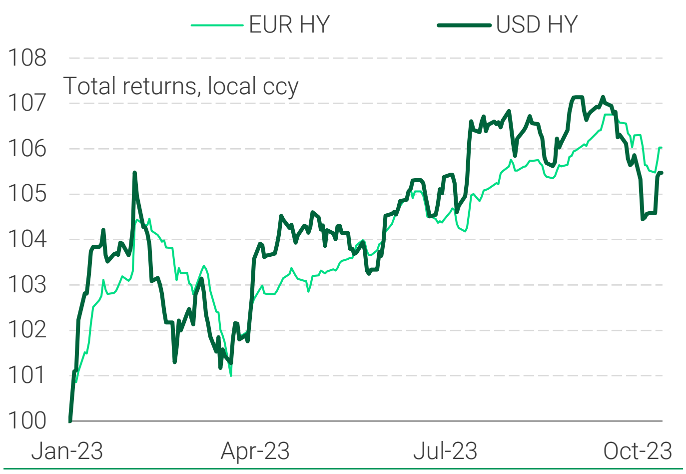
Sources: Bloomberg, GlobalData TS Lombard.

GBP IG outperforming since the summer



Sources: Bloomberg, GlobalData TS Lombard.

HY Credit posting positive returns this year



Sources: Bloomberg, GlobalData TS Lombard.

Asset allocation and portfolio changes

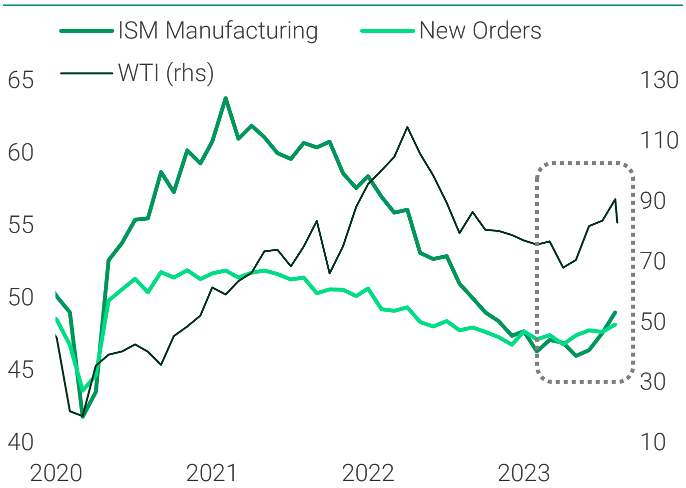
We keep a mild pro-risk stance. With the likelihood of a US recession in the near term decreasing fast, we retain a relatively pro-risk asset allocation this month. However, we acknowledge that higher yields have shifted balance of risk towards bonds somewhat. At the same time, higher bond yields and a stronger dollar have become more of a headwind for emerging markets.

We rotate from EM assets to DM. For this reason, we rotate from EM equities to DM this month, reducing our overall equity exposure marginally but remaining overweight. We also reduce EM bonds and add to DM Government Bonds, while keeping our exposure to Corporate Bonds. We are underweight Fixed Income as a result, albeit less so than before.

Model portfolio risk up slightly. We make no changes to Alternative Assets, where we keep a small underweight in both Real Estate and Commodities. Within the latter, we retain a preference for Energy, where a combination of tight supply, improving demand outlook and low reserves should support prices.

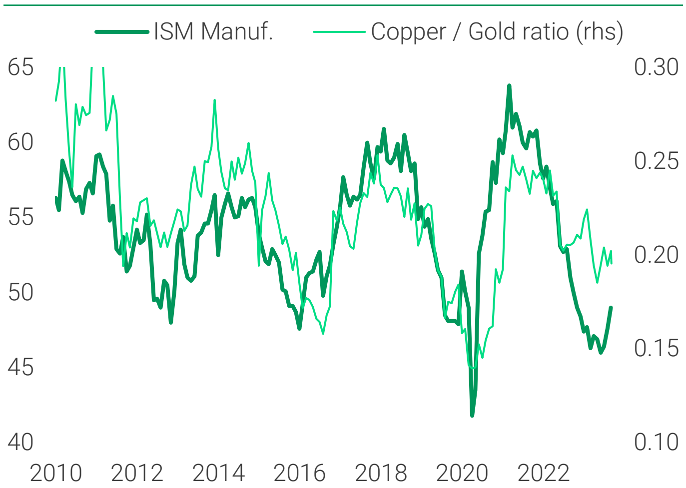
Our model portfolio beta increases somewhat to 1.03 from 1.00 last month.

Improving manufacturing outlook supports oil



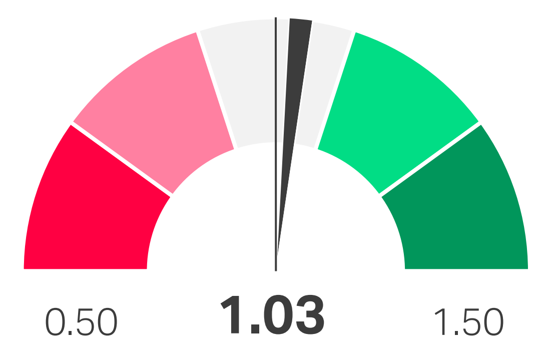
Sources: Bloomberg, GlobalData TS Lombard.

Copper/Gold points to further activity rebound



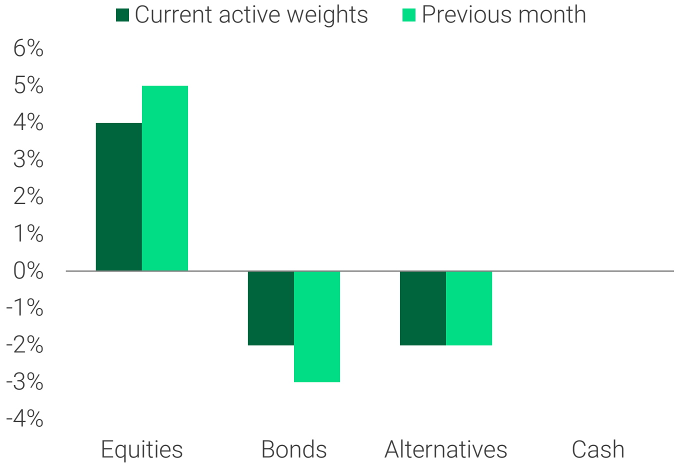
Sources: Bloomberg, GlobalData TS Lombard.

Model portfolio beta to benchmark



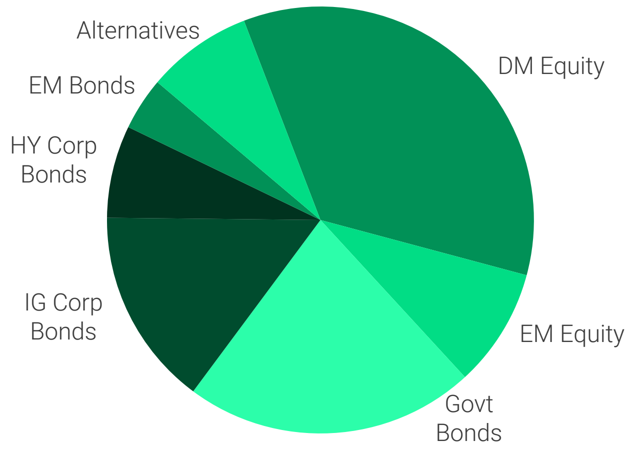
Source: GlobalData TS Lombard. Thin line = last month

Model portfolio changes



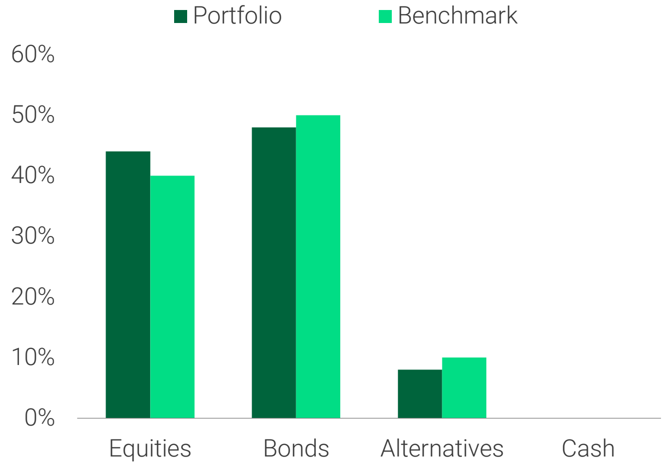
Source: GlobalData TS Lombard.

Model portfolio composition



Source: GlobalData TS Lombard.

Model portfolio vs benchmark



Source: GlobalData TS Lombard.

Multi Asset dashboard

	Total Return LC			Volatility			Sharpe Ratio			1Y Correlation			3Y Beta		
	1y	3y	5y	1y	3y	5y	1y	3y	5y	LI	Infl.	Rates	LI	Infl.	Rates
DM Equities	22.1	8.9	9.5	13.0	14.6	17.7	1.3	0.5	0.4	38.3	15.4	-39.1	7.2	3.0	-5.8
EM Equities	12.6	-0.3	4.0	12.7	14.2	15.1	0.6	-0.2	0.2	43.5	24.3	-46.8	7.0	4.3	-6.2
DM Govt Bonds	3.9	-6.9	-1.5	7.2	6.0	5.5	-0.1	-1.5	-0.6	35.3	5.0	-78.1	3.0	0.5	-5.6
DM Corp Bonds	4.7	-5.9	1.1	9.4	8.5	8.6	0.0	-0.9	-0.1	27.9	4.2	-73.1	3.1	0.5	-6.6
EM Bonds	11.5	-2.8	1.4	6.4	6.7	6.8	1.1	-0.7	-0.1	34.2	11.1	-55.8	3.5	1.3	-4.8
Energy	-2.3	40.7	2.8	30.0	34.8	42.3	-0.2	1.1	0.0	11.4	13.1	0.0	4.1	5.0	0.0
Industrial Metals	0.9	6.4	3.4	19.9	20.8	18.3	-0.2	0.2	0.1	37.6	29.2	-28.8	8.7	7.4	-5.5
Precious Metals	11.5	-1.8	7.8	14.5	15.9	16.5	0.5	-0.2	0.4	4.6	-10.5	-38.5	0.7	-1.9	-5.2
DM Currencies	10.0	-10.2	-7.7	8.0	7.0	6.5	0.6	-1.7	-1.5	30.0	3.8	-58.5	2.4	0.3	-4.0
EM Currencies	-51.5	-54.4	-53.3	54.8	31.8	24.8	-1.0	-1.8	-2.2	38.3	20.1	14.1	2.0	7.8	4.2

All figures % except 3Y Beta.

MODEL PORTFOLIO

Andrea Cicione

- We reduce our Equities overweight and rotate more into Bonds
- We rotate from EM to DM in both equities and bonds
- Our portfolio beta rises slightly to 1.03 from 1.00

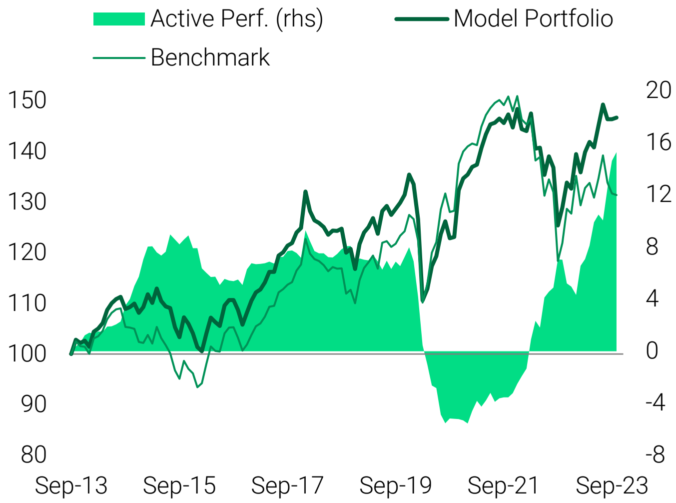
- **We stay close to neutral on risk as we rotate from Equities to Bonds.** We reduce our equity exposure by 1% to a 4% overweight, while adding 1% to Fixed Income for a 2% underweight. We stay 2% underweight in Alternative Assets.
- **We rotate from EM to DM Equities.** We cut our EM Equity exposure by 3%, reducing Mexico and Brazil, and add 2% to DM Equities, in the UK and Switzerland. As a result, we are now 5% overweight DM and 1% underweight EM Equities.
- **We also rotate from EM to DM in Fixed Income.** We reduce DM bonds by 1% to a 1% underweight and increase DM Government Bonds by 2% to a 3% underweight. We stay overweight HY Credit and benchmark weight IG.
- **We stay underweight Alternative Assets.** We make no changes to our Alternatives allocation and remain 2% underweight. We remain 1% underweight Real Estate and 1% underweight Commodities, where our preference is for Energy.
- **Our model portfolio beta increases to 1.03 from 1.00.**

Model portfolio statistics

	Model Portfolio	Benchmark
Returns (since Sep-13)	46.7%	31.4%
YTD	10.6%	2.9%
2022	-10.6%	-15.4%
2021	10.2%	7.8%
Annualized return	3.9%	2.7%
Volatility	9.1%	9.4%
Sharpe Ratio	0.36	0.23
Sortino Ratio	0.65	0.46
Beta	0.93	
Alpha	1.3%	
Tracking error vol	2.5%	
Information ratio	0.44	

Sources: Bloomberg, GlobalData TS Lombard.

Model portfolio performance



Sources: Bloomberg, GlobalData TS Lombard.

	Portfolio	Benchmark	O/W (U/W)	1m change
DM Equities	**35%**	**30%**	**5%**	**+2%**
US	21%	17.4%	3.6%	-
Canada	1%	1.1%	(0.1%)	-
UK	3%	2.4%	0.6%	+1%
Switzerland	1%	1.1%	(0.1%)	+1%
Germany	1%	1.1%	(0.1%)	-
France	1%	1.1%	(0.1%)	-
Italy	1%	0.3%	0.7%	-
Spain	1%	0.4%	0.6%	-
Japan	4%	2.5%	1.5%	-
Australia	1%	0.8%	0.2%	-
Others	-	1.8%	(1.8%)	-
EM Equities	**9%**	**10%**	**(1%)**	**-3%**
China	2%	2.7%	(0.7%)	-
South Korea	2%	1.5%	0.5%	-
Taiwan	2%	1.3%	0.8%	-
India	2%	0.9%	1.1%	-
Brazil	1%	0.8%	0.3%	-1%
Mexico	-	0.4%	(0.4%)	-2%
South Africa	-	0.7%	(0.7%)	-
Others	-	1.9%	(1.9%)	-
Government Bonds	**22%**	**25%**	**(3%)**	**+2%**
USTs	9%	10.0%	(1.0%)	+1%
Canada	1%	0.4%	0.6%	+1%
Bunds	2%	1.7%	0.4%	+1%
Gilts	3%	2.1%	1.0%	-
JGBs	2%	4.4%	(2.4%)	-
OATs	2%	1.9%	0.1%	+1%
BTPs	2%	1.9%	0.1%	-1%
BONOs	1%	1.0%	0.0%	-1%
Australia	-	0.4%	(0.4%)	-
Others	-	1.4%	(1.4%)	-
IG Corporate Bonds	**15%**	**15%**	**-**	**-**
US	9%	8.6%	0.5%	-
EA	4%	3.0%	1.0%	-
UK	2%	1.1%	1.0%	-
Others	-	2.4%	(2.4%)	-
HY Corporate Bonds	**7%**	**5%**	**2%**	**-**
US	4%	2.8%	1.3%	-
EA	3%	0.9%	2.1%	-
Others	-	1.3%	(1.3%)	-
EM Bonds	**4%**	**5%**	**(1%)**	**-1%**
China	1%	1.0%	-	+1%
Brazil	1%	0.5%	0.5%	-1%
Mexico	-	0.5%	(0.5%)	-2%
India	1%	0.5%	0.5%	+1%
Taiwan	-	0.5%	(0.5%)	-
South Africa	1%	0.5%	0.6%	-
South Korea	-	0.5%	(0.5%)	-
Others	-	1.1%	(1.1%)	-
Alternative assets	**8%**	**10%**	**(2%)**	**-**
Real Estate	4%	5.0%	(1.0%)	-
Energy Commodities	4%	3.5%	0.5%	-
Industrial Metals	-	0.3%	(0.3%)	-
Precious Metals	-	0.2%	(0.2%)	-
Other commodities	-	1.0%	(1.0%)	-
Currency Hedging	**(5%)**	**-**	**(5%)**	**-2%**
JPY	-	-	-	-
GBP	-	-	-	-
EUR	(5%)	-	(5.0%)	-2%
AUD	-	-	-	-
Cash	**-**	**-**	**-**	**-**

EQUITIES

Andrea Cicione

- Since July, US valuations have cheapened more than the rise in yields warrants…
- …but they are still more expensive than in 2022 – partly due to fading recession risk
- We reduce our equity overweight slightly and rotate from EM to DM

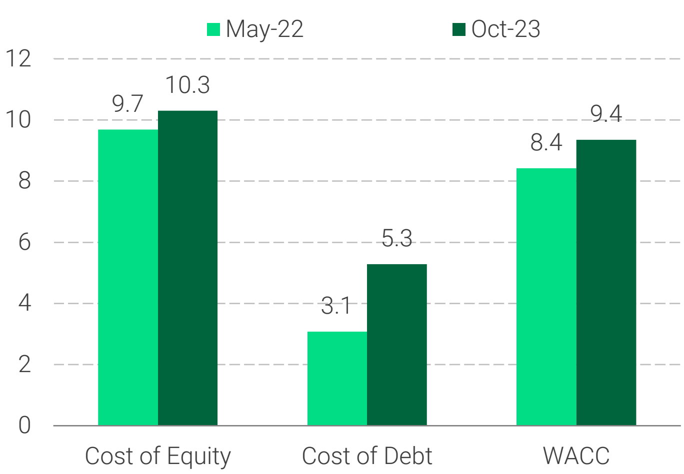
The cost of capital is set to increase for the foreseeable future. The surge in yields over the past few years has had a profound impact on companies' cost of capital. Because of the typically long duration of corporate debt, companies' cost of debt (CoD) will likely continue to rise for the foreseeable future. The cost of equity (CoE) tends to change relatively little over time, but after the 4%+ increase in both US Treasury and IG corporate yields, the CoE has risen significantly, too.

All else equal, a higher cost of capital means lower equity valuations, as the present value of future cash flows is lower when the discount rate is larger. But how much lower? **Our DCF model of the S&P 500 helps quantify how much changes to the cost of capital affect valuations**. It can also be used to estimate how the sensitivity of valuations to the cost of capital evolves.

100bp of CoD are worth 1-1.5 points of p/e. Our model shows that a change of 100bp in the CoD impacts equity valuations by about 1-1.5 points of p/e. The impact of a higher CoD is relatively muted because debt account for only about 20-25% of total capital of the S&P 500 (and even less for the Nasdaq). The vast majority of enterprise value is constituted by equity; and for relatively small changes in the CoD, we assume no changes in the CoE.

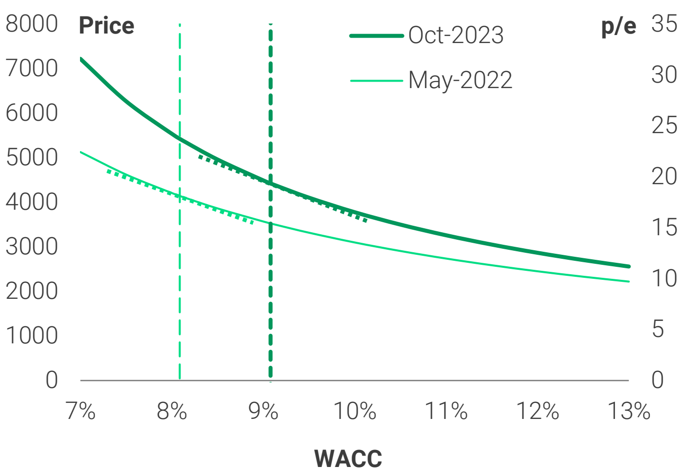
S&P 500 sensitivity to WACC is little changed. Of course, following the large increase in yields in recent years, the CoE has increased alongside the CoD, as investors require higher expected returns in equities as well. The chart below left shows the changes in the CoD, CoE and weighted average cost of capital (WACC) since May 2022. The chart below right shows that while the S&P 500 valuation curve (price, p/e vs WACC) has steepened since May 2022, the increase in WACC means we have slid down the curve, where it is less sensitive to changes in the cost of capital.

WACC nearly 1% higher than in May 2022



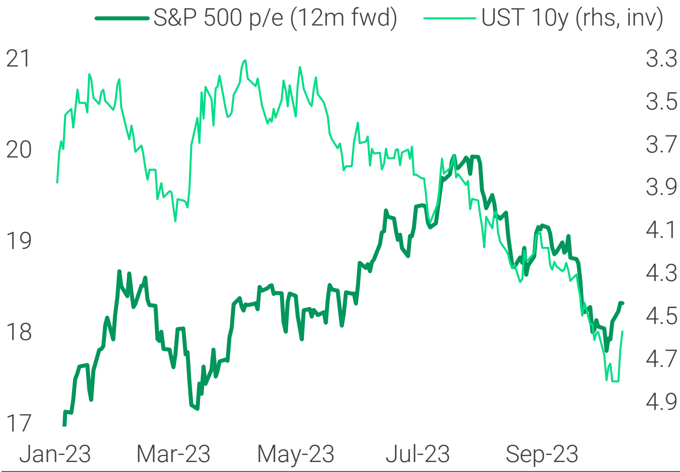
Sources: Bloomberg, GlobalData TS Lombard.

S&P500's sensitivity to WACC little changed



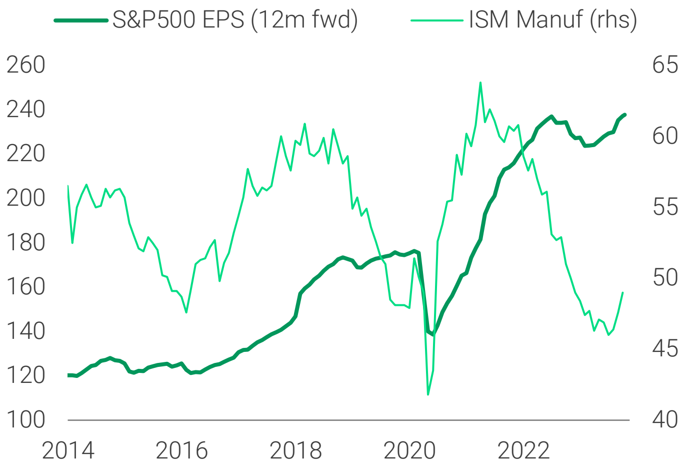
Sources: GlobalData TS Lombard.

Valuations marched down as yields pushed up



Source: Bloomberg.

S&P earnings outlook looks brighter



Source: Bloomberg.

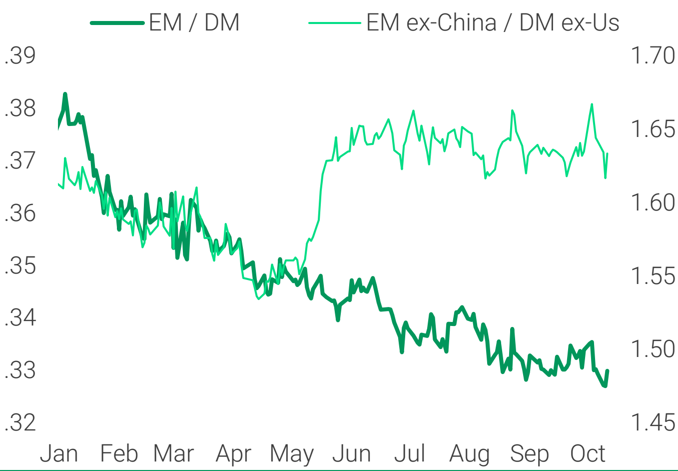
A brighter outlook for earnings. Compared with May 2022, when S&P 500 forward EPS was roughly the same as today, forward p/e ratios have increased from about 17.5 to 18.5. With the WACC some 100bp higher, why aren't valuations lower? The answer is to be found in earning expectations beyond 12 months out. Looking at 24m forwards, p/e ratios are more or less unchanged between May 2022 and today. The reason is that the recession has largely been priced out, making the outlook for earning much brighter than it was in 2022.

Since July US stocks have cheapened more than warranted by higher yields. Taking the end of July 2023 as a starting point (when S&P 500 p/e peaked at about 20x forward EPS), Treasury yields have increased about 90bp and US IG corporate bond yields about 80bp. Our DCF suggests that the impact on S&P 500 p/e should have been just below 1 point of p/e. Instead, 12m forward p/e ratios have fallen by 1.7. In other words, relative to July, equities have cheapened more than the increase in the CoD alone should warrant.

Recommendation and portfolio changes

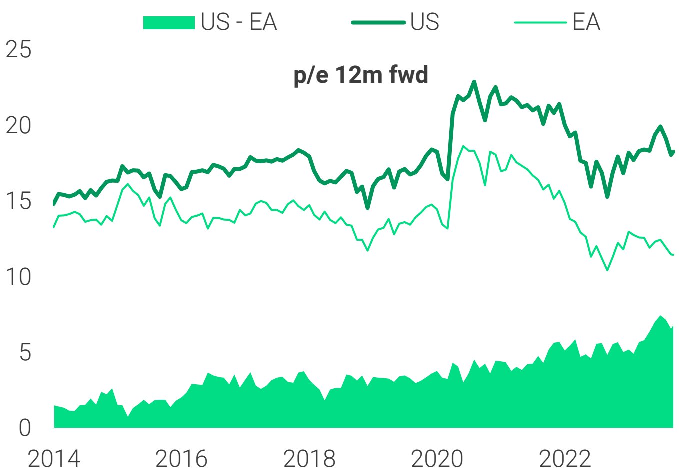
We stay positive on US equities. We keep a +1 recommendation on US equities as valuations still look expensive given the higher cost of capital but are normalizing. As we expect yields to stabilize from here and the earnings outlook remains positive amid the receding immediate

EMs lagging DM – mostly owing to China and US



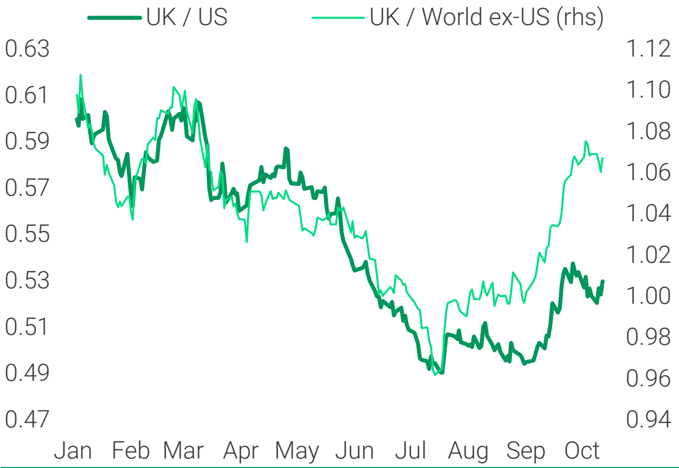
Sources: Bloomberg, GlobalData TS Lombard.

Euro-US valuation gap widening



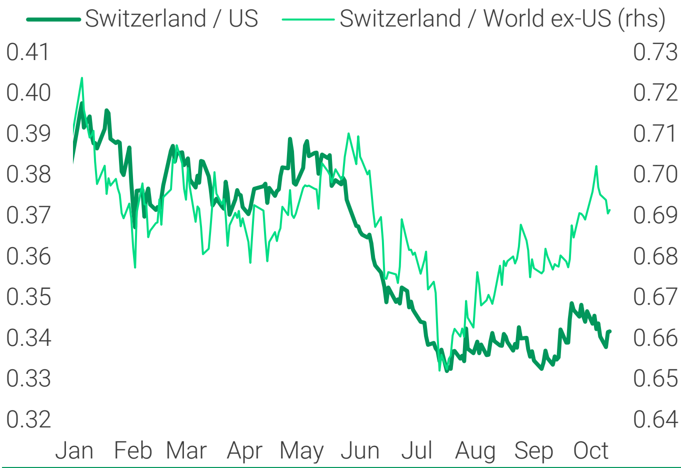
Sources: Bloomberg, GlobalData TS Lombard.

UK outperforming other DMs – including US



Sources: Bloomberg, GlobalData TS Lombard.

Swiss equities leading ex-US DMs



Sources: Bloomberg, GlobalData TS Lombard.

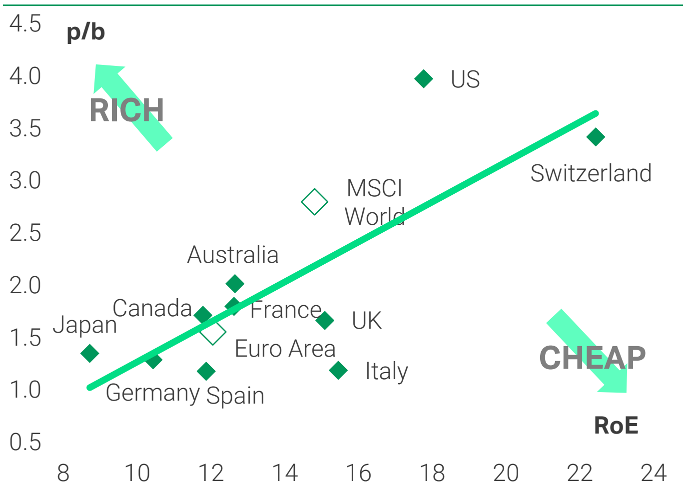
recession risk, a positive recommendation is still warranted. Additionally, the US remains one of the few economies where growth dynamics are improving, justifying higher multiples.

UK, Switzerland upgraded to 0 from -1. The defensive characteristics of the UK and Swiss markets have allowed them to post good performance in recent months. While the US cycle appears to have moved to the Recovery stage, Europe's is still in Slowdown (below-trend growth and slowing). We therefore turn more positive on defensive markets, especially as the momentum in yields is likely to moderate. Further, the UK will benefit from both cheap valuations and commodity exposure, as oil prices are likely to remain supported by supply cuts, improved demand outlook and low reserves.

Brazil cut to 0 from +1. The longer-term outlook for structural reform remains positive, but accelerating global EM equity outflows increase the pressure on investors with profitable positions in Brazil to cut exposure. At the same time, challenging external conditions have raised the bar for deep policy-rate cuts.

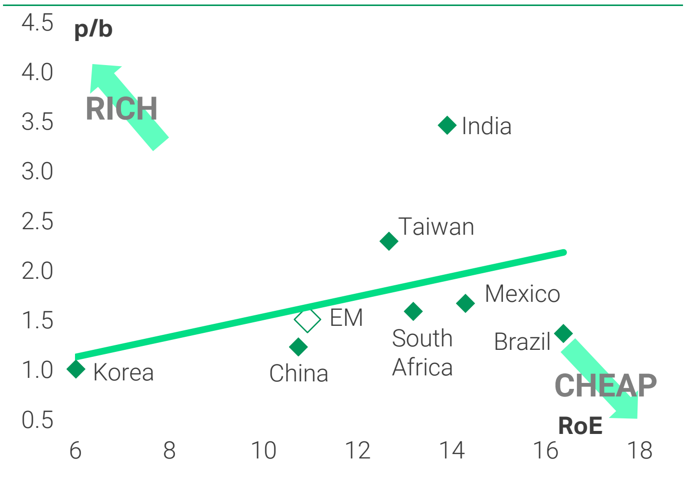
Mexico downgraded to -1 from +1. Anti-business measures and growing fiscal fragilities combine with dollar appreciation to undermine an otherwise positive nearshoring outlook. Resilient growth in H1 2023 will lose momentum in the remainder of the year.

DM price-to-book ratio vs RoE



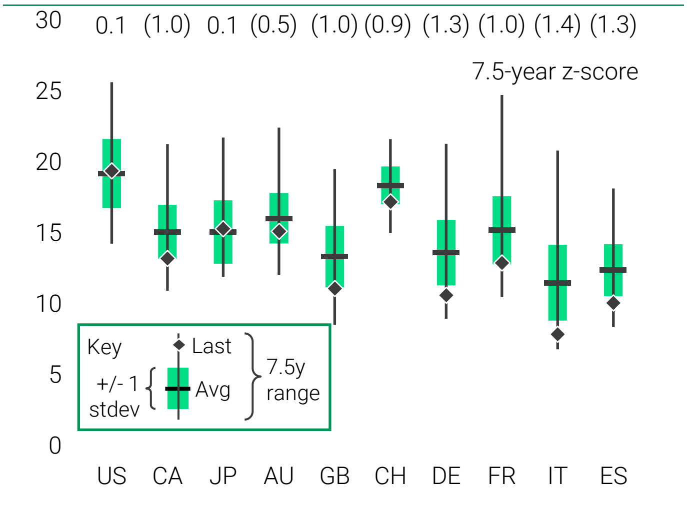
Source: Bloomberg

EM price-to-book ratio vs RoE



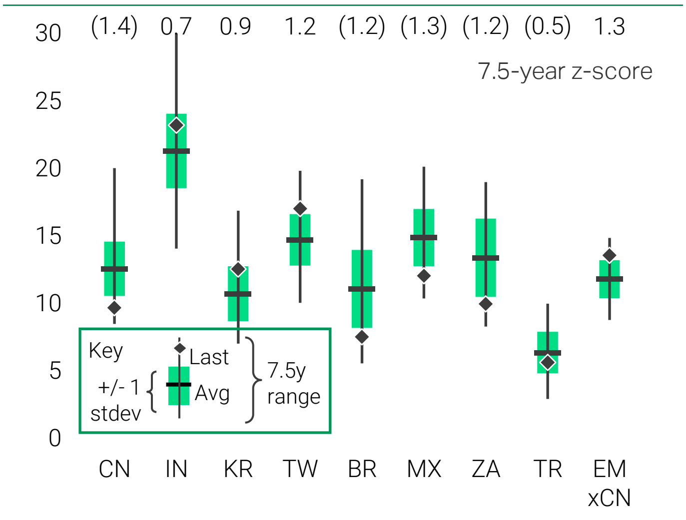
Source: Bloomberg.

DM price-to-earnings ratio vs cycle



Sources: Bloomberg, GlobalData TS Lombard.

EM price-to-earnings ratio vs cycle



Sources: Bloomberg, GlobalData TS Lombard.

Equities dashboard

		MktCap	Total return LC			P/E (x)			P/B (x)			RoE			EPS growth		Dividend yield		
	Memb.	(US$)	1m	ytd	2022	Trail.	Fwd	ZScr	Trail.	Fwd	ZScr	Trail.	Fwd	ZScr	Fwd	3m	Trail.	Fwd	ZScr
World (AC)	2948	61,721	-2.1	11.7	-17.9	18.0	16.4	-0.2	2.6	2.5	0.6	13.8	14.3	0.9	-3.4	-0.7	2.2	2.3	-0.4
United States	627	38,501	-2.4	15.2	-19.5	22.3	19.4	0.1	4.2	3.8	0.7	17.2	17.9	0.8	-1.0	2.9	1.6	1.6	-0.9
Canada	88	1,728	-2.7	4.4	-5.8	14.5	13.2	-1.0	1.9	1.7	-1.0	11.5	12.3	0.4	-1.9	-1.2	3.4	3.6	1.1
Japan	235	3,416	-0.5	27.5	-4.1	17.1	15.3	0.1	1.5	1.3	0.5	9.4	8.6	0.1	-3.1	2.7	2.1	2.3	-0.2
Australia	59	1,071	-1.4	6.9	3.6	15.0	15.1	-0.5	2.1	2.0	0.1	13.1	13.1	0.5	-2.9	-1.1	4.4	4.2	-0.4
UK	83	2,274	2.1	5.7	7.0	10.9	11.1	-1.0	1.7	1.6	-0.9	15.2	14.0	0.9	-7.1	0.6	4.0	4.6	0.9
Switzerland	45	1,480	-0.5	4.8	-16.5	18.9	17.2	-0.9	3.7	3.3	1.5	23.0	16.8	1.9	-23.6	1.8	3.1	3.3	0.3
Germany	59	1,222	-2.2	10.6	-16.5	12.2	10.6	-1.3	1.4	1.2	-1.8	9.7	9.9	-0.4	0.9	0.0	3.9	4.7	2.8
France	63	1,759	-2.3	11.0	-7.0	13.7	12.9	-1.0	1.8	1.8	0.9	11.4	13.2	1.6	-4.1	0.6	3.1	3.4	0.2
Italy	23	384	-0.4	24.5	-7.7	6.6	7.9	-1.4	1.2	1.2	0.6	15.1	15.3	1.8	-5.3	7.8	4.9	6.0	1.5
Spain	19	384	-0.5	19.1	0.6	10.7	10.1	-1.3	1.3	1.2	0.1	12.1	11.9	1.6	0.1	4.6	4.3	5.3	1.4
Euro Area	229	4,801	-1.7	11.1	-11.7	12.7	11.9	-1.2	1.6	1.5	-0.3	11.4	12.1	1.2	-1.2	2.2	3.4	4.0	1.6
DM ex-US	884	16,617	-1.9	7.7	-13.7	13.6	13.3	-0.9	1.7	1.6	0.0	11.9	11.6	0.9	-7.8	-4.6	3.3	3.7	1.2
China	765	1,991	-0.3	-5.2	-21.7	12.5	9.7	-1.4	1.2	1.2	-1.4	9.4	11.5	-0.7	7.5	-5.9	2.5	2.6	0.7
India	122	1,030	-0.6	9.4	3.0	26.4	23.2	0.7	3.5	3.6	0.9	13.1	14.6	-0.2	13.4	1.8	1.3	1.4	-0.8
Korea	104	801	-2.1	14.9	-24.7	16.8	12.6	0.9	0.9	1.0	-0.3	5.3	7.6	-0.9	-4.2	-4.2	1.7	2.5	0.8
Taiwan	90	999	1.9	21.8	-21.5	17.5	17.1	1.2	2.3	2.2	0.6	13.8	13.1	-0.3	-6.9	-1.3	3.5	3.2	-1.5
Brazil	47	353	-0.3	7.6	8.6	6.6	7.6	-1.2	1.4	1.2	-1.6	21.4	16.5	0.1	-18.1	-7.2	6	7	1.0
Mexico	23	154	-2.9	4.5	-6.3	13.3	12.1	-1.3	1.8	1.6	-1.5	16.6	13.4	-0.1	-1.1	-7.3	3.4	5.4	2.0
South Africa	34	194	-0.6	3.3	3.4	15.0	10.0	-1.2	1.7	1.5	-1.6	13.1	15.2	0.0	-1.5	-3.9	4.3	4.6	0.8
EM ex-China	672	4,599	-1.6	7.3	-18.9	14.5	13.6	1.3	1.7	1.7	0.7	11.9	12.3	-0.2	-5.2	-4.3	3.0	3.4	-0.3

ZScr is the number of standard deviations from the 7.5-year avg (numbers below -1 and above 1 highlighted). All figures % unless stated otherwise. P/e, p/b, RoE and DY ZScr are over 7.5y on 12m forward measures. EPS growth is forward / trailing. EPS 3m growth is on forward earnings.

MSCI sector weights

%	US	Canada	Japan	Australia	UK	Switzerland	Germany	France	Italy	Spain	Euro Area	Brazil	China	Taiwan	India	Mexico	South Africa	Korea	DM	EM
Industrials	8.9	12.8	23.4	5.5	11.3	9.2	18.5	23.1	5.9	8.8	16.4	7.8	9.9	3.1	7.8	15.5	2.5	11.3	11.1	8.4
Energy	4.5	18.7	0.8	5.9	14.0			8.3	12.3	4.9	5.1	20.4	2.4	0.3	8.8		1.8	1.2	5.0	6.1
C. Discr.	10.6	3.7	19.0	5.9	5.5	4.6	15.4	18.3	23.4	17.8	15.5	2.2	19.4	2.1	9.7		12.8	8.0	10.6	11.8
Healthcare	13.1		8.3	8.9	13.0	36.2	9.7	11.3	2.7	1.1	8.2	3.3	7.3	0.3	4.2		1.6	4.5	12.8	4.8
Financials	12.2	33.2	12.2	33.2	19.0	17.2	18.9	11.4	33.8	33.0	18.3	31.7	18.1	14.1	34.1	15.9	39.1	8.4	14.8	22.9
Real Estate	2.3		3.1	5.6	0.9						1.0		2.3	0.1			3.2		2.3	1.7
Utilities	2.3	3.2	1.2	1.6	4.0	0.2	3.9	2.6	18.3	24.9	5.9	7.7	2.2		3.6			0.5	2.6	2.3
Tech	28.6	7.9	13.4	1.6	1.0	1.1	15.8	4.8	1.0		11.9	0.7	11.6	71.2	10.9			48.8	22.3	18.5
Communications	9.0	4.4	7.9	3.6	2.8	1.1	6.3	2.9	1.8	9.5	4.4	1.7	10.2	2.6	2.4	14.9	6.4	6.0	7.6	7.2
Materials	2.4	10.6	4.7	23.4	10.2	7.7	6.5	6.0			5.6	16.5	7.6	4.8	8.4	20.1	23.7	9.3	4.0	8.5
C. Staples	6.0	4.6	5.9	4.8	18.4	22.2	3.0	10.3	1.7		7.8	7.8	8.9	1.4	9.7	30.4	8.9	2.0	6.9	7.3

Largest three sectors for each market highlighted

Sector price-to-earnings ratio (12-month trailing)

	US	Canada	Japan	Australia	UK	Switzerland	Germany	France	Italy	Spain	Euro Area	Brazil	China	Taiwan	India	Mexico	South Africa	Korea
Market	22.0	14.7	14.5	15.1	10.7	15.7	12.0	14.6	7.3	9.6	12.5	6.5	10.7	15.3	25.2	10.1	11.0	11.1
Industrials	21.3	23.9	12.0	30.2	22.0	21.0	11.7	17.8	9.4	20.9	15.3	32.8	6.4	5.8	44.9	12.1	15.0	10.5
Energy	8.1	13.4	9.4	7.9	7.0			8.4	5.7	5.8	8.0	3.4	5.9	33.3	17.1		6.0	16.6
C. Discr.	31.3	16.6	14.7	25.6	17.3	16.8	6.4	17.7	5.9	24.4	10.4	22.0	23.8	25.3	45.2		10.5	5.8
Healthcare	26.3		27.8	35.2	22.4	24.6	22.2	18.3		57.2	20.6	32.0	17.7	491.7	39.9		14.9	55.2
Financials	13.3	10.6	12.6	13.5	7.2	6.1	9.5	7.3	6.8	5.8	7.1	7.9	4.4	16.1	20.1	8.2	9.2	4.6
Real Estate	30.4	37.1	14.6	23.8	6.8	32.2	608.4	55.8			68.9		6.6	19.0	75.6	3.6	8.6	
Utilities	17.9	14.2	7.2	19.0	9.3	9.6	14.8	21.8	10.8	11.7	13.3	14.0	8.4		14.9			64.4
Tech	34.9	76.5	24.3	191.8	38.1	39.8	35.7	15.9		35.0	28.0	31.6	14.2	14.9	26.3			13.7
Comms	24.2	19.0	10.9	30.7	11.0	17.3	12.5	15.3	51.5	19.8	16.3	16.6	16.0	23.7	39.3	7.2	9.7	27.2
Materials	17.0	18.8	11.2	11.5	10.7	18.5	12.1	17.2			12.6	4.5	10.6	39.1	19.5	11.2	13.2	23.1
C. Staples	22.2	16.7	23.5	24.9	12.4	28.3	27.1	25.3			21.1	17.6	24.0	14.9	54.5	15.6	26.0	15.2

Sector 12-month total returns (local currency)

%	US	Canada	Japan	Australia	UK	Switzerland	Germany	France	Italy	Spain	Euro Area	Brazil	China	Taiwan	India	Mexico	Russia	South Africa	Korea
Market	20.6	9.6	30.0	14.4	15.4	9.5	25.0	22.3	43.7	34.8	24.4	8.4	13.8	35.0	14.5	24.5		14.5	18.5
Industrials	21.9	10.1	31.5	16.4	30.1	27.7	29.1	26.7	-0.7	39.8	26.4	6.2	-2.8	15.7	22.6	21.4	0.0	45.1	15.3
Energy	7.8	8.5	27.5	21.2	21.5			29.5	34.2	21.1	24.3	46.6	27.2	9.2	13.1	0.0		2.1	1.4
C. Discr.	15.6	13.5	35.6	22.4	19.6	13.1	24.1	15.4	55.1	46.3	23.9	-38.8	11.1	23.5	29.0		0.0	34.6	20.3
Healthcare	6.0		4.2	-7.2	16.6	1.6	-2.3	20.5		44.8	13.4	-27.5	9.3		19.7		0.0	22.5	0.0
Financials	8.0	4.9	62.0	10.3	29.1	27.4	37.4	29.4	61.6	53.8	35.5	4.9	21.1	22.0	14.4	25.1		20.2	28.4
Real Estate		15.5	14.3	21.2	11.6	14.8	18.6	19.6					-6.9	-9.1	52.2	64.6		8.8	
Utilities	-4.0	-5.8	49.2	34.6	22.1	0.0	14.8	33.8	41.7	21.0	22.2	6.1	-6.4		-18.4				1.5
Tech	43.0	62.6	34.9	22.8	21.4	0.0	45.4	13.8			32.2	-2.7	9.7	44.8	12.6			0.0	21.7
Comms	40.3	0.9	13.8	20.5	2.2	26.5	18.6	25.5	41.4	14.3	21.7	33.1	35.8	10.4	20.7	-1.7		-12.8	7.7
Materials	12.7	3.2	36.0	24.8	0.8	16.7	15.5	34.4	0.0	0.0	17.9	6.8	0.0	3.7	12.2	44.9		-0.1	28.4
C. Staples	1.2	15.8	14.5	7.8	0.3	0.9	15.8	14.1			10.2	-6.7	-5.3	5.1	15.3	30.1		21.8	-2.9

FIXED INCOME

Skylar Montgomery Koning

- We maintain a bullish US FI bias but remain nimble, preferring to find safety in markets where the economic outlook is less rosy (UK and EU)
- The EU economy is stagnating, forcing the ECB to turn dovish; we upgrade EU core govvies to +1 and downgrade the periphery to 0 amid returning fiscal worries

Stay nimble US FI

Where do US yields go from here? In last week's Macro Strategy, we discussed the bull and bear case for bonds. In the bull case, 10y yields could drop to around 3.5% driven by a dovish about-face from the Fed against the backdrop of sustained disinflation and a pronounced slowdown in economic activity. And, indeed, the past few days have shown how quickly the narrative can change, with dovish Fed remarks weighing on yields globally. In the bear case, nominal US 10yr yields could reach as high as 6.5%, predicated on a hawkish path for the Fed funds rate compounded by higher term premia and persistent momentum trading.

We maintain a bullish US FI bias but remain nimble. We are still positive that the most likely sustained move in yields is downwards, especially as the US economy could easily slip into a recession in the next few quarters. The above highlights the massive range of possible yield scenarios; and currently, with the market rushing to price a transition to higher rates, the burden of proof is with the bond bulls. We thus retain our neutral US FI stance with a slight underweight in the portfolio, preferring to be overweight markets where the economic outlook is less rosy.

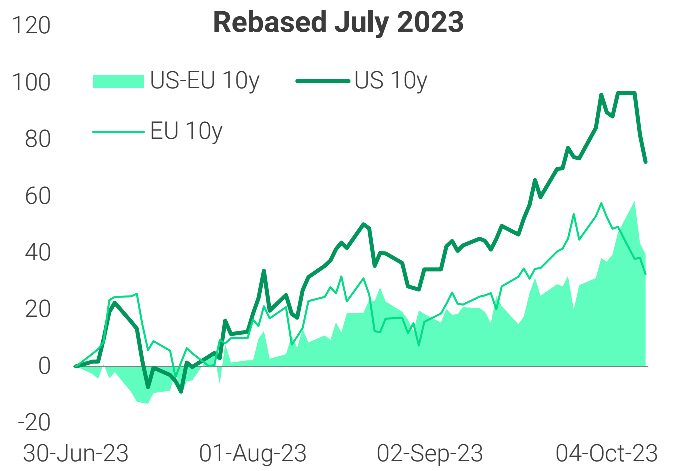
There is more safety in bunds than in USTs

The European economy is under pressure... Our view for Europe has been one of stagnating growth and disinflation, with risks to the downside on both. What stopped us from being +1 on the European core was the high correlation to USTs and the relatively low carry when compared with the periphery (more on the latter below). Indeed, the US 10y has pulled up the EU 10y with around half the magnitude over the past three months. But the stagnatory growth outlook that was showing up in the EU front end is now emerging more strongly.

…and the stagnatory growth outlook is starting to show up in the long end, too. Last week, 10y bunds began to diverge from USTs with the speed of spread widening picking up as investors sought safety in bunds (that is, before the most recent dovish Fed driven rally – see chart on top of next page left). These nascent signs of divergence give us the confidence **to upgrade German and French govvies to +1 from 0**. We gain further confidence from our view that it will be harder to get significant US yield upside from here.

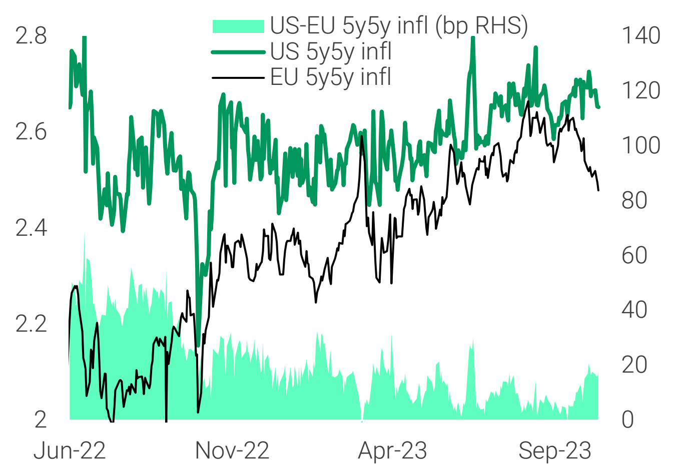
US yields have risen largely because of US-centric drivers; US cuts were being taken out, deficits are countercyclically increasing, there is large uncertainty around the long-term economic outlook, and the US economy has been more resilient to high policy rates than expected, indicating a higher neutral rate (see here and here for more on US FI). So, while USTs are driving global yields and when we are certain on US recession, we want to be in higher yielding pure play of owning USTs; right now, this is where the most upside risk to yields is to be found.

US-EU 10y spread widening



Sources: GlobalData TS Lombard, Bloomberg.

US-EU LT inflation expectations diverging



Sources: GlobalData TS Lombard, Bloomberg.

EU domestic yield drivers point to yield downside. By contrast, ECB cuts are being brought forward; and if we get a bad enough growth scare, they could be brought further forward ahead of the Fed, despite the negative currency implications. Stimulus was never as large in Europe and debt in some countries looks unsustainable; but compared with the low bar of the US, there is, in fact, an effort to rein in deficits. Moreover, the economic outlook is more certain – the economy is clearly stagnating. That stagnation is finally feeding into inflation expectations with European 5y5y inflation swap peaking; they should continue to fall below the equivalent US measure (see chart above right – historically, the EU measure is 60bp lower on average).

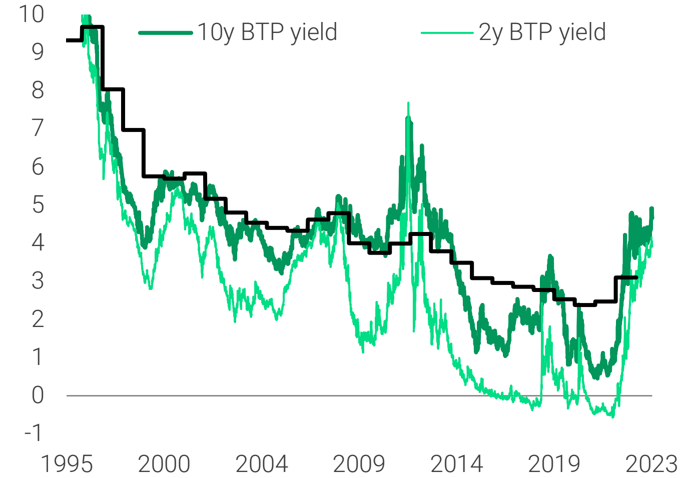
Essentially, it comes down to the European economy not holding up against rate rises (i.e., there is no need to price in a higher neutral rate), as the ECB has tightened more than the Fed. The nature of inflation started very differently in the US from how it began in Europe: it was demand-driven in the US and supply-driven in Europe, but the monetary policy response was the same – and that means monetary policy will likely weigh more on European growth going forward (amid a host of reasons why the EU economy will underperform the US).

Bunds are now a better safe haven. Fundamental drivers make the bullish case for bunds; but amid the US yield uncertainty, bunds have become a better safe haven, rallying as the Israel-Hamas conflict has escalated (USTs did not truly join until we got the dovish Fed commentary).This is also a positive signal for bunds because the greatest risk to markets from the conflict is the involvement of Iran leading to higher oil prices – i.e., an inflationary impulse to which the ECB has pointed as the reason for hiking at its last meeting. However, the market is discounting the inflation implications and focusing on the negative growth implications, which we think is the right thing to do.

Periphery back in the firing line

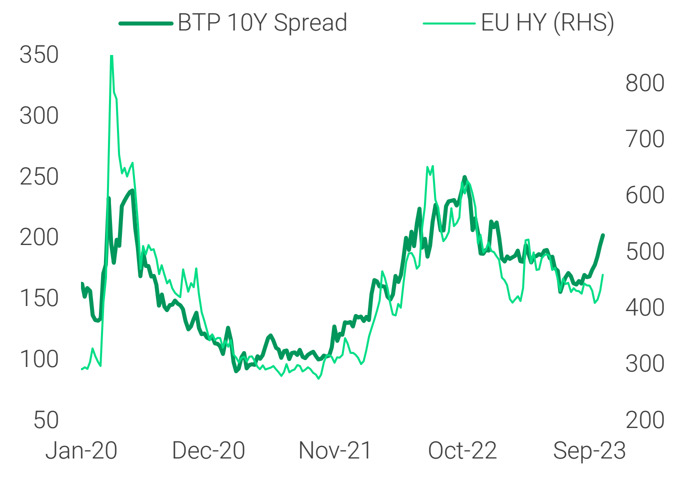
The global backdrop of bear steepening driven by real yields and a strong dollar has added pressure to the home-grown issues of the periphery. The wider EU economic woes discussed above are a part of the problem, but it is the return to fiscal missteps that has really put the periphery back in the market's firing line. As the debate around the new EU fiscal reform heats up and rating agencies review Italy's credit outlook, the BTP-Bund spread will likely continue to test 200bp.

Italy's (r-g) turns positive



Sources: GlobalData TS Lombard, Bloomberg.

Periphery widening => credit widening



Sources: GlobalData TS Lombard, Bloomberg.

Italian fiscal back tracks... The Italian budget deficit has been revised higher through 2026, amidst higher spending and lower growth; the debt-to-GDP ratio does not decline until 2026. But, Davide Oneglia our Chief EU Economists thinks these forecasts are likely still too optimistic.

…putting the cost of debt on an unsustainable path. The rate hikes in Europe means the cost of debt has risen in Italy and will increase further only as more debt is refinanced at higher rates. Italy's implicit cost of debt in 2022 already stood at 3.1%, even assuming a generous 3% nominal growth going forward and (r-g) turning positive, putting more pressure on debt containment via higher primary budget surpluses. Moreover, it exposes Italy to the risk of financial market stress and means the economy has more limited fiscal room to respond to a downturn. For the ECB, it makes the early end of PEPP much harder – potentially a dovish impulse.

We downgrade Italy and Spain government bonds to 0 from +1. We had been collecting carry in the periphery but the deteriorating fiscal backdrop means the yield is no longer worth the risk. We do not go to outright negative, though, as vol is relatively compressed (vs last year), the widening has been orderly, we have a more positive stance on the core and the ECB is at the end of its tightening path.

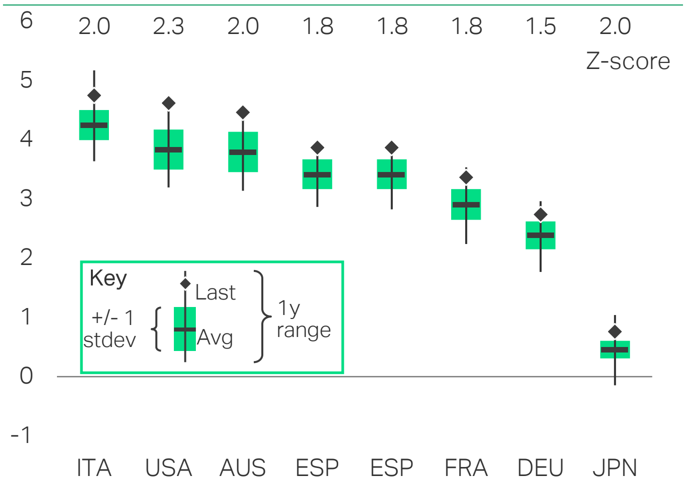
We upgrade India government bonds to 0 from -1. The inclusion of India debt in the J.P Morgan GBI-EM will attract portfolio inflows, reduce borrowing costs and increase the incentives for the RBI to stabilize markets and for the government to pursue fiscal prudence.

We downgrade Brazil government bonds to 0 from +1. Challenging external conditions have raised the bar for deep policy-rate cuts.

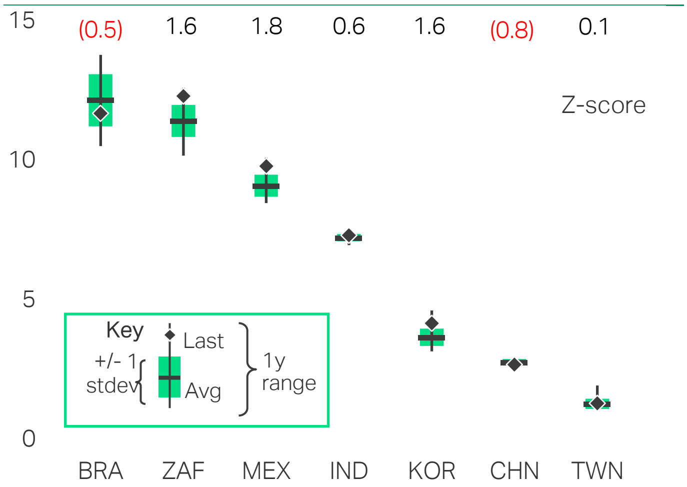
We downgrade Mexico government bonds to -1 from +1. There is a growing trend within the government to fiscal sustainability, while the central bank has a resurgent inflation problem to deal with.

We downgrade South Africa government bonds to -1 from 0. The SARB remains hawkish as the economy faces continued upward pressure on inflation.

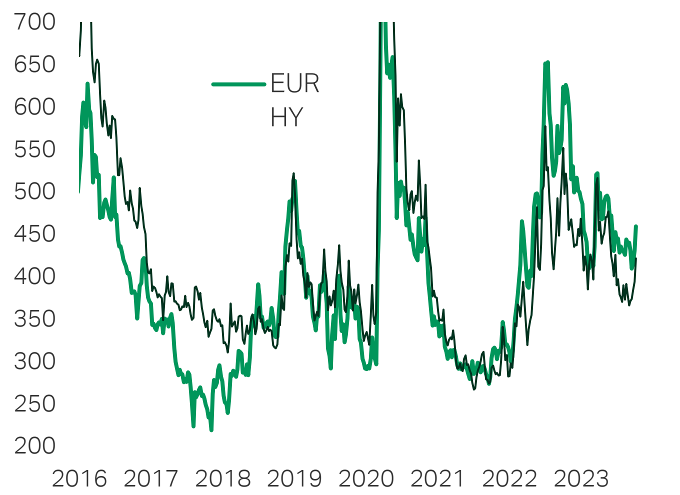
DM yields (%)



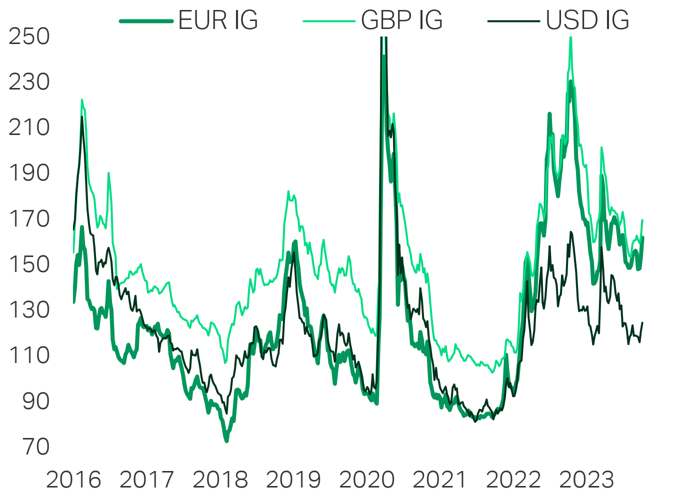
EM bond yields (%)



HY corporate spreads



IG corporate spreads



	Policy	Inflation		2y yield		10y yield		7-10y total return			5y CDS (bp)		Money grth		Budg	Debt	GDP
	rate	Rate	Target	Last	Zscore	Last	Zscore	1m	ytd	2022	Last	StDev	Narrow	Broad	%GDP	%GDP	y-y
US	5.50	3.9	2.0	5.04	2.2	4.61	2.5	-1.7	-3.6	-14.9	51	0.2	22.9	-3.7	-7.6	126	2.4
Canada	5.00	4.0	1.0-3.0	4.80	2.4	3.95	2.5	-0.7	-3.4	-11.6	51	-0.1	-6.3	5.4	-0.5	72	-0.2
Japan	0.10	3.2	2.0	0.05	1.6	0.76	3.7	0.0	-0.6	-3.3	28	0.0	5.6	2.4	-4.3	216	1.6
Australia	4.10	6.0	2.0-3.0	4.03	2.1	4.46	2.3	0.2	0.9	-14.1	15	-1.3	-9.6	4.6	-2.7	69	2.1
UK	5.25	6.7	2.0	4.84	2.7	4.37	2.6	-1.0	-1.8	-17.1	32	1.1	N.A.	-0.8	-2.3	195	0.6
Germany	4.00	4.3	<2.0	3.13	2.7	2.73	2.5	-0.1	0.5	-18.9	24	2.3	-10.4	-1.3	-2.6	64	-0.2
France	4.00	4.3	<2.0	3.45	2.7	3.36	2.6	-0.2	0.5	-18.7	28	0.2	-10.4	-1.3	-4.7	123	1.0
Italy	4.00	4.3	<2.0	4.02	2.7	4.74	2.2	-0.8	3.0	-19.8	115	-0.5	-10.4	-1.3	-8.0	132	0.3
Spain	4.00	4.3	<2.0	3.55	2.7	3.86	2.4	-0.4	0.9	-19.1	54	-0.2	-10.4	-1.3	-4.8	141	2.2
Brazil	12.75	5.2	2.5-6.5	10.70	0.6	11.69	0.8	-2.8	18.3	13.4	182	-0.6	2.8	9.8	-7.3	101	3.4
Mexico	11.25	4.5	2.0-4.0	10.69	1.9	9.81	2.1	-4.1	13.0	5.8	124	0.0	5.6	8.6	-6.2	54	3.6
India	6.50	5.0	4.0	7.24	1.1	7.34	0.8	-1.1	4.8	-8.0	N.A.	N.A.	7.3	10.8	-6.8	47	7.8
Taiwan	1.88	2.9	5.0	0.00	N.A.	1.30	1.4	0.1	-3.2	-13.7	N.A.	N.A.	2.8	6.5	11.6	36	1.4
S Africa	8.25	4.8	3.0-6.0	N.A.	N.A.	12.32	2.8	0.8	2.7	4.7	279	0.9	12.2	8.5	0.2	53	1.6
Korea	3.50	3.7	2.0	3.90	2.2	4.17	2.4	-1.3	-5.5	-15.0	38	0.0	-2.9	2.9	1.7	46	0.9

Zscore is number of standard deviations from the 7.5-year average (numbers <-1, >1 highlighted). All figures % unless stated otherwise.

CURRENCIES

Skylar Montgomery Koning

- US exceptionalism remains the strongest argument for USD strength, especially as it feeds into the Fed's "higher for longer" narrative and US FI underperformance
- Geopolitical tensions and a higher energy price floor are negative for importers; the periphery is now a problem for the EU once again – we downgrade EUR to -1

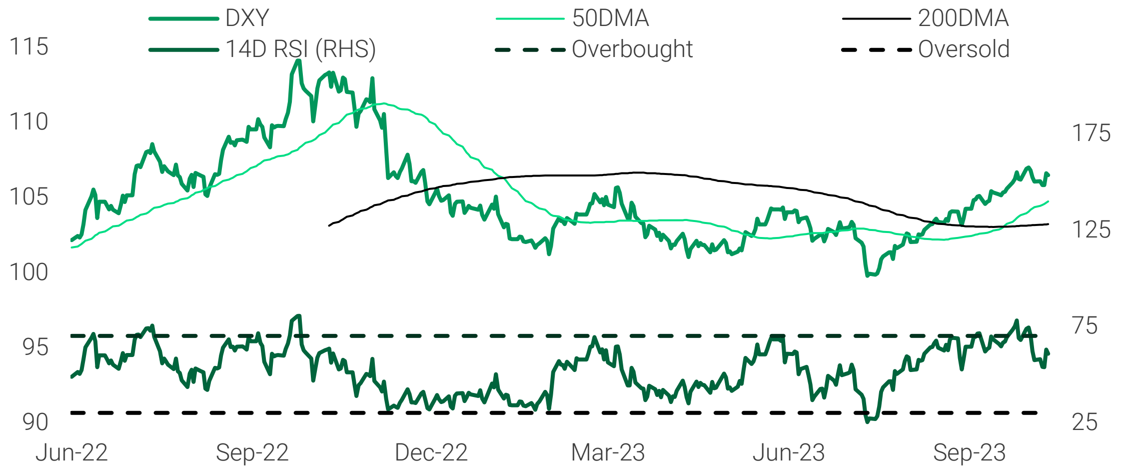
The dollar is not yet defeated…

The dollar has stumbled from overbought levels, with the market taking dovish Fed commentary as an impetus to pull back from stretched levels. However, with a golden cross established in the past month – DXY's 50DMA has crossed over its 200DMA – momentum is still in USD's favour. More important, fundamentals still point to dollar upside in the near term.

US exceptionalism remains the strongest argument for USD strength. Global macro divergence has continued over the past month, with the US cycle in Recovery (above-trend growth and accelerating) and Germany still firmly in Slowdown (below trend and slowing). Soft-landing expectations continue to grow in the US, with both 2023 and 2024 GDP forecasts being upgraded; still firmly positive economic surprises mean data have continued beating the upwardly revised consensus. The opposite is true for Europe.

Rising yields are pushing up the dollar. The driving force behind the market in the past month has been the rapid rise in US yields on the back of the Fed's September FOMC "higher for longer" narrative. And our long-held view has been that with the US economically outperforming, dollar weakness is contingent on Fed cuts. But the expected cuts have now been pushed out even further with the corresponding yield upside driving up the dollar. From here, US yields can stabilize but FX is relative and what is happening on the other side matters.

USD not yet defeated



Sources: GlobalData TS Lombard, Bloomberg.

…as the outlook worsens for the major DXY counterparts

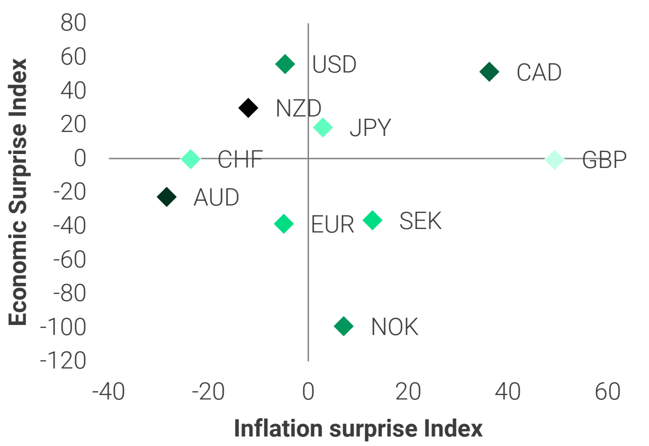
European stagnation => ECB dovishness. Stagnation in Europe has brought forward ECB cuts, with the risk being that the bank will be forced to cut ahead of the Fed, despite the negative currency implications. We expect US yields to continue to underperform DM, but especially Europe (see the Fixed Income section for further details). Rates momentum has signalled EUR/USD downside since the beginning of August and points to more downside ahead.

Geopolitical tensions and a higher energy price floor are a negative for importers. As we saw in 2022, rising energy prices are much more negative for energy importers (EUR, GBP, JPY) than the historical correlation suggests, owing to the corresponding dollar upside, current account deterioration and the threat to growth. Moreover, supply shock-driven commodity upside triggered by political tensions is generally a risk-off environment that also weighs on the high-beta energy importers and supports the dollar. The most recent shock has come from the Israel-Hamas conflict, where the potential involvement of Iran has added a risk premium to the oil price, putting a higher floor under energy prices (we remain +1 energy commodities).

For Europe in particular, recent news of a potentially sabotaged Finnish gas pipeline and the corresponding spike in natural gas prices has brought Europe's energy dependence back into focus. European gas storage levels are high for this time of year and infrastructure has improved versus 2022, but there will be increasing attention on this potential downside risk to the Euro as we head into the winter heating season. With regard to the potential ECB response, higher energy prices motivated the hike in September; but we are now at the point where if the ECB turns more hawkish, the resulting negative implications for growth would likely mean that the net result would still be Euro weakness.

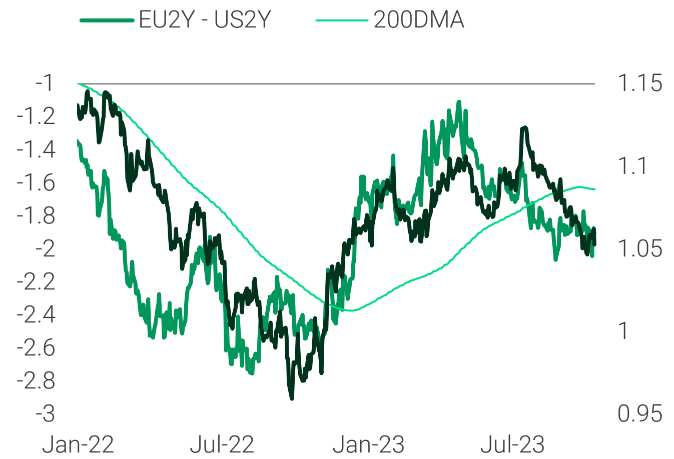
Periphery worries are weighing on the Euro. The new Italian budget puts the cost of debt on an unsustainable path, as a result of which the periphery is back in the firing line against the global backdrop of tightening financial conditions (see the FI section for more details). And as the debate around the new EU fiscal reform heats up and rating agencies review Italy's credit outlook, the BTP-Bund spread will likely continue to test 200bp, putting continued downward pressure on the Euro. Moreover, pressure here could be an impetus for ECB dovishness. **We downgrade EUR to -1 from 0.**

US exceptionalism



Sources: GlobalData TS Lombard, Bloomberg.

Rates momentum => EUR/USD downside



Sources: GlobalData TS Lombard, Bloomberg.

Recommendation changes

We upgrade CNY to 0 from -1. The PBoC has made it clear that defending the 7.3 level is a policy priority – for now. A still large trade surplus and improving growth differentials mean the cost of intervention has been relatively small and will continue to be manageable despite accelerating capital outflows.

We upgrade INR to 0 from -1. The inclusion of Indian debt in the JP Morgan GBI-EM is a vote of confidence that will attract portfolio inflows, reduce borrowing costs and increase the incentives for the RBI to stabilize markets and for the government to pursue fiscal prudence. Moreover, the central bank has ample FX reserves and has been highly effective in its intervention (see our 9 October 2023 EM Watch). We expect the extended pause in policy rates to last longer amid upside pressures to inflation from oil prices and unprecedented food-price shocks.

We downgrade BRL to 0 from +1. A bumpy external backdrop and an easing Banco Central are weighing on the currency. Moreover, accelerating global EM equity outflows increase the pressure on investors with profitable positions in Brazil to cut exposure. However, the longer-term outlook for structural reform remains positive.

We downgrade MXN to 0 from +1. AMLO's focus on prioritizing high-profile projects instead of addressing key infrastructure bottlenecks poses yet another risk to nearshoring FDI inflows. The record fiscal deficit projected in the 2024 budget draft highlights the growing fiscal sustainability challenge that will face the next government from October 2024 while resilient growth in H1/23 will lose momentum in the remainder of the year.

We downgrade ZAR to -1 from 0. Headline and core inflation ticked higher in August, while the still high contribution of oil and food prices, together the depreciation of the rand over the past month, raises the upward pressure on inflation. In EM, South Africa's current account is among the most vulnerable to higher oil prices. The SARB's hawkish rhetoric will provide some defence for the currency, but the weak growth outlook – as evidenced by falling PMIs – leaves little room for manoeuvre.

Periphery weighs on Euro

Sources: GlobalData TS Lombard, Bloomberg.

From steps to ceilings?

Sources: GlobalData TS Lombard, Bloomberg.

Currencies Scoreboard

(Scoreboard primer)

FX RANK		Momentum direction	Momentum accel.	Carry 3m chg	Surprise Index level	Surprise Index 1m chg	Valuation REER level	Valuation 1y chg	Positioning level	Positioning 1m chg	NTM GDP f/c 3m chg	CA 1y chg
1	CHF											
2	JPY											
3	NZD											
4	USD											
5	SEK											
6	CAD											
7	AUD											
8	NOK											
9	GBP											
10	EUR											

As of 12-Oct-23

Currencies dashboard

	FX spot	12m fwd	Spot chg ytd	Spot chg y-y	REER chg ytd	REER chg y-y	REER chg ZScr	Policy Rate	Inflation Rate	Inflation Target	CA %GDP Last	CA %GDP ZScr	ToT Last	ToT ZScr	Money grth Narrow	Money grth Broad	Budg. %GDP	Debt %GDP	GDP y-y
USD	105.70	–	2.10	-6.72	2.5	-2.6	1.8	5.50	3.7	2.0	-3.2	-0.9	-13.2	-0.2	22.9	-3.7	-7.6	126	2.4
EUR	1.063	1.081	-0.75	9.50	2.3	5.9	0.5	4.00	4.3	<2.0	0.4	-1.4	-9.5	-0.4	-10.4	-1.3	-3.6	91	0.5
JPY	149.1	140.7	-12.04	-1.44	-8.7	-3.6	-2.1	0.10	3.2	2.0	2.2	-1.7	-33.6	-0.6	5.6	2.5	-4.3	216	1.6
GBP	1.230	1.232	1.8	10.8	4.8	7.7	1.7	5.25	6.7	2.0	-1.8	1.0	5.8	-0.7	–	-0.8	-2.3	195	0.6
CAD	1.359	1.354	-0.29	1.64	2.4	0.7	0.1	5.00	4.0	1.0-3.0	-1.0	0.8	15.5	1.0	-6.3	5.4	-0.5	72	-0.2
AUD	0.641	0.648	-5.87	2.15	-0.9	1.8	0.0	4.10	6.0	2.0-3.0	1.2	0.6	43.9	0.7	-9.6	4.6	-2.7	69	2.1
CHF	0.900	0.866	2.69	10.85	3.2	3.2	1.1	1.75	1.7	<2.0	9.8	1.4	-9.3	-0.7	-25.8	-2.1	0.4	21	0.5
SEK	10.877	10.716	-4.1	4.25	-2.4	0.8	-1.4	4.00	7.5	2.0	5.0	0.4	-9.5	-1.4	-7.2	-5.0	0.7	44	-1.0
NOK	10.858	10.760	-9.71	-0.77	-6.6	-6.3	-1.2	4.25	3.3	2.5	25.8	1.7	94.3	0.8	-1.5	-0.9	16.2	37	-9.2
SGD	1.362	1.338	-1.68	5.35	3.8	5.9	2.7	N.A.	4.0	–	18.1	0.5	-8.9	-0.8	-5.6	4.1	8.6	153	0.5
CNY	7.298	7.121	-5.47	-1.69	-4.8	-7.5	-1.6	4.35	0.1	3.5	2.2	0.9	-26.6	-0.8	9.5	10.6	-4.7	47	6.3
BRL	5.050	5.259	4.55	4.99	8.0	3.0	-0.2	12.75	5.2	2.5-6.5	-2.7	-0.4	11.8	1.1	1.1	9.8	-7.3	101	3.4
INR	83.19	84.76	-0.55	-1.06	8.7	2.3	2.3	6.50	-0.5	2.0-6.0	-1.7	-0.6	-44.8	-0.6	7.3	10.8	-6.8	47	4.7
ZAR	18.82	19.41	-9.46	-2.78	-5.8	-4.9	-1.0	8.25	4.8	3.0-6.0	-1.4	-0.2	18.0	-0.1	12.2	8.5	0.2	53	1.6
MXN	17.78	18.92	9.7	12.4	12.3	11.9	2.7	11.25	4.5	3.5	-1.2	-0.4	11.9	0.5	5.6	8.6	-6.2	54	3.6
KRW	1339	1310	-5.45	6.44	-1.0	7.5	-1.0	3.50	3.7	2.0	0.5	-2.2	-35.4	-0.7	-2.9	2.9	1.7	46	0.9
TWD	32.12	31.12	-4.38	-0.85	0.7	-1.5	-0.1	1.88	2.9	–	11.9	-0.8	-18.5	-0.8	2.8	6.5	11.6	36	1.4
HKD	7.822	7.772	-0.26	0.36	3.7	-0.6	1.2	5.75	1.8	–	9.2	0.8	0.0	0.0	-18.8	1.4	N.A.	N.A.	N.A.
PHP	56.67	56.88	-1.67	4.04	3.9	5.1	1.3	6.25	6.1	3.0-5.0	-3.3	-1.0	-16.9	-0.5	17.7	23.7	-2.0	40	4.3
PLN	4.266	4.283	2.56	17.08	7.5	15.2	1.8	5.75	8.2	1.5-3.5	0.7	0.6	-6.6	-0.3	4.4	7.3	-3.7	51	-0.6
CZK	23.10	23.01	-2.31	9.57	4.9	7.8	2.0	7.00	6.9	1.0-3.0	-4.2	-1.4	-9.1	-0.3	12.3	9.4	-3.6	35	-0.6
HUF	363.5	375.7	2.72	22.43	7.8	22.1	1.3	13.00	12.2	3.0	-5.1	-1.1	-6.1	-0.3	101.7	-3.3	-6.2	96	-2.4
TRY	27.751	39.585	-32.6	-33.1	4.2	2.8	-0.9	30.00	61.5	5.0	-5.7	-1.2	-22.4	-0.5	N.A.	N.A.	1.5	42	3.1
IDR	15690	15803	-0.78	-2.12	3.4	-3.5	0.3	5.75	2.3	3.5-5.5	0.7	1.3	-0.8	0.3	5.8	5.9	-1.8	43	5.2
THB	36.23	35.11	-4.49	5.11	-2.2	1.8	-0.9	2.50	0.3	0.5-3.0	-1.4	-1.2	-23.2	-0.4	6.8	1.4	0.3	50	1.8
MYR	4.717	4.606	-6.63	-0.69	-3.7	-3.1	-1.8	3.00	2.0	–	3.3	0.4	-5.5	0.0	-0.1	2.9	-4.4	62	2.9
CLP	928.5	944.2	-8.33	-0.02	-4.8	0.7	-0.5	9.50	5.1	2.0-4.0	-4.0	0.3	35.0	0.7	-10.9	4.5	-0.3	24	-1.1
COP	4230	4571	14.73	8.93	22.1	14.1	0.1	13.25	11.0	2.0-4.0	-5.1	-0.5	64.3	1.1	N.A.	N.A.	-5.4	90	0.3

ZScr is the number of standard deviations from the 7.5-year avg (numbers below/above -1/1 highlighted). All figures % unless stated otherwise.

REAL ESTATE

Andrew Lawrence

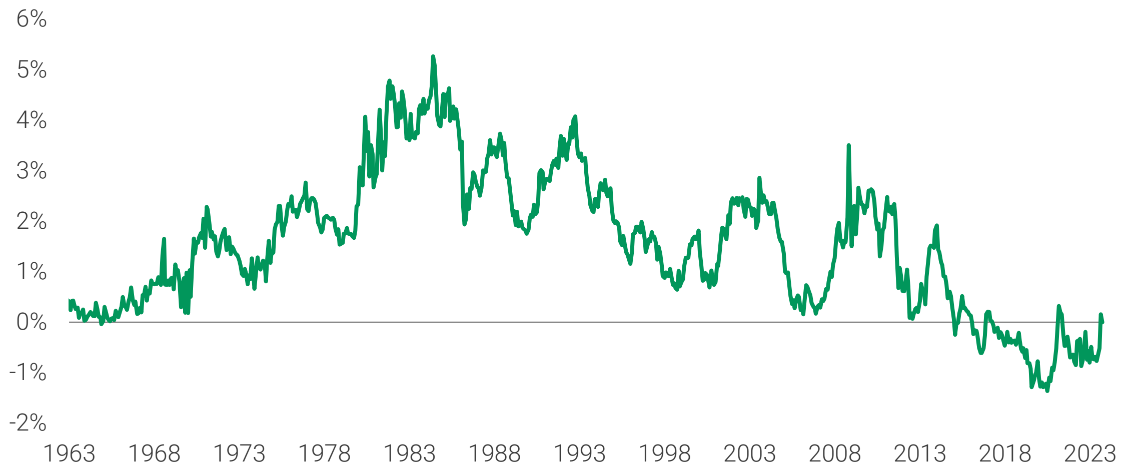
- Real estate returns have benefitted from high liquidity and low macro volatility
- Hence, rising long-term bond yields have negative implications for real estate pricing
- For now, this is a duration crisis, but it could turn into a credit crisis for some real-estate investors

Rising Long-Term Bond Yields

Long-term bond yields have been rising. At the start of the week, the 10-year treasury yield had risen to 4.8% – an increase of 54bps in the past month. This rise in long-term yields has come from increases in real rates, as opposed to changes in inflation expectations. The term premium, a key component of yields that we discussed in our Asset Allocation of May 2023, is once again positive.

The term premium is the extra compensation investors should demand for holding long-duration paper rather than rolling over a series of shorter-dated securities. The higher the term premium, the higher the return investors demand to take on duration risk. The recent sharp rise in term premium points to a fundamentally more cautious long-term outlook among investors – and a potential shift in asset allocations.

The ACM 10-year treasury term premium



Source: Bloomberg

Assets can be graduated by their degree of duration. Cash is the zero-duration asset, while equities and real estate are typically long-duration assets; bonds are somewhere in between. Hence, any downward shift in duration demand could have significant implications for real estate pricing, as prolonged high long-term rates could force another cut in property valuations just as significant amounts of loans are set to mature.

Duration crisis

The price of duration risk tends to be positively correlated to liquidity and negatively correlated to volatility. Hence, much of the recent rise in the term premia can be attributed to a mismatch between the supply and demand for long-term debt. The "higher for longer" narrative for Fed rates, the reduced purchasing by price-insensitive buyers – including the Fed, US commercial banks and foreign central banks – and the increased Treasury supply have all coincided with the downgrade of US debt by Fitch, projections that US public debt/GDP will exceed 200% within the next 25 years and a strengthening US dollar.

For the moment, it would appear that financial liquidity is simply not keeping pace with rising debt demand: financial markets are, after all, refinancing systems not new financing systems. The Fed could stem the rise in long-term bond yields by injecting liquidity into financial markets; but the fact that they have not suggests that monetary policy is now being run through long bonds rather than overnight rates. This makes sense, given that the tenor of most US loans is more than five years; however, it does imply that the Fed is comfortable to let the 10-year yield rise further.

Yet, it is also reasonable to think that investors are shifting to the idea of secularly higher long-term bond yields longer-term secular higher bond yields and a more volatile inflationary environment. Part of this duration repricing could be attributed to recognition among investors that the demand for loanable funds will be much greater in the future: fiscal deficits are growing; governments want a more active role in the economy; there will be more borrowing to adapt societies to adverse climate change; spending on technology and national defence will be higher; and there will be recognition that much of the existing capital is stranded.

Hence, the era of falling inflation and stable macroeconomics is over, and the shocks hitting the economy – deglobalization, climate change, geopolitics – are likely to be inflationary and that inflation will be volatile. Central banks will no longer be cutting rates in response to deflationary procyclical demand shocks but will raise rates in response to inflationary countercyclical supply shocks. The resulting bond-market volatility will increase the size of "haircuts" on the collateral pool that backs loans, increasing the burden of refinancing the already high levels of debt.

Furthermore, inflation volatility also matters because when inflation rises and growth deteriorates, the return on bonds becomes positively correlated with the return on risk assets: when people lose money on stocks, they also lose money in fixed income. It is therefore natural for investors to demand more return for taking on duration risk when long-term rates no longer act as a guaranteed hedge against economic shocks and when rising bond yields could, in fact, amplify the price pain for long-duration assets.

Why did it take so long?

It is fair to ask why such a shift in duration risk took so long to be repriced, given that the post-pandemic global economy is entirely different from the pre-pandemic one. As we have argued, the decades-long psychological conditioning of ever-lower inflation, bond yields and policy interest rates means that it has taken a while for investors to wake up to the potential for a macro-economic regime shift. In a reverse of the 1980s, investors have simply been conditioned to hold long bonds as part of a "balanced" portfolio.

An enormous number of institutions and investors have built their business models on the continuation of a high-liquidity and low-volatility macro environment – the 60/40 portfolio being the classic example. Yet, given that so many entities still need to hedge their exposure, it is reasonable to think that the bond bear market has further to run. TS Lombard strategists estimate that under a bear scenario, nominal US 10yr yields could reach 6.5%.

But the path to structurally higher long-term rates is unlikely to be one-way. Recession risks have increased because higher rates during uncertain times inevitably mean an excess supply of goods, labour and assets. And while this is a duration crisis, the credit cycle is starting to sour. Hence, higher rates could themselves cause a rate reversal if they trigger the collapse of asset prices and soaring unemployment. TS Lombard strategists estimate that a Fed reversal could cause 10yr yields to drop to around 3.5%.

Implications

Shifts in desired duration are typically transmitted through the implicit risk and term premia that are notionally embedded in asset prices. In the 2010s, low and falling interest rates prompted a flow of capital into real estate, which drove up valuations, enabling investors to take advantage of "cap-rate compression" to drive returns. If we are at the start of secularly higher bond yields, then investors should expect a period of "cap rate expansion" and cap rates settling at higher average levels than we have seen for the past 10 years.

In a world of countercyclical inflationary supply shocks, property will at best offer a partial time-varying hedge to inflation with real estate prices becoming more volatile over the course of the cycle. Higher and more volatile inflation will not necessarily be met by rental increases; property performs poorly in periods of economic contraction when credit becomes too tight.

If we are at the point of a macro regime shift, then investors will no longer be able to acquire assets in the comfortable expectation that they will sell for a higher price in five to seven years' time. In the near term, we are likely to see more losses across private-equity real estate funds whose business models were built on the expectation of abundant liquidity and low volatility. Refinancing loans on properties hit by structural economic changes – such as secondary offices – will likely prove more difficult.

As we emerge from artificially low to more historically average interest rates, investors will have to rethink their investment strategies. Discerning asset selection that reflects longer-term thematic trends, the ability to enhance returns and ensure the sustainability of individual assets and the skill of managing flexible relationships are likely to become key differentiators.

Chart 1: FTSE EPRA Nareit – Global TR

Source: Bloomberg

Chart 2: FTSE EPRA Nareit – Europe TR

Source: Bloomberg

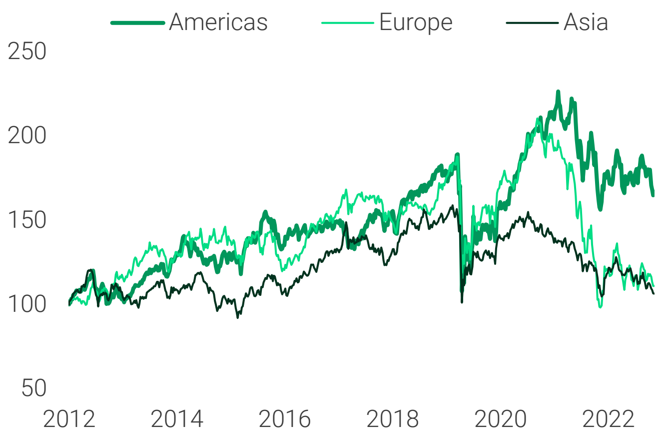
Chart 3: FTSE EPRA Nareit – Asia Pacific TR

Source: Bloomberg

Chart 4: FTSE EPRA Nareit – Americas TR

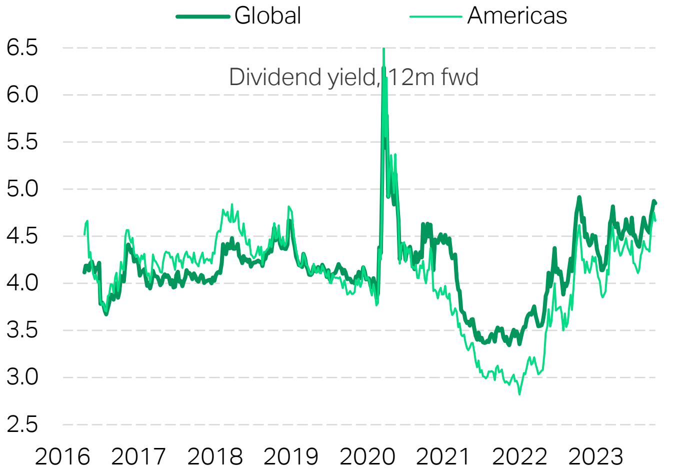
Source: Bloomberg

Chart 5: FTSE EPRA Nareit – Rebased TR



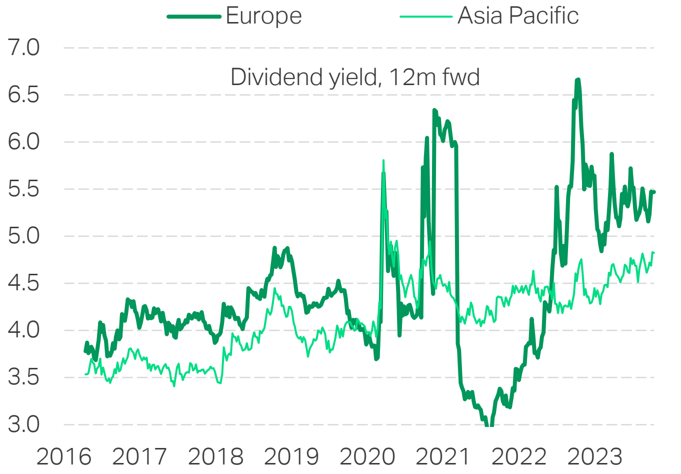
Source: Bloomberg

Dividend yield: Global and Americas



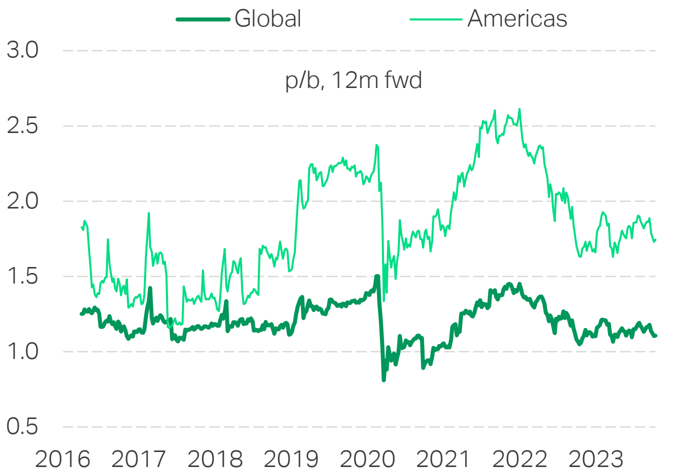
Sources: FTSE EPRA/NAREIT, Bloomberg

Dividend yield: Europe and Asia Pacific



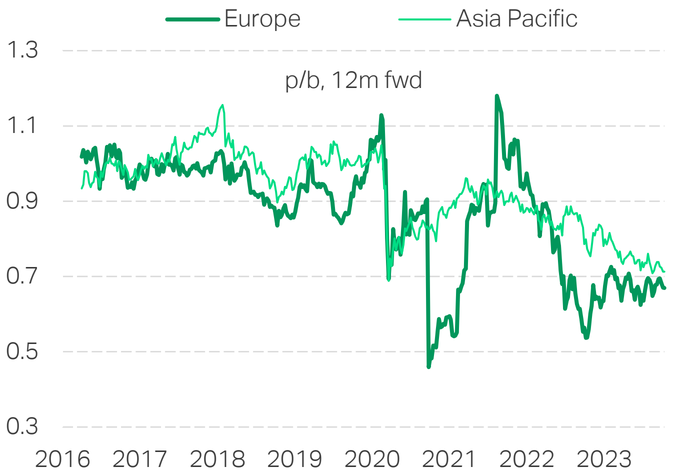
Sources: FTSE EPRA/NAREIT, Bloomberg

Price-to-book: Global and Americas



Sources: FTSE EPRA/NAREIT, Bloomberg

Price-to-book: Europe and Asia Pacific



Sources: FTSE EPRA/NAREIT, Bloomberg

Real Estate Dashboard

		MktCap	Total return (US$)			P/E (x)			P/B (x)			RoE			EPS growth		Dividend yield		
	Memb.	(US$)	1m	ytd	2022	Trail.	Fwd	ZScr	Trail.	Fwd	ZScr	Trail.	Fwd	ZScr	Fwd	3m	Trail.	Fwd	ZScr
Global	497	1,951	-4.7	-4.4	-23.6	26.8	21.2	-0.1	1.1	1.1	-0.2	1.8	3.3	-1.2	-35.2	-8.9	4.5	4.8	1.7
America	150	990	-6.0	-1.9	-24.4	34.3	30.8	-1.0	1.7	1.7	-0.1	5.9	5.6	0.7	-54.6	-3.2	4.5	4.6	0.9
Europe	115	245	-3.1	-4.2	-40.2	19.2	13.8	-1.7	0.6	0.7	-1.0	-8.9	-4.4	-2.0	N.A.	-8.1	4.4	5.2	1.7
Asia Pacific	197	652	-2.4	-10.1	-12.4	21.1	14.6	1.1	0.7	0.7	-2.0	2.7	4.7	-2.4	5.1	-22.4	4.6	4.7	1.6

ZScr is the number of standard deviations from the 7.5-year avg (numbers below -1 and above 1 highlighted). All figures % unless stated otherwise
P/e, p/b, RoE and DY StDev from 7.5y average are on 12m forward measures. EPS growth is forward / trailing. EPS 3m growth is on fwd earnings.

MACRO OUTLOOK

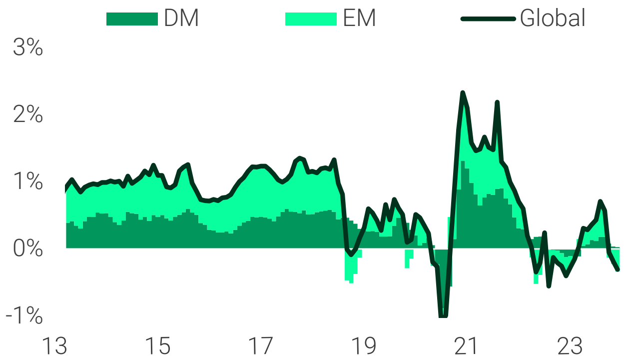
Global Team

- The perfect storm that has propelled long yields to new highs in 2023 H2 is still raging, fuelled by "high(er) for longer" Fed signalling that leaves the burden of proof with the bond bulls.
- Bear-steepening curves alongside rising term premia tell the story of a market that is rushing to price in a transition to a higher interest rate environment.
- The longer simultaneous strength in bond yields, USD and oil persists, the greater the chances that "something breaks", precipitating a deeper economic slowdown that ultimately calls time on the bond bear.

Read more in the latest Global Macro Monthly

Global macro at-a-glance

TSL Global leading indicator



TSL Global growth forecasts

	2023	2024
US	1.3	1.0
China	5.3	4.9
EA	0.6	0.8

Bold indicates changes from last month

US in the driver's seat

- The US recession is not here yet, but it is coming sooner than later. The revival in employment and some of the production indexes implies that the neutral real rate is above 50bps and hence the current level of the nominal funds rate is too low.
- Europe's economies are stagnating. The disinflationary trend in the euro area has much more to run. A year of two halves is unfolding in the UK as the positive economic surprises of 2023 H1 reverse in 2023.
- For China, we continue to expect weak stabilization in mid- to late 2023 Q4 and an "L-shaped" recovery from there onwards. For now, stimulus is more pistol than bazooka.

Major risks

- Sustained simultaneous strength in bond yields, USD and oil persists, raising the chances that "something breaks" and precipitates a deeper economic slowdown.
- Central banks continue to be whipsawed into aggressive monetary tightening, amplifying the volatility of this fake cycle and raising the risk of a global recession.
- For equity investors, the most dangerous point lies in the period where true recessionary dynamics take hold, but policymakers have not yet switched their focus away from inflation.
- Financial market dislocation and/or sharp deterioration of labour market conditions trigger an abrupt policy U-turn.

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