



## Market Compass

October 2023

### MARKET OUTLOOK

- The US economy has been exceptionally resilient to the 525bp Fed tightening but is now showing signs of fatigue. Surging oil prices may keep inflation high for longer.
- Market pricing seems disconnected from the significant economic and financial stability challenges associated with the delayed effects of massive rate hikes and ongoing Quantitative Tightening (QT). Risk asset volatility is too low, and earnings consensus too high.
- The key risk to our views lies in another supply shock causing higher energy prices and elevated bond yields for longer.
- Our tactical asset allocation recommendation continues to show a preference for the safer segments of Fixed Income over Equity and High Yield.

Edited by  
**MACRO & MARKET RESEARCH TEAM**

A team of 13 analysts based in Paris, Cologne, Milan and Prague runs qualitative and quantitative analysis on macroeconomic and financial issues.

The team translates macro and quant views into investment ideas that feed into the investment process.

#### US

- + Q3 showing still strong growth
- Services keep inflation high
- + Labour demand and supply are rebalancing, unemployment still at record low
- The Fed is strongly motivated to keep rates high for longer

#### UK

- + BoE held Bank Rate constant at 5.25%
- + Wage growth still strong but other labour market indicators cooling
- + CPI inflation eased to 6.7% yoy, but larger decrease in service inflation

#### EUROZONE

- Economic indicators still weak but hinting at stabilisation at low level
- + Inflation receded to a 2-year low in September
- + Labour market remains strong
- ECB to stick to keep rates high for longer

#### CHINA

- + China's data saw first green shoots
- + Policymakers stepped up their efforts to support the real estate sector
- + Another cut into the policy rate, more help likely

#### EMERGING MARKETS (EM)

- + Positive EM ex-China outlook with activity resiliency
- + EM disinflation accelerates, rotating from goods to services
- + EM central banks start cutting, more to come
- ! Deeper involvement of Iran (tougher sanctions, direct military confrontation) can block oil supplies and drive up prices

- + Positive
- Negative
- ! Topics to watch

## DIRECTION OF TRAVEL

- We stick to our underweight (UW) equity, but slightly reduce it following the late summer correction.
- We continue to prefer Investment Grade (IG) credit, relative to both peripheral spreads and High Yield (HY) - still UW.
- We have positive return expectations for US and EA Govies with a clear preference for the longer-dated maturity buckets.
- Expecting only a moderate spread widening, we will keep our overweight (OW) to EM sovereigns.
- We switch cash to almost Neutral.

### Equity

- Slight underweight short term: macro slowdown and stretched valuation vs bonds
- Keep a constructive view over 12 months: Cheap ex-US valuations, bottoming US margins
- Overweight Japan, Switzerland, China, India and slightly US vs EMU

### Bonds

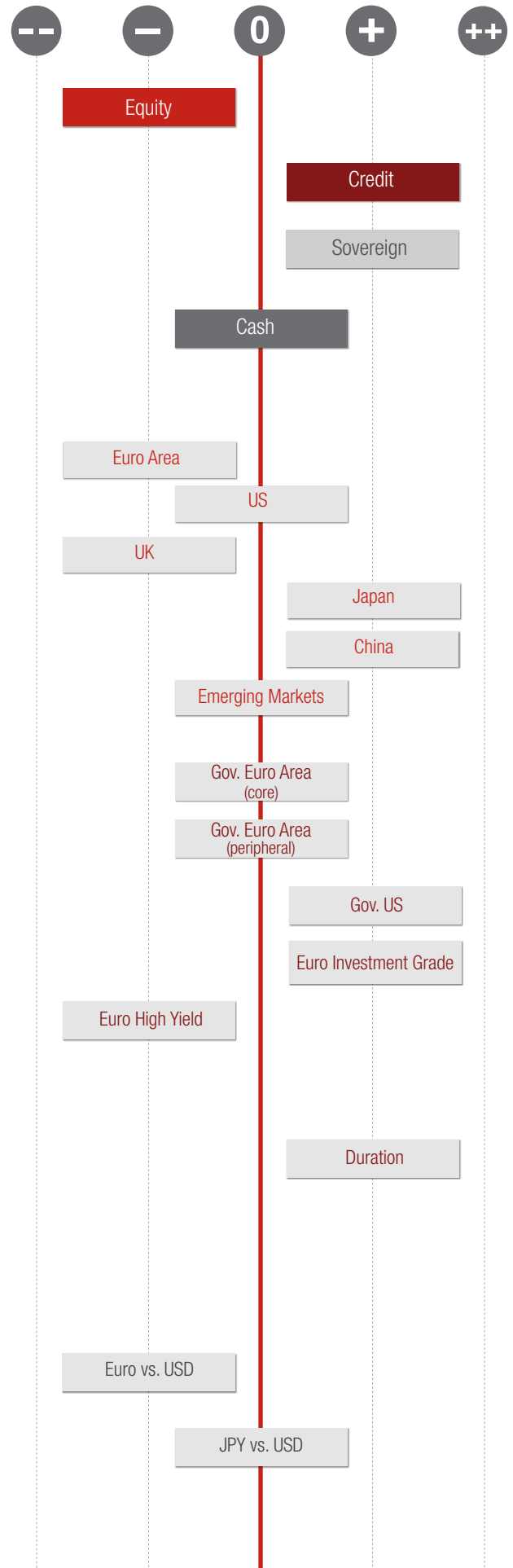
- With key rate cycles coming to an end, yields are likely to decline going forward. US real yield level and EA inflation expectations look unsustainable
- Spread widening on EA non-core government bonds is seen to continue amid high fiscal deficits, weak growth, and ECB's ongoing QT

### Duration

- Long duration recommended

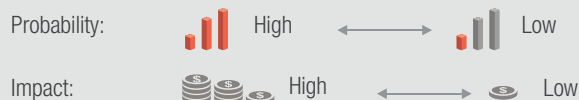
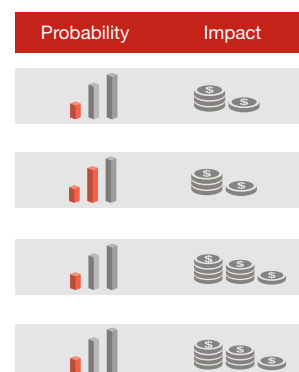
### Currencies

- USD remains supported by near-term resilience in the US, weaker global growth, higher risk aversion and a still favourable yield gap of the US vs. the rest of major economies
- EUR is exposed to faltering growth and a rising peripheral risk premium, keeping the EUR/USD tilted to the downside short-term
- JPY to recover from deeply undervalued levels only gradually, helped by a decline in US yields and mounting prospects of a first rate hike by the BoJ in 2024



## TOPICS TO WATCH

- Extreme weather events having a disproportionate impact on the growth-inflation mix
- Two-sided inflation risks (Goldilocks vs. bouncing energy prices, extended policy tightening leading to boom & bust)
- Cracks in financial stability as tighter conditions feed through (banking, housing, CRE defaults, non-bank liquidity...)
- Oil supply and value chain disruptions originating from escalating political tensions (Israel/ Iran, Ukraine, Taiwan)



## GLOSSARY

### INFLATION TRENDS: GOODS VS SERVICES

In most developed economies inflation has a similar dynamics. The price of goods, which are mostly traded internationally, is decelerating fast as the supply chain disruption originated first by the pandemics and then by the war in Ukraine is unwinding. Inflation for services (restaurants, retail trade, etc.), however, is stickier, as consumer purchases remain strong allowing high margins. Monetary policy has a limited impact on inflation on globally traded goods and is focussed on services, as it can control effectively domestic demand.



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