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Asset Management

BAROMETER OF FINANCIAL MARKETS APRIL OUTLOOK
April 2024

Marketing Material

# Barometer: A spring in the market's step

Equities should extend their rally as interest rate cuts appear imminent in the US and other developed economies.

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## 01 Asset allocation: sticking with equities

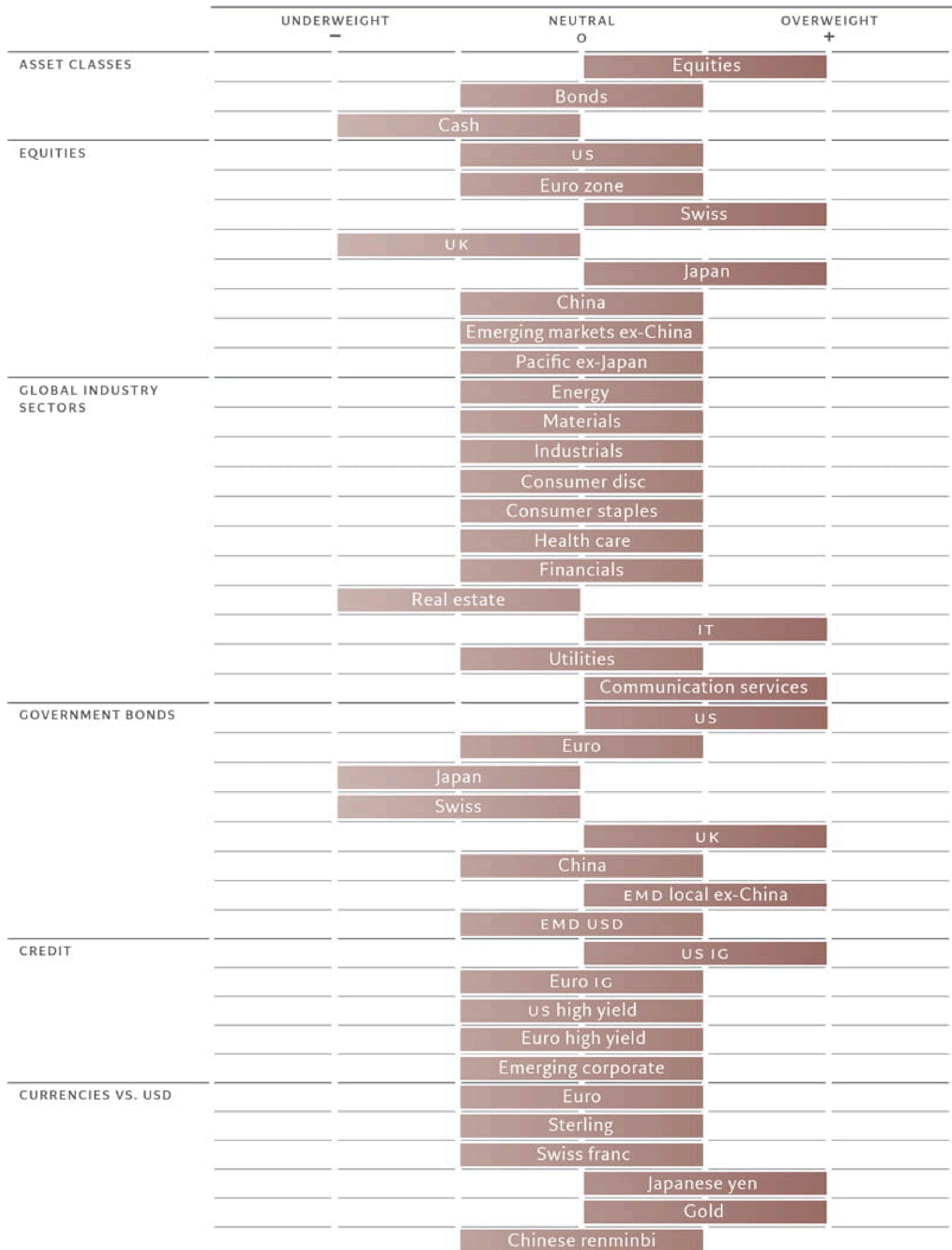
While global economic and liquidity conditions are far from rosy, we see pockets of improvement that are supportive for risky assets.

The US economy remains resilient, while China is showing signs of a recovery. Also, most major central banks are likely to begin cutting interest rates in a matter of months and banks are willing to lend more. Partly in response, we have increased our forecast for global corporate earnings this year to 8.1 per cent from the previous 7.2 per cent – largely in line with the consensus estimate.

We recognise that equities are getting expensive, especially in markets like the US and Japan. Yet we don't believe they are forming a bubble.

Considering all this, the balance of risks points towards a continuation of the equity market rally. We therefore remain overweight equities, neutral bonds and underweight cash.

Fig 1. Monthly asset allocation grid
April 2024




Source: Pictet Asset Management

Our **business cycle** analysis shows that, in the US, domestic demand, supported by tight labour market conditions, remains the engine of growth.

Although economic conditions are healthy, we still expect the US Federal Reserve to begin cutting interest rates as early as June for a total of 2-3 times,

even if sticky inflation means the scale of easing is uncertain. We expect Fed funds rate to end the year at 4.50-4.75 per cent.

Other major economies are in a less healthy state.

Japan is flirting with recession with industrial production, retail sales and housing starts all softening. However, domestic demand is resilient and jobs markets remain tight, which support what the Bank of Japan considers as a virtuous cycle of rising income and higher spending.

In a well telegraphed but historic move, the BOJ ended eight years of negative interest rates and other unorthodox policy and raised interest rates for the first time in 17 years. We expect the central bank to lift the benchmark rate by 20-25 basis points this year, but above-target inflation opens the door to further tightening.

That said, interest rate hikes are unlikely to dent the attractiveness of Japanese assets this year as monetary policy still remains accommodative and domestic investors are awash with unattractive cash which stand ready to be deployed.

Growth in the euro zone, while currently weak, is likely to move gradually above potential in the second half of this year as inflationary pressures ease. This should allow the European Central Bank to cut interest rates in the coming months.

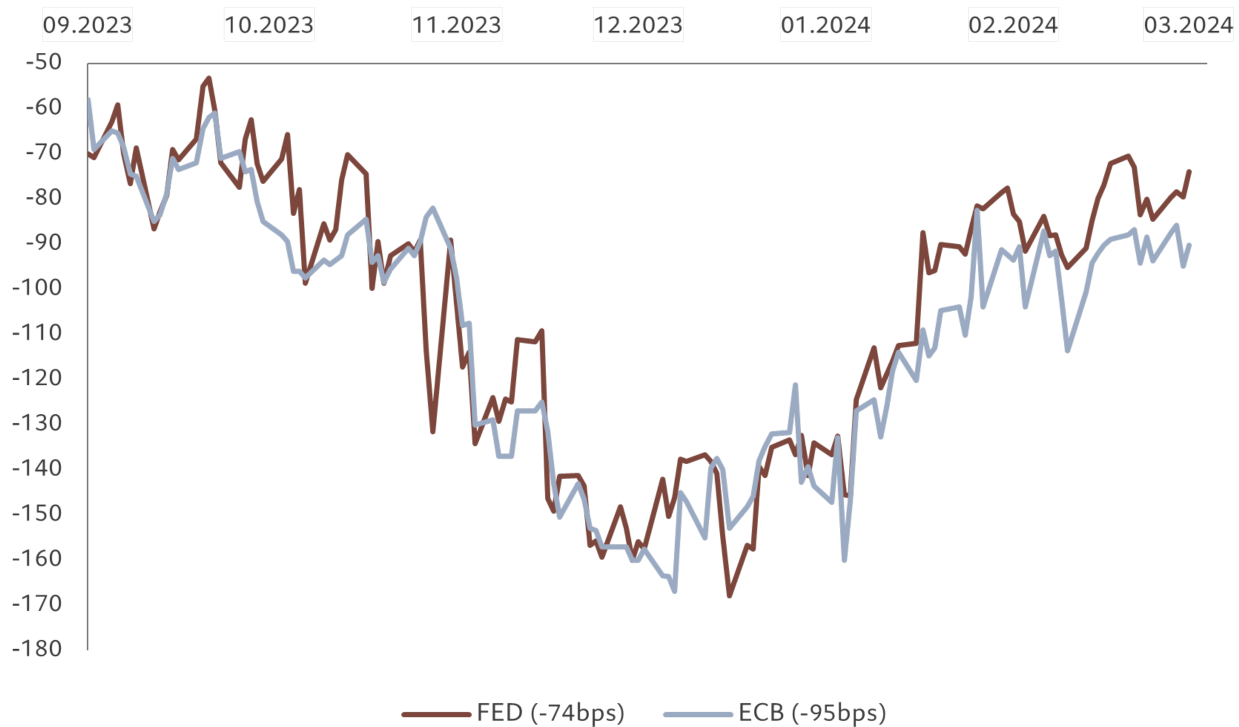
China's economy is showing early signs of bottoming out. Data released so far this year is consistent with a first-quarter GDP reading of around 7 per cent points – a strong start towards our full-year growth forecast of 4.9 per cent. A composite purchasing managers' survey shows manufacturing and services activity is growing again.

That said, we feel it is too early to be positive about China's economic prospects after many false starts in the past. What is more, China's central bank is unlikely to accelerate the pace and scale of monetary policy easing given its focus on deleveraging and maintaining currency stability.

Outside China, emerging economies are growing strongly. We expect the growth gap between developing and industrialised markets to widen further to a two-year high of nearly 3 percentage points on a 12-month moving average basis, which is above the long-term average of 2.1 per cent and points to stronger local currencies in the medium term.

Fig. 2 Getting easier

Market implied rates for the Fed and ECB by December 2024




Source: Bloomberg, data covering period 28.09.2023 – 28.03.2024

Our analysis of **liquidity** conditions doesn't give a particularly bullish or bearish signal for riskier asset classes, although the reading is likely to improve for equities and riskier bonds in the near term as developed central banks join emerging counterparts in easing monetary policy.

Another potential boost to liquidity could come via US and euro zone commercial banks, which are increasingly willing and able to lend, which bodes well for liquidity generated from the private sector.

Our **valuations** readings show equities are becoming less attractive relative to bonds. The equity risk premium – which measures an excess return investors receive in equities over a risk-free rate – has fallen to 3.5 per cent, compared with a historical average of 4-4.5 per cent. However, global corporate earnings are expected to remain strong, with a consensus forecast projecting "no landing" – or no earnings recession in the next three years.

What is more, we don't think equities have reached what might generally be considered to be bubble territory yet. Our model shows the bubble territory of the S&P 500 index begins at around 6,200 – some 15 per cent above the current level -- with 12-month price earnings of 25 times.

US Treasuries are fairly valued; the benchmark 10-year yield of some 4.3 per cent is more or less in line with what our fair value pricing model shows.

**Technical indicators** support our overall asset allocation stance. Equities attracted a strong USD52 billion of inflows in the past four weeks, with US equity products being among the most favoured. This trend looks likely to

hold firm. Money market funds, in contrast, just registered the largest weekly outflows in five months.

## 02 Equities regions and sectors: a broadening market

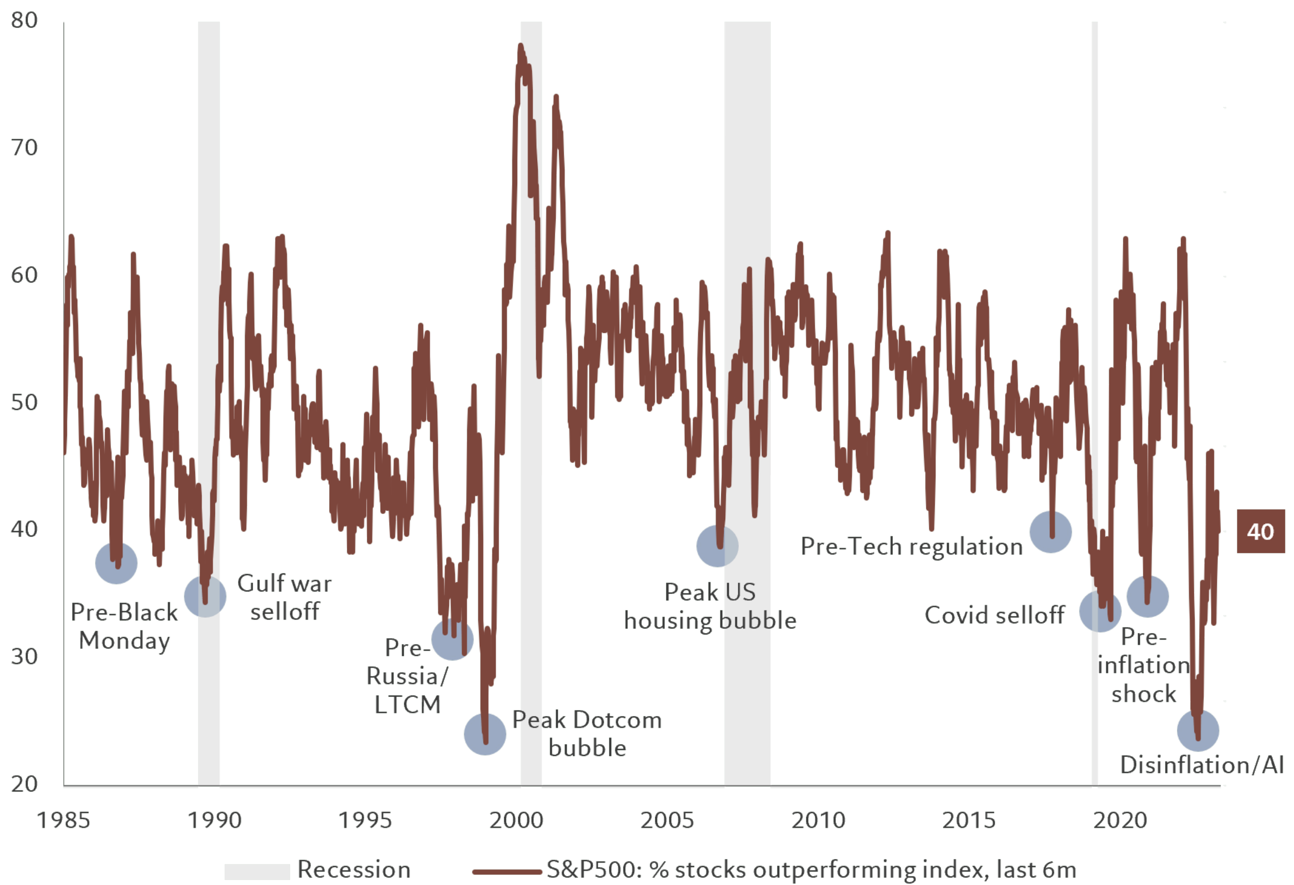
We retain our regional and sectoral positioning in equities alongside the overall overweight in the asset class. Although we note the potential for a market pull-back after a strong start to the year and a stellar 2023, our concerns are, for now, offset by the fact that the rally has broadened to encompass most sectors.

The big rally in equities has seen investors either chase momentum, continually buying stocks with the strongest gains, or focusing on quality, purchasing the shares of companies with the most reliable earnings . Our technical indicators show that the two strategies, which have a lot of overlap, have become crowded trades which makes these stocks vulnerable to a reversal: sudden shifts in sentiment can see investors stampede out of market segments even faster than they pile into them.

Nonetheless, gains are no longer just concentrated in the Magnificent 7 – the US tech behemoths that drove market performance during 2023. In fact, a few of those stocks have started to backpedal. Instead, gains have broadened into cyclical sectors like energy, materials and financials, which were leading performers during March. The narrowness of the market's gains last year was a function of Big Tech exceptionalism in a low growth, higher-for-longer rates environment. But now investors increasingly expecting growth to remain robust, while also anticipating the start to an easing cycle. That offers the market broader support (see Fig. 3).

Fig. 3 - A breath of bredth

Share of S&P 500 stocks that have outperformed the market, last 6m




Source: Refinitiv, Pictet Asset Management. Data covering period 01.01.1986-27.03.2024

This broadening applies even within market segments. For instance, in AI, investors are no longer just focusing their demand on specialist semiconductor manufacturers but moving to other parts of the value chain, like super-sized cloud service providers able to handle AI related-computing demands.

Tech might yet become vulnerable to a correction, but we don't think just yet. And while the earnings momentum gap is closing between Big Tech and the rest of the US market, strong earnings prospects for Tech and Communication Services sectors are keeping them at the front of the market.

Strong earnings dynamics keep us overweight Japanese equities, reinforced by reforms in corporate governance, the fact that investors are underweight the market and reasonable valuations. Our preference for quality stocks means we also retain an overweight on Swiss equities. Finally, we remain overweight Communication Services given the sector's reasonable valuation and exposure to structural themes like AI.

## 03 Fixed income and currencies: the cuts are coming

Dovish central bank guidance has reaffirmed expectations of imminent interest rate cuts. In such an environment, we are inclined to lock in the

highest yields that our risk tolerance allows while they are still on offer.

The US market is home to some of the most attractive opportunities – be they Treasuries or investment grade credit. The benchmark 10-year Treasury yield stands at 20 basis points above our year-end fair value estimate of 4.0 per cent, which points to a total return of around 5 per cent over the rest of 2024.

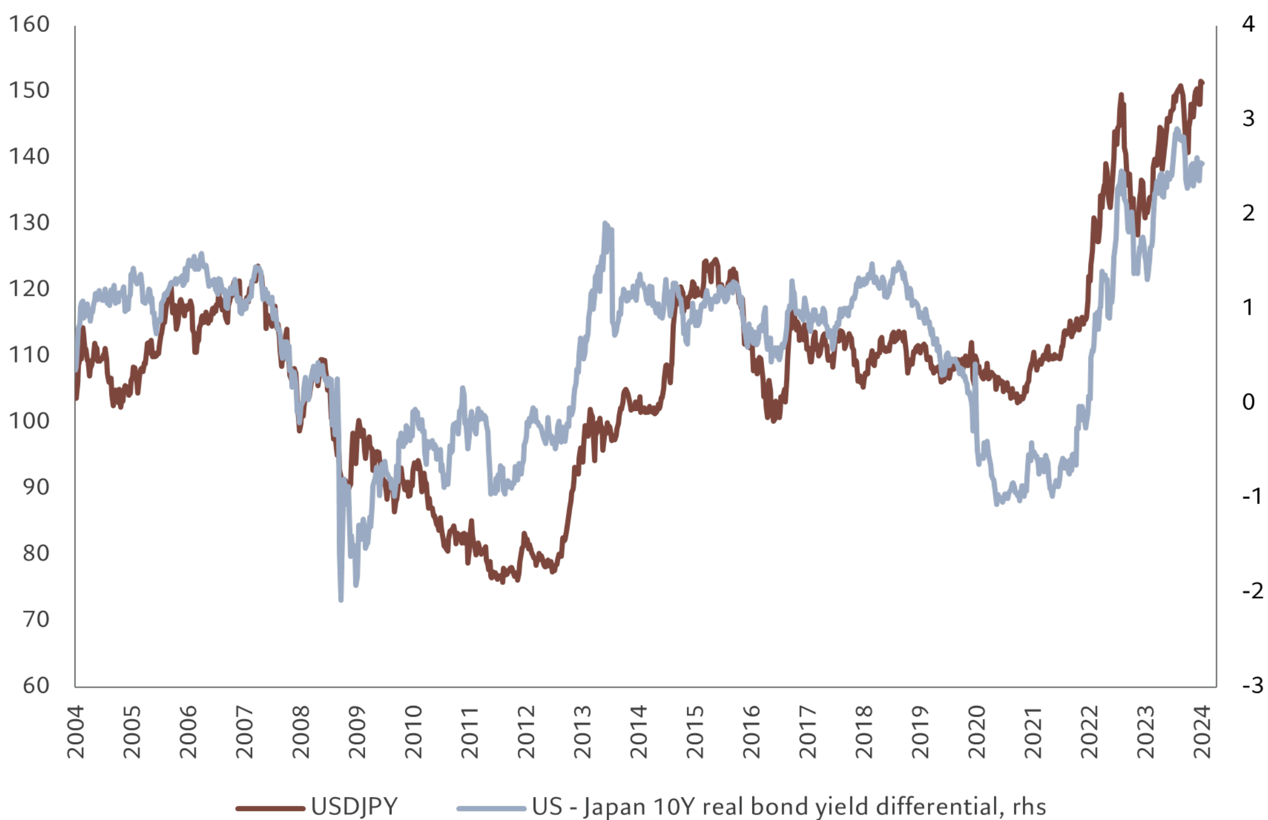
US investment grade bonds, meanwhile, should benefit from positive and improving momentum in corporate earnings. Based on our macro forecasts, US earnings should grow by around 8 per cent this year. Although the investment grade credit is no longer cheap, it continues to offer better value than US equities.

Emerging market local currency debt is another source of attractive yields. We expect economic activity in the emerging world to slightly exceed potential, extending the growth gap versus its developed peers. Global trade is stabilising and interest rates have peaked, both of which bode particularly well for emerging markets. The expected Fed rate cuts should keep a lid on the dollar, while also making room for emerging market central banks to cut rates if needed. All this should prove supportive for EM bonds and currencies.

We also continue to see potential in UK government bonds. Despite their recent outperformance, gilts are still attractively valued according to our model. It is the only market where, in our analysis, the level of bond yields is above nominal trend growth, a gap we expect will close as the Bank of England cuts rates perhaps even as soon as May.

Fig. 4 - Japan's low yields

USD/JPY exchange rate versus US-Japan 10-year bond yield differential




Source: Refinitiv, Pictet Asset Management. Data covering period 25.03.2004-28.03.2024.

Conversely, we remain underweight on relatively low-yielding Japanese and Swiss bonds. The latter are looking even less attractive now after the Swiss National Bank surprised markets with a 25 basis point rate cut in March.

Admittedly, the Bank of Japan is moving in the opposite direction, having recently announced the much-anticipated end of its yield curve control and negative interest rate policies. However, the hikes will likely be modest, and much is already priced in.

While we don't see upside for Japan's bonds, we do continue to like its currency as a potential haven should economic conditions unexpectedly worsen. Furthermore, as the US starts to ease policy, the rate differential will become less punitive for the yen (see Fig. 4).

We also retain an overweight position on gold. Although it scores a double negative on our valuation model, it does offer a hedge against two of today's key risks: weak economic growth and unexpectedly stubborn inflation.

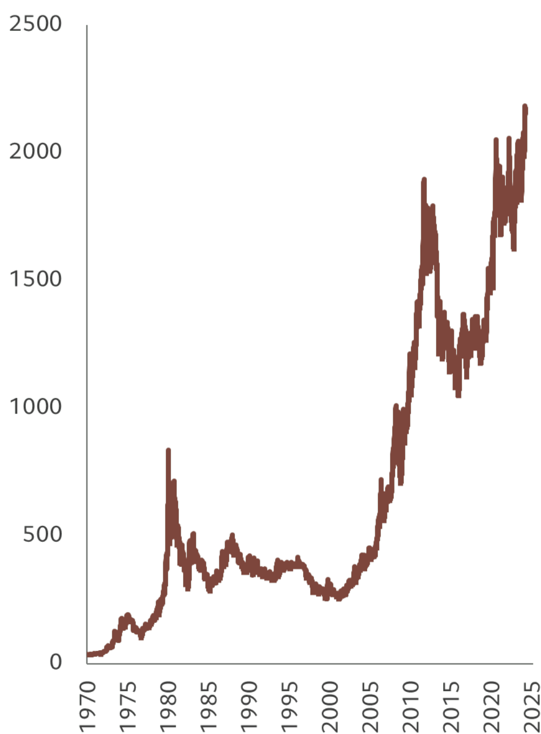
## 04 Global markets overview: a gold rush

Equities outperformed bonds in March as expectations intensified that central banks in developed markets would join their emerging counterparts in cutting

interest rates in the coming months – a move that would support corporate earnings.

Rate cut expectations triggered a rush to buy gold, which rose more than 8 per cent to hit an all-time high of USD2,160 per ounce and became the biggest outperforming asset in March. US, European and Japanese stocks rose between 3-4 per cent. Tokyo stocks remain the biggest winner so far this year with gains of nearly 20 per cent since January. A virtuous cycle of increasing wages, rising consumer spending and moderately higher inflation is likely to underpin growth in the world's third largest economy.

Fig. 5 Precious performance
Gold price per oz in USD




Source: Refinitiv DataStream, Pictet Asset Management. Data covering period 03.01.1968 - 27.03.2024.

Energy stocks outperformed other sectors as oil prices gained further against the background of persistent geopolitical tensions and a resilient global economy. IT stocks took a breather after breakneck gains of recent months, ending March with a gain of 2.5 per cent.

Bonds ended the month slightly higher with expectations of lower interest rates supporting developed market sovereign bonds. Japanese government bonds eked out slim gains after the Bank of Japan ended its negative interest rates in a widely expected move and kept monthly purchases of JGBs.

Swiss government bonds rose nearly 1 per cent after the Swiss National Bank unexpectedly cut its key interest rate by 25 basis points to 1.5 per cent, moving months ahead of global peers as policymakers sought to prevent gains in the franc.

In credit, corporate bonds on both sides of the Atlantic rose around 1 per cent as investors grew more confident about the outlook for economic growth.

In currency markets, the dollar edged higher in the month, leaving other major currencies in red. The Japanese yen fell nearly 1 per cent as expectations rose the Bank of Japan is unlikely to deliver aggressive interest rate hikes. The Turkish lira hit a record low before ending the month down more than 3 per cent as capital outflows intensified from an economy battling with soaring inflation.

## 05 In brief

BAROMETER MONTH YEAR

### Asset allocation

The balance of risks points towards a continuation of the equity market rally. We remain overweight equities, neutral bonds and underweight cash.

### Equities regions and sectors

We remain overweight Swiss and Japanese equities and underweight the UK. We also remain overweight IT and communication services.

### Fixed income and currencies

We see attractive opportunities in the US (both in Treasuries and investment grade credit) and are less optimistic about the prospects for low-yielding Swiss and Japanese bonds.

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Written by

Pictet Asset Management Strategy Unit

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