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Asset Management

BAROMETER OF FINANCIAL MARKETS MARCH INVESTMENT OUTLOOK
March 2024

Marketing Material

Barometer: Tech's profit growth should continue to propel stocks

Robust earnings from the IT sector suggest tech stocks should add to their gains. Japanese equities are also set to extend their rally.

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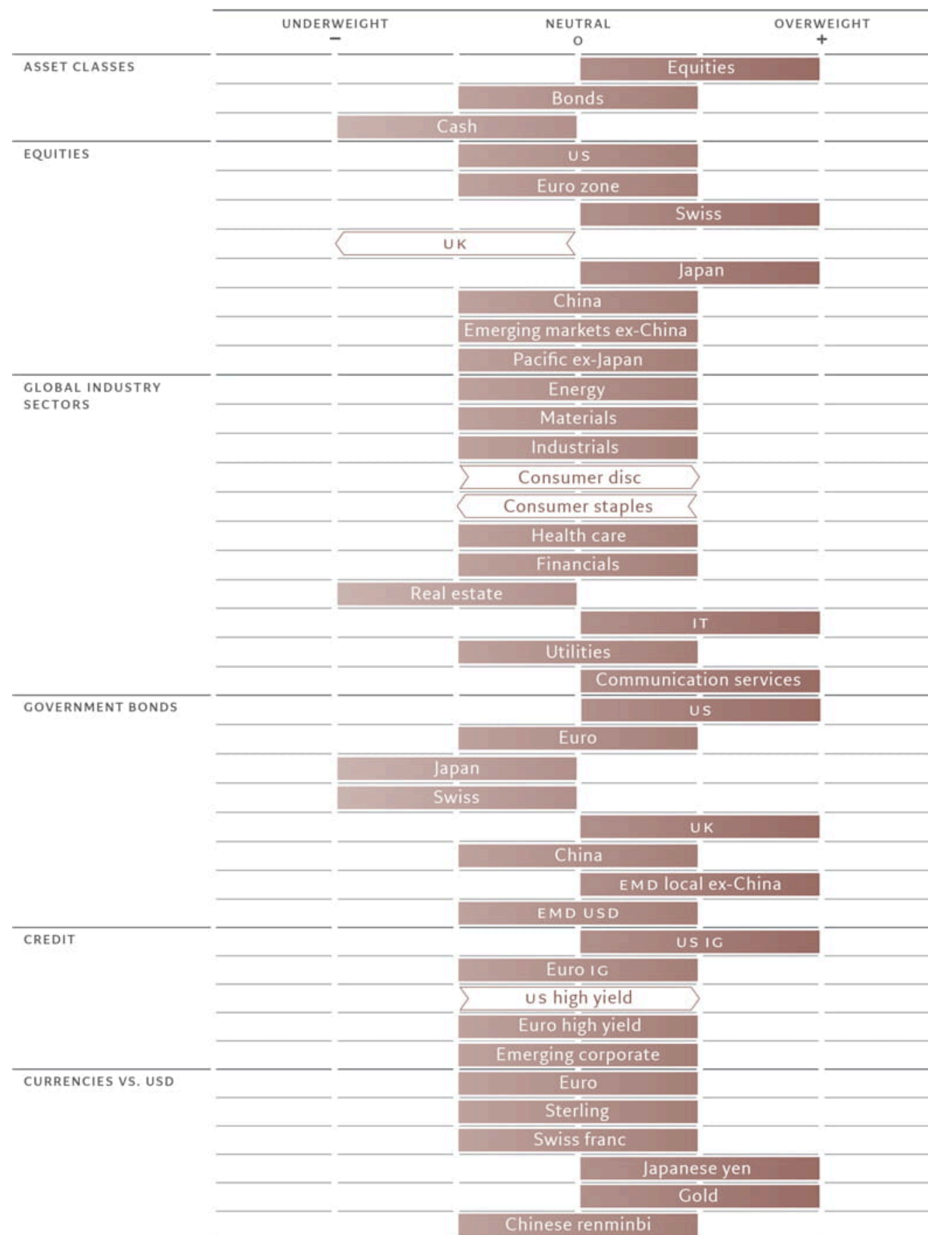
01 Asset allocation: equities still looking good

The US economy's resilience and US inflation's resistance to swiftly return to the US Federal Reserve's target means we remain overweight equities and neutral bonds.

We retain our view that economic growth will slow later in the year, but the timeline is stretching. Corporate profits remain buoyant and the Fed is clearly indicating an aversion to premature monetary easing. So where a few months ago we felt that bond valuations were attractive we now think they're fair; the near -term prospects for equities, meanwhile, remain encouraging. As Fig. 2 shows, earnings among the world's listed companies have been responding positively to improving US economic data.

Fig 1. Monthly asset allocation grid
March 2024



Source: Pictet Asset Management

Our **business activity indicators** show that the US economy is stronger than we'd previously envisioned and is one reason why we remain overweight global equity.

If US consumers continue to spend much more than they save - the US savings rate is currently running at 3-4 per cent of disposable income compared to a historical 7-10 per cent - both growth and inflationary pressures could remain elevated for some time. Inflation looks likely to linger as price rises within services sectors remain high and conditions in the labour market are still tight.

On balance, though, we think consumer and business spending will eventually fade, converging towards the other already weak parts of the US economy, like the residential sector.

In contrast with the US, the euro zone has been flirting with recession for the past few months due to weak manufacturing activity. Growth should pick up, however, as the post-Covid supply shock and impact of the Ukraine war both lessen. Elsewhere in Europe, the UK economy is flat, with construction activity struggling and the hitherto tight labour market starting to loosen. On top of that there are signs that inflation expectations are starting to pick up, hampering the Bank of England's ability to cut interest rates.

Japan's economy is also starting to splutter. Retail sales are contracting, as are machinery orders. And industrial production is still very weak. Nonetheless

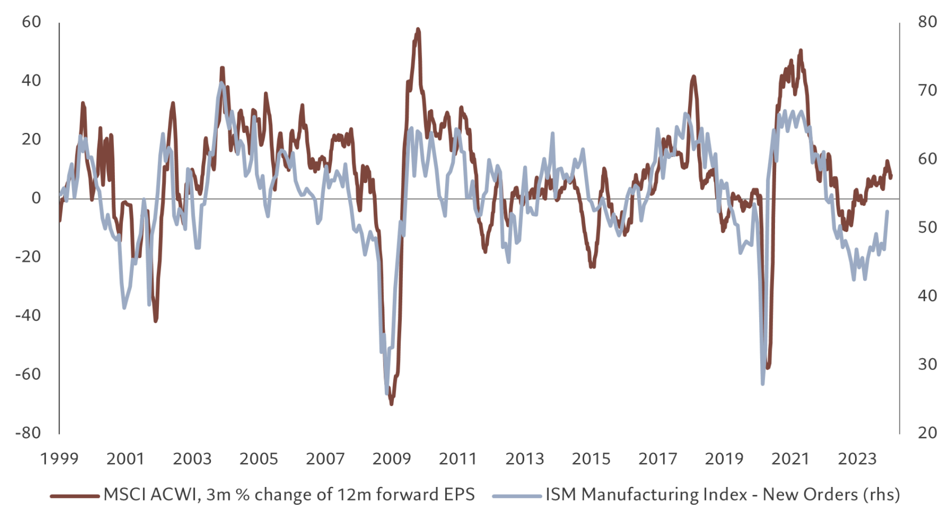
Japan’s is still expected to grow near its long-term potential while its long period of deflation is finally over.

Strengthening the case for being overweight equity are our **liquidity** indicators. These show a short-term increase in the supply of liquidity from both central and private sector banks. Even the Swiss central bank has started to shift from quantitative tightening to easing. But it’s not certain the easing will gather pace. Signs from the Fed are that its central bankers view the risks of waiting a little longer to cut rates as smaller than the risk of cutting too soon and then having to reverse course.

As for private credit, banks are beginning to ease lending standards. It’s early days yet, but the direction is clear. The question, though, is of magnitude. Elsewhere, the Chinese central bank has accelerated its modest pace of easing policy, but it remains alert to any potential foreign exchange instability, which is likely to limit how far it goes. For now, it is focused on targeted credit provision.

Fig. 2 - Looking up

Global equities earnings momentum vs US ISM New Orders



Source: Refinitiv, IBES, Pictet Asset Management. Data from 15.02.1999 to 26.02.2024.

Our **valuation** indicators show equities trading at their most expensive levels since December 2021. With US equities trading at multiples of 20.5 times earnings - considerably higher than the 10-year average of 17.5 - there appears to be little headroom for the market to add much to its gains. Still, corporate earnings have been solid and consensus analyst projections for 2024 are now reasonable considering the continued resilience in global growth. Bonds are marginally more attractive, with US government bonds at fair value and inflation-protected Treasuries also trading at reasonable levels. Gilts look attractive too, albeit vulnerable to news from the upcoming budget.

Our **technical** indicators show that equities are supported by a strong trend while bonds are less so and Chinese bonds look overbought.

Investor positioning data paints a less positive picture for riskier assets, however.

Risk sentiment among professional investors is firmly in bullish territory according to market surveys, with fund managers having cut their cash positions and turning their most overweight on equities for two years. Moreover, portfolio flows into equity and bond funds have been strong while those into money market funds have slowed. All of which suggests there is less scope for the market to extend its rally.

02 Equities regions and sectors: tech's magnificent reign

A chasm is opening up in global equities. On one side are IT stocks, dominated by the so-called 'Magnificent Seven' tech firms. On the other is almost everything else.

The tech sector has rallied by some 50 per cent over the last 12 months – more than double the gains of the broader world stock market. Consequently, valuations are looking very stretched: tech is the most expensive sector in our global model, while the Magnificent Seven stocks trade on a price/earnings ratio of 29 times, compared to the rest of S&P 500 at 18 times. That is clearly expensive, but we believe that tech's reign may have further to run because, this time, market exuberance is supported by fundamentals.

In the recent earnings season, tech was the clear leader, mostly on the back of the stellar growth of artificial intelligence. Within the S&P 500, 89 per cent of tech companies beat analysts' quarterly earnings estimates, compared to an average beat of 77 per cent for the index. And, crucially, the outlook for future profits remains bright. Our analysis suggests that, when factoring in analysts' earnings forecasts, the Magnificent Seven are not as expensive relative to the broader market as might first appear (see Fig. 3).

Fig. 3 - Lofty earnings

Magnificent Seven's 12m forward P/E ratio versus rest of the US market

Magnificent Seven includes Apple, Microsoft, Amazon, Alphabet, Nvidia, Meta and Tesla. Source: Refinitiv DataStream, MSCI, IBES, Pictet Asset Management. Data covering period 25.02.2017-25.02.2024.

We therefore maintain our overweight on tech, as well as on communications services. The latter sector offers exposure to similar technological trends but at more palatable valuations.

Tech's dominance also has implications for the performance of regional and national equity markets. It should offer some support to the US market, for example, where tech and communication services make up some 38 per cent of the S&P 500. So even though we believe US stocks are expensive, tech's strong fundamentals mean we are comfortable holding a neutral position in US stocks.

In contrast, the UK market's low tech exposure (tech and telecoms account for just 2 per cent of the FTSE 100) is one reason why we've decided to downgrade UK equities to underweight. The domestic economic backdrop is another. We think the UK economy will not manage to grow at all in 2024. With elections looming, it is unclear whether the economy will enjoy monetary or fiscal support anytime soon, an uneasy setup for the local equity market. Finally, the region's stocks also continue to have poor earnings momentum.

Elsewhere, we remain overweight Japan and Switzerland. Japan is supported by structural tailwinds of corporate reforms, an economy emerging out of

deflation and a still-weak yen. Switzerland, meanwhile, provides exposure to quality stocks at a reasonable price.

At the same time, mindful of the continued resilience of the US consumer and the potential recovery in European spending, we have upgraded consumer discretionary stocks to neutral and downgraded consumer staples, also to neutral.

03 Fixed income and currencies: improved risk reward for US high yield bonds

Continued strength in the US economy paints a more positive picture for risky credit, such as high yield.

America's resilience, especially in consumption and capital spending, suggests the world's biggest economy may continue to expand a little longer before an eventual slowdown.

That bodes well for US high yield bonds in particular. With such debt yielding around 8 per cent, holding an underweight position in the asset class involves forgoing a considerable level of carry – too much, in our view.

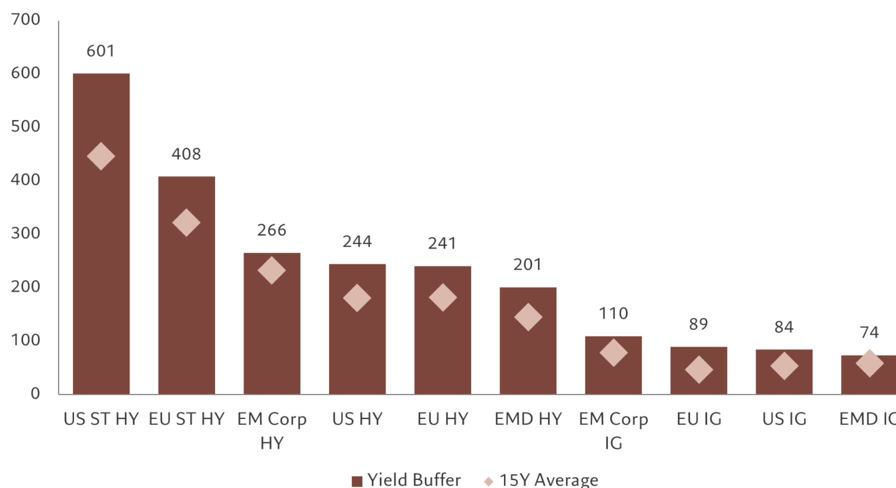
We find the shorter maturity US high yield bonds particularly attractive as they offer high carry but without the higher refinancing and credit risks of longer-dated debt.

That said, some risks remain – economic conditions could deteriorate if companies put investment on hold in the lead-up to November's US Presidential election.

Taking this into account, we prefer a more cautious upgrade of US high yield bonds – moving from underweight to neutral rather than to overweight.

Fig. 4 Credit yield buffer*

Near-term additional return over cash likely to be driven by carry



* The amount by which the yield can rise whilst still offering positive returns. Source: Refinitiv DataStream, Pictet Asset Management, data as of 28.02.2024

Our overweight stance in US Treasuries remains unchanged.

While the asset class is attracting strong demand from foreign private investors, valuations have remained fair. The benchmark 10-year yield stands at 40 basis points above our year-end fair value estimate of 3.9 per cent, which points to a total return of around 7-8 per cent for the asset class in 2024.

Inflation-protected Treasury bonds (TIPS) also look attractive given that inflation in services industries remains stubbornly high.

We also like UK gilts, with the BOE potentially becoming the first major developed central bank to cut interest rates in the coming months thanks to

falling inflation and weak growth.

We maintain our overweight positions in emerging market local currency debt. Across the emerging world we see considerable headroom for continued monetary easing especially once the Fed begins cutting rates. Investors in this asset class should also benefit from likely appreciation of emerging market currencies, which our models show are trading at as much as 20 per cent below fair value.

We are underweight Swiss and Japan bonds – low-yielding securities issued by countries where monetary conditions are tightening. The Bank of Japan is poised to raise interest rates in the coming months, while the Swiss National Bank has just conducted the most aggressive quantitative tightening to date, leading to strong imported price deflation and overall muted inflation dynamics.

In currencies, we leave our allocation unchanged, maintaining a slightly anti-dollar bias. We overweight the Japanese yen, a safe-haven currency which offers a good hedge in case of a global economic slowdown. We also like gold, which should benefit from lower interest rates and a weaker dollar.

04 Global markets overview: Japan and tech lead the charge

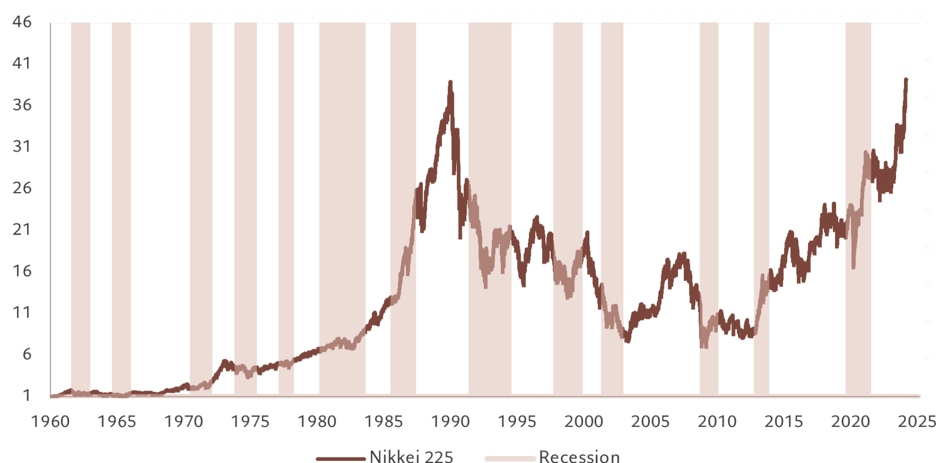
Equities outperformed bonds by a considerable margin in February, with stocks lifted by healthy quarterly corporate results but fixed income markets unsettled by unexpectedly strong inflation data. The MSCI World Index ended up almost 5 per cent in local currency terms. US and euro zone government bonds were down about 2 per cent in aggregate.

Among the best performing markets were Japanese stocks. The Nikkei broke through the peak it hit in 1989, notching up a 17.5 per cent gain year to date, while the Topix index also closed in on a record. Japan's stock markets have been a magnet for investment in recent months for several reasons, including an ongoing improvement in corporate governance and a profit-boosting depreciation in the yen for the country's listed exporters. Flows into Japanese markets have also risen as foreign investors have been pivoting away from China, where Sino-US geopolitical tensions and falling property prices have hit stock prices.

Another bright spot within equity markets was the tech sector. The tech-heavy Nasdaq index closed at a record high on the final trading day of the month as investors were buoyed by forecast-beating quarterly results from a number of technology bellwethers, including chipmaker Nvidia, which said demand for artificial intelligence helped boost revenues by almost 250 per cent year-on-year.

Fig. 5 - Japan's ascendancy

Nikkei 225 stick price index and Japanese recessions



Source: Refinitiv DataStream, Pictet Asset Management. Data covering period 31.01.1960-25.02.2024.

As equities rallied, bond markets ended the month nursing losses. Data pointing to unexpectedly persistent inflationary pressures suggested central banks would refrain for cutting rates any time soon. Ten-year US Treasury yields climbed some 20 basis points to 4.2 per cent by the end of February. US investment grade bonds were among the hardest hit of all non-government debt markets, suffering a drop of some 1.5 per cent. One possible explanation for the decline was a sharp increase in the supply of corporate bonds in February. The month saw some USD175 billion of new bonds come to market, bringing net bond issuance for the year to date almost USD190 billion, the strongest start to the year for at least seven years, Bloomberg figures show.

05 In brief

BAROMETER MARCH 2024

Asset allocation

We remain overweight equities, neutral bonds and underweight cash.

Equities regions and sectors

We remain overweight tech on fundamental grounds and downgrade UK equities to underweight due to weak economic prospects and earnings momentum. We continue to see attractive investment opportunities in Switzerland and Japan.

Fixed income and currencies

We upgrade US high yield debt to neutral as the outlook appears more balanced.

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Written by

Pictet Asset Management Strategy Unit

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