STAY INVESTED BUT DIVERSIFY

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Dear Reader

Equity markets had a good start to the year lifted by a robust growth backdrop and the anticipation of near-term rate cuts. Bonds did not fare quite so well overall, as yields kept on creeping higher, but still delivered decent returns.

Going forward, market conditions may again become more challenging. In particular, the uncertain inflation outlook may impact markets because central banks, especially the US Fed, could wait longer before cutting rates. We still expect the global cycle to pick up later this year, and the latest leading indicators support this view. Nevertheless, corporate earnings may not continue to expand at their recent pace. Within this risk context, we recommend maintaining balanced, well-diversified exposure, including assets and strategies that can limit the downside if needed but still accrue positively in a more benign environment.

Collective investments are the most efficient way to diversify within and across asset classes. As a refresher for our readers, we cover their key features in our Special Topic.

The year has been good so far but we are certain that there will be some surprises along the way. Let's keep in touch and compare notes. As always, we look forward to your critical feedback.

Yours sincerely

Dr. David Wartenweiler
Chief Investment Officer

THE MACRO BACKDROP
Global cycle turning upward

With the monetary tightening cycle about to give way to moderate easing, the global cycle is poised to turn upward, if only modestly, in the second half of the year. Much of the growth will come from emerging markets, which continue to expand at higher rates than the advanced economies.

Key points

- US set for a soft landing
- European growth to pick up gradually
- India to remain the fastest-growing large economy

US: Prepare for landing

Economic growth has continued to decelerate from the blistering pace recorded last summer. It should reach its low point by mid-year and, based on current data, we should witness the rare event of a soft landing. This will partly be the result of anticipated monetary easing, which has prevented tighter monetary conditions. In addition, positive supply shocks such as in the labor market have helped contain lingering inflationary pressures. In fact, ongoing though slowing disinflation should allow the Fed to reduce the policy rate for the first time in summer, with the prospect of two more cuts by year-end as the core rate continues to move toward target. The resilience of the US economy owes much to the fact that households have their strongest balance sheets in more than a decade, which has allowed them to weather higher rates. As the Fed prepares for a modest easing cycle, refinancing costs will also decline; this will include areas of consumer finance such as credit card lending where delinquency rates have picked up. Meanwhile, a soaring federal budget deficit is emerging as the Achilles heel of the US economy, but the real test will only come next year when the Trump-era tax cuts are set to expire.

Europe on the mend

While Europe's manufacturing sector has yet to find a bottom, services appear to have turned the corner earlier this year. Falling inflation has also opened a path to lower rates. Following the surprise rate cut by the Swiss National Bank, both the Bank of England and the ECB are likely to reduce their policy rates, possibly as early as June. This bodes well for moderately stronger growth across the continent in the second half of the year.

India racing ahead

China finally agreed on a growth target of 5% for 2024. This looks like a tall order given weak consumer confidence and the unending problems in the property sector. The government has yet to pivot from its focus on control and security to prioritizing growth. India, meanwhile, reported growth of 7% for 2023 and is expected to deliver over 6% this year as past efforts to enhance infrastructure and productivity continue to bear fruit. For yet another year, the country will be the fastest-growing large economy in the world, attracting further foreign investments in the process.

Table 1: Real GDP growth (y/y in %)

	2023E	2024F	2025F	Short-term trend
United States	2.5	2.2	1.7	↘
Eurozone	0.5	0.5	1.3	↗
Germany	-0.1	0.1	1.1	↘
United Kingdom	0.3	0.3	1.2	→
Japan	1.9	0.7	1.1	→
China	5.2	4.6	4.3	→
India	7.5	6.6	6.6	→
Russia	3.3	2.0	1.1	↘
Brazil	3.0	1.7	2.0	→

Table 2: Consumer price inflation (y/y in %)

	2023E	2024F	2025F	Short-term trend
United States	4.1	2.9	2.4	↘
Eurozone	5.4	2.4	2.1	↘
Germany	6.0	2.5	2.1	↘
United Kingdom	7.3	2.5	2.1	↘
Japan	3.3	2.3	1.8	↘
China	0.2	0.8	1.6	→
India	5.4	4.5	4.5	→
Russia	6.0	6.7	5.0	↗
Brazil	4.6	3.9	3.5	↘

Source: Bloomberg, HBZ

INVESTMENT STRATEGY

Stay invested but diversify

Global equity markets have performed strongly since their bottom in October last year; rates markets, by contrast, are still in normalization mode. While some risk management may be in order, investors should retain their exposure, as time in the market matters more than timing when it comes to achieving long-term investment goals.

Key points

- Time in the market matters most
- Diversification is the best risk management
- Delayed rate cuts a major risk for markets

Diversification is risk management

Lofty equity valuations, especially in the US markets, have raised investor concerns. However, valuations alone usually don't trigger sustained down markets. Some limited market correction is always a distinct possibility, but generally, fundamentals have remained robust enough as the economy has withstood higher rates remarkably well. In contrast to the situation during the notorious dot-com bubble, most of the currently high-flying stocks also have tried-and-tested business models and are highly profitable. Still, delayed rate cuts would impact valuations negatively via higher discount rates and could lead to lower equity market returns. At the same time, unlike any time since 2009, the fixed-income market is providing attractive running yields. In the event of a sustained market sell-off, growth expectations will also come under pressure, which should feed into lower interest rates for longer maturities of government and quality corporate bonds. An allocation to high-grade credit and some duration, best expressed with Treasuries, thus offers the kind of diversification that could substantially limit the overall portfolio drawdown in periods of market stress.

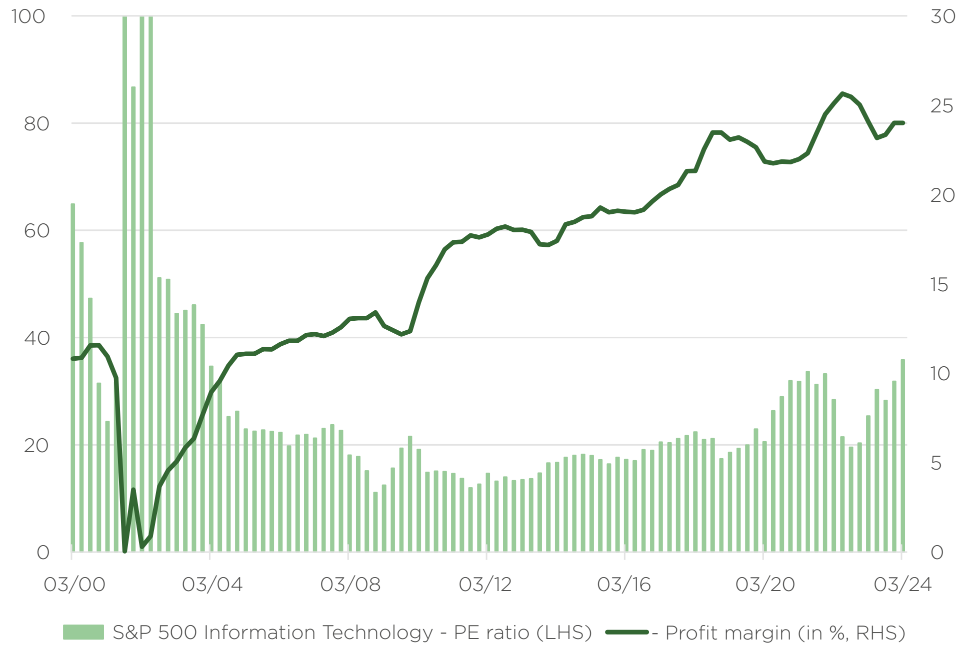
Our positioning

In recent months we have continued with our tactical adjustments, increasing our equity exposure further with a focus on tech-centric sectors in the US. We have also tilted our EM equity exposure away from China in favor of India. Overall, we maintain a fairly balanced allocation between equities, where we have some built-in downside protection, quality fixed-income for yield and potential capital gains, and gold to hedge against geopolitical risks.

What to watch

At this juncture, the main risks for financial markets are that either the expected interest rate cuts will fail to materialize or earnings suddenly underperform expectations. We are therefore monitoring the relevant data flow and central bank communications closely. Over the coming months, the US elections will increasingly dominate the news flow and may or may not influence markets.
At any rate, investors need to stay alert to the potential ramifications for financial markets in the most likely scenarios. In particular, they need to keep an eye on the dynamics of US government debt under a new administration.

US IT stocks: expensive, maybe, but certainly profitable



Source: Bloomberg, HBZ

FIXED INCOME

Lengthen duration

Despite the latest rise, yields on 10-year US Treasuries should remain range-bound between 4.0% and 4.5%. Longer term, we favor longer duration in the US, as the economy will slow, as it will in Europe, where the ECB is likely to ease soon. Credit spreads are expensive, but high core yields offer a cushion in terms of total returns.

Key points

- Favor carry and relative value trades
- European investment-grade most attractive
- Preference for diversified exposure to investment-grade EM sovereigns

Investment grade: tight spreads, attractive yields

Global investment-grade credit has seen a mixed performance owing to rising sovereign yields as anticipated Fed rate cuts have been postponed. Despite record new issuance, credit spreads have tightened on strong demand. Valuations are approaching post-2008 highs but absolute yields remain attractive. Spreads in the US have tightened despite record supply, particularly in the technology, pharmaceutical, and healthcare sectors. We prefer financials but remain cautious given the spread rally. European investment-grade spreads have also tightened, especially in industrial sectors, but they remain wider than the multi-year low of early 2018. The main risk is that mounting financial pressure on weaker companies may at some stage lead to margin erosion and price competition, an argument for preferring less cyclical sectors and shorter- to intermediate-dated high-quality bonds. Despite higher dispersion and increasing idiosyncratic risks, we still see select opportunities among quality bonds, including subordinated issuers. Overall, we are neutral on global high-grade credit, with a preference for European issuers based on valuations.

Opportunities in emerging markets

Emerging market (EM) bonds have put in a mixed performance, with sovereigns outperforming corporates and local currency bonds underperforming owing mainly to negative currency returns. Despite this, sovereign credit spreads have tightened on positive macroeconomic developments. We recommend longer duration in EM (for both hard and local currency), largely because of the favorable divergence of monetary policy from the US. The EM central bank easing cycle is already in its ninth month thanks to lower inflation and inflation expectations. We continue to argue for diversified exposure across Latin America and EMEA sovereigns; disinflation and rate cuts across the regions favor longer duration. For EM corporates, in light of expectations of continued spread compression and alpha opportunities in lower-rated areas, we prefer higher-yielding issuers with market access. We are more cautious when it comes to leveraged sections of the corporate universe. At any rate, given the high idiosyncratic risk of many issuers, we recommend investing in EM corporates only through well-diversified fund solutions.

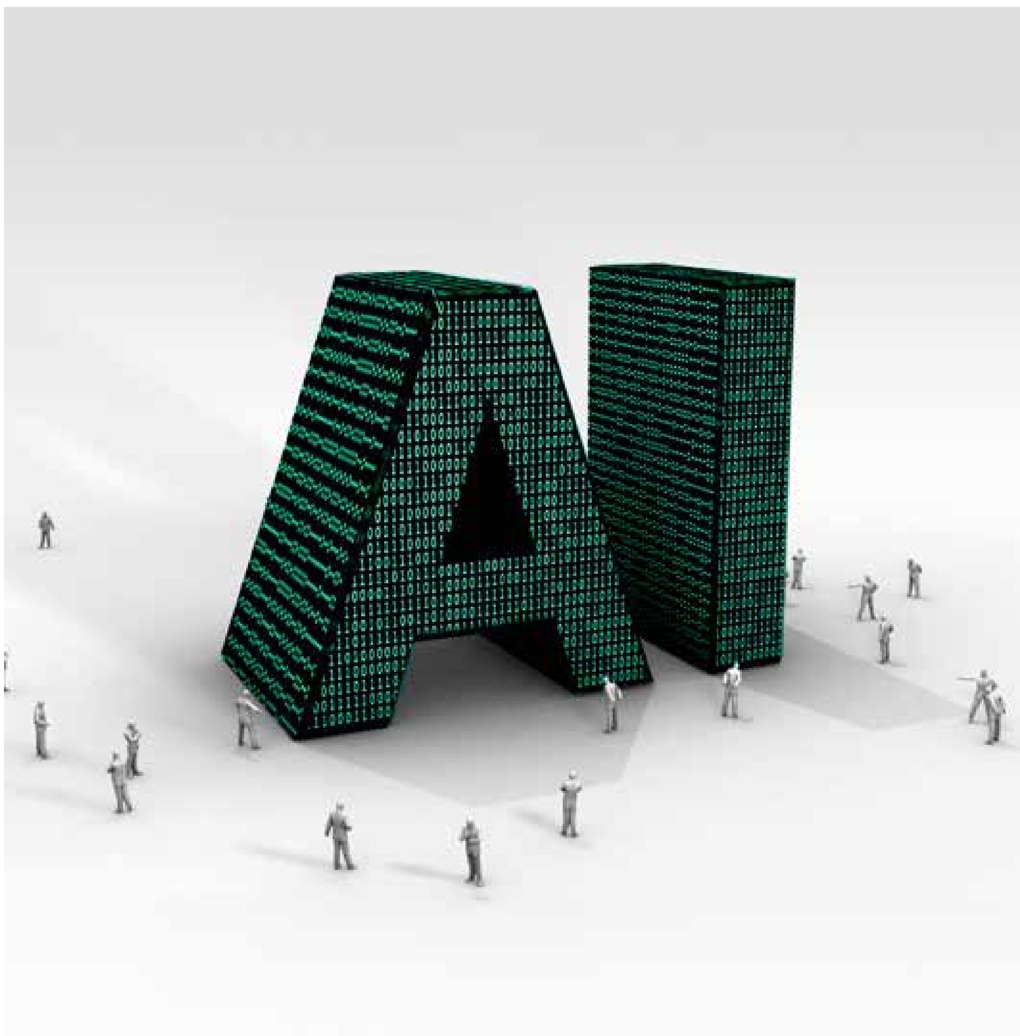
EUR bonds outperforming (total return in %)

Source: Bloomberg, HBZ

EQUITIES

AI theme with further upside

AI integration remains a hot topic, but substantial infrastructure investments will be required to accelerate adoption. Generally, equities surged in the first quarter, with slower earnings growth posing the main risk. We favor quality growth stocks but are also positioned for a broadening of the market rally.



Key points

- AI will require large infrastructure investments now to harvest future returns
- Earnings surprised to the upside, supporting a strong equity rally in the first quarter
- Equity rally set to broaden and continue in the second quarter

Low adoption rates leave room for future gains

The development and integration of AI (artificial intelligence)-related capabilities remains a hot topic. Goldman Sachs reported that around 36% of US companies explicitly mentioned AI during their Q4 earnings calls. They also estimated that semiconductor revenues have risen by 50% over the past year. So far, however, actual adoption has been modest, leaving room for productivity gains in the coming years. Significant infrastructure investments will be required to facilitate the transition. Providers of semiconductor and cloud solutions are therefore likely to be the early beneficiaries of this transition. In a second phase, we expect data owners to experience important gains, as user-specific data is needed to train more sophisticated models. In the end, only time will tell whether we're on the verge of another major revolution, but from today's perspective it certainly feels that way.

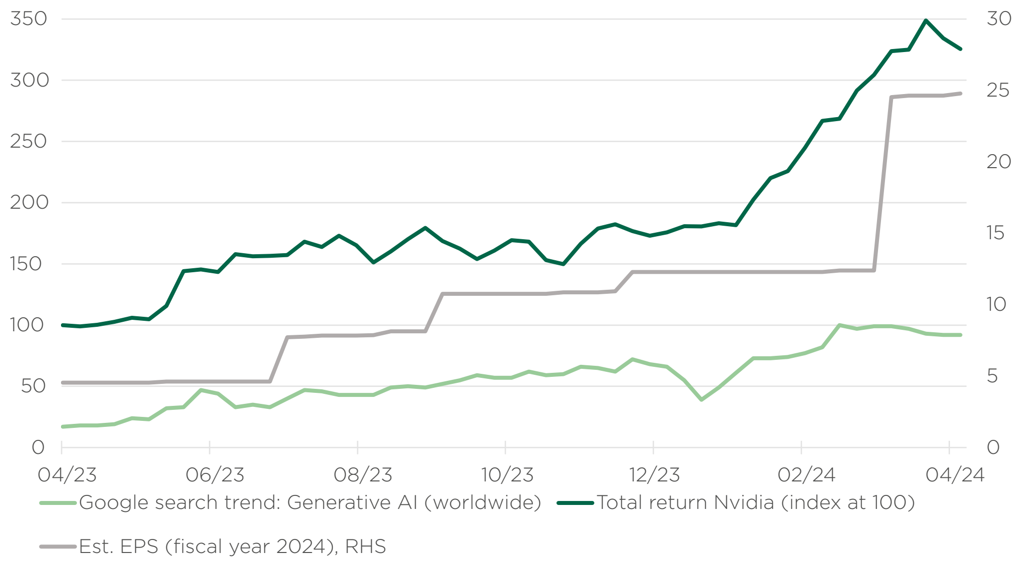
Strong earnings and optimistic valuations

Developed market equities posted a strong first quarter, with the S&P 500 Index surging more than 10%. Q4 earnings grew faster than expected and the Fed has indicated three rate cuts this year. As a result, money flows into equities picked up again, while earnings multiples have grown from around 21.5x to 25x so far this year. The current level seems elevated compared with the 10-year average of 21x and reflects the robust macro backdrop and optimism about the AI transition. As long as earnings continue to keep up, multiples will be supported, whereas any multiple contraction would likely be driven by stronger earnings growth.

Positioning for the second quarter

For the second quarter, we continue to see a positive backdrop for equities supported by healthy growth and declining inflation. However, slower-than-expected earnings growth could pose the biggest risk to our outlook, followed by sticky inflation causing interest and discount rates to stay higher for longer. We continue to favor high-quality stocks, which are not just well positioned to benefit from the AI transition but also tend to perform well in a slowing growth environment. Moreover, we believe that in the high-powered chip segment, market leader Nvidia will be able to defend its almost 80% market share and will likely continue to enjoy strong earnings growth. Overall, we are positioned to benefit from a broadening market rally, with additional overweights in communication services, financials, and energy.

The face of AI: Nvidia share price rises with earnings, interest in AI



Source: Bloomberg, HBZ

COMMODITIES AND FX

Gold at all-time high

Even the high carry of the US dollar is no match for gold as investors seek diversification in a hard asset. As global growth is about to turn upward, the fundamentals point to rising demand and increasing prices for many commodities, with crude oil looking particularly well placed for more upside.

Key points

- Gold at new all-time high
- Crude supported by fundamentals
- No currency to rival the USD

Record gold price

For the past few years the gold price has traded in what has arguably been a wide range, averaging around USD 1,850/oz. Last year, just ahead of the rebound in global equity markets, gold started to surge, and has now reached a new all-time high of USD 2,397oz., despite high nominal and real interest rates. There are a number of reasons for this stellar performance. For one, ever since the freezing of Russia's foreign currency assets, non-G10 central banks have added gold to sanction-proof their balance sheets. In addition, for many investors, gold offers an easy way to diversify away from a toppish US dollar and hedge for inflation surprises. Finally, geopolitical risk remains elevated, and gold has a record of holding its own in times of high international tension, although not during financial crises. While gold is technically stretched, the global context remains supportive.

Tailwinds for crude oil

Sluggish growth appeared to cap oil earlier in the year, but in the meantime the macro context has changed. Global growth is set to rebound in the quarter ahead and OPEC+ is committed to keeping its output cuts in place, potentially leading to a significant supply deficit by year-end. With heightened geopolitical tensions in the Middle East and Ukraine's strike on Russian refineries increasing the global call on crude, the fundamentals point to further upside over the coming months.

US dollar: strong for longer

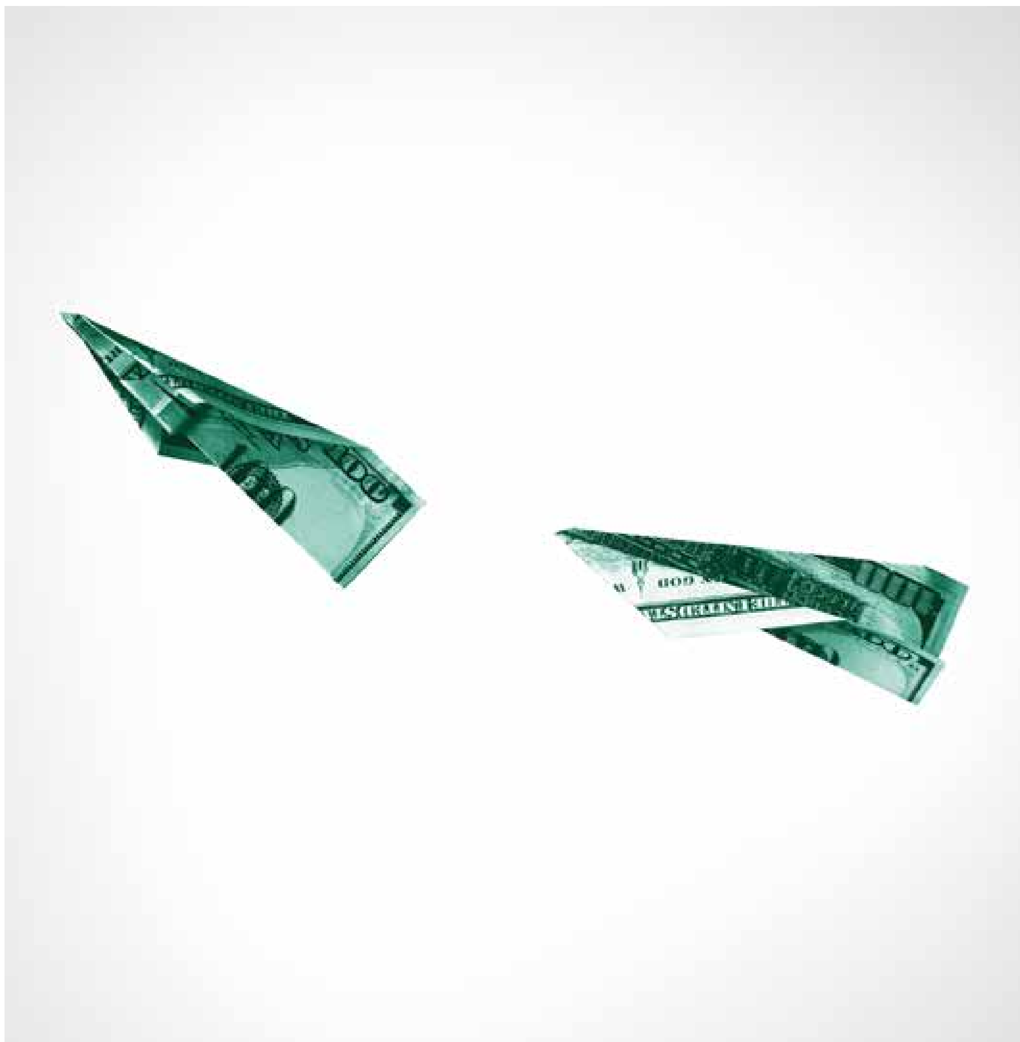
The US dollar continues to offer the highest carry among G10 currencies and the Fed is in no hurry to change this. In addition, perceived US economic exceptionalism and the strong performance of the US stock market have also supported the US dollar despite its high valuation. Indeed, there are few currencies which can offer the advantages of the US dollar, which is why even central bank diversification and concerns about exceedingly high US federal debt levels have yet to dent its appeal. Some EM currencies offer distinctly higher carry, but only a few look attractive once these high levels are adjusted for the currency's volatility.
That said, trading and investing in EM FX is not for the faint-hearted. One slip-up and performance accumulated over several years can evaporate in no time.

Gold: new all-time high!

Source: Bloomberg, HBZ

KEY MARKETS
Off to a good start

A quarter into the new year, our key markets are showing positive momentum, with Pakistan embarking on the path to more economic stability, the UAE counting on stronger oil to lift GDP growth, and the UK better positioned to escape the technical recession.



Key points
- Pakistan emerges from volatile election period
- Higher crude prices to lift UAE growth
- UK emerging from recession

Pakistan: new resolve

Following a bumpy election period, Pakistan has displayed a semblance of stability as a coalition attained the required majority to form a government, ending the caretaker interlude. The newly formed cabinet includes technocrats, including the finance minister, who is committed to the successful, albeit unpopular, policy measures taken by the caretakers to ease the economic turmoil. The country also reached a staff-level agreement on the final review of the 9-month standby agreement with the IMF, which will put Pakistan on a better footing to meet external financing needs for the rest of the fiscal year. Additionally, investor confidence improved, with the KSE100 index up some 12% this year. The country's eurobonds also rallied after the IMF showed its willingness to formulate a new medium-term economic program. Economic activity picked up moderately, with strong agricultural output. The central bank left its monetary stance unchanged, but probably not for long, as inflation continues to fall. The incoming government appears determined, although political fragmentation remains a risk in the absence of a clear majority in parliament.

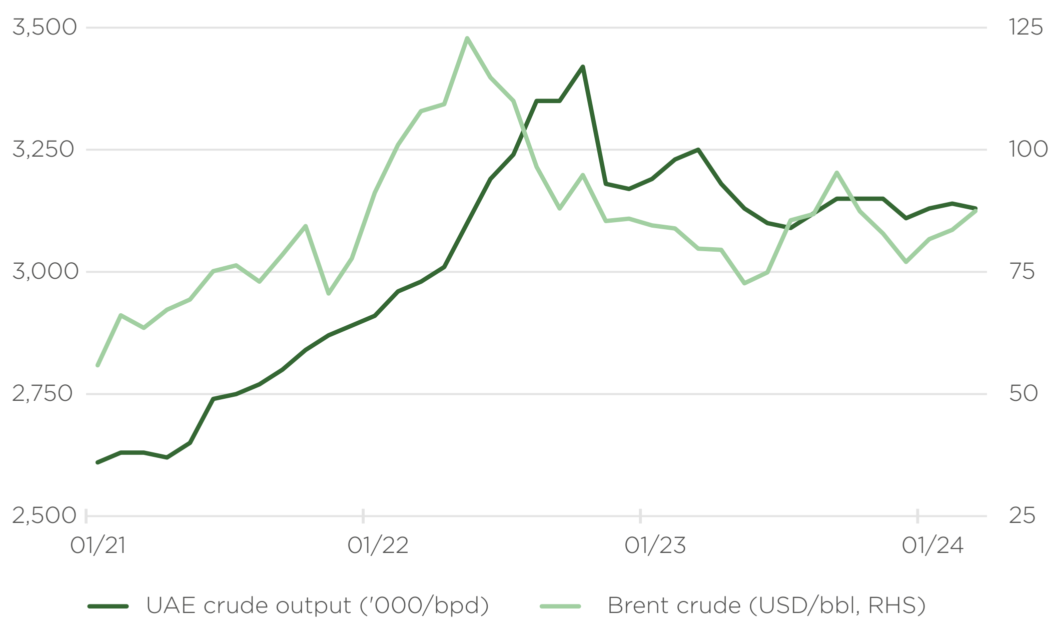
UAE: onward and upward

Despite being held back by OPEC's crude output cuts, robust non-oil sector growth is estimated to have helped the UAE's GDP growth rate reach 3.1% last year. The main contributors were construction, financial services, trade, and tourism, with a record 17 million visitors to Dubai alone. Tensions in the Middle East and limited supply are expected to support oil prices and raise real GDP growth to 4.2% this year. Meanwhile, the UAE continues to build trade relationships, having negotiated five bilateral economic agreements (India, Israel, Indonesia, Turkey and Cambodia), with sixteen more in the pipeline.

UK: desperate for results before the elections

While data revision confirmed a technical recession in 2023, early indicators suggest that it was merely transient. Thanks to stronger domestic demand, even the manufacturing sector appears to have returned to growth after a 20-month hiatus. Other positive signs are high mortgage approvals, declining inflation, and a better official growth forecast for 2024. Even some monetary easing is on the cards. By far the most likely outcome of the local elections held in May and the general election later in the year are victory for the Labour party, currently in opposition.

Tailwind for UAE: oil output capped, but not price



Source: Bloomberg, HBZ

SPECIAL TOPIC
The case for investment funds

By far the most efficient way of gaining access to the financial markets is via collective investment schemes such as mutual funds and exchange-traded funds (ETFs). Ease of market access, instant diversification, and ample choice outweigh concerns about cost and performance.

Key points

- Collective investments offer most efficient access to markets
- Large choice of active and passive solutions
- Costs are not everything

The fund idea

Collective investments give investors access to the universe of listed – and increasingly of unlisted assets as well. Their key advantages are ease of access via established banking and trading channels, generally low minimum investments, mostly daily if not intraday liquidity, and diversification. By opting for a collective solution, investors reduce the idiosyncratic risks of an asset and benefit from asset-class-specific return drivers and performance while operating in a highly regulated and supervised space. Having grown tremendously over the past decades, collective solutions exist for all major and minor markets in almost unlimited permutations. These range from the straightforward, such as accumulative or distributive shares classes and currency hedged units, to strategies that operate with a certain degree of leverage or with embedded risk overlays.

Active vs. passive

An important choice is between active and passive solutions. Actively managed funds represent the classic collective investment but expose investors to manager risk and so-called style drift (managers moving away from their original strategy). Moreover, in many developed markets, active managers notoriously underperform their benchmarks, voiding the advantage of their discretion in asset selection and portfolio construction. Passive instruments in the form of index funds and ETFs, on the other hand, are a cost-efficient way of gaining market exposure without the risk of material deviation from benchmark returns. In addition, so-called smart beta products reflect tailor-made benchmarks focused on factors such as growth, quality or size. At the same time, passive instruments have to replicate, either physically or synthetically, their entire benchmark universe. In the fixed-income space in particular, this may be a disadvantage as, for example, issuers with a high probability of default are not excluded from the outset.

Too costly? Not always

Costs are an important factor when making investment decisions. This is one of the reasons why ETFs have become so popular. Nevertheless, actively managed funds, with their generally higher load, definitely have their place when it comes to investing in less efficient markets. Fees paid to a market-beating manager are money well spent.

Mutual fund offering: embarrassment of riches

	Mutual funds/ETFs (number)	Assets under management (USD tn)
Europe	34,615	12.8
US	10,095	26.9

Note: Data refers to open-ended UCTIS/SEC funds
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Source: EMSA, EMFA, statista.com

MARKET SUMMARY DATA

As of 12 April 2024

Equity indices	Last	-3M %	YTD %	-3Y %
BBG World USD	1,802.4	7.4	7.1	19.7
S&P 500	5,199.1	8.7	9.0	25.9
EuroStoxx 50	5,008.8	11.8	10.8	26.4
FTSE 100	8,019.1	5.2	3.7	16.5
SMI	11,523.3	2.6	3.5	2.9
Nikkei	39,523.6	11.1	18.1	33.8
BBG EM USD	1,165.4	5.1	2.3	-15.2
Sensex 30	74,352.7	3.7	2.9	49.9
KSE 100	70,352.2	10.1	12.8	55.7
Hang Seng	16,721.7	2.9	-1.9	-41.2
Russia RTS	1,165.9	2.6	7.6	-18.6
Brazil Bovespa	127,396.4	-2.7	-5.1	7.2

Bond indices	Last	-3M %	YTD %	-36M %
FTSE US Gov	1,488.46	-2.5	-2.8	-9.8
FTSE US Corp	2,380.07	-2.0	-2.3	-7.9
FTSE US HY	1,262.85	0.7	0.6	5.5
FTSE Euro gov	215.08	-0.8	-1.6	-14.9
FTSE Euro Corp	237.24	0.6	0.0	-7.4
FTSE EM Sov	863.04	1.9	0.8	-5.7
DB EM Local USD	162.50	-2.4	-2.1	-5.0

Currencies vs. USD	Last	-3M %	YTD %	-3Y %
DXY	105.28	3.2	4.3	14.7
EUR	1.07	-2.5	-3.3	-10.5
CHF	0.91	-6.6	-7.8	1.0
GBP	1.25	-1.9	-1.7	-9.0
JPY	153.24	-5.5	-8.0	-28.7
AUD	0.65	-2.7	-4.5	-14.7
CAD	1.37	-2.4	-3.6	-8.7
ZAR	18.77	-0.6	-2.2	-22.4
INR	83.19	-0.6	-0.2	-10.0
PKR	277.95	0.5	1.3	-45.2
Gold oz.	2,349.88	16.9	16.1	38.2

Interest rates	3M interbank %	10Y government %
USD	5.59	4.54
EUR	3.91	2.38
GBP	5.30	4.15
CHF	1.46	0.73
JPY	0.11	0.86
AUD	4.35	4.27
CAD	5.29	3.73
ZAR	8.36	12.32

FOR YOUR NOTES

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