WEEKLY VIEW: 11 SEPTEMBER 2023

FADING STRENGTH

SUMMARY

– **US CPI data, ECB policy meeting in focus for markets**
– **Tense US auto sector wage talks risk strike in Detroit**
– **China's domestic economy appears to turn a corner**

DETROIT ON STRIKE?

César Pérez Ruiz
Chief Investment Officer

After a difficult time for risk assets last week, markets will be looking for direction in the coming days from US inflation data and the European Central Bank's policy meeting. They will also watch to see whether the United Auto Workers union can secure substantial pay rises with the "Big Three" US auto makers by end-Thursday, having threatened to strike if it does not. On the August US consumer price inflation data, the consensus expectation is for a further decline in the core measure from 4.7% to 4.3% year-on-year, but a pick-up in headline inflation to 3.6% on unfavourable energy base effects. Upside risks to inflation may return as expectations are low and energy prices rising. A Wall Street Journal report that a shift is underway in Federal Reserve officials' rate stance strengthens our view that the Fed hiking cycle is done, but if so this raises the risk of complacency if inflation surprises to the upside. Last week, most stocks indices and bonds ended down. It would be a first in history if US Treasuries were to post a third consecutive negative annual return in 2023. An increasingly important factor has been the strength in the USD as the US economy remains more resilient than others. A senior Japanese official said authorities would not rule out any option to clamp down on "speculative" currency moves, and Bank of Japan Governor Kazuo Ueda said the central bank could have enough data by year-end to determine whether it can end negative rates. Last week saw bumper issuance of debt by high-grade companies. **We prefer investment-grade over noninvestment-grade debt.** At a micro level, markets will watch a big tech product release this week.

We expect the ECB to raise interest rates one last time this week, to 4%, but it is a very close call. Since the beginning of this tightening cycle, the ECB has argued the risk of doing too little has been higher than the risk of doing too much. This should remain a guiding principle going into Thursday's meeting. However, if the ECB does not hike this week, the case for additional tightening will likely weaken further in coming months.

In China, exports and imports both fell by less than expected in August. It looks like domestic demand has troughed. We continue to believe **some of the pessimism about China is overdone** as policy measures will help stabilise the property sector and the economy. **Oil prices rose again on the week and while US strategic reserves remained near a 40-year low, there is no change to the supply picture, and so we remain moderately bullish on oil.** Finally, severe flooding in Greece again highlighted the impact of climate change.

CHART OF THE WEEK: FOREIGNERS GROW COLD ON CHINA

The ongoing real estate crisis has led to a decline in net buying on the northbound portion of the China-Hong Kong Stock Connect scheme in recent weeks. In other words, Hong-Kong and overseas investors have been buying less mainland Chinese equities. Pessimism around China means that managers of emerging-market funds have underweight positions in Chinese shares. More forceful policy support will be needed for investor sentiment to improve, although positive signs have been emerging on that front in recent weeks.

Source: Pictet Wealth Management, Bloomberg Fnance L.P., as of 01.09.2023

PICTET 1805

MACROECONOMY: US AHEAD OF THE PACK

US services activity revs up

US services sector picked up further in August. The ISM purchasing manager index for services rose from 52.7 in July to 54.5 in August, well above the 50 level that separates contraction from expansion.

Chinese trade slump eases

Chinese exports slumped by 8.8% on a year earlier in August. This was actually an improvement on July when they fell at an annual rate of 14.3%. In a similar trend, imports, fell by 'only' 7.3% year-on-year in August, compared with 12.4% in July. Elsewhere in Asia, official estimates of Japanese GDP growth in Q2 were revised down from an annualised 6.0% to 4.8%.

Germany sings the blues

German industrial production in July was down 0.8% on the previous month. This was the third consecutive month of decline. German consumer inflation declined slightly in August, to an annual rate of 6.4% from 6.5% in July. Separately, Eurostat revised down its estimate of GDP growth in the euro area in Q2 from 0.3% quarter-on-quarter to 0.1%.

MARKETS: MOOD TURNS MORE SOMBRE

Cracks in the equity edifice

The S&P 500 dropped back last week by 1.3%[1] (in USD), as investors worried about the risk of a further Fed rate hike this month following some strong data as well as by tensions in the oil market. While valuations on the S&P 500 are becoming less daunting, the relative attractiveness of stocks slipped further last week as real yields on 10-year Treasuries reached toward 2%. Reports that the Chinese wanted to curb official usage of iphones by state officials hurt an eminent member of the Big Tech club, which was further hit by the unveiling of fresh new legal obligations in Europe. And a certain nervousness about the US economy's prospects could be seen in the small-cap Russell 2000 index, which dropped 3.6%[2] (in USD) on the week. All in all, the week's market action provided further arguments for staying underweight US equities. Outside the US, the boost from a raft of new measures designed to restore confidence in the Chinese economy was negated by a fall in the value of the renminbi, leaving the CSI 300 2.4%[3] lower on the week (in USD). The Topix bucked the negative trend in equities by posting a positive performance (0.4%[4] in yen), despite a downward revision to Japan's Q2 growth. While underweight the market, we remain neutral the Japanese equity market.

Bond issuers make hay while the sun shines

Bond yields rose strongly early last week before dropping back somewhat. The rise in the two-year US Treasury yield (by 11 bps over the week to reach 4.99%) was essentially due to robust services data and a decline in initial jobless claims, which seemed to increase the chances of a further Fed rate increase this year (a 48% probability priced in for November). Economic momentum is much more sluggish in Europe, but the recent hike in oil prices will likewise heap pressure on the ECB to raise rates again this month. Yet our forecast is for the 10-year US Treasury yield to fall back from its 4.26% level on Friday, as we expect fears of a US recession to re-emerge. We now expect the US 10-year Treasury yield to end 2023 at round 4%, up from our previous forecast of 3.5%. Corporate issuance has picked up notably ahead of this month's central bank meetings, with last Tuesday one of the busiest days ever. High yields are certainly attractive for debt investors, while conditions also look good from borrowers' point of view given the relatively thin spreads premium they pay over government debt. But it is unlikely such conditions will last, with the spreads on noninvestment-grade debt still looking too tight for comfort.

Yen's prospects improve

The increasing sluggishness of the euro area economy and a further raft of poor export figures in China compared to robust data in the US meant the euro and renminbi had another rough week. Yet we remain neutral on the euro, believing the US economy's strength will soon waver whereas pessimistic investor sentiment on other major economies may be overdone. The greenback could also be challenged if the Fed adopts a less aggressive stance this month. And concerns over the strong dollar are increasing. While Chinese authorities continue to curb renminbi weakness through various tweaks, including by adjusting the renminbi's daily reference rate, Japan's Ministry of Finance hinted strongly at renewed FX intervention to prop up the yen. And Bank of Japan governor Kazuo Ueda signalled a possible end to negative rates by year's end if there is convincing evidence of sustainable inflation. By contrast, the National Bank of Poland turned more dovish, announcing a hefty cut to its benchmark interest rate last week (from 6.75% to 6.0%), despite double-digit inflation. Predictably, the zloty fell hard and should remain volatile ahead of the October general election—although the currency will find support in Poland's healthy balance of payments.

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HIGH-YIELD BONDS: RESILIENT FOR HOW LONG? (10 JULY 2023)

[1] Source: Pictet WM AA&MR, Thomson Reuters. Past performance, S&P 500 Composite (net 12-month return in USD): 2018, -4.38%; 2019, 31.5%; 2020, 18.4%; 2021, 28.7%; 2022, -18.1%.
[2] Source: Pictet WM AA&MR, Thomson Reuters. Past performance, Russell 2000 (net 12-month return in USD): 2018, -11.0%; 2019, 25.5%; 2020, 20.0%; 2021, 14.8%; 2022, -20.4%.
[3] Source: Pictet WM AA&MR, Thomson Reuters. Past performance, CSI 3000 Index Total Return (net 12-month returns in USD): 2018, -27.6%; 2019, 37.2%; 2020, 38.4%; 2021, -1.0%; 2022, -26.5%.
[4] Source: Pictet WM AA&MR, Thomson Reuters. Past performance, TOPIX (net 12-month return in JPY): 2018, -17.8%; 2019, 15.2%; 2020, 4.8%; 2021, 10.4%; 2022, -5.1%.

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