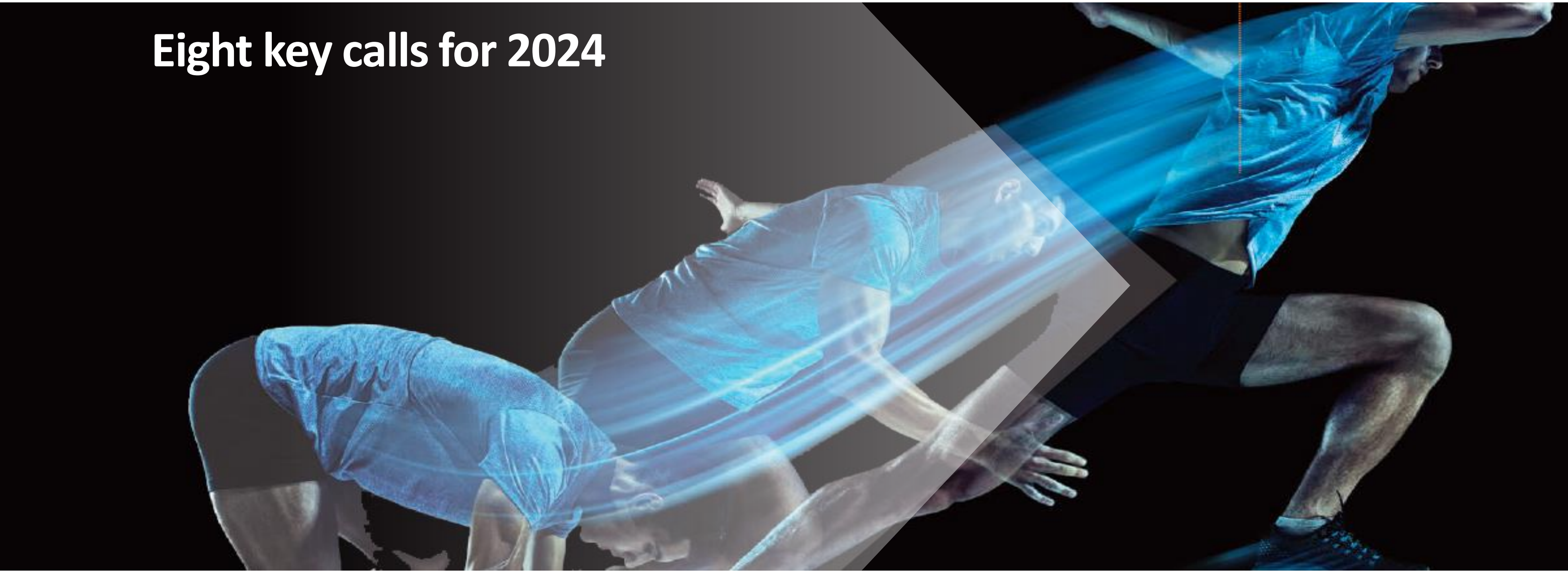
Workout
Weekly

Kepler Cheuvreux

Economics & Cross-Asset Strategy Research

11 December 2023

Eight key calls for 2024



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Executive summary (1/2)

Eight key calls for 2024

- **There is always a psychological barrier when you get close to record highs,** and equity markets in Europe and the US are now just 3-5% short of early 2002 levels, when interest rates were at 0%. One associated question is how long it will take to get there, and how far above equity markets can go in 2024. In our view, the upside is limited in price return terms in Europe and the US, considering the growth and inflation deceleration. But taking into account dividends and buybacks, our medium-term stance on equities is not too defensive, at slight Underweight.
  - Recent macro releases still to point to a robust pace of job creation in the US, which should continue to support consumption. The strength of the labour market, nonetheless, tends to be a lagging indicator for markets, and we see no reason to reconsider our views.
- **In this special edition of our weekly report, we dig into eight key calls from a cross-asset perspective,** following the release of our 2024 outlook (link).
  - **Key call 1: bull steepening of the EUR yield curve**. We believe inflation is starting to be something of the past. Although fixed income markets have started to price in sharp rate cuts from central banks in 2024, any pushback from them next week during their regular monetary policy meetings would offer attractive entry points.
  - **Key call 2: IG credit, bank tier 2, corporate hybrids.** IG credit keeps an attractive risk/reward profile, while we are more selective on high yield ahead of the growth deceleration that is taking shape in Europe. With regards to corporate hybrids and financials, yields are very high, while extension risk has receded, with the majority of hybrid issuers having exercised the call at the first call date.
  - **Key call 3: increase bond duration.** We find equities richly valued versus bonds and expect the bond market rally that has started to take shape to continue into 2024 as inflation keeps falling. Next week, the US CPI release for November should see a further easing of price pressure.
  - **Key call 4: reduce Japanese equities.** The BoJ is in a corner. It wants to normalise monetary policy, but the window of opportunity is closing, as other global central banks have finished their rate hike cycle. The USD/JPY has room to fall substantially, which would be a severe headwind for Japanese equities after a great run in 2023.

Executive summary (2/2)

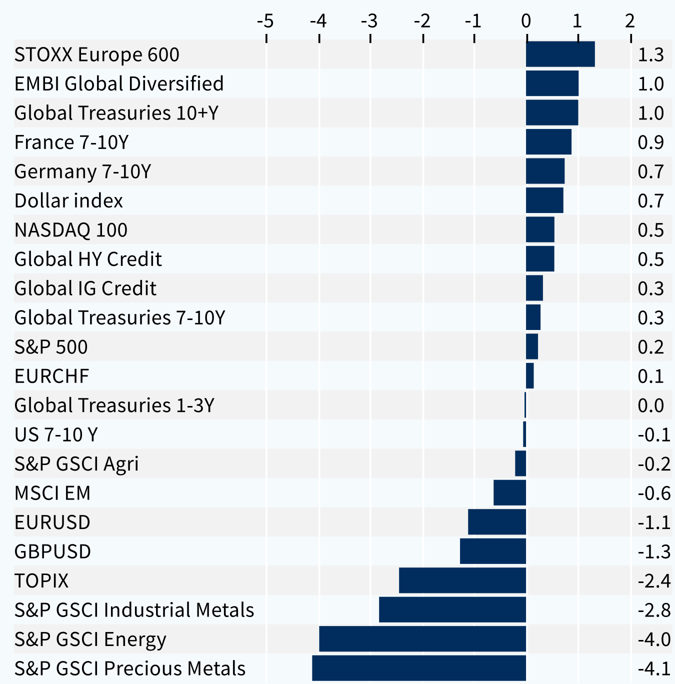
- **Key call 5: EM equities, prefer Brazil/India in core EM.** We find valuation appeal in EM equities on top of significant growth potential in countries such as Brazil and India. Brazil is cheaply valued, oil production is rising fast, and politics are quiet. India is richly valued but should be the growth star of the next decade. Investors should not focus too much on valuation, as India is structurally richly valued due to its Tech bias. China could surprise on the upside.
- **Key call 6: reweighting some growth sectors in European equities.** Although our overall sector allocation maintains a value bias, we upgrade MedTech and luxury, two growth sectors, on the back of recent weakness and support from lower yields ahead. We also upgrade professional and business services. We downgraded Pharma and we still favour the high dividend style.
- **Key call 7: OW EM sovereign credit in hard currency.** Yields are near 8%, while sovereign risk in core emerging markets is low. EM central banks are ahead of the curve with regards to rate cuts, and external balance sheets are strong, suggesting that refinancing in US dollars is not an issue. Political risk also appears highly manageable.
- **Key call 8: buy gold in commodities.** We stay constructive on gold in 2024, although the recent rally suggests a pause is due. Falling interest rates, a complex geopolitical environment, and strong demand from EM central banks are likely to lift gold prices to new highs. Energy commodities deserve a tactical look after the severe pullback recently.

- **Week ahead:**
  - The US CPI for November, as well as the ECB/Fed monetary policy meetings, will be key milestones. The consensus expects US inflation to have marginally decelerated to 3.1% YOY from 3.2% in October, while the core CPI is expected to have remained unchanged at 4%. US retail sales and industrial production for November will also be released.
  - We expect the Fed/ECB to keep rates on hold, but not yet explicitly pivot. The median dot for the end-2024 Fed funds rate will be revised down by 25bps to 4.875%, in our view.
  - In China, retail sales and industrial production figures for November will also be available. Consensus expects a rebound, which has failed to materialise so far this year.

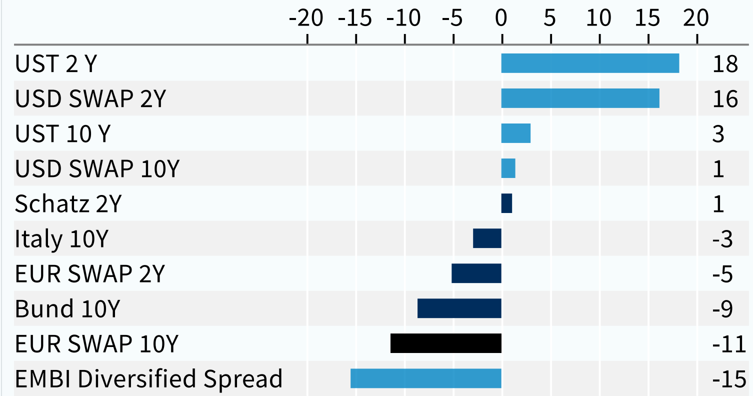
Contents

Cross-asset snapshot: the rebound in Treasuries takes a breather

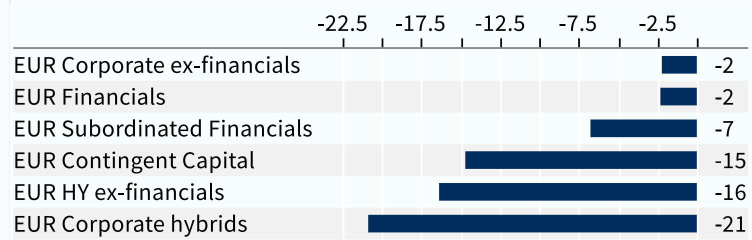
Cross-asset performance (last week, %)



Change in bond yields (last week, bps)



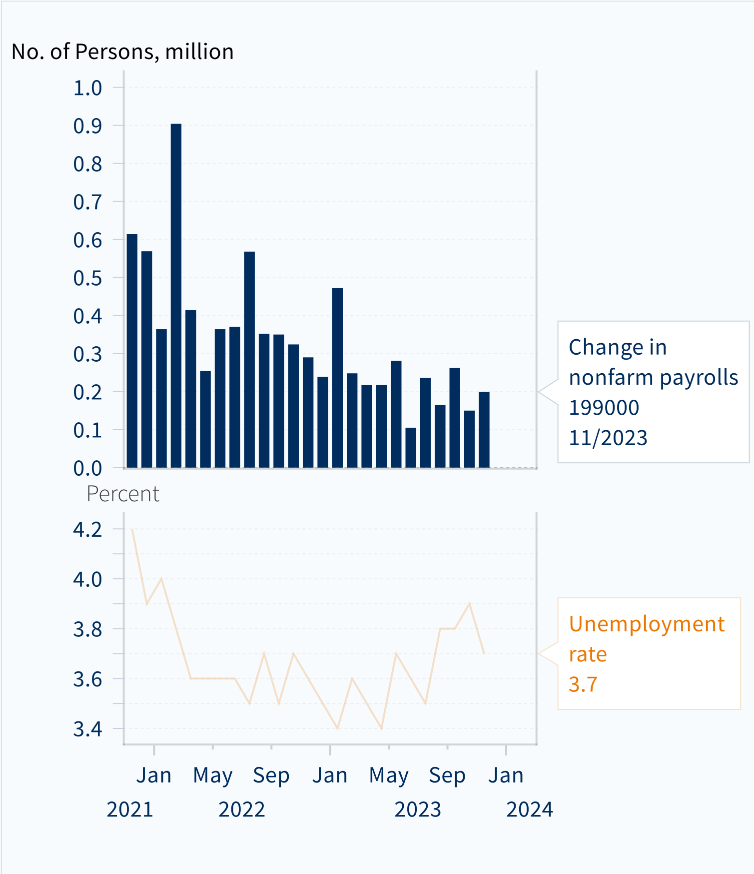
Change in credit spreads (last week, bp)



As of 08/12/2023. Total return indices. Global indices are hedged USD, local indices in local currency. Source: Macrobond, Bloomberg, Kepler Cheuvreux

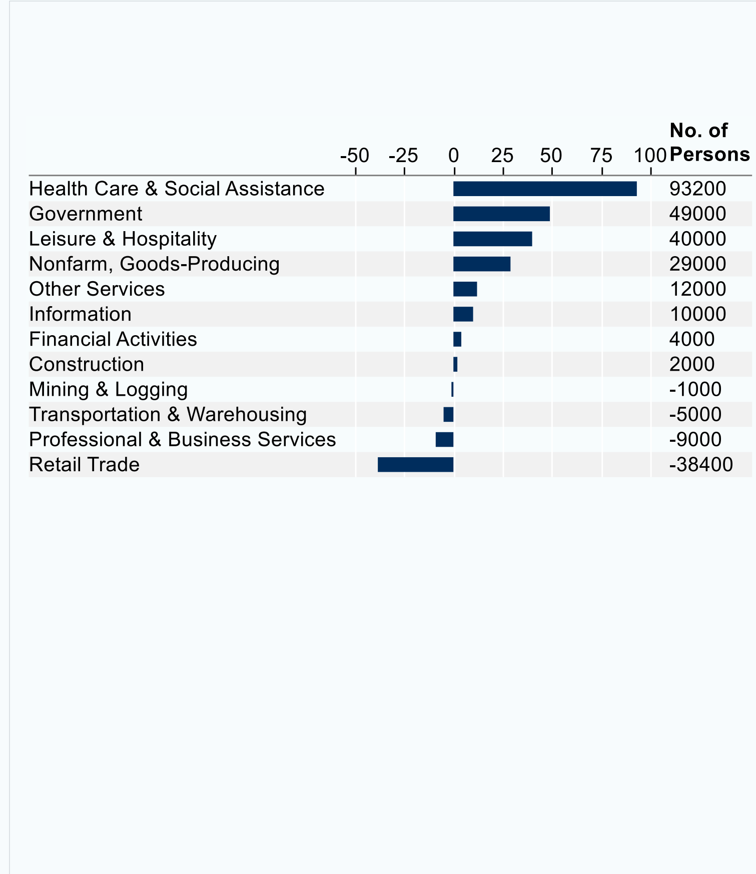
The US employment picture stays strong

Job creation rebounded in November *(nonfarm payrolls, one-month net change)*



Source: BLS, Macrobond, Kepler Cheuvreux

Net job creation stays robust in services *(nonfarm payrolls, one-month net change, thousands)*



Source: BLS, Macrobond, Kepler Cheuvreux

Sections

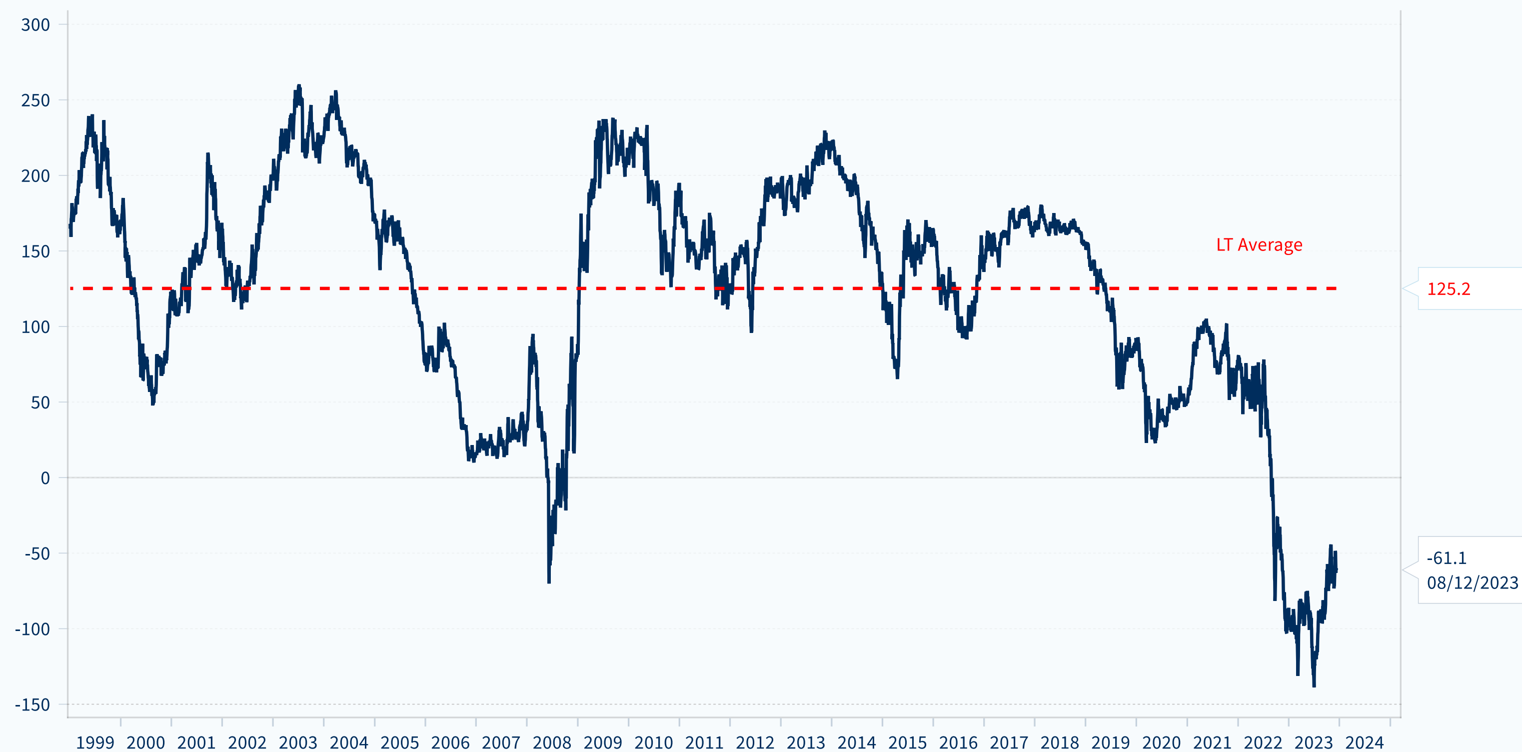
Eight key calls

- **Bonds:** Curve steepeners, European credit, Duration
- **Equities:** Reduce Japanese equities, Buy EM equities, Back to growth style in Europe
- **Diversification:** EM sovereign credit, Gold

Key call 1: a bull steepening of the EUR yield curve

"When the facts change, I change my mind." (ECB's Isabel Schnabel, 5 December, link)

The 30-2y EUR swap curve is reverting swiftly towards positive territory



Source: Bloomberg, Macrobond, Kepler Cheuvreux

Key call 2: IG credit, a no brainer with interest rates due to fall further

A good entry point for corporate hybrids bonds and Bank Tier2s (link)

Our credit team recommendations

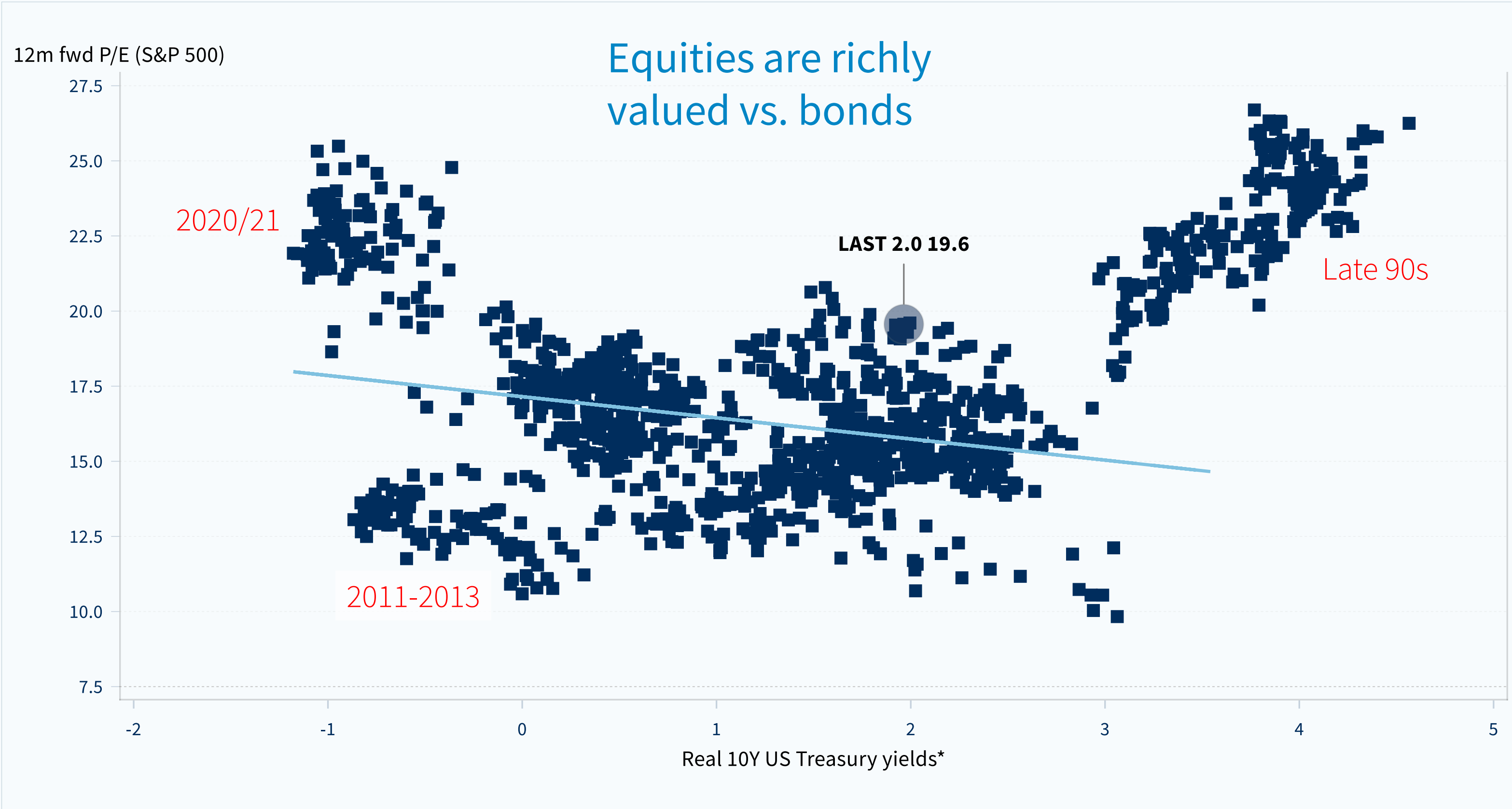
- **Credit markets rebounded markedly in recent weeks thanks to lower rates,** while expectations of defaults have remained roughly unchanged. HY and AT1 are the best performers in terms of total return YTD, followed by Insurance Tier2s and corporate hybrids.
- **We continue to think that it is still a good entry point for corporate hybrids bonds and Bank Tier2s:**
  - Regarding corporate hybrids, the extension risk has receded, with the majority of hybrid issuers having exercised the call at the first call date. Going forward, we see very limited extension risk at this stage for hybrids that have call dates in the next six months, except (unsurprisingly) for real estate issuers, which are still in the eye of the storm.
  - For the banking sector, the shockwaves from the collapse of Credit Suisse and the US banking turmoil, have now receded, as has the extension risk. We continue to recommend Bank Tier2s as they offer an attractive investment opportunity in the credit universe. European banks' AT1s have recovered some lost ground, and the extension risk has significantly declined thanks to an open primary market and lower sovereign yields. We maintain our Neutral stance on AT1s.

High yield & AT1 registered the best returns YTD *(total return, rebased on 31 December 2022)*

Source: Bloomberg, Macrobond, Kepler Cheuvreux

Key call 3: increase duration; bonds attractively valued vs. equities

Equities are richly valued vs. bonds



* 10-year Treasury yields minus 10-year inflation breakeven. Source: Datastream, Bloomberg, Kepler Cheuvreux

Key call 4: reduce Japanese equities; sell USDJPY

The BoJ is exploring options to normalise monetary policy *(Nikkei 225)*

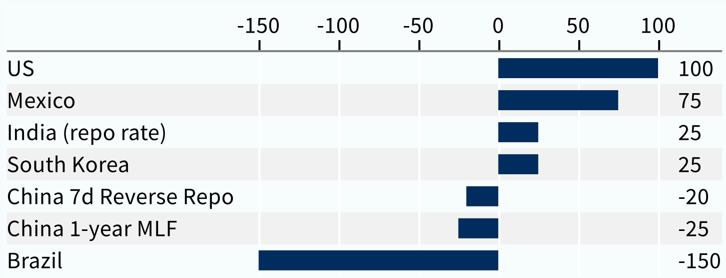
Source: Macrobond, Kepler Cheuvreux

Japanese equities are tightly correlated to currency movements *(1y correlation TPX / SPX vs USDJPY)*

Source: Macrobond, Kepler Cheuvreux

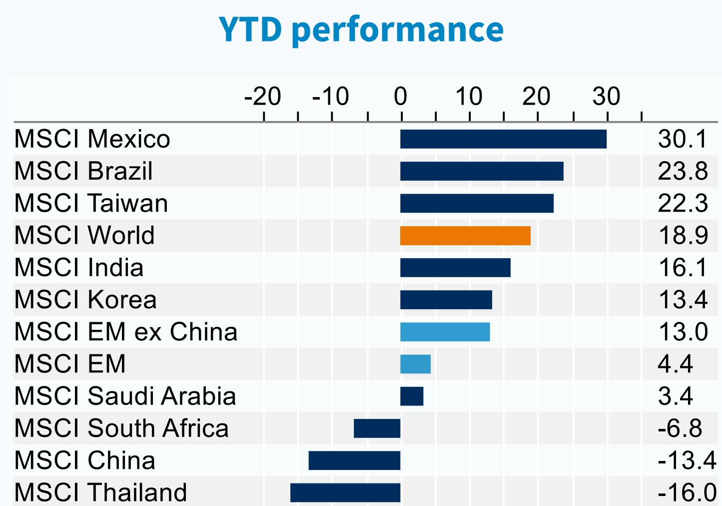
Key call 5: Buy EM equities; manage China's risk carefully

The monetary stance has started to turn more dovish in EM *(change in policy rates YTD, bps)*



Source: Bloomberg, Kepler Cheuvreux

LATAM has much more potential ahead *(net total return, USD indices)*

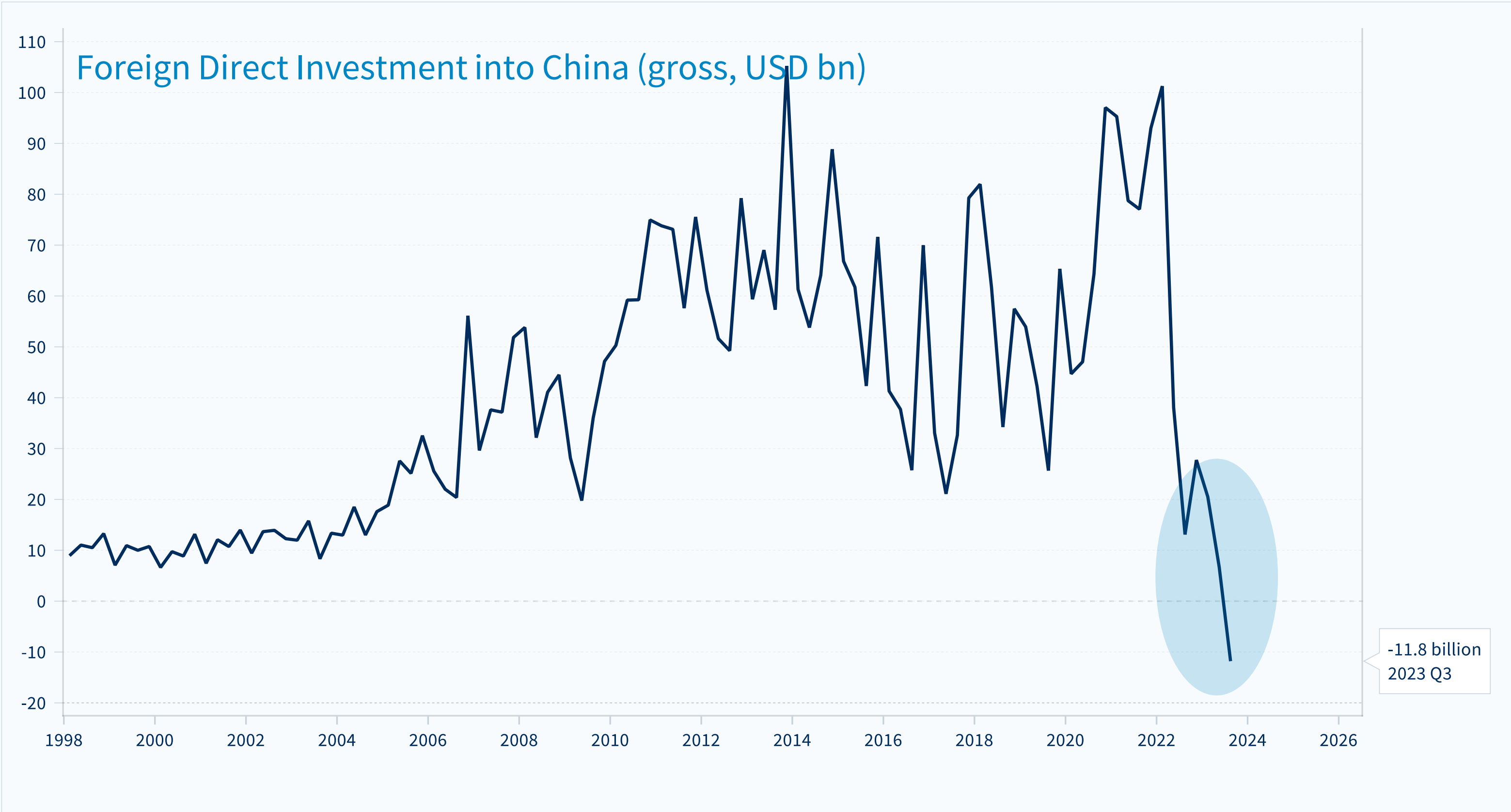


The above country indices represent more than 85% of the MSCI EM benchmark

Source: Bloomberg, Kepler Cheuvreux

Overcoming China's confidence deficit will take time

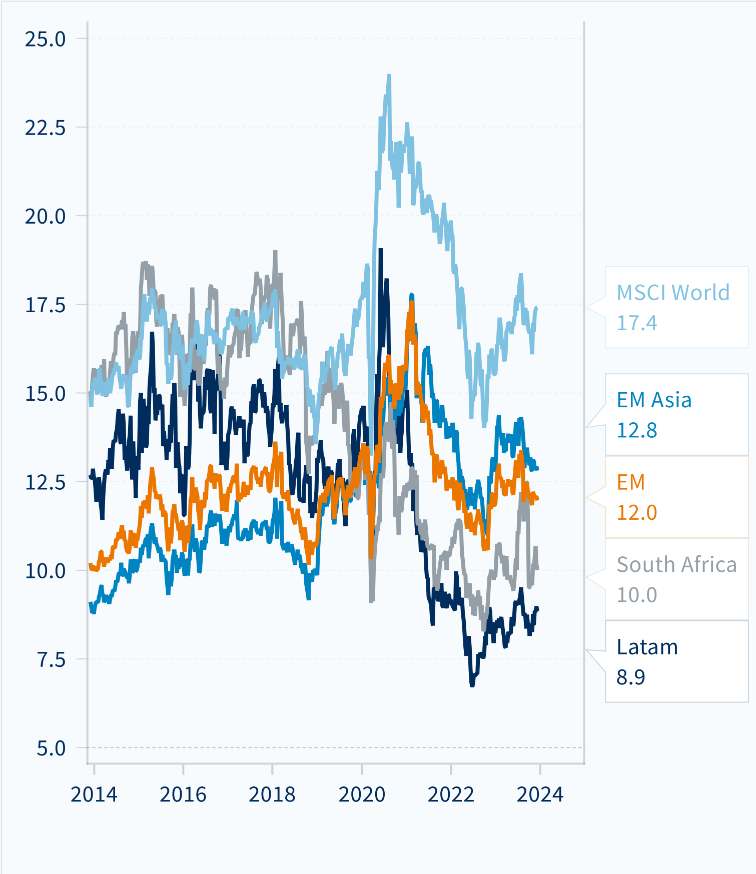
Global corporates are repatriating their assets from China for the first time in decades



Source: SAFE, Macrobond, Kepler Cheuvreux

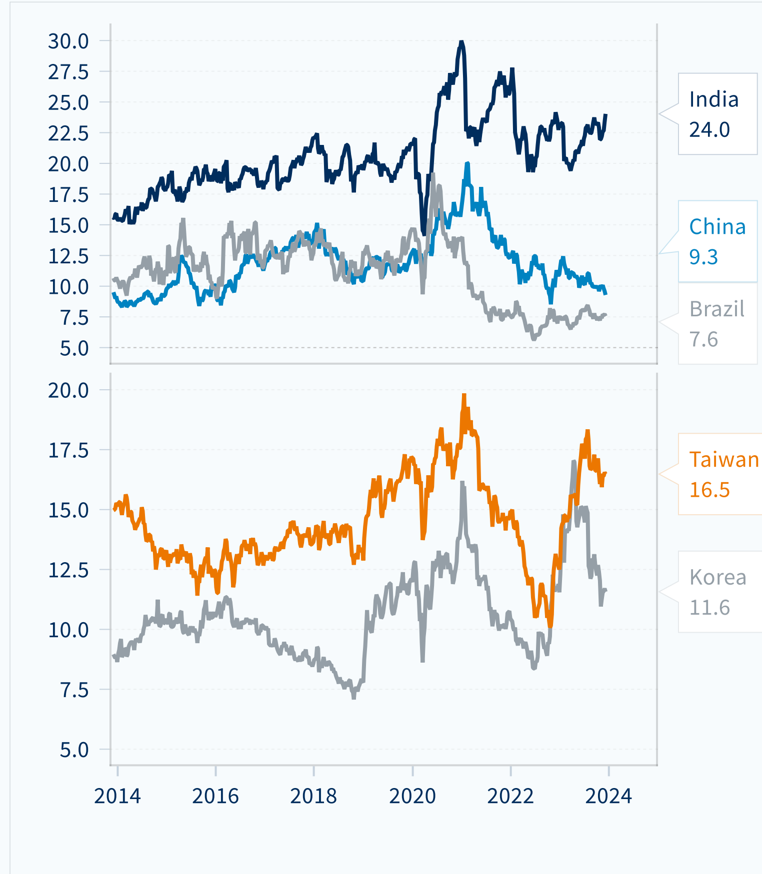
China's valuation is close to the lows of the past decade. We structurally prefer Brazil/ India in core EM

12-month forward P/E *(x)*



Source: Bloomberg, Kepler Cheuvreux

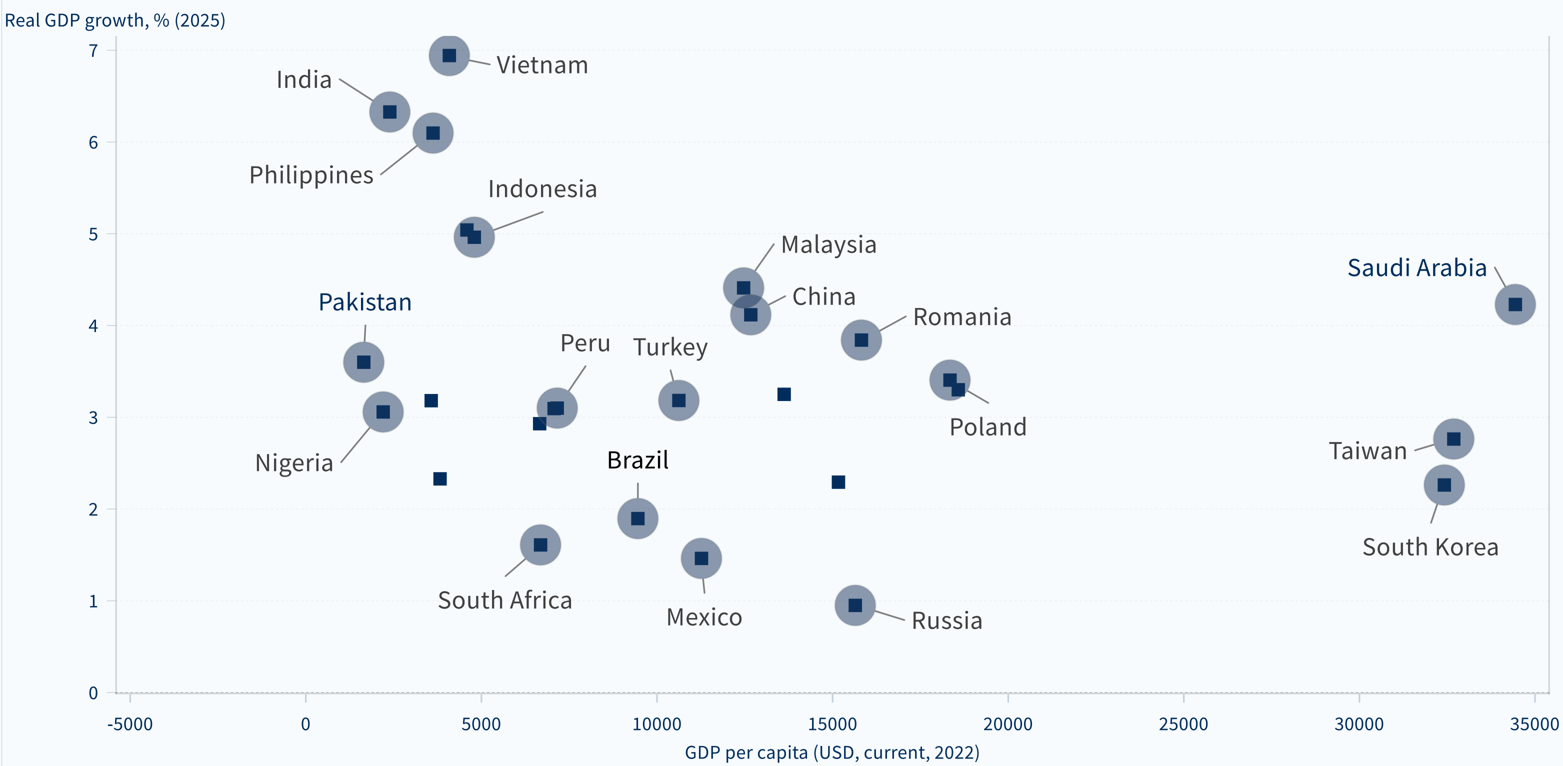
12-month forward P/E *(MSCI country indices, x)*



Source: Bloomberg, Kepler Cheuvreux

EM Asia ex-China to experience high single-digit growth

Poorest countries with good governance set to grow faster

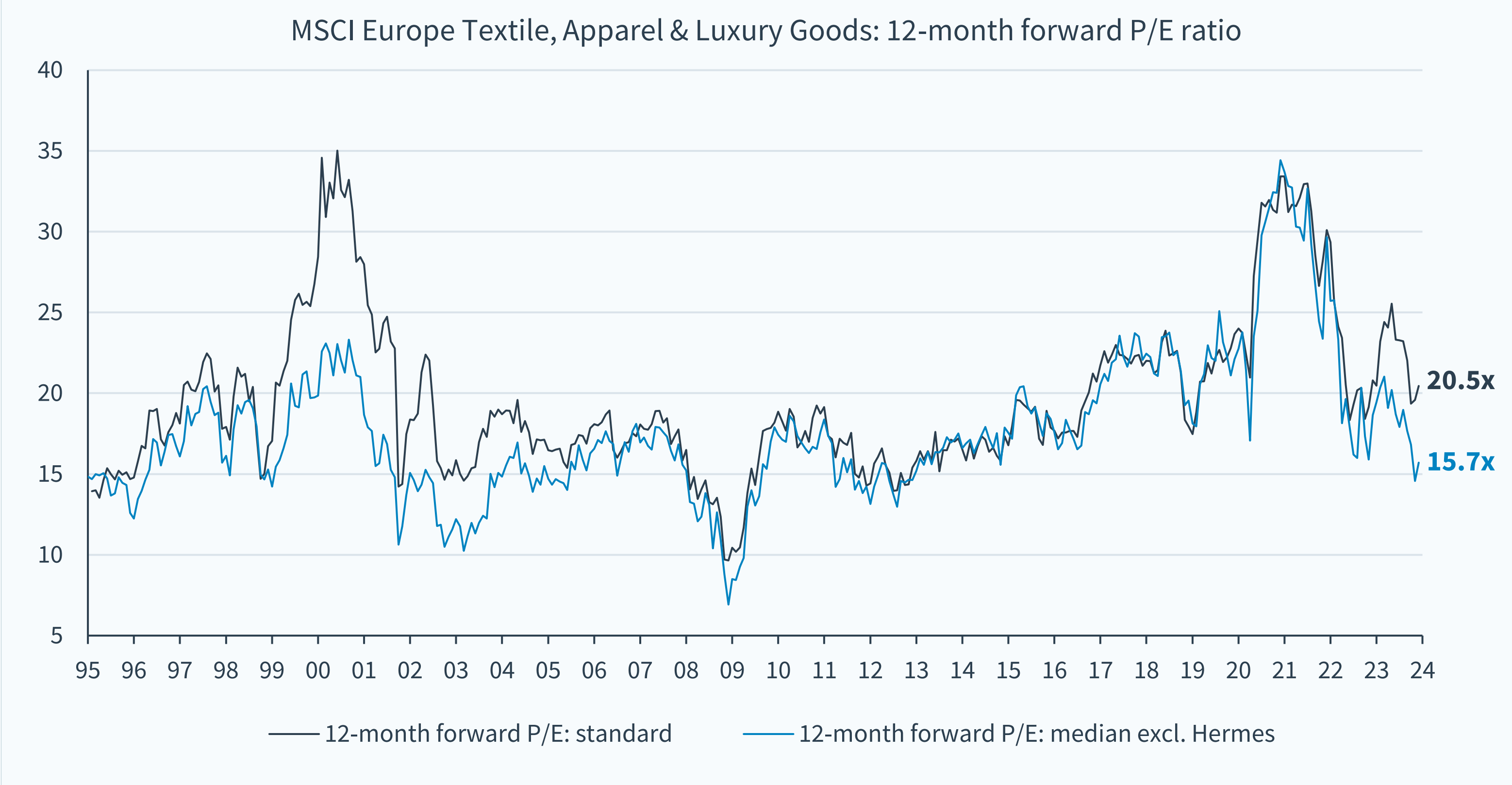


Forecasts are from the World Economic Outlook database. Source: IMF, Kepler Cheuvreux

Key call 6: reweighting some growth sectors in European equities

Luxury upgraded from UW to N

The forward Price-to-Earnings ratio of the Luxury Goods sector has normalised



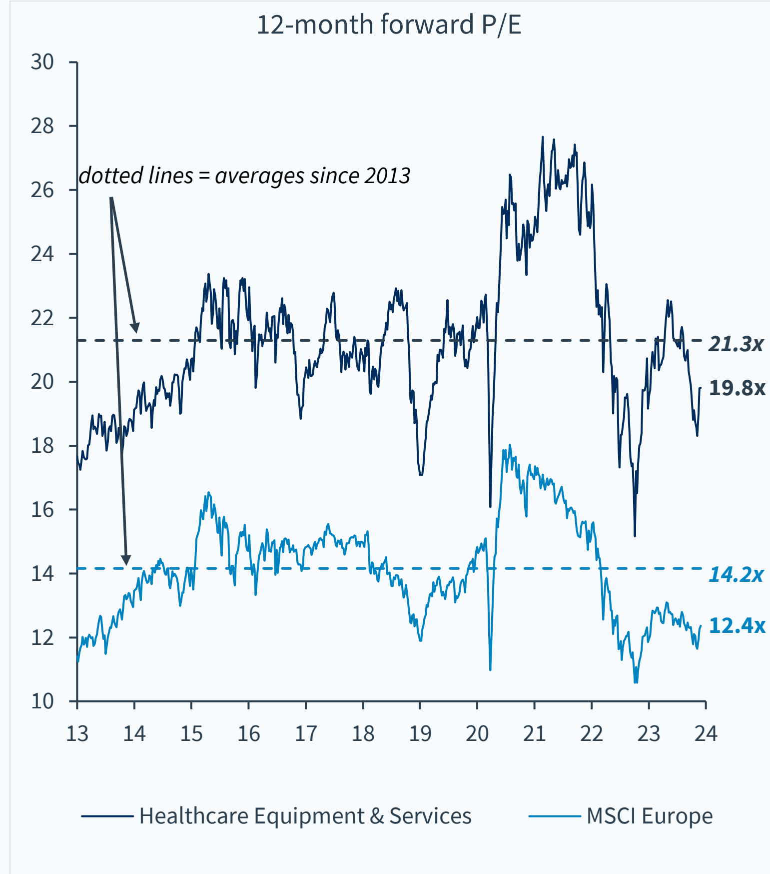
Source: Datastream, Kepler Cheuvreux

We turn positive on Medtech: *Upgraded from UW to OW*

The relative performance of the European Medtech sector and the 10Y Treasury yield

Medtech = MSCI Europe Health Care Equipment & Services. Source: Datastream, Kepler Cheuvreux

The fwd P/E of the Medtech sector and the MSCI Europe



MSCI Europe universe. Source: Datastream, Kepler Cheuvreux

We turn positive on Business Services: *Upgraded from UW to OW*

The relative performance of TICs and the broader business services sector in European equity

TICs = Testing, Inspection and Certification stocks = Bureau Veritas, Intertek, SGS (market-cap weighted).
Business Services = MSCI Europe Commercial & Professional Services. Source: Datastream, Kepler Cheuvreux

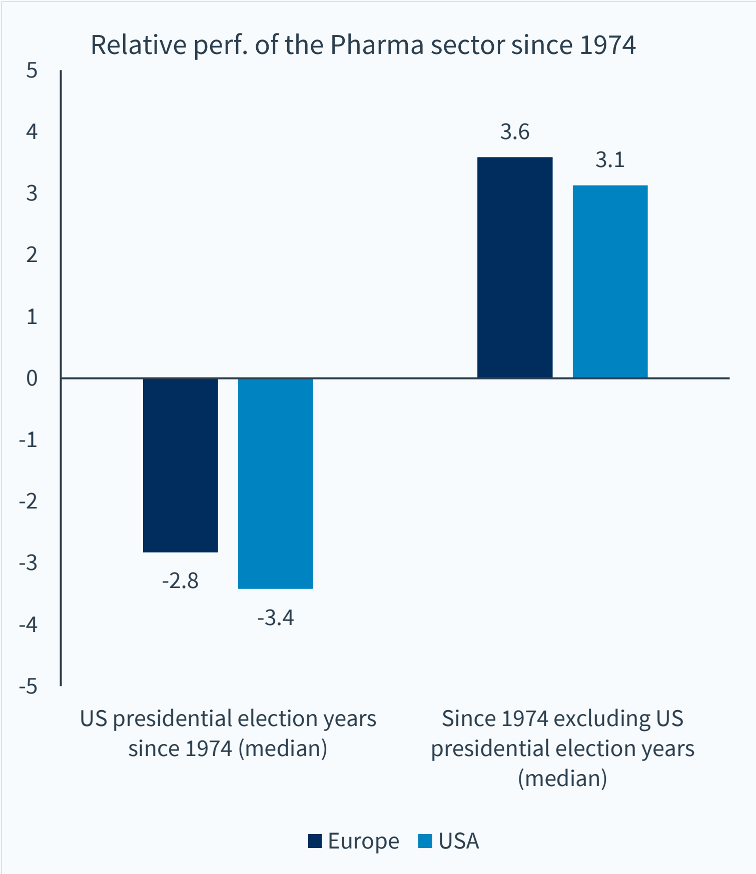
The performance of TIC stocks since the pandemic

Source: Datastream, Kepler Cheuvreux

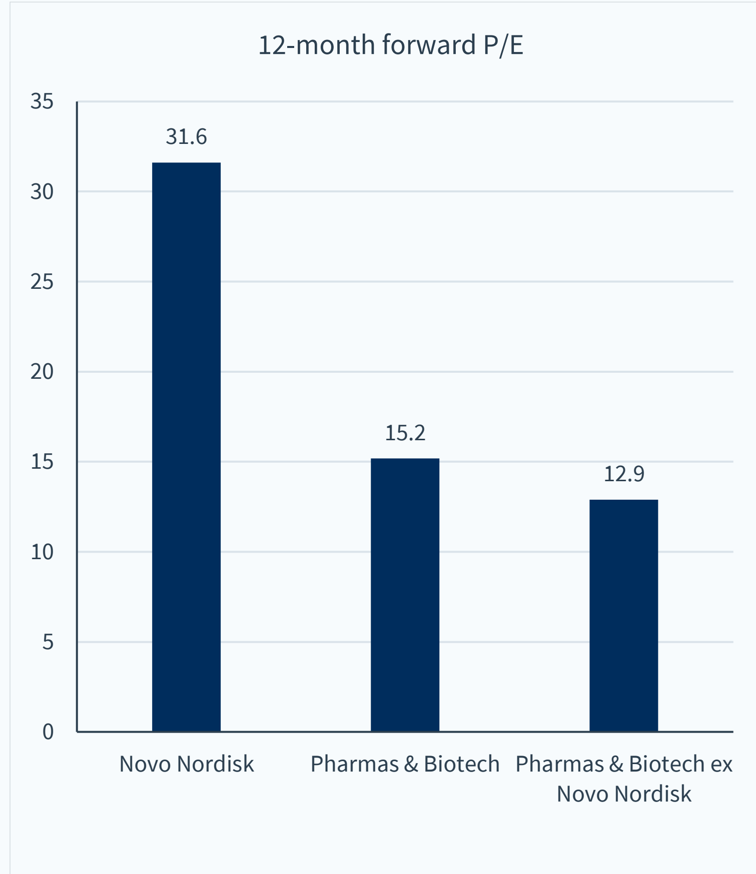
We neutralise our rating on Pharmaceuticals, Biotech & Life Science

Downgraded from OW to N

Typically, election years tend to be tricky for pharma stocks, both in Europe and the US



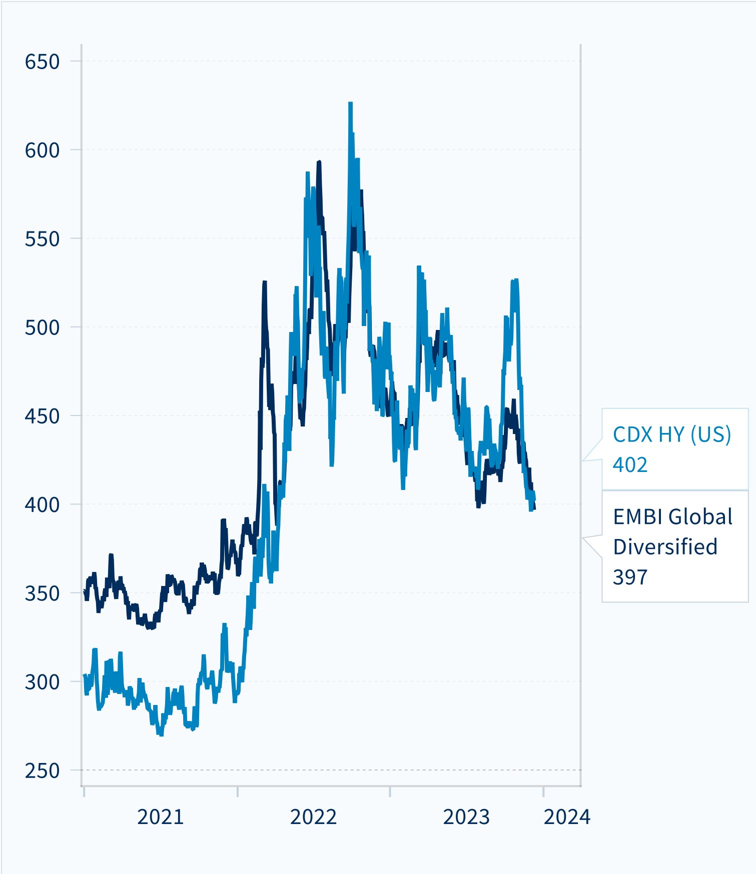
Figures shown are the average annual relative price returns of the Pharmaceutical sector vs total market (local Datastream indices). Source: Datastream, Kepler Cheuvreux



Source: MSCI, Datastream, Kepler Cheuvreux

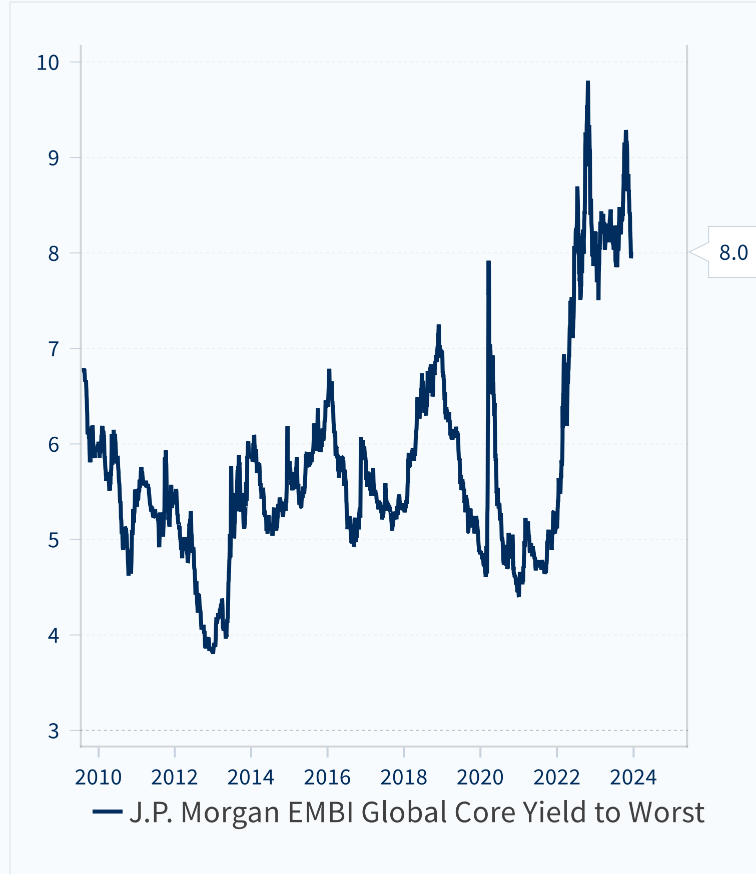
Key call 7: EM sovereign credit in hard currency - attractive yields…

Spreads vs. Treasuries tightened but…



Source: Bloomberg, Kepler Cheuvreux

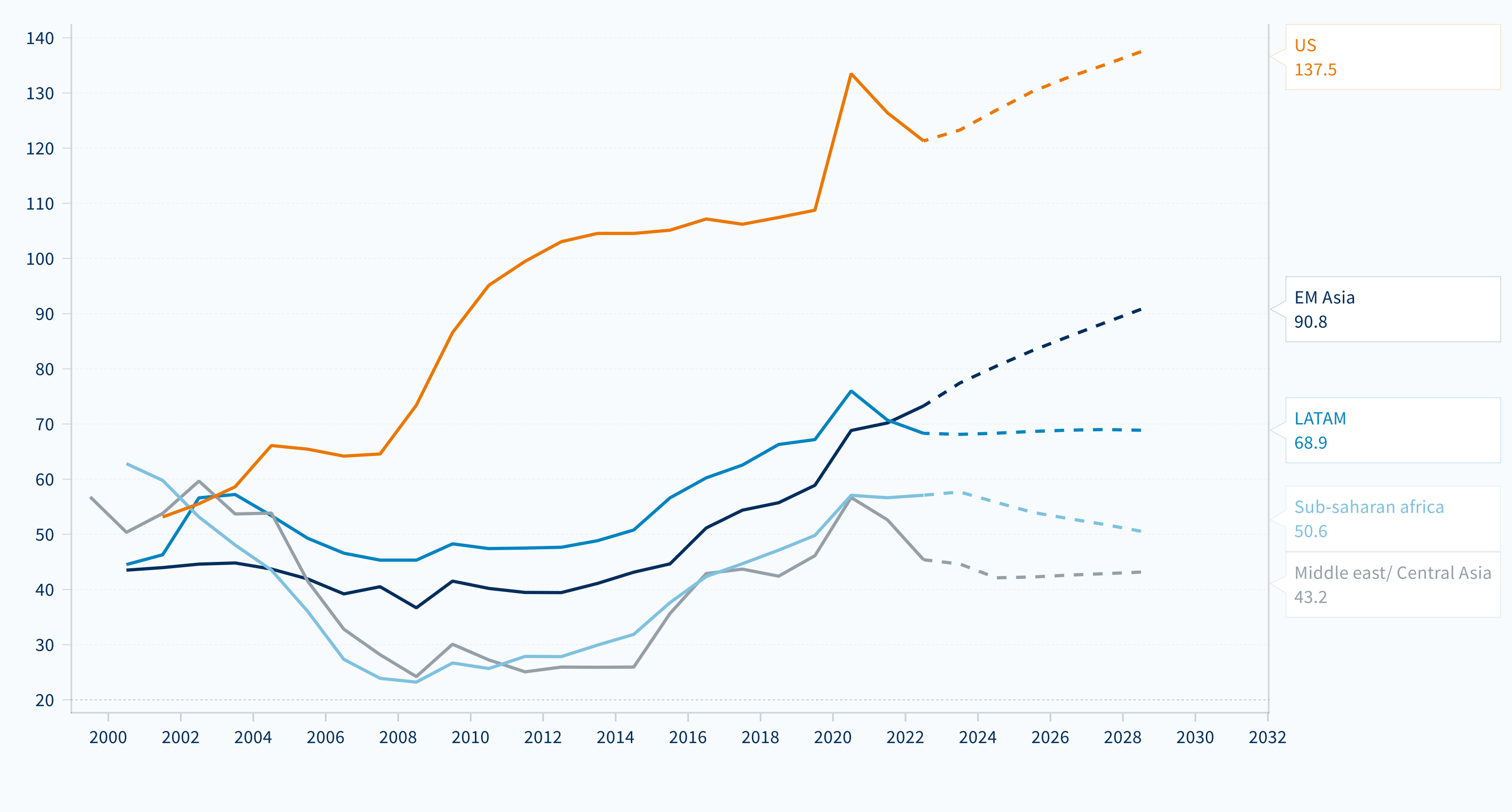
…yields are above 8%, while credit risks are highly manageable



Source: Bloomberg, Kepler Cheuvreux

…and limited credit risks as Treasury yields edge lower

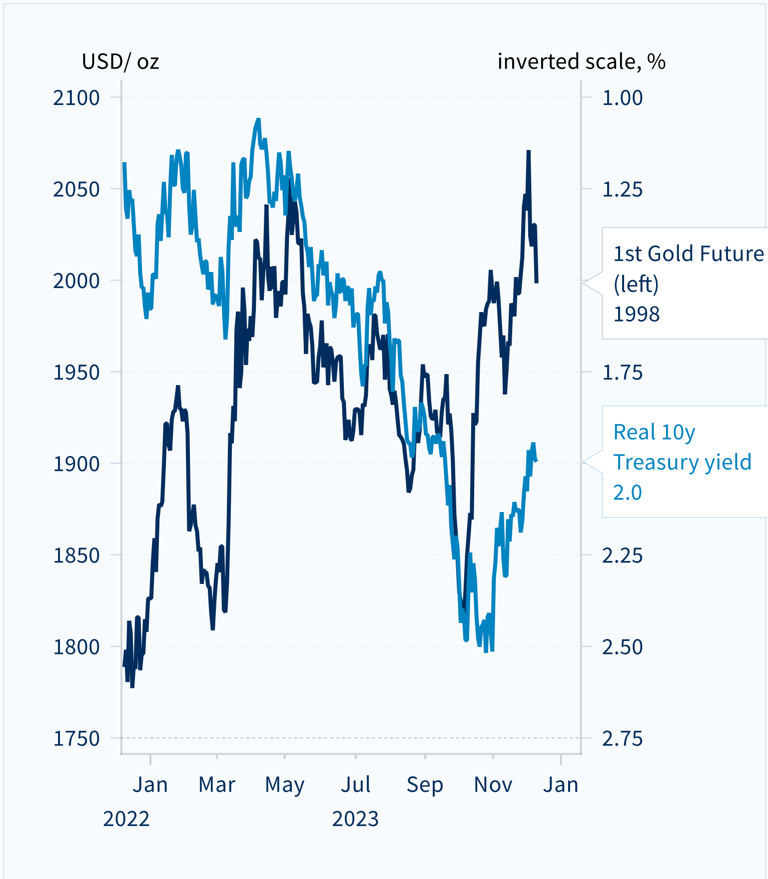
General government gross public debt (% of GDP)



Forecasts are from the World Economic Outlook database. Source: IMF, Kepler Cheuvreux

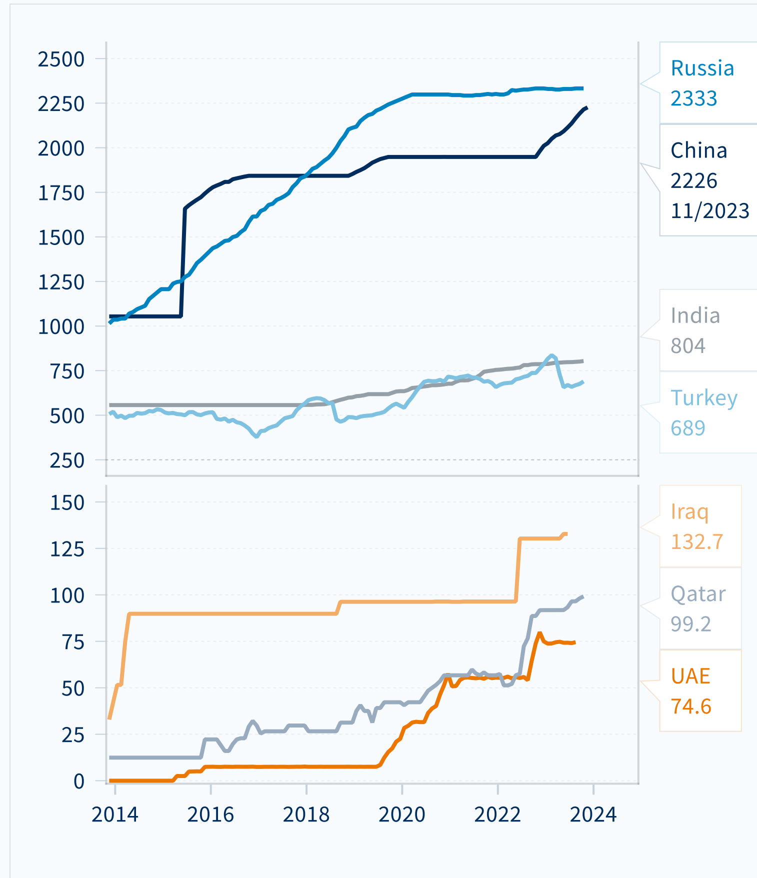
Key call 8: gold, a bond proxy chased by EM central banks

Lower real yields, a tailwind for Gold



Source: Bloomberg, Macrobond, Kepler Cheuvreux

Gold purchases from EM central bank have proved supportive

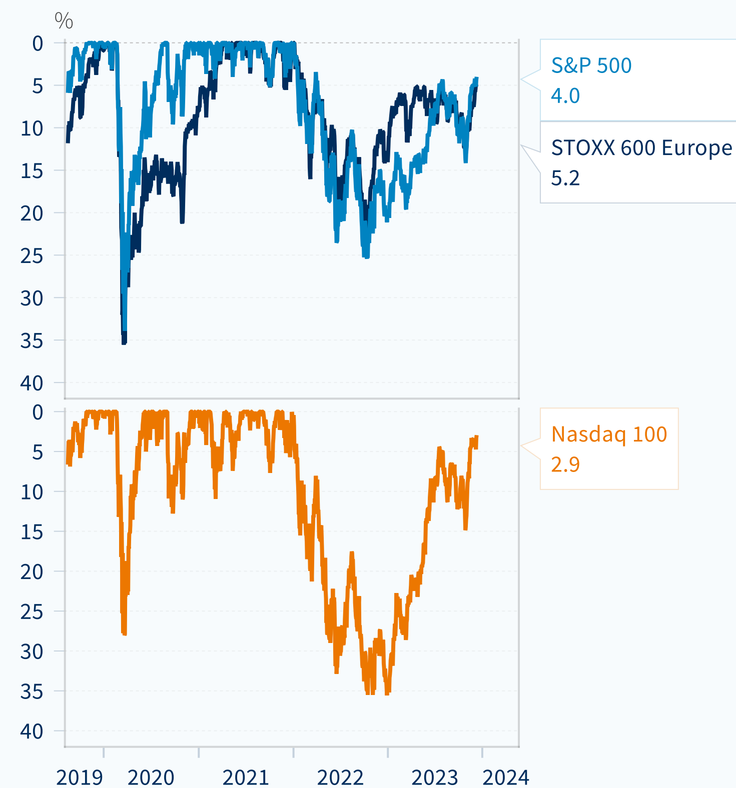


Source: IMF, Macrobond, Kepler Cheuvreux

Summing up: equity markets are almost back to all-time highs; diversification is key

- **Key call 1:** bull steepening of the EUR yield curve
- **Key call 2:** IG credit, bank tier 2, corporate hybrids
- **Key call 3:** increase bond duration
- **Key call 4:** reduce Japanese equities
- **Key call 5:** EM equities, prefer Brazil/ India in core EM
- **Key call 6:** reweighting some growth sectors in European equities
- **Key call 7:** OW EM sovereign credit in hard currency
- **Key call 8:** buy gold in commodities

Drawdown *(distance from previous market peak, price index, %)*



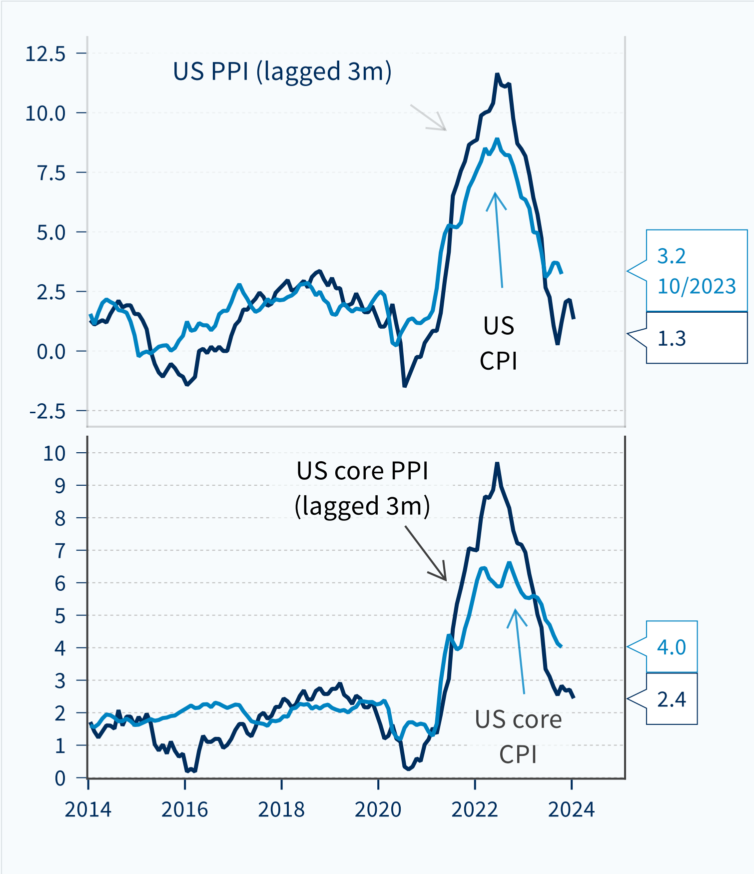
Sections

Week ahead

- US CPI
- Fed/ ECB meetings

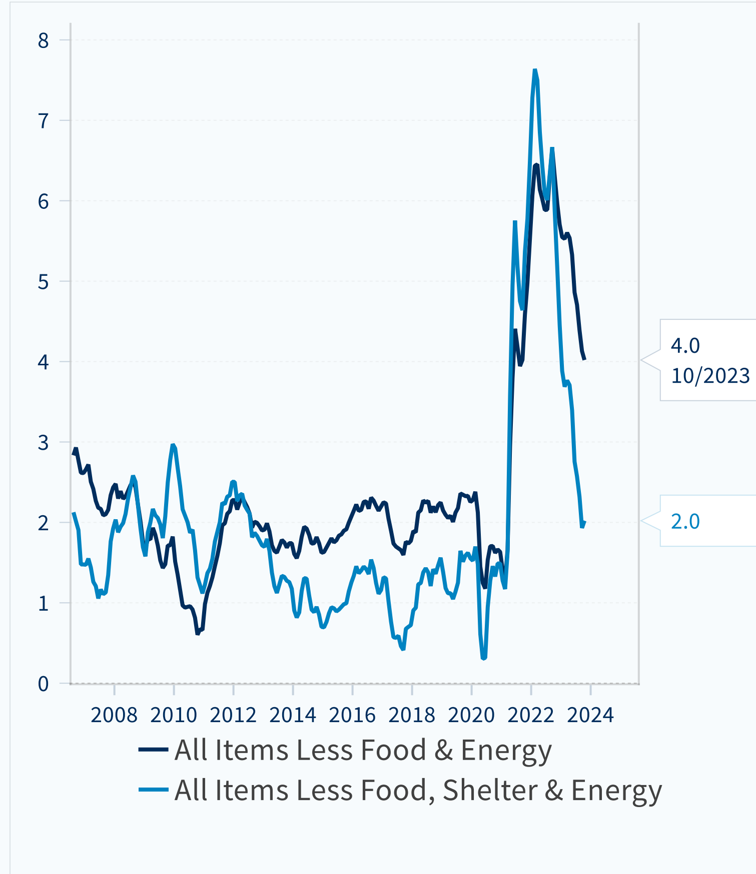
US CPI has room to keep decelerating with oil prices falling fast

Headline CPI on the way down



Source: Bloomberg, Macrobond, Kepler Cheuvreux

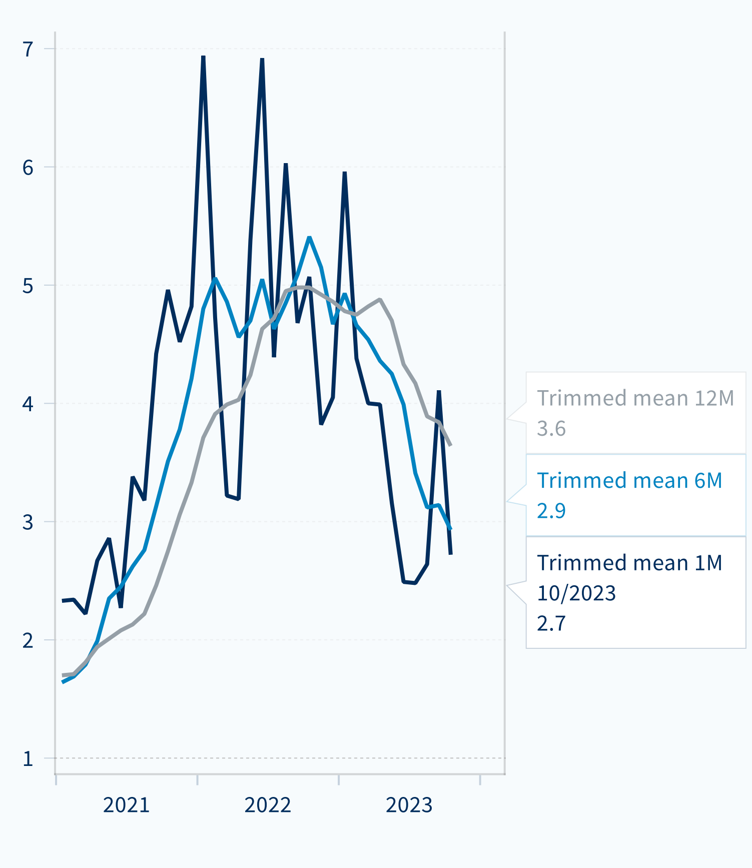
Shelter: the main culprit behind the above-target CPI



Source: IMF, Macrobond, Kepler Cheuvreux

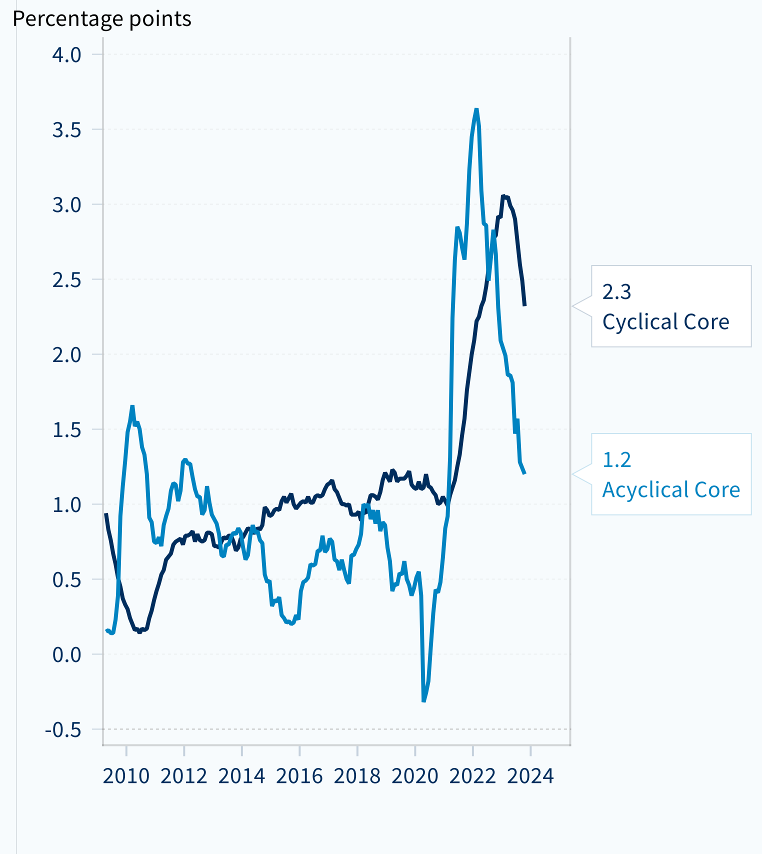
Every measure of US inflation suggests this is an issue of the past

Trimmed mean measures of inflation from the Fed Dallas



Annualized rates. Source: Fed Dallas, Macrobond, Kepler Cheuvreux

Contributions from cyclical and acyclical sources of inflation to the core PCE deflator in the US



Source: FRBSF, Macrobond, Kepler Cheuvreux

Fed and ECB previews: holding, not yet explicitly turning (1/2)

- **The outcome of this week's Fed and ECB meetings are not in doubt. Both central banks are unanimously expected to leave rates unchanged, and we do not see any reason to disagree. We thus expect the Fed funds target range to be maintained at 5.25-5.50%, and the ECB deposit rate to remain at 4.00%.**

- **That said, with several of the hawkish-leaning, influential members of the FOMC, and the ECB Governing Council having become much less anxious as regards inflationary risks recently, communication on the monetary policy outlook will need to be closely watched.** In the US, indeed, Governor Waller acknowledged that he was increasingly confident that the Fed has done enough and did not totally dismiss the possibility of cutting rates as early as in the first half of 2024. In the eurozone, Isabel Schnabel judged that a further rate increase had become "rather unlikely", and, by calling for data-dependency going forward when questioned on the possibility of a rate cut in the coming months, she sounded surprisingly pragmatic.

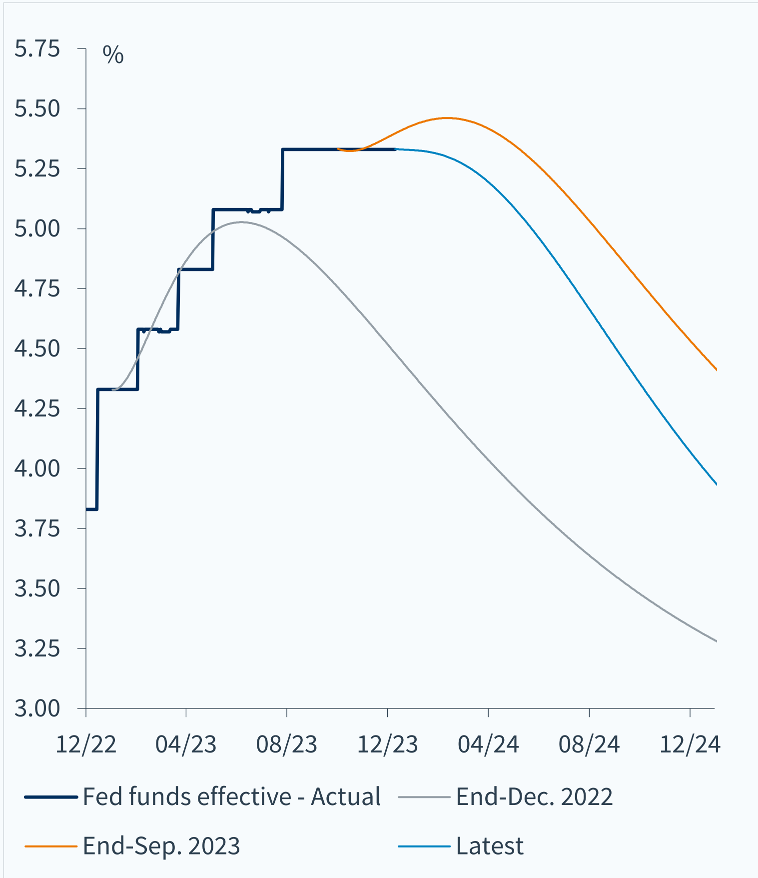
- **We expect this week's meetings to give additional evidence that the tightening cycle has come to an end in both the US and the eurozone.** Regarding the Fed, it is likely that the statement will be amended to signal that an additional firming of the policy stance has become an even more remote possibility. Importantly, also, we think that, on the back of a more favourable view of inflation prospects, the "dot plot" will imply that the peak in the hiking cycle has been reached. In fact, we expect both the median dot for end-2023, and end-2024 to be revised down by 25bps, to 5.375% and 4.875% respectively. As for the ECB, while the broad guidance on future policy steps was already quite neutral, the new macroeconomic projections are likely to confirm that the policy stance will not need to be tightened further. Thanks to lower-than-expected inflation numbers recently, more favourable assumptions on energy prices, and a somewhat weaker growth outlook, we think they are likely to show inflation coming back at the 2% target in 2025 (vs. 2.1% YOY in September).

- **However, we expect the Fed and the ECB to tread cautiously as far as policy prospects for next year are concerned, and, following the large, repricing of investors' expectations seen over recent weeks, they will likely be wary of striking an overly dovish note.** While both central banks will acknowledge the progresses made on the inflation front, they will take care of not sounding the all-clear. Chair Powell is likely to stress that, with US growth having yet to slow down materially, and a labour market that is still tight, the Fed cannot yet be sure that inflation will return to a level consistent with its target on a sustained basis. As for the ECB, President Lagarde can be expected to emphasise that the risk remains that that high labour costs will hamper disinflation going forward. **That said, our perception is that, at this juncture, it would probably take forceful pushback for investors to significantly reassess their expectations of monetary policy prospects, which we do not expect.**

- In the case of the ECB, another hot topic of this week's meeting will be its bond holdings. Lagarde clearly suggested recently that PEPP reinvestments will start being discussed this week as a large number of ECB members are calling for terminating the full reinvestment policy before end-2024 (as currently planned). However, while it is increasingly likely that the ECB will switch to partial reinvestments in the early part of 2024, we expect a firm decision to be taken only in January, or March when the ECB will also conclude the review of its operational framework. Going forward, one important question on this front will be whether the reduction in bond holdings will continue once policy rates start being cut. This is a question the Fed will also need to answer.

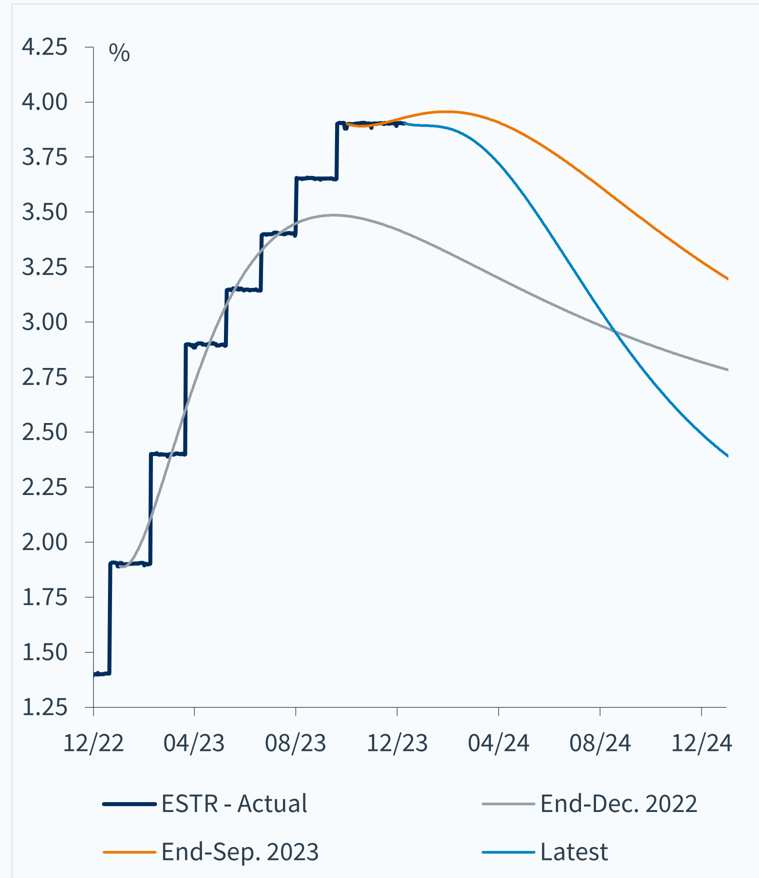
Fed and ECB previews: holding, not yet explicitly turning (2/2)

Market-based expectations of the Fed funds rate



Source: Bloomberg, Kepler Cheuvreux

Market-based expectations of the ECB deposit rate



Source: Bloomberg, Kepler Cheuvreux

Sections

Global asset allocation
European equity sector allocation

Strategic asset allocation: prefer fixed income & credit vs. equities

EQUITIES **(UW) 45%**	**- US 25%** **- Europe 10%** **- Japan 0% (-5)** **- EM 10% (+5)**	• Equities downgraded to slight Underweight in early October; US equities at slight Underweight; Europe at Neutral • We remain exposed to EM (ex-China) on the back of the higher growth potential. We reduced Japan.
Fixed Income **(N) 25%**	**- US (7-10Y) 15%** **- Europe (7-10Y) 10% (Germany, UK)**	• In early October, we reinforced Govies to take advantage of higher yields. In Europe, we took profits on Italy and switched to Germany.
CREDIT **(OW) 25%**	**- IG $ 10%** **- IG € 10%** **- EM debt 5%**	• Our stance on credit stands at OW, with a preference for IG vs. HY • IG credit: an attractive risk-reward as yields stand near 15-year highs • HY is exposed to the growth deceleration and the rise in default rates • We have balanced US credit and European credit. • We recently reinitiated the position on EM debt with spreads above 400 bp and risks in check
COMMODITIES **(N) 5%**	**- Gold 5%** **- Commodities 0%**	• We stay invested in gold on the back of troubled geopolitics and lower expected yields going forward.
CASH **(N) 0%**		
FX	**- USD long (15%)**	• **We recently increased our short EURUSD exposure, from 10% to 15%, when the EURUSD above 1.09.**

OW stands for Overweight; UW for Underweight. * Benchmark: 50% MSCI ACWI & 50% Bloomberg Global Aggregate

Equity sector allocation (1/2)

Sector	Strong UW	UW	N	OW	Strong OW	Rationale	Weight in MSCI EUROPE	P/E (12mf)	P/B (12mf)	Div. yield (12mf)	Beta 2Y
Communication Services				●		**Defensive, attractive dividend yield**	**3.2%**	**13.4**	**1.3**	**4.7%**	**0.78**
Media & Entertainment		●				Heterogeneous sector but bulk is cyclical and therefore exposed to the ad spending downturn.	0.9%	14.7	1.8	3.0%	1.10
Telecom Services					●	Relative winner in disinflation. Cautious capital allocation. Upside risk on EU regulatory stance towards consolidation.	2.3%	13.0	1.1	5.3%	0.66
Consumer discretionary		● →	●			**Cyclical nature (vulnerable to slowdown) but valuations discounting further pain**	**10.6%**	**11.9**	**1.6**	**3.2%**	**1.32**
Automobiles & Components	● →	●				Margins under pressure and very competitive BEV market but support from low valuations + strong cash returns	2.7%	5.4	0.7	5.9%	1.30
Consumer Durables & Apparel		● →	●			Late-cyclical, not recession-proof. Still, bond yields have peaked and valuations have normalised. Upside risk = China	4.8%	20.0	3.4	2.3%	1.37
Consumer Services		●				Post re-opening boom. Disinflation to bite.	1.8%	20.5	3.3	2.4%	1.14
Consumer Discretionary Distribution & Retail				●		Resilient demand (small ticket items). Margin tailwinds. Valuations back to LT average	1.4%	16.0	2.4	2.3%	1.35
Consumer Staples				●		**Appealing defensive characteristics, preference for Food & Beverages**	**11.9%**	**16.4**	**2.8**	**3.3%**	**0.69**
Consumer Staples Distribution & Retail			●			Defensive value, neutral valuation. Risk that disinflation impacts margins.	0.9%	11.8	1.5	4.1%	0.77
Food, Beverage & Tobacco					●	Defensive-growth sector. Valuation has come back to neutral. Easing raw mats pressure.	7.5%	16.1	2.7	3.4%	0.66
Household & Personal Product			●			Defensive sector but valuation not reflecting new bond yield context (compared to Food).	3.5%	19.0	3.9	2.9%	0.73
Energy				●		**Renewable development slower than expected. Balance sheet strength. Geopolitical hedge. Dividend yield.**	**5.9%**	**7.0**	**1.1**	**5.1%**	**0.84**
Financials			●			**Strong dividends and rather healthy capital ratios**	**18.0%**	**7.9**	**0.9**	**6.3%**	**1.15**
Banks				●		EPS peak but still attractive shareholder returns and valuation discount already factoring in severe recession	8.3%	6.1	0.7	8.4%	1.20
Financial Services		●				Mixed-bag sector, private equity tail risks, higher bond yields not favourable to the sector	4.3%	12.3	1.1	2.8%	1.23
Insurance			●			Better fairly valued relative to banks. Private equity tail risks.	5.4%	9.6	1.5	5.8%	1.00
Europe							**-**	**12.4**	**1.7**	**3.8%**	**-**

As of 04/12/2023. Source: MSCI, Datastream, Kepler Cheuvreux

Equity sector allocation (2/2)

Sector	Strong UW	UW	N	OW	Strong OW	Rationale	Weight in MSCI EUROPE	P/E (12mf)	P/B (12mf)	Div. yield (12mf)	Beta 2Y
Healthcare			●	●		**Defensive/quality feature. Preference for Medtechs**	**15.5%**	**15.7**	**3.2**	**2.7%**	**0.70**
Healthcare Equipment & Services		●		●		Peak in bond yields is a relief for this growth sector. Cyclical over past two years, but historically resilient in slowdowns.	2.3%	19.8	1.9	2.1%	1.07
Pharmaceuticals & Biotechnology			●	●		Probably the most defensive sector. Novo Nordisk risk after strong performance. US elections years can be tricky.	13.2%	15.2	3.7	2.9%	0.64
Industrials		●				**Late cyclical (in current business cycle), monetary policy effects with a lag**	**15.4%**	**16.6**	**2.9**	**2.7%**	**1.16**
Capital Goods		●				Mega-trends driving the sector but likely not immune to monetary cycle. Awaiting an entry point.	12.1%	16.2	2.9	2.6%	1.22
Commercial & Professional Services		●		●		Mixed-bag but overall low-beta and "all weather" stocks (earnings visibility). TICs look appealing.	2.1%	19.6	5.5	2.5%	0.87
Transportation			●			No restocking in sight yet and US macro risks increasing	1.3%	16.5	1.7	3.3%	1.11
Information Technology			●			**Prefer Software over Semis.**	**7.2%**	**22.0**	**4.2**	**1.4%**	**1.35**
Software & Services			●			Booming 2023, valuations no longer attractive, late cyclical.	2.5%	22.5	3.7	1.5%	1.17
Technology, Hardware & Equipment			●			Small segment within IT, valuations are close to historical bottom. Capex cycle unlikely to recover soon.	0.8%	13.8	1.6	3.0%	1.14
Semiconductors		●				Global restocking cycle has already been anticipated for the last 12 months. No big valuation support.	3.9%	24.4	6.9	1.1%	1.56
Materials			●			**Significant Chinese exposure on which sentiment is already depressed but weakening global growth coming.**	**7.1%**	**13.8**	**1.6**	**3.7%**	**1.11**
Chemicals				●		Mixed sector with large quality-defensive stocks but also early cyclicals. Destocking customer process well advanced.	3.4%	19.5	2.1	3.0%	1.09
Construction Materials		●				Vulnerable to weakening US investment, margins at risk.	0.9%	11.1	1.3	3.4%	1.14
Containers & Packag., Paper & Forest Prod.			●			Global growth play, consumer-derivative	0.6%	16.0	1.3	3.6%	1.15
Metals & Mining				●		Sentiment on China depressed. A US recession would help China lower rates.	2.1%	9.9	1.3	4.9%	1.15
Real Estate				●		**Real yields peaking, implicit assets' valuation depressed but stock picking key to avoid weak balance-sheets**	**0.9%**	**12.8**	**0.8**	**4.7%**	**1.27**
Utilities				●		**Defensive and key enabler of energy transition, high dividend yield. Renewables' valuation has normalised**	**4.4%**	**12.3**	**1.5**	**5.2%**	**0.82**
Europe							**-**	**12.4**	**1.7**	**3.8%**	**-**

As of 04/12/2023. Source: MSCI, Datastream, Kepler Cheuvreux

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