SEB

SEB House View

4 September 2023

Reducing equities amid inflation concerns and bullish sentiment

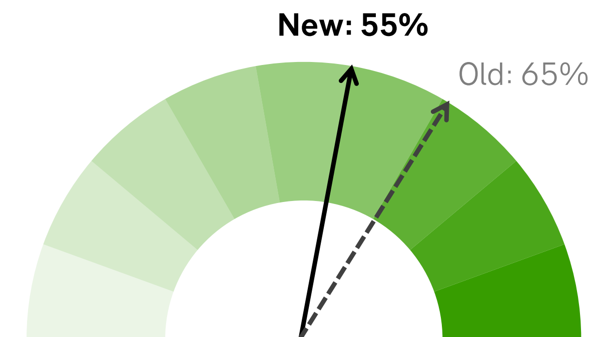
- Inflation remains a key variable in shaping the financial market outlook, but uncertainty persists on how inflation will evolve, especially as recent improvements have moderated
  - U.S. inflation has come down from last summer's peak, but the recent rise in headline inflation raises raised concerns of renewed inflationary pressures
  - Supply cuts and strong oil demand have pushed up global crude and U.S. gasoline prices, elevating the inflation risk
  - Stubbornly high inflation in the euro area and signs of re-accelerating price growth in some European countries, also questions the pace and direction of future disinflation
  - In addition, Fed Chair Jerome Powell has warned that strong U.S. economic momentum could add upward pressure on future core inflation
  - We see increased upside risks to our inflation outlook, due to the recent surge in oil prices and economic resilience, and remain vigilant for signs that inflation may start to pick up again
- We anticipate that the disinflation process will continue, but likely at a slower pace due to a more resilient economy
  - We expect inflation to continue falling due to moderating consumer spending, slowing hiring and wage gains, excess savings depletion, and the impact of the Fed's tight monetary policy
  - Having said that, we think that it is likely that the disinflation process will continue at a slower pace than before, because of the surprisingly robust economy
- Positioning and sentiment may offer less support for equities going forward
  - Investor positioning is more bullish than a few months ago, evidenced by an increase in net long positions in equity futures
  - With money markets and bonds offering higher yields nowadays, less incentive exists for investors to fully shift from cash and bonds to equities, potentially constraining further upside in long equity positions
  - Because of the increased upside inflation risks and bullish shift in positioning and sentiment, we chose to reduce risk utilization to 55% from 65%, by increasing our exposure to government and IG bonds at the expense of equities

Investment Regime

Our regime-based framework defines the major characteristics of the investment regime

Tight financial conditions	Strong "hard" data	Earnings revisions mixed
Employment gains slowly cooling	A soft landing is priced in	Rising oil prices
Weakness in China		Upside risks to inflation

Speedometer



The speedometer controls to what extent the portfolios should utilize their risk budgets. It is connected to the model portfolio (page 4) which at all times utilizes its risk budget in-line with the speedometer. In a very general sense it can be interpreted as equities on/off (with 50% being neutral).

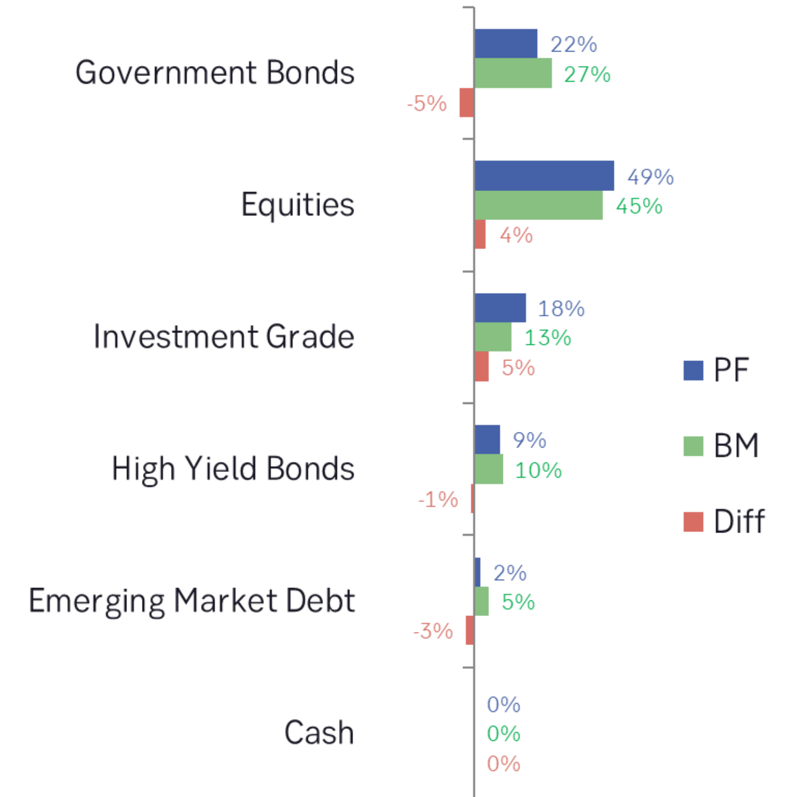
SEB

Asset Allocation

We reduce our position in equities and HY bonds in favor of government and IG bonds

- Markets now anticipate a US soft landing and growth expectations have improved over the past months as the robust US economy has defied fears of a recession
- Market consensus suggests central banks can lower inflation without triggering an economic downturn
- Markets also believe that central banks have ended or are nearing the end of their rate-hiking cycles
- We are remain overweight to equities as we believe disinflation will persist, but reduce our equity overweight, given the increased upside risks to our inflation outlook and less likelihood of positive data surprises ahead
- We do not expect a recession, instead we anticipate positive, but slowing growth due to late-cycle dynamics and the impact of higher interest rates
  - positive growth should support earnings and in turn equities as an asset class, however, there is also potential for more volatile corporate earnings and negative macro data surprises as growth decelerates
  - With growth expectations being higher than six months ago, it is less likely that we get positive economic data surprises going forward, especially in the US
- As growth slows, we expect weakening demand, job market, and consumer spending, likely putting downward pressure on inflation
  - Continued disinflation should also put downward pressure on bond yields and support equity valuations
  - But the path to 2% inflation could be stickier and more volatile than earlier disinflation stages, possibly inducing greater market volatility in the process
- Another reason for reducing our equity overweight is that earnings expectations have not increased at the same rate as price-to-earnings levels and bond yields, the alternative to equities, have increased as well
  - The forward earnings-yield for S&P 500 is currently around 40 bps below the yield on IG corporate bonds
- We reduce our underweight to government bonds and increase investment grade bonds to an overweight as they offer relatively attractive yields and protection
- In addition, we reduce our position in high-yield bonds to a underweight as credit spreads have narrowed, remaining at historically tight levels despite a more cautious credit outlook due to higher interest rates
  - In our view, there is risk of widening for high-yield credit spreads because of rising delinquency rates for loans, bond defaults and tightening bank lending standards, evident in the Fed senior loan officer survey

Model Portfolio



Long only portfolio. Yearly VaR(95%) ex. mean between 7% and 21%.No restrictions on the individual asset classes. The weights are set manually by the House View committee; i.e. they are not based upon an optimization model.

SEB

Regional equity allocation

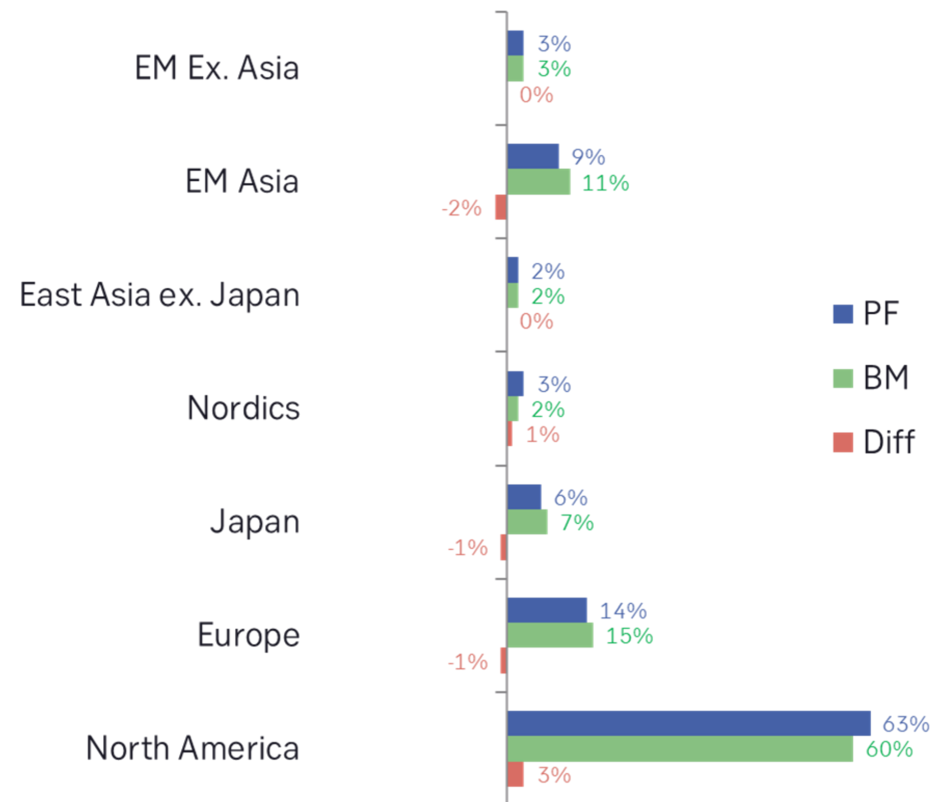
We increase our position in North America and EM Ex. Asia

- There is still divergence between "hard" and "soft" macro data: soft data like PMIs are overly pessimistic about the economic deacceleration, while hard data has been stronger than expected in the US and Europe
- Our macro indicators show U.S. positive economic surprises fading, while data surprises in the euro area are less negative due to improved hard data
- We increase our position in North America to an overweight as we expect disinflation to continue in the US and economic growth to slow, albeit remain positive in the coming quarters
  - Atlanta Fed's nowcast model has spiked to 5.9% real growth for the US in Q3 , which we expect to be revised down as more economic data comes in, but still think the US economy will continue to expand
  - Growth in US consumer spending will likely soften, but remain positive, supporting the equity market
- Furthermore, the Fed is probably closer to a pivot than other central banks given the disinflation progress in the US, which should benefit US equity valuations
- We also lift EM Ex. Asia to neutral, which can work as an inflation hedge as the region in our view is best positioned to benefit from rising commodity prices

We reduce our overweight to EM Asia and reduce our exposure to Europe

- We reduce Europe to a small underweight, due to a lack of potential positive triggers in the near-term
- Furthermore, overall core inflation in Europe needs to decline before we can be constructive on the region
  - Inflation seems to be more sticky in Europe than in the US, for instance, and there are worrying signs of accelerating inflation in major Western European economies, including France and Spain
- China's slowing recovery poses a bigger headwind for the euro area than for the U.S., given greater economic dependence
- We also reduce EM Asia to underweight given its continued weakness and multiple headwinds to growth
  - Macro momentum has been negative in China, driven by soft domestic demand, weak sentiment, a housing market slump, and more recently deflationary pressures, adding to uncertainty to its economic outlook
  - Beijing's measures aimed at boosting Chinese demand and equity market have been ineffective so far, indicating further weakness ahead is more likely
- There is also a high risk that a default by Country Garden spill over to the rest of the Chinese economy, however, we believe that the risk of spill-over to global financial markets is relatively low
- We reduce our underweight to Japanese equities due to Japan's positive macro momentum and upward revisions in GDP growth forecasts for 2023

Regional equity positioning

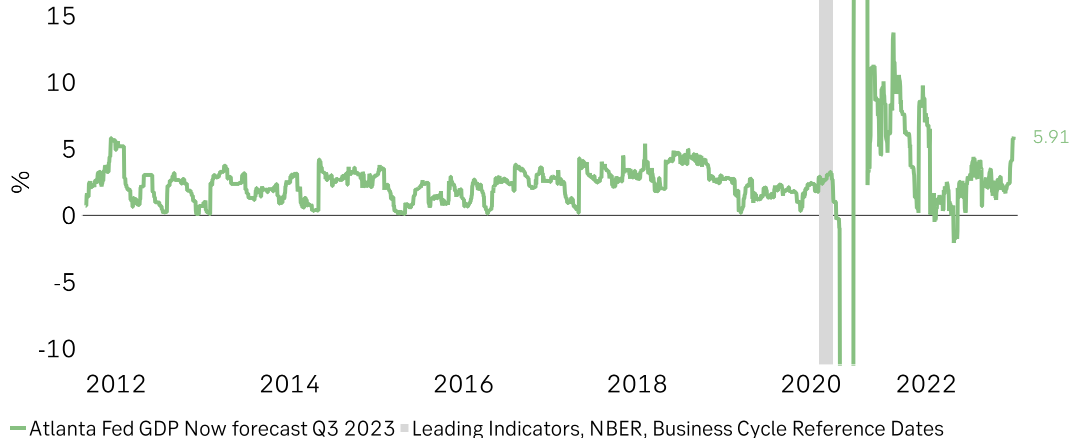


Benchmark is MSCI All Country

SEB

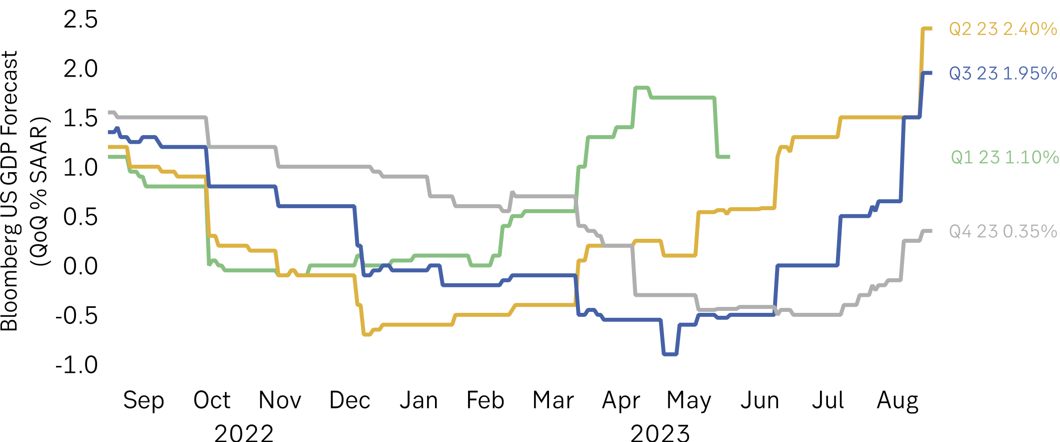
Hard macro data is still strong in contrast to soft data

Figure 1: Atlanta Fed GDP Nowcast has shot up, boosted by strength in recent macro data, but will probably moderate some as this extremely strong trend is less likely to persist



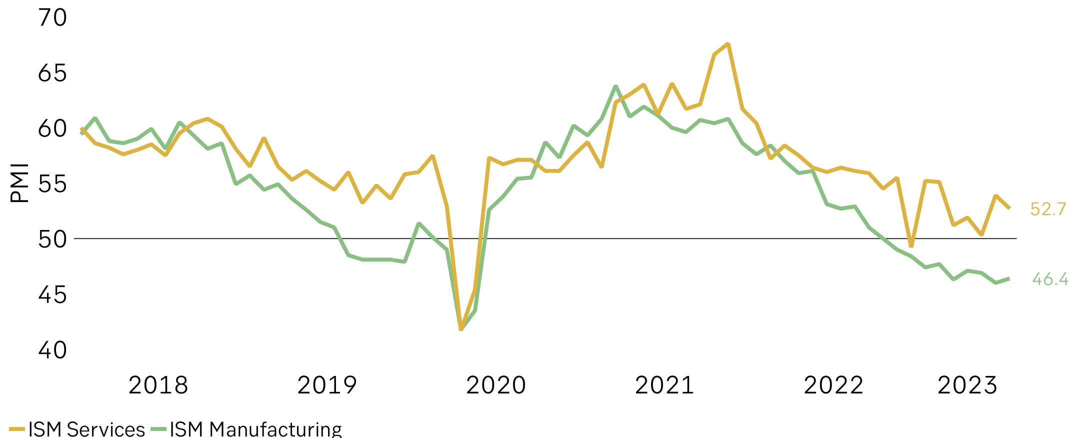
Source: Macrobond, SEB

Figure 2: US growth expectations for 2023 have increased since the beginning of the year, meaning we are less likely to get positive economic surprises..



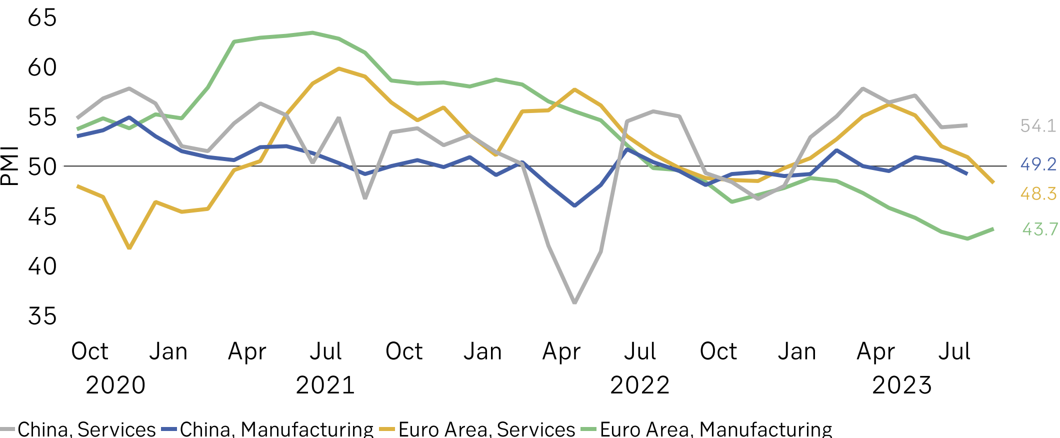
Source: Macrobond, SEB

Figure 3: Soft data such as PMIs have weakened, especially manufacturing, in the US



Source: Macrobond, SEB

Figure 4: Euro area and China PMIs also point to a contraction in manufacturing activity



Source: Macrobond, SEB

Macro surprises have been mixed

Figure 1: US macro has surprised to the upside, but is starting to fade. Looking ahead, positive surprises should continue to fade as expectations are being revised upwards

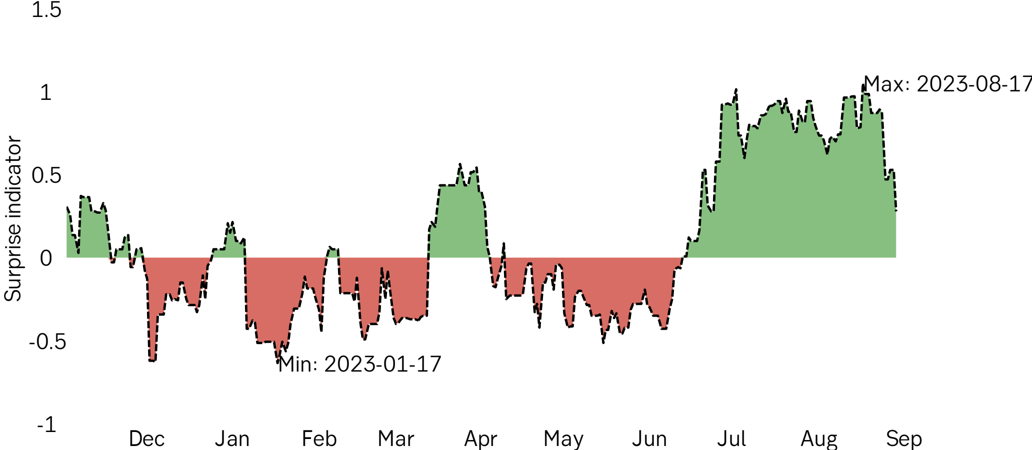


Figure 2: European macro surprises have been negative, but macro could start to surprise to the upside as expectations are lower. However, the EU is very much exposed to China.

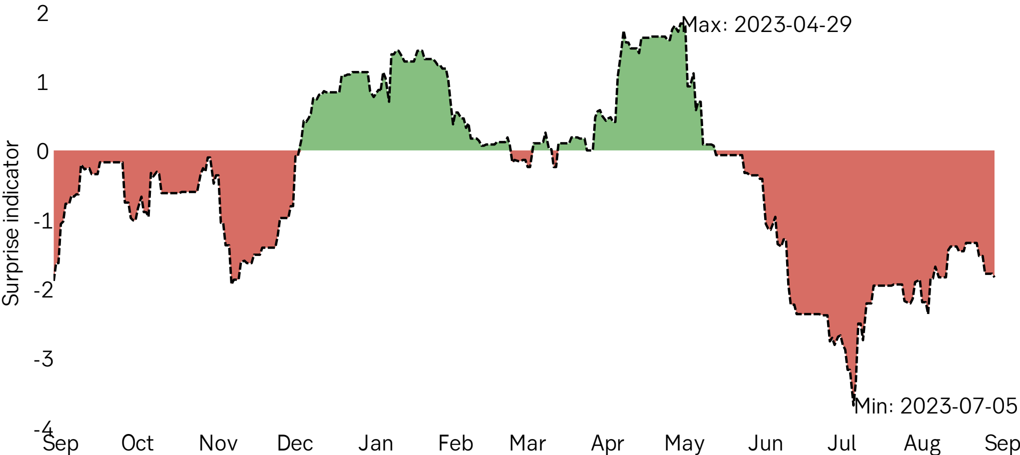
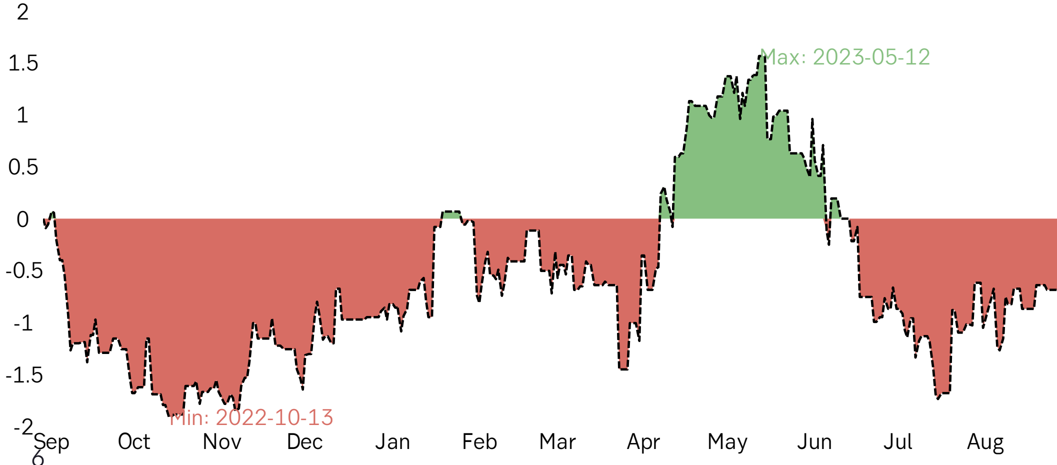


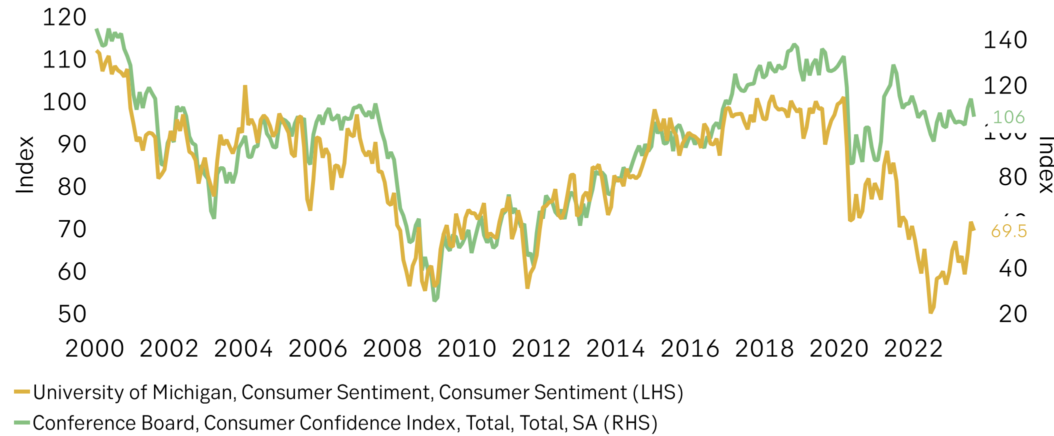
Figure 3: China's growth has disappointed amid its property slump and deflationary issues. Weakness could persist in China as stimulus measures have so far been ineffective



SEB

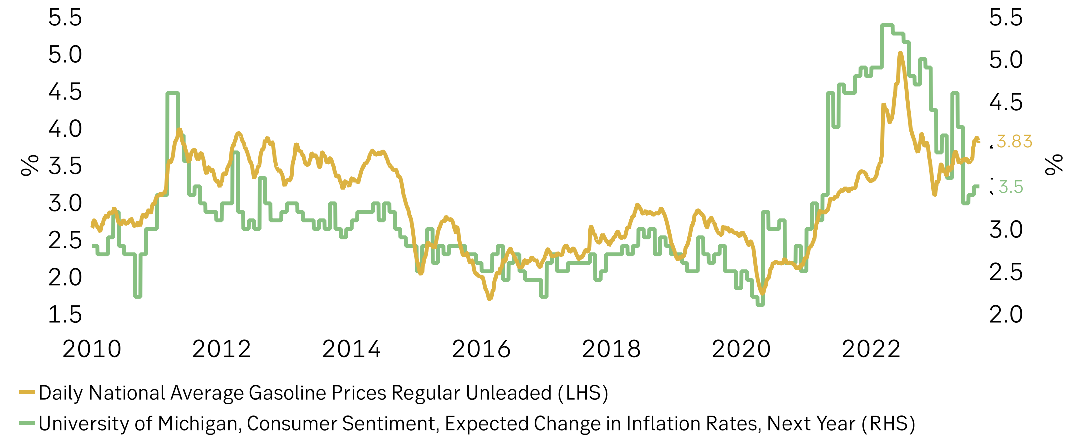
Consumers are becoming more cautious

Figure 1: Consumer sentiment has recently declined following the increase in gasoline prices



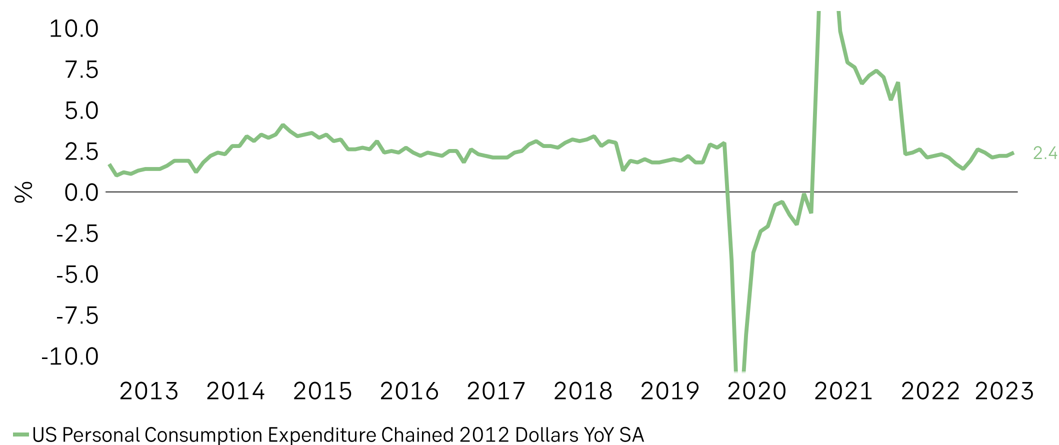
Source: Macrobond, SEB

Figure 2: 12-month inflation expectations have also ticked up due to rising gasoline prices



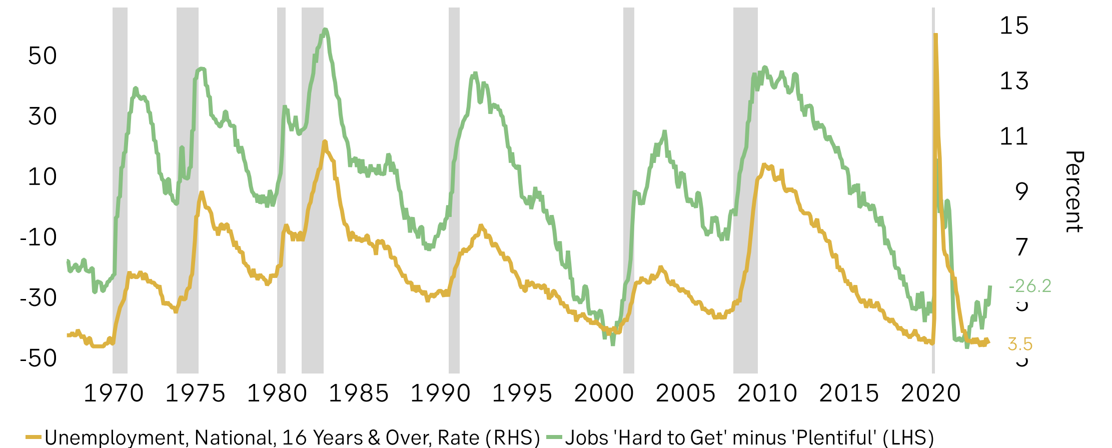
Source: Macrobond, SEB

Figure 3: The US economy has been resilient, aided by solid consumer spending, but dwindling excess savings and student loan repayments could soften future consumption



Source: Macrobond, SEB

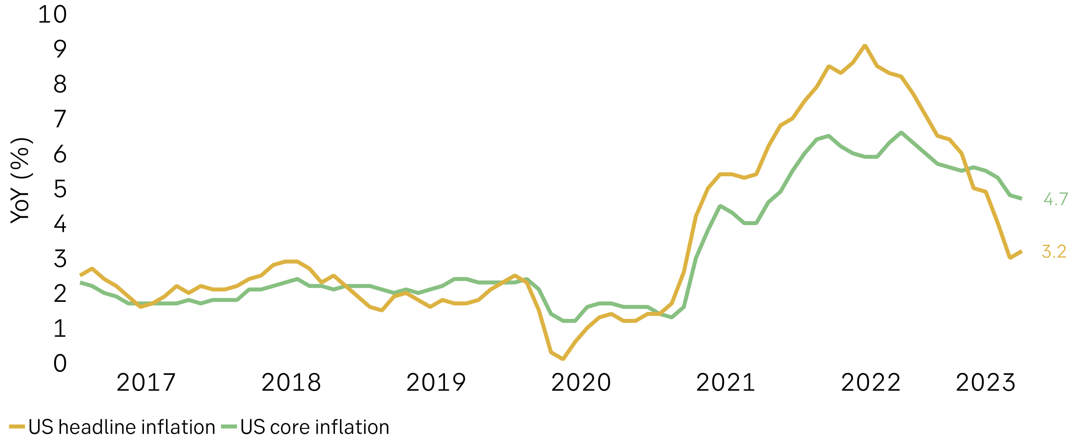
Figure 4: We still do not see an outright recession in the US as consumers are still supported by a tight labor market and real income growth



Source: Macrobond, SEB

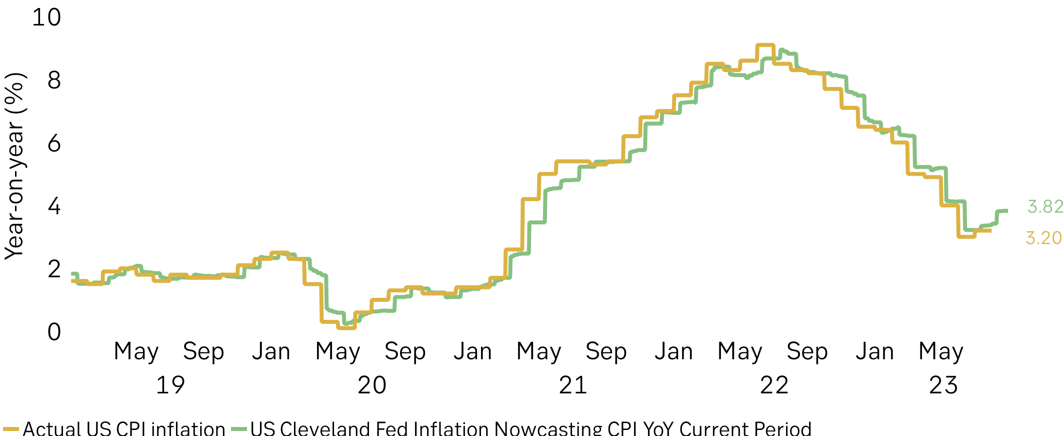
Renewed inflationary pressures is a risk

Figure 1: US core inflation is slowly falling, but the recent economic strength could mean upward pressures on inflation ahead.



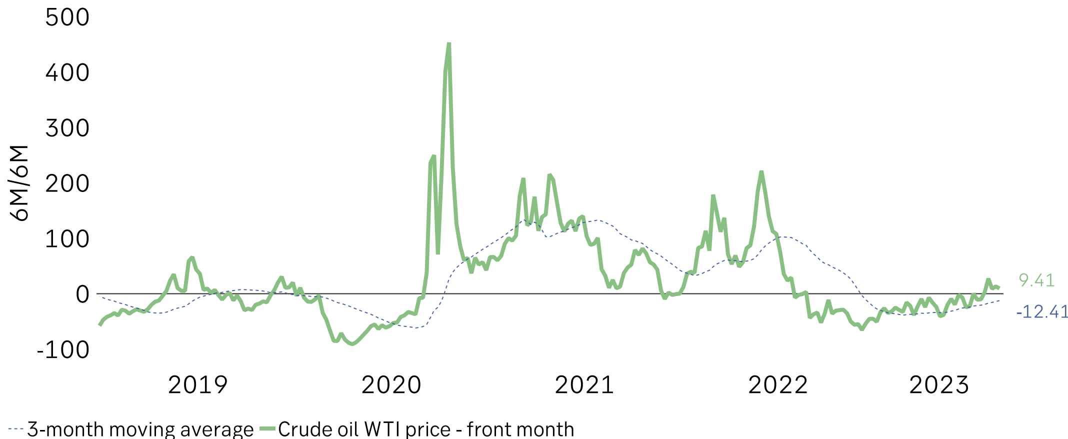
Source: Macrobond, SEB

Figure 2: Cleveland Fed's inflation nowcast has indicated that annual headline inflation could further rise, which in turn could prompt the Fed to keep raising rates



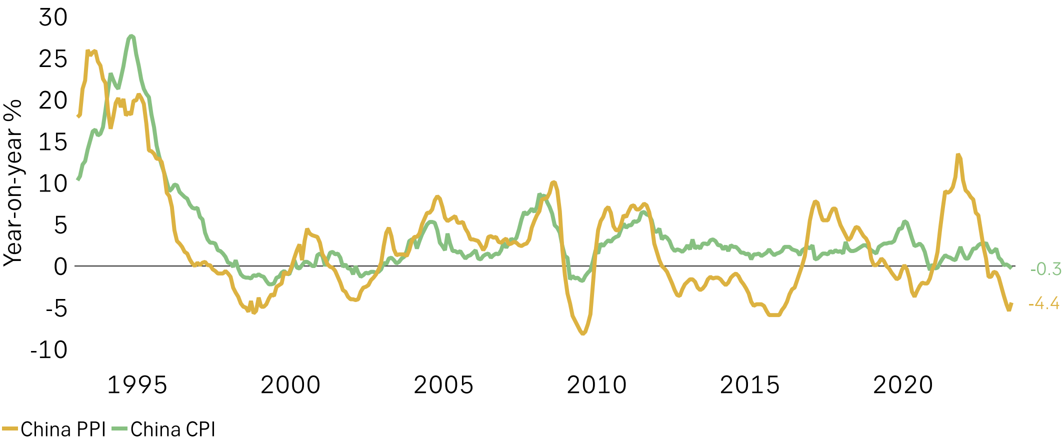
Source: Macrobond, SEB

Figure 3: The recent jump in global oil prices pose upside risks to our inflation outlook



Source: Macrobond, SEB

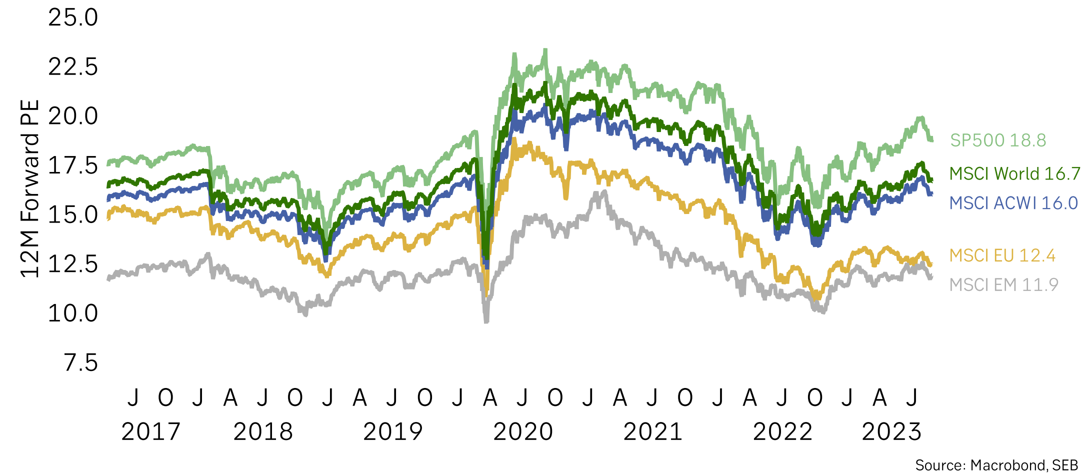
Figure 4: However, deflationary forces from China may spill over to the global economy, helping to reduce still elevated inflation in the US and Europe



Source: Macrobond, SEB

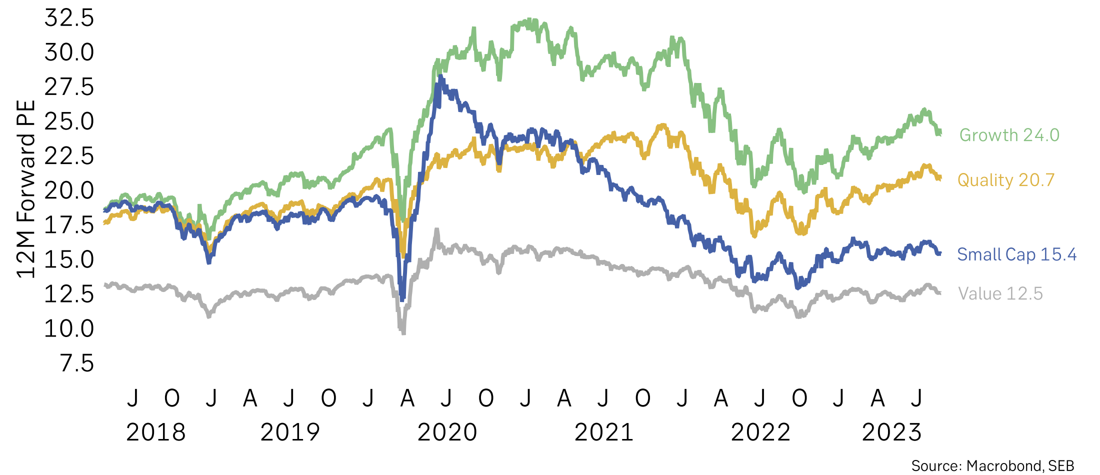
Valuations and risk premiums

Figure 1: Forward equity valuations have come down across regions lately, markedly in EM



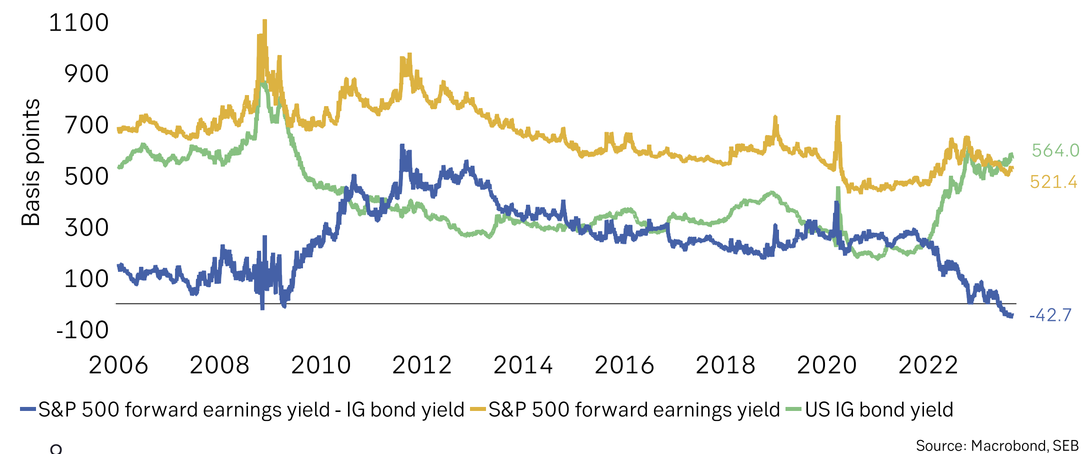
Source: Macrobond, SEB

Figure 2: Growth stocks have de-rated in recent months, but are still up this year



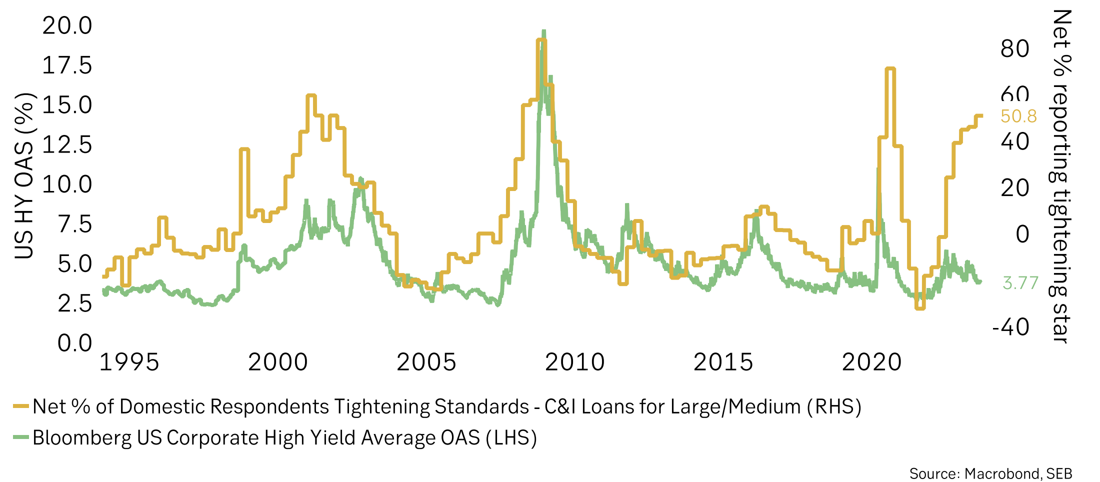
Source: Macrobond, SEB

Figure 3: S&P 500 EPS earnings yield has fallen below investment-grade bond yields



Source: Macrobond, SEB

Figure 4: US HY credit spreads have diverged from bank lending standards



Source: Macrobond, SEB

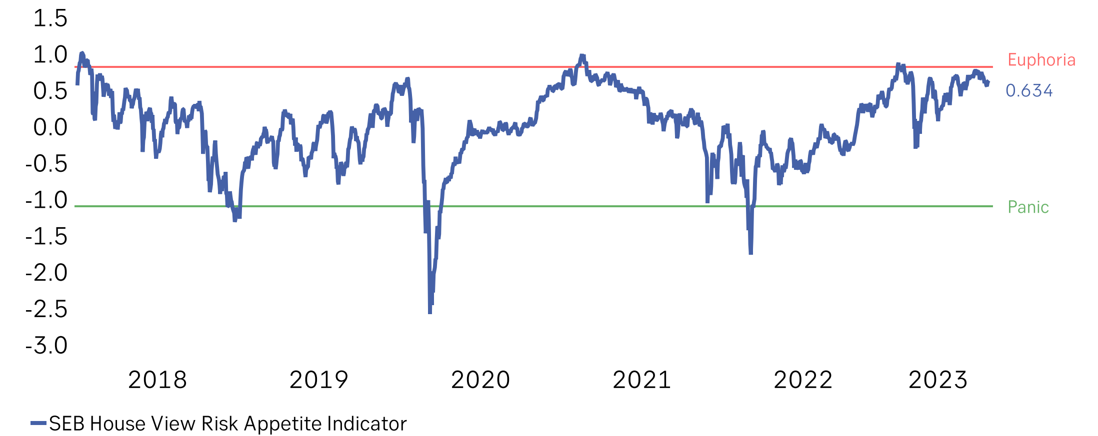
SEB

Investor sentiment has improved rapidly

Market optimism around a US soft landing scenario has increased compared to 6 months ago

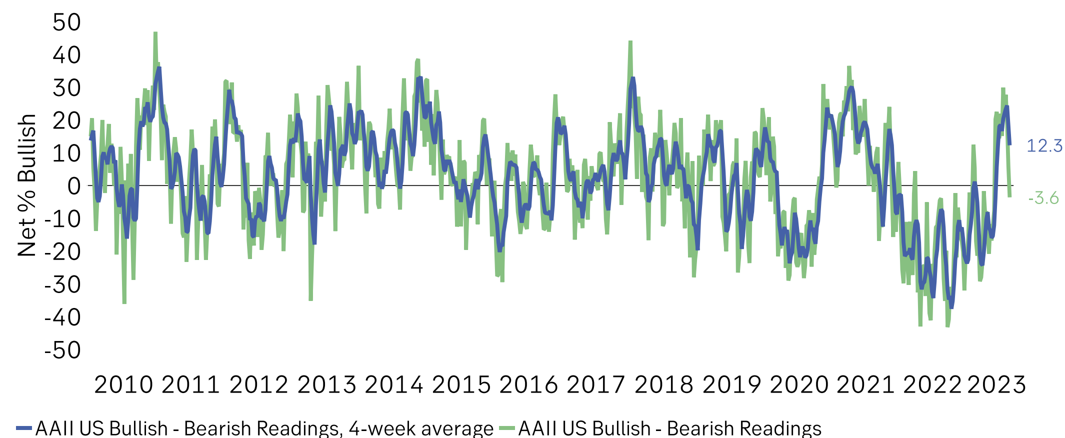
- Investor sentiment towards the stock market, measured by the AAII survey, has improved rapidly over recent months, boosted by optimism around a US soft landing scenario
- Having said that, equity markets have most likely already priced in a soft landing and global risk appetite appears to have peaked, albeit remains elevated, according to our risk appetite indicator
- Stock market volatility has remained muted, however, increasing bearish sentiment over China could dampen global risk appetite and spike market volatility, unless the situation stabilizes

Figure 1:Global risk appetite appears to have peaked, but remains elevated



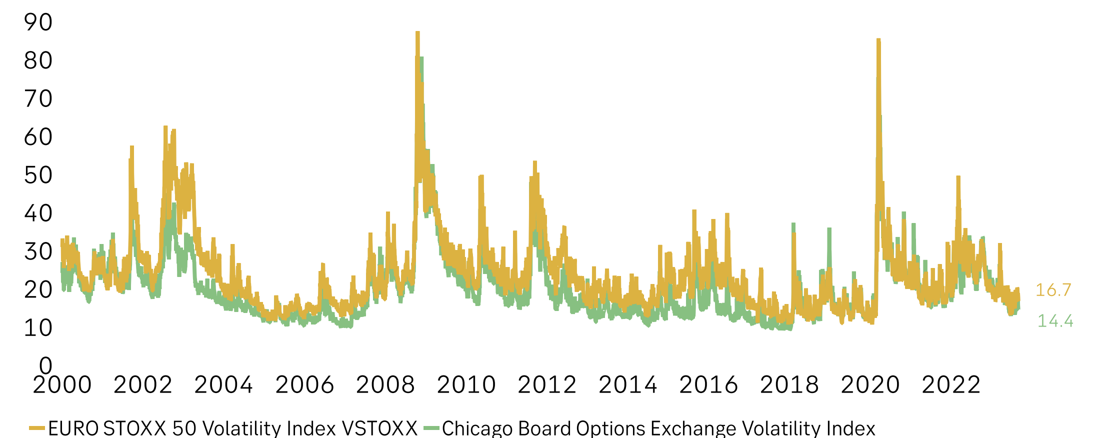
Source: Macrobond, SEB

Figure 2: The AAII bull-bear spread has increased from extremely bearish levels last year



Source: Macrobond, SEB

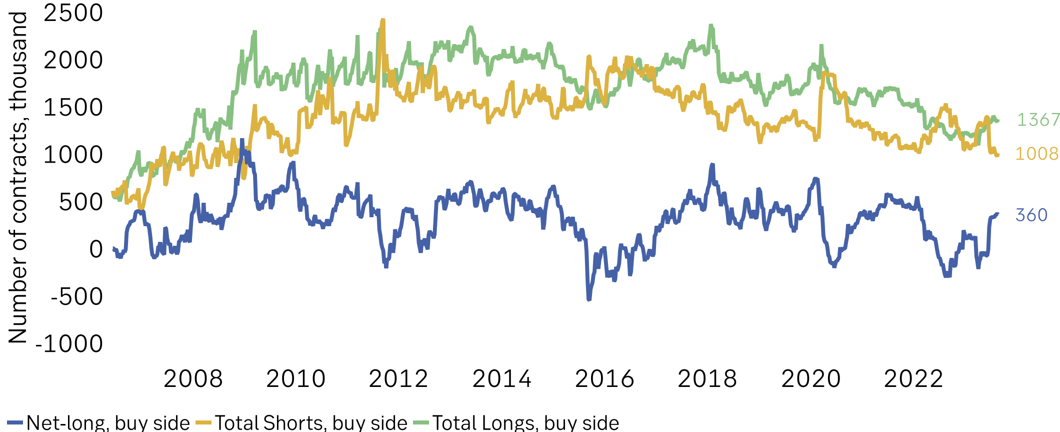
Figure 3: Implied equity volatility has been muted, reflecting low market fears



Source: Macrobond, SEB

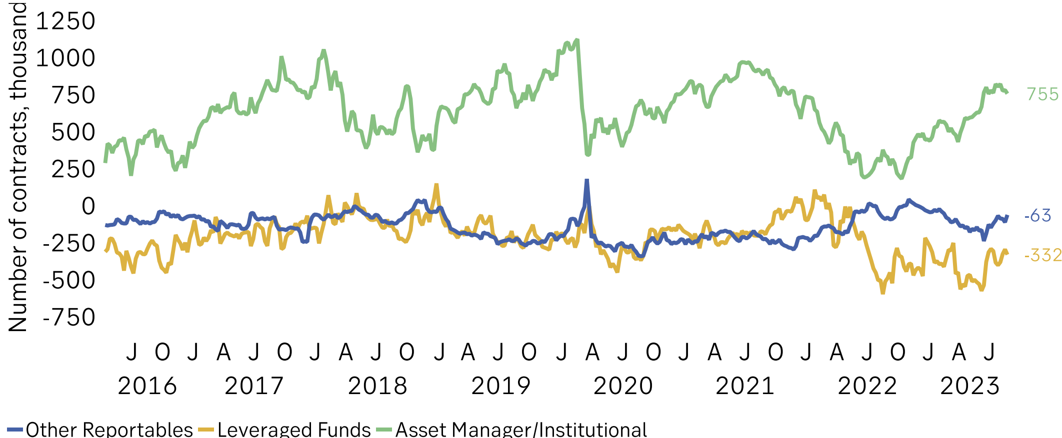
Positioning has turned more bullish

Figure 1: S&P 500 futures net positioning (buy side) is no longer bearish



Source: Macrobond, SEB

Figure 2: Net long position in S&P 500 E-mini futures by investor type



Source: Macrobond, SEB

Figure 3: Beta to equities implies macro/CTA hedge funds have steadily increased their positioning and are now long equities

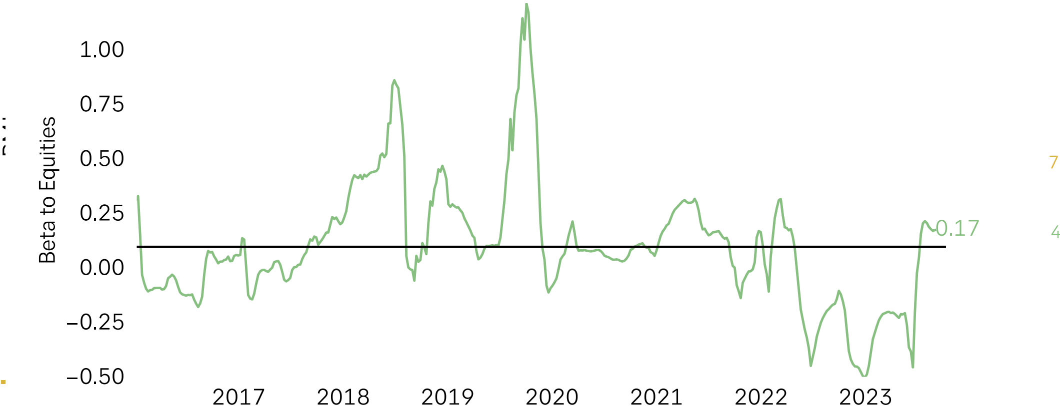
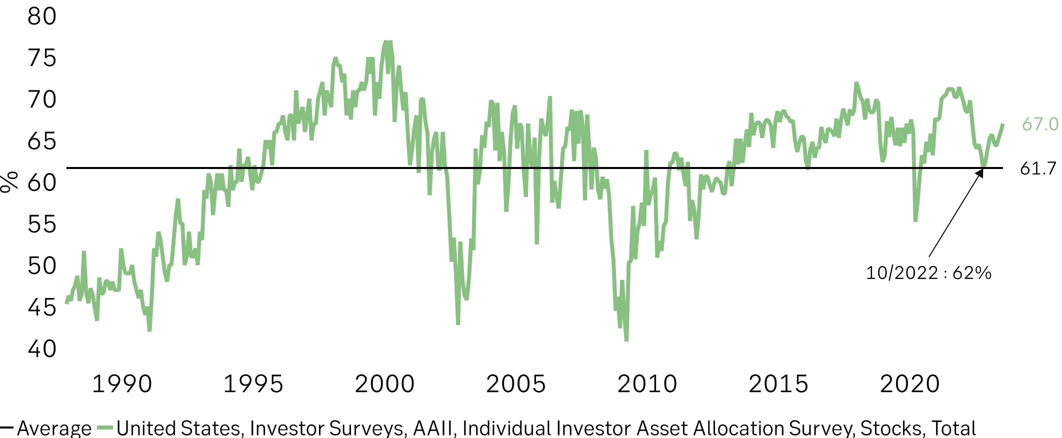


Figure 4: US retail investors are increasing their equity allocations, reaching a 14-month high in July. The allocation to stocks is above the historical average.



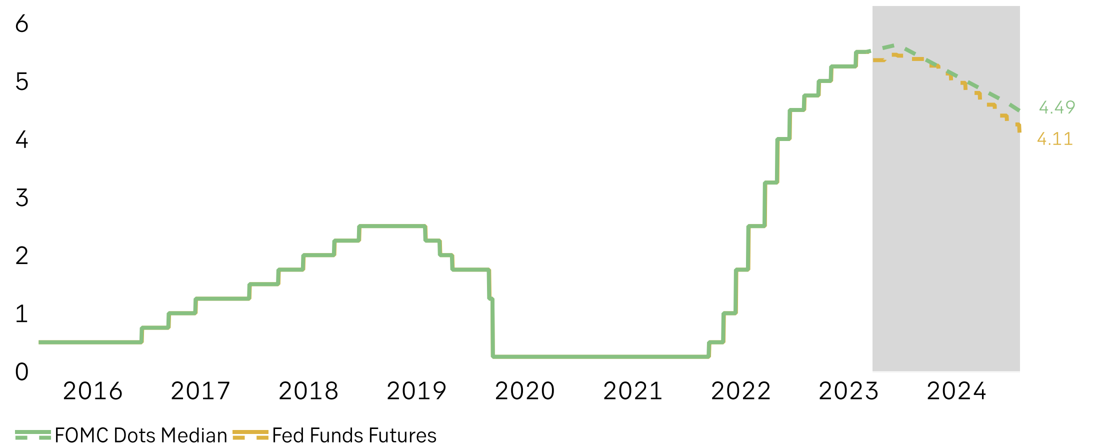
Source: Macrobond, SEB

The Fed can keep monetary policy tight for longer

Risks going forward

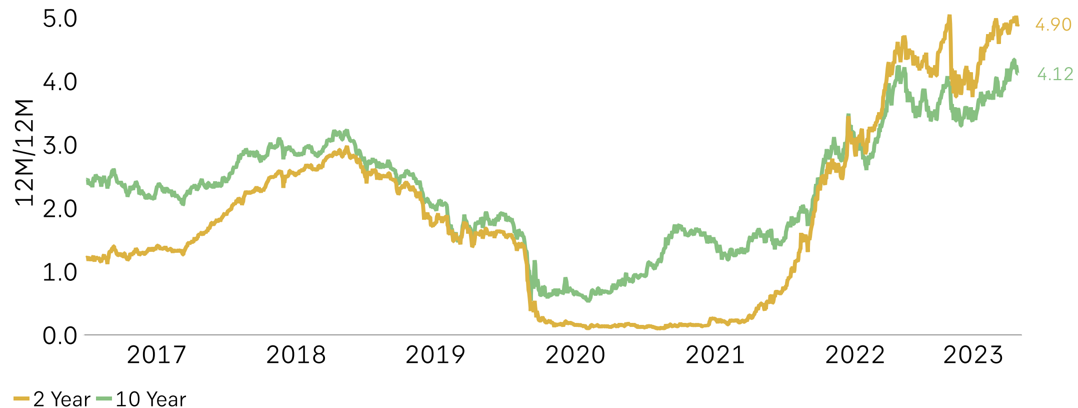
- FOMC July minutes and Powell's Jackson Hole speech indicate Fed could either raise rates further or keep them steady, depending on the "totality of data"
- Risk exists that inflation stays high or rises, possibly leading the Fed to either tighten policy or hold rates longer than anticipated
- Current market pricing suggests traders expect the Fed to maintain steady rates through year-end
- Markets underestimate the risk of extended tight monetary policy, in our view
- A hawkish pivot by the Fed could significantly lower market levels by shifting interest rate expectations upwards

Figure 1: Current market pricing is roughly in line with the Fed's median fed funds forecast



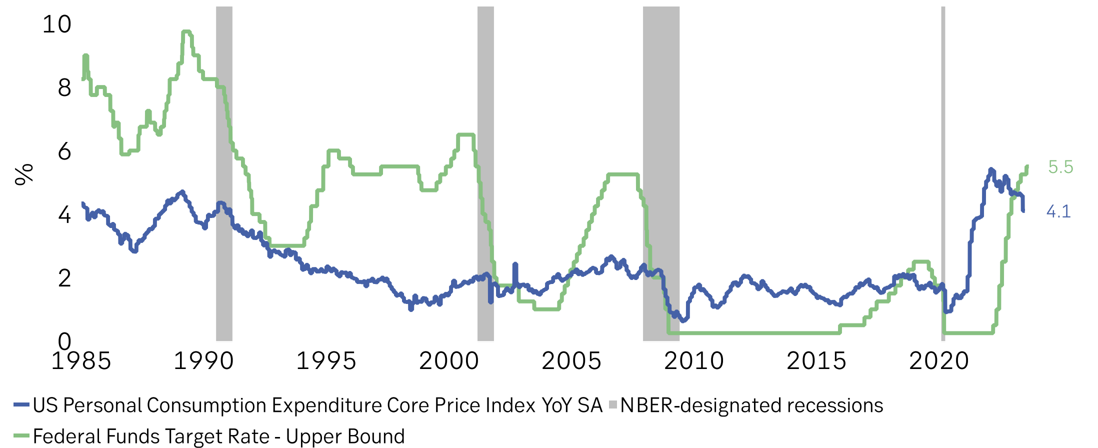
Source: Macrobond, SEB

Figure 2: The Fed can keep rates higher for longer, putting upward pressure on treasury yields, which in turn would lead to lower equity multiples and eventually lower growth



Source: Macrobond, SEB

Figure 3: The Fed's inflation goal remains at 2%, but will Powell succeed in bringing down inflation closer to this level without also bringing down the economy in the progress?



Source: Macrobond, SEB

Disclaimer

- This report has been compiled by SEB Group to provide background information only and is directed towards institutional investors. The material is not intended for distribution in the United States of America or to persons resident in the United States of America, so called US persons, and any such distribution may be unlawful. Although the content is based on sources judged to be reliable, SEB will not be liable for any omissions or inaccuracies, or for any loss whatsoever which arises from reliance on it. If investment research is referred to, you should if possible read the full report and the disclosures contained within it, or read the disclosures relating to specific companies. Information relating to taxes may become outdated and may not fit your individual circumstances. Investment products produce a return linked to risk. Their value may fall as well as rise, and historic returns are no guarantee for future returns; in some cases, losses can exceed the initial amount invested. You alone are responsible for your investment decisions and you should always obtain detailed information before taking them. If necessary, you should seek advice tailored to your individual circumstances from your SEB advisor.
- This material is not directed towards persons whose participation would require additional prospectuses, registrations or other measures than what follows under Swedish law. It is the duty of each and every one to observe such restrictions. The material may not be distributed in or to a country where the above mentioned measures are required or would contradict the regulations in that country. Therefore, the material is not directed towards natural or legal persons domiciled in the United States of America or any other country where publication or provision of the material is unlawful or in conflict with local applicable laws.