SEB House View

April 2024

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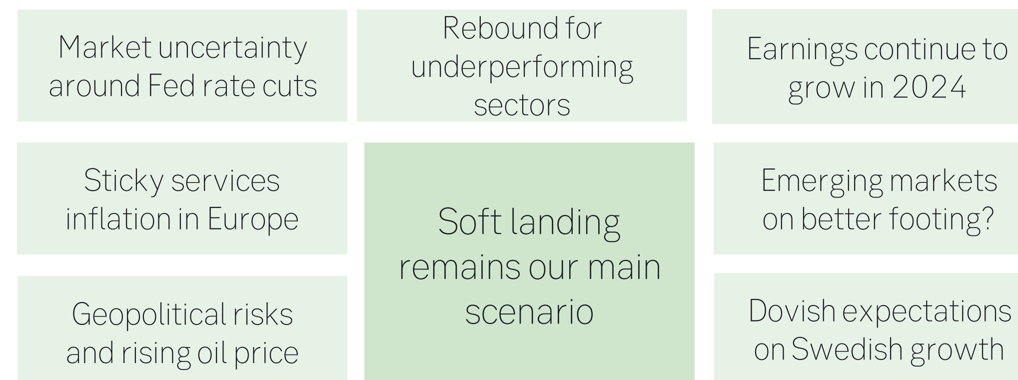
House View Update: Bullish still, but inflation is a short-term risk

SEB House View maintains risk utilization above normal at 60%. Despite the possibility of a market correction after nearly six months of strong gains, we think that improving global growth and rate cuts should be supportive for risk assets

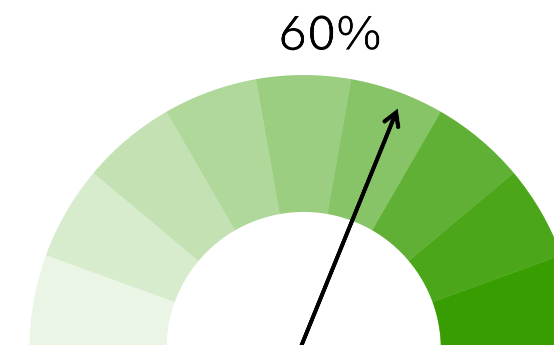
- US equities have rallied 26% since the lows back in October 2023 amid upbeat global risk appetite which has spilled over to global equities outside the US as well. Recent US inflation data showed price pressures are still too elevated for the Fed to cut interest rates which creates uncertainty in the near-term
  - US equity market fundamentals remain healthy with surprisingly strong GDP growth indicating better prospects for rising earnings. Mega-cap tech currently drive the majority of profit growth, however, we anticipate this trend to broaden to other sectors. With AI poised to boost productivity, there is potential for more upside in equity markets
  - Markets will likely be trading sideways in the near term due to concerns about sticky inflation and the Fed's response as growth is close to or even above trend. Should inflation continue to moderate, as we expect, market sentiment should turn more positive. Attention will likely remain on labor market and wage data. Earnings should come into focus again as we enter the Q1 earnings season
  - Markets are beginning to price in a "no landing" scenario with no rate cuts, increasing the risk of a major set-back should the Fed be forced to slow the economy more thoroughly, or otherwise potentially face run-away inflation. Nonetheless, the likelihood of such a risk is still relatively low in our view.
  - European growth prospects have shown some signs of improvement with PMIs rising above 50, though the GDP outlook remains subdued. Equities have re-rated while earnings growth has been tepid. Further market gains depend on a dovish ECB , recovery in China, active fiscal policy and stable energy prices
- Central banks in Europe will likely start cutting rates in Q2 and we still anticipate a Fed rate cut in June, but expect this mid-cycle easing phase to be shallow

Investment Regime

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



Speedometer



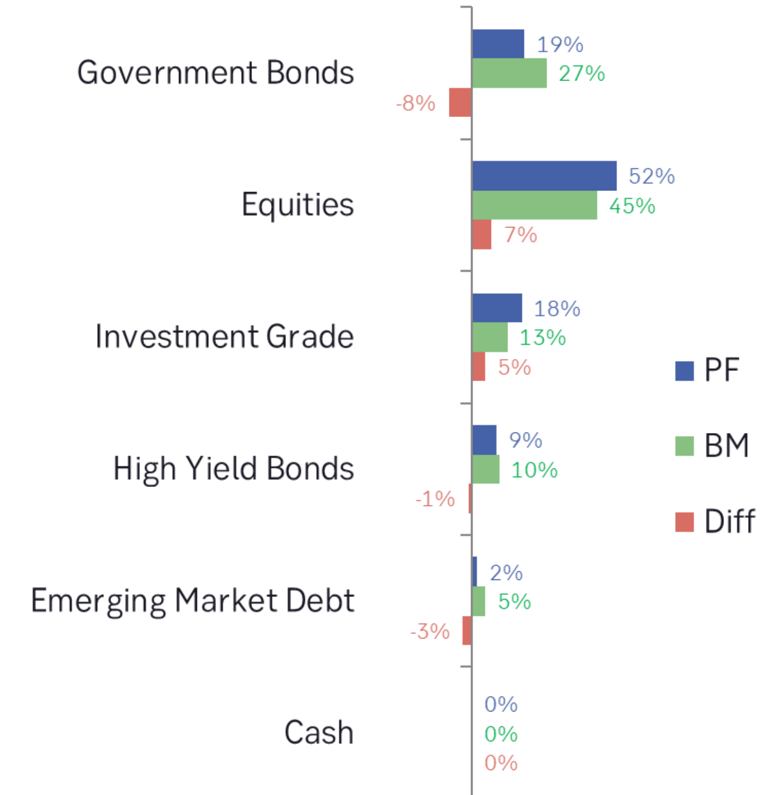
The speedometer controls to what extent the portfolios should utilize their risk budgets. It is connected to the model portfolio (page 4) which at all times utilizes its risk budget in-line with the speedometer. In a very general sense it can be interpreted as equities on/off (with 50% being neutral).

Asset Allocation

Equities have surged amid rising bond yields, reflecting a better growth outlook and somewhat stickier inflation. We stay overweighted in Equities for now

- We maintain our overweight position in Equities, expecting inflation to ease. Additionally, we consider the short-term challenges from recent high inflation data and potentially more hawkish Fed talk as insufficient to change our stance
- That said, we are closely monitoring the Middle East conflict after Iran's attack on Israel. While currently contained, any further escalation could introduce new market volatility, potentially spike oil prices and send stocks lower
  - Equities have rallied significantly, making valuations more challenging, especially in the US. The low equity risk premium argues against lifting risk utilization now
  - That said, European and Swedish stocks are trading close to historical averages, suggesting potential for some further expansion in multiples as interest rates fall
  - The outlook for Emerging Markets, especially China, remains weak, yet this is already priced in. EM has performed roughly in line with general markets which calls for a potential upgrade as the year progresses
- We remain underweighted in Government Bonds as yields have probably not peaked yet, but a 10-year US yield close to 5% should be monitored closely
  - We also note that equity-bond correlations have declined and is now less positive, meaning we could see diversification benefits from 60/40 portfolios, leading to improved risk-adjusted returns going forward. However, inflation would need to continue its downtrend for this to materialize
- We prefer to stay overweighted in IG Bonds, but note that the recent rise in bond yields and tightening credit spreads make the case for OW IG Bonds vs. UW Government Bonds weaker
- We keep our underweight to Emerging Market Debt, as bonds have already rallied, approaching record tight spread levels (below 300 basis points)

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.

Regional equity allocation

We prefer to stay overweighted to US equities, supported by a stronger growth backdrop, positive earnings revisions and outlook, as well as its defensive sector composition and dollar exposure

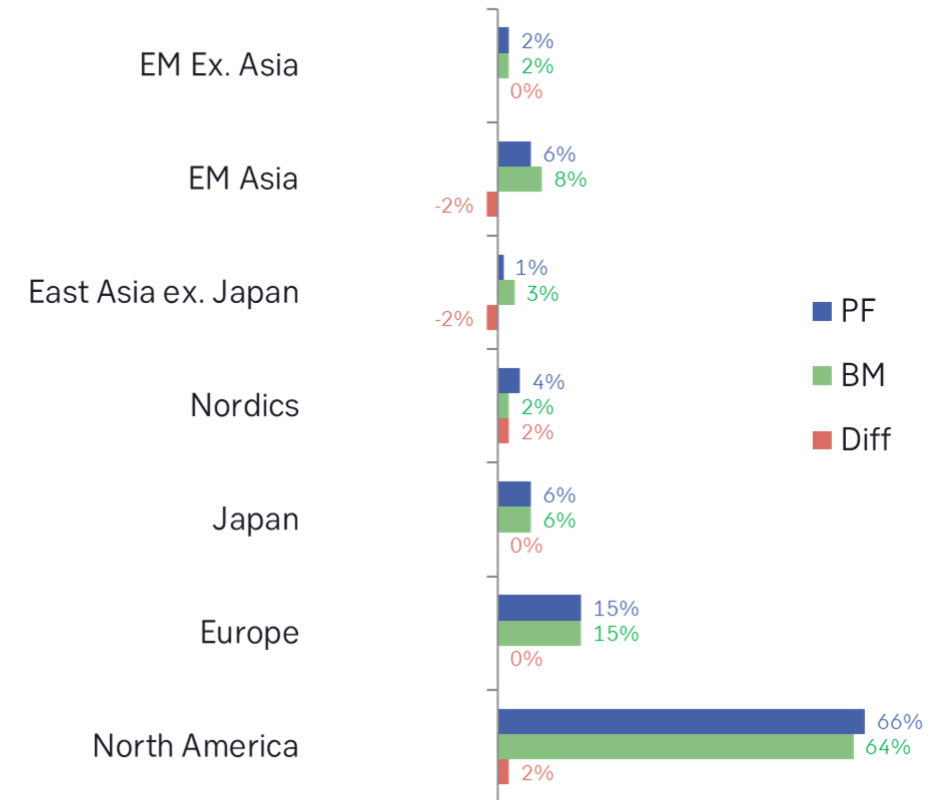
- The large valuation gap between the US and the rest of the world rests on continued strong growth momentum in the US, which has recently been validated and even strengthened. Stronger domestic growth should also turn into better earnings prospects for US-based companies.
- Negative catalysts for the US could be sector & company-specific surprises (big tech) and the uncertainty regarding US politics and elections

We maintain our neutral stance to Europe

- The European growth outlook is slowly improving with recent economic releases surprising more positively on aggregate and most of the PMIs showing a turn for the better. With earnings expectations for the year still relatively muted, there is room for positive surprises
- We expect the ECB to start cutting rates in June, which is heavily supported by recent soft inflation prints. The deviating monetary policy relative to the US may weaken the EUR and further support export-driven companies

- We also maintain our overweight to the Nordic market
  - Swedish inflation has eased which should allow the Riksbank to cut rates as early as May. We anticipate that rate cuts will lift risk appetite for more interest-rate sensitive equity sectors which have been laggards
  - A backdrop of rising PMIs may help business cycle-sensitive markets like Sweden and Finland
- EM Asia remains undervalued, and we are closely watching China's recent positive developments
  - Both soft and hard data has recently surprised to the upside in China even though the serious issues with the real estate sector remain. We still consider the strategic risks of the market outweighing recent positive tactical catalysts, but monitor our stance very actively
- We remain neutral on Japanese stocks. Earnings growth will likely be positive due to the weak currency and export-driven index composition. But it remains a question how the market can cope with tighter monetary policy, the recent strong rally as well as slightly higher multiples

Regional equity positioning



Benchmark is MSCI All Country. Benchmark weights updated by September 2023. Portfolio weights have been adjusted accordingly to keep our active weights unchanged.

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Risks to the investment regime

US growth and inflation risk being "too hot"

- The US is looking more and more like it will reach the scenario of "no landing" (Fig. 1)
- This "no landing"-scenario will likely lead to a more hawkish response from the Fed

Re-emerging inflation and higher bond yields

- Recent inflation prints have surprised to the upside (March core at +0,4% MoM)
- Meanwhile growth, manufacturing activity, inflation expectations and oil have increased, signaling further upside potential in inflation (Fig. 2)
- Bond yields approaching last year's levels where they became a negative factor for markets.

Negative earnings surprises

- The higher multiples for equities leave no room for negative surprises in earnings (Fig. 3)
- Relative pricing (vs. real rates) of equities has also increased, implying higher need for earnings growth. Q1 earnings season to properly begin mid-April.

Surprise downturn in growth due to lagged effects from tighter monetary policy

- We still see that risks are currently tilted towards a higher growth picture. However, we do not exclude the possibility of negative growth surprises due to for example lags in tighter monetary policy.

Escalation of geopolitical tensions and impacts on oil, inflation and rates

- Ukraine-Russia and Middle-East –tensions are a constant risk. Recent strength in the price of oil implies tightness in the oil market and a higher sensitivity for further negative geopolitical shocks.

Figure 1: 2024 Growth estimate development: US "No-landing" has become consensus

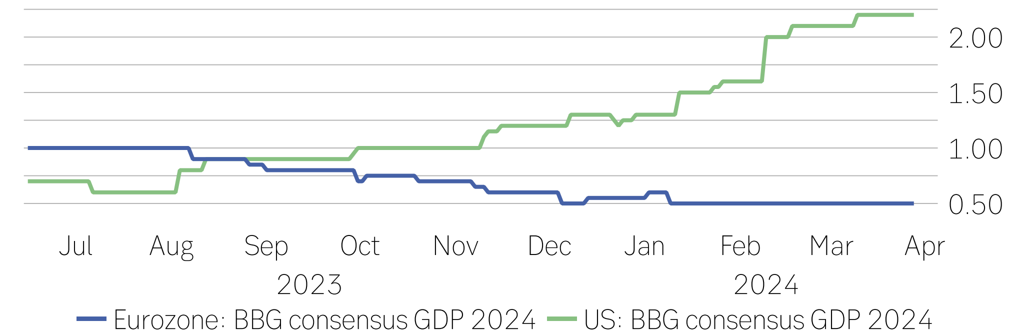


Figure 2: Higher bond yields, inflation expectations and oil

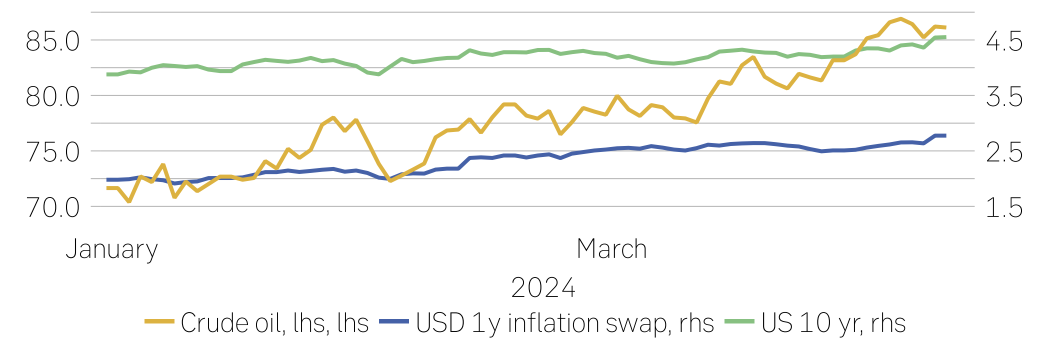
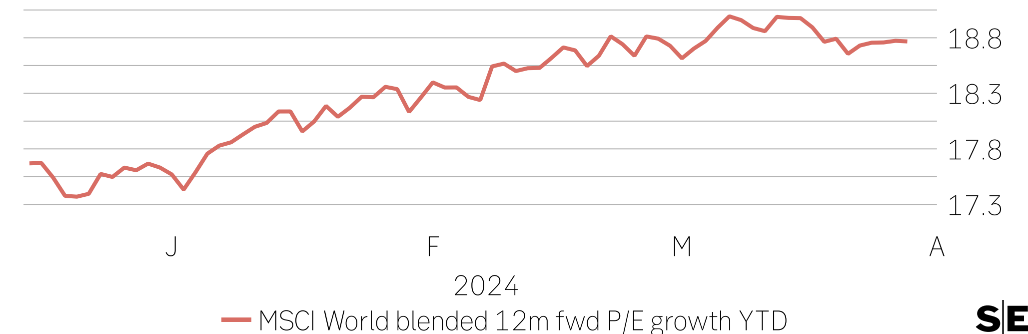


Figure 3: Increase of equity multiples globally



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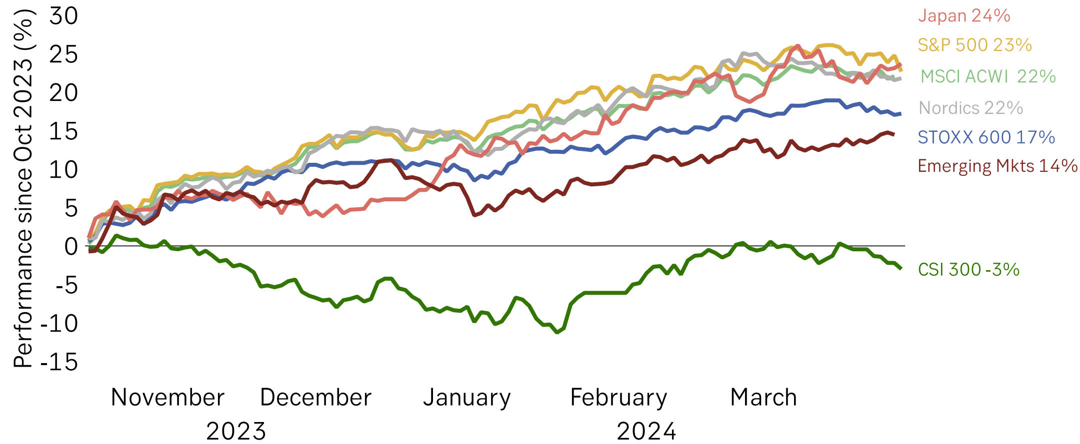
Sources: SEB, Bloomberg, Macrobond

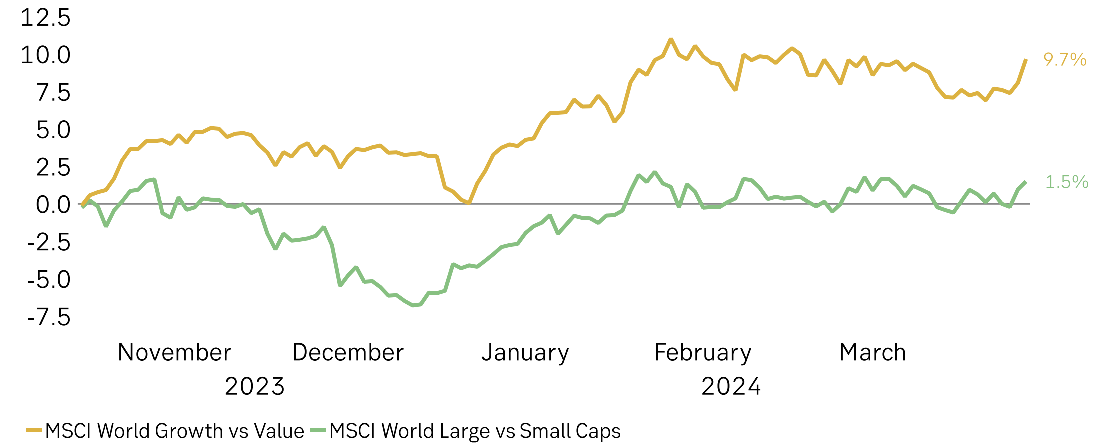
Risk assets have continued to perform despite rising bond yields

Figure 1: Equities have performed strongly since October, across most regions. If history is any guide, strong Q1 returns for the S&P 500 tend to precede a solid full-year performance



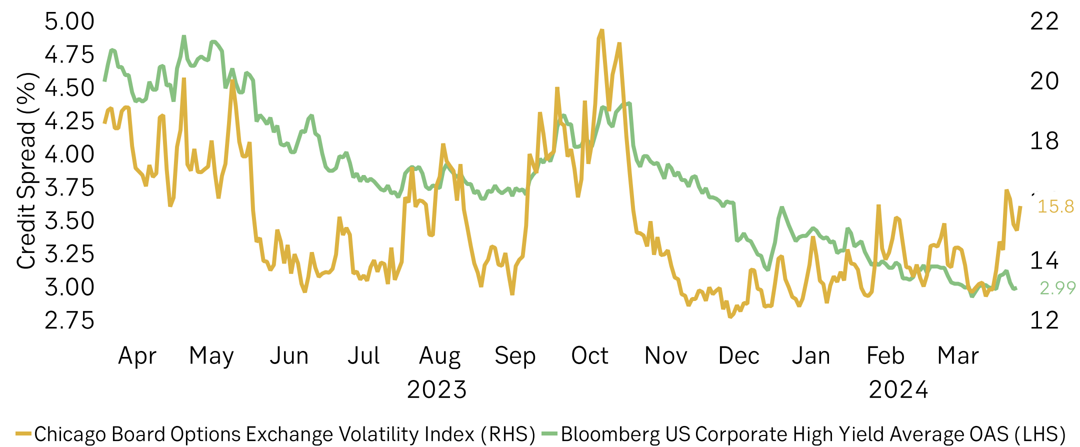
Source: Macrobond, SEB

Figure 2: Growth has outperformed value, and large-caps have seen greater gains than small-caps since October, but we anticipate that small-caps will outperform ahead



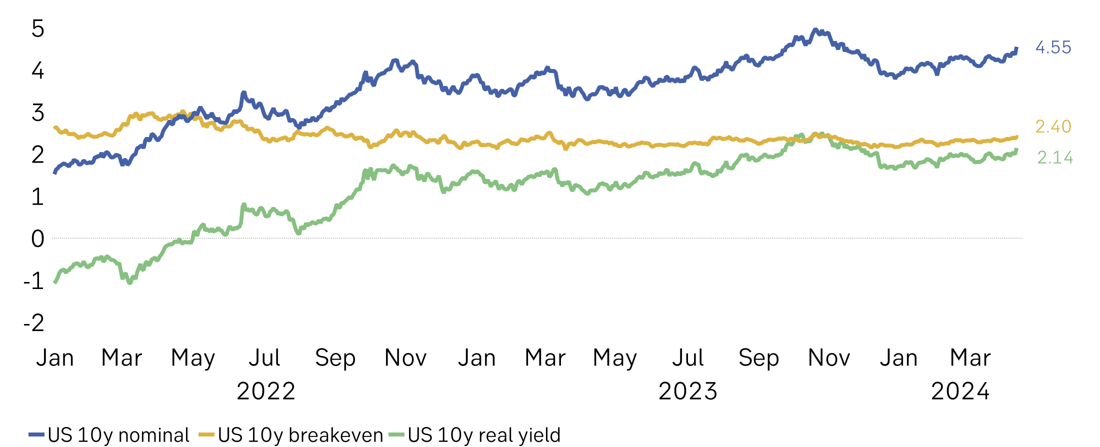
Source: Macrobond, SEB

Figure 3: High-yield corporate bond credit spreads have tightened, remaining near historically tight levels as stock market volatility has been mostly subdued



Source: Macrobond, SEB

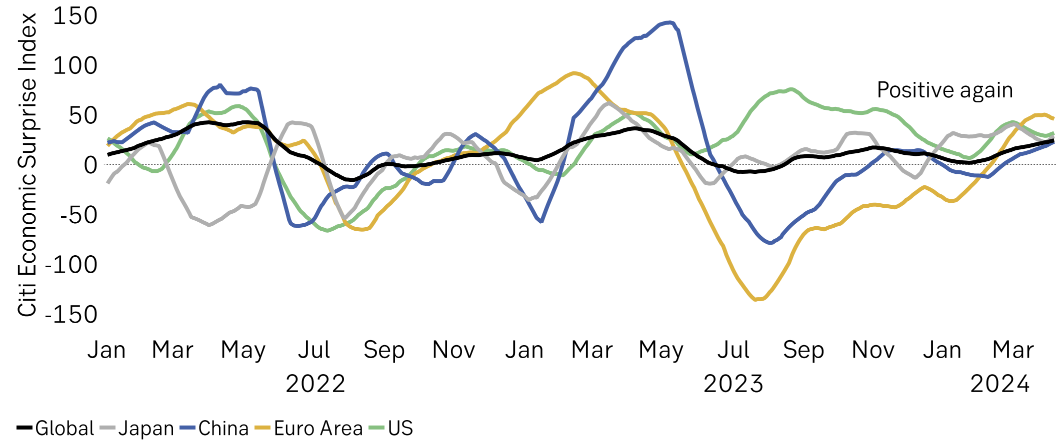
Figure 4: US 10y nominal bond yields have risen, while long-term inflation expectations have remained relatively stable, leading to an increase in real US 10-year yields



Source: Macrobond, SEB

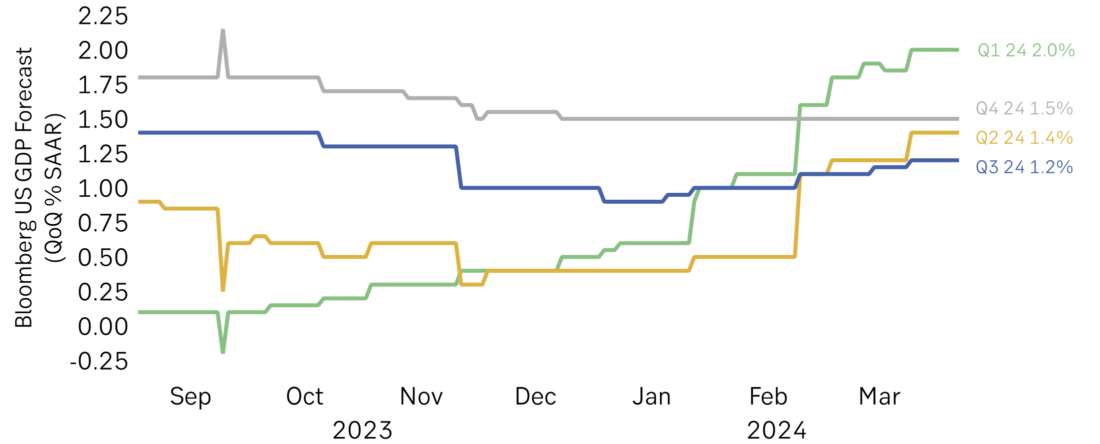
The likelihood for a "no landing" scenario in the US has increased

Figure 1: Macroeconomic data has surprised more on the upside than downside globally, not just in the US, indicating stronger-than-anticipated growth



Source: Macrobond, SEB

Figure 2: Consensus US GDP growth expectations for the first half of 2024 have been revised upwards following solid economic data, particularly in the US

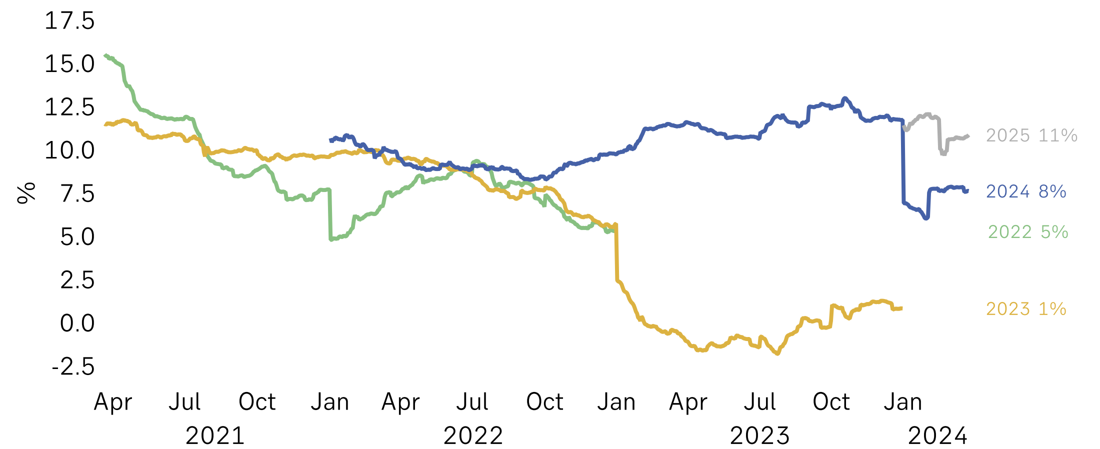


Source: Macrobond, SEB

Figure 3: Atlanta Fed's GDPNow model forecasts 2.47% US growth in the first quarter, a solid print which would suggest continued robust fundamentals for companies

Source: Macrobond, SEB

Figure 4: An improved outlook for US economic growth has also raised expectations for a rebound in US corporate earnings this year and the next, following a dismal 2023



Source: Macrobond, SEB

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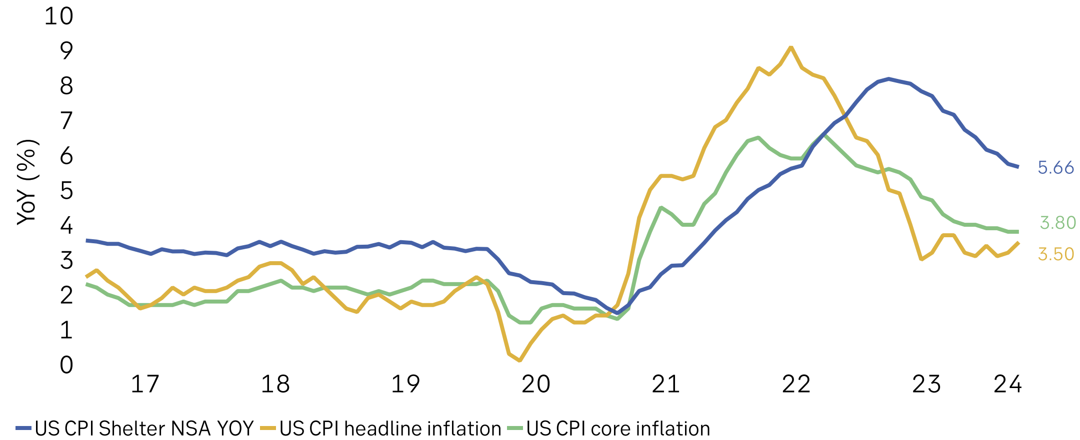
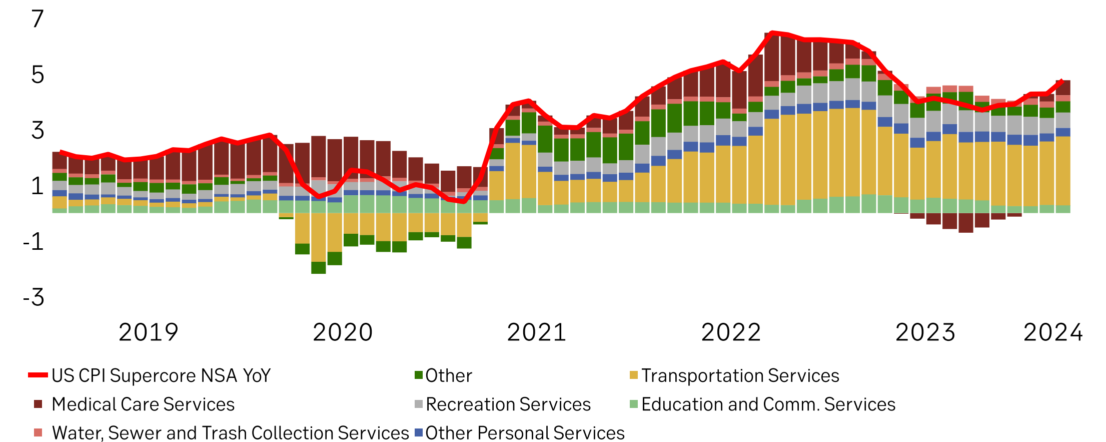
Renewed inflationary pressures is a risk

Figure 1: US CPI inflation rose more-than-expected in March, driven rising costs for gas, rents and auto insurance. That said, forward-looking indicators point to falling rent inflation



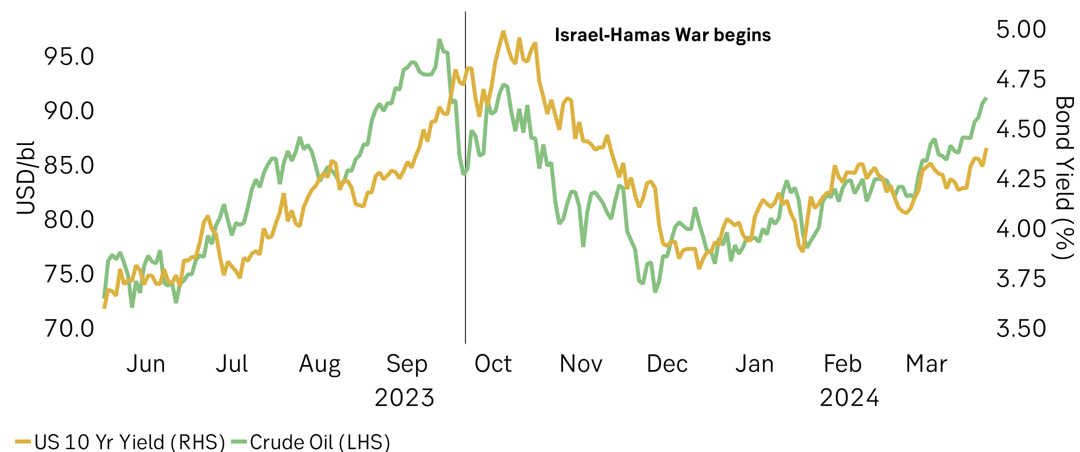
Source: Macrobond, SEB

Figure 2: US 'supercore' inflation (core CPI services ex-shelter) remains high, due to a jump in vehicle insurance prices. Looking ahead, we expect auto insurance to moderate.



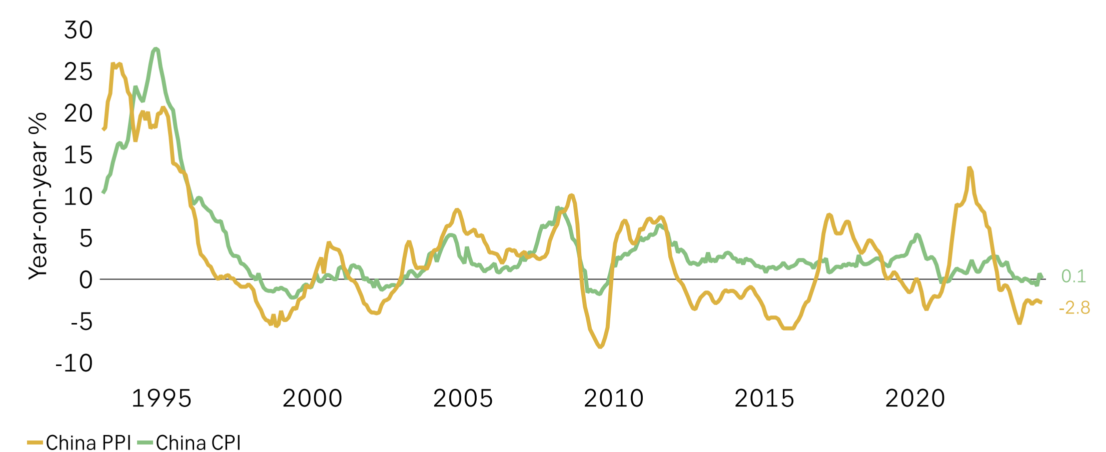
Source: Macrobond, SEB

Figure 3: The spike in crude oil prices, driven by more limited supply and escalating Middle East tensions, may heighten inflation, leading central banks to reconsider rate cuts



Source: Macrobond, SEB

Figure 4: On a more positive note, deflationary pressures from China may spill over to the rest of the global economy, helping to reduce still elevated inflation in the US and Europe



Source: Macrobond, SEB

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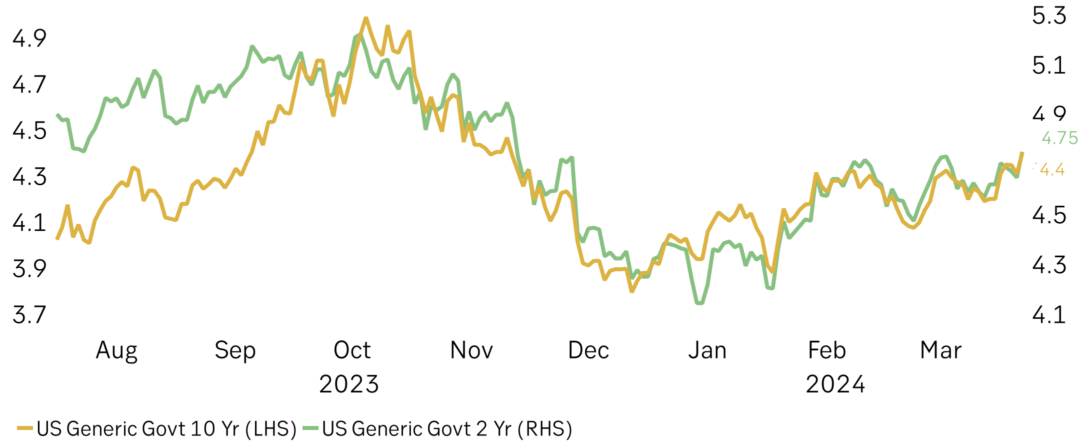
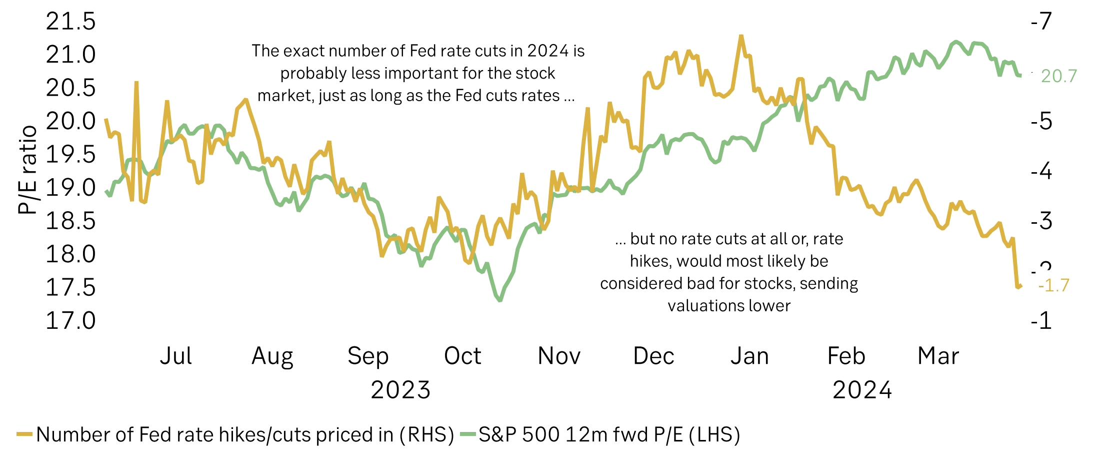
The Fed is in no rush to cut rates, ECB is still set to ease by summer

Figure 1: Hawkish remarks from some Fed officials, upside surprises in US economic data, and rising oil prices have raised doubts about Fed rate cuts, boosting Treasury yields



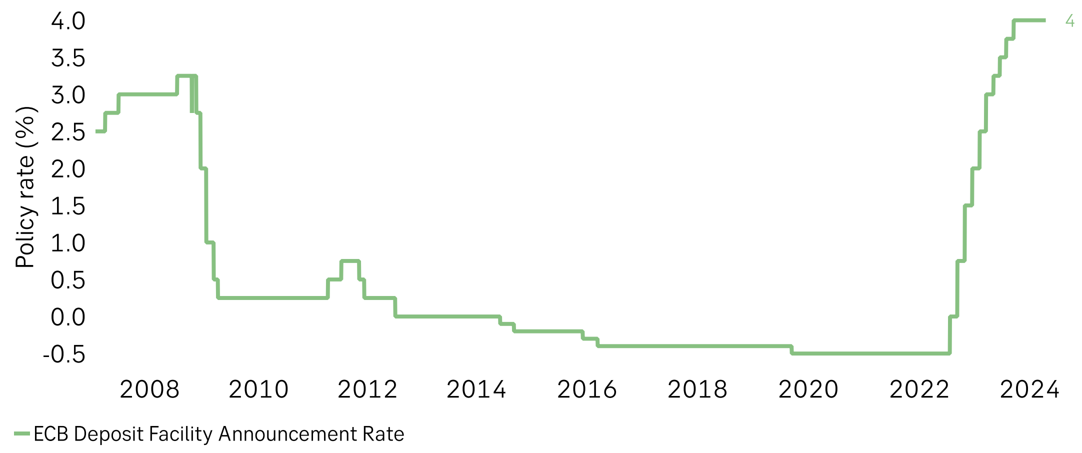
Source: Macrobond, SEB

Figure 2: Equities have rallied even as markets have discounted future rate cuts, reflecting optimism for better growth. The question is whether inflation will surge if growth accelerates



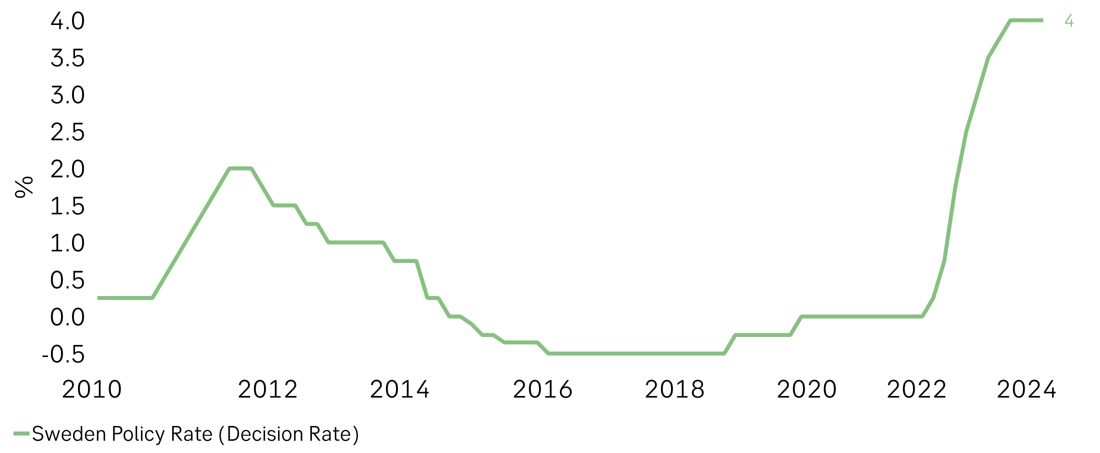
Source: Macrobond, SEB

Figure 3: The ECB minutes held rates steady in April, but sent more clear signals that it will begin to cut rates in June as inflation is falls closer to their 2 % target



Source: Macrobond, SEB

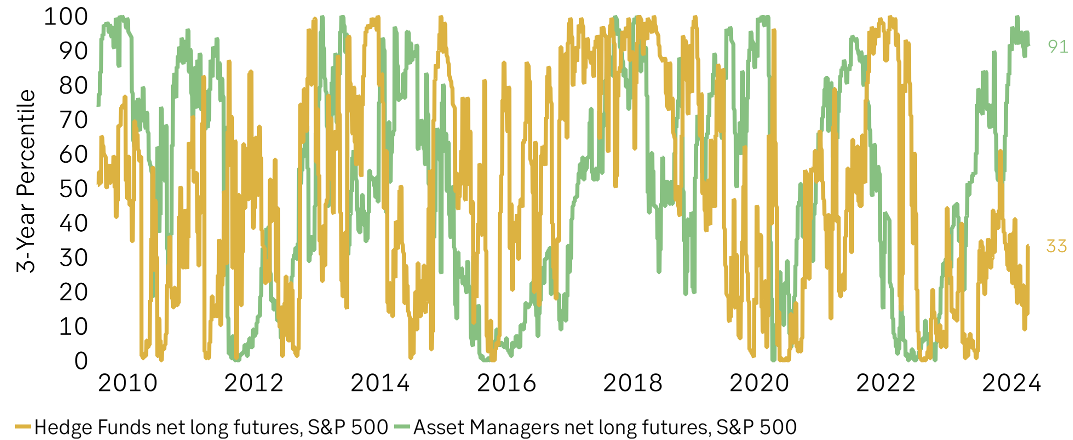
Figure 4: Swedish inflation has declined more than forecasts and dovish Riksbank minutes signaled a first potential rate cut by May or June – we expect the first cut in May



Source: Macrobond, SEB

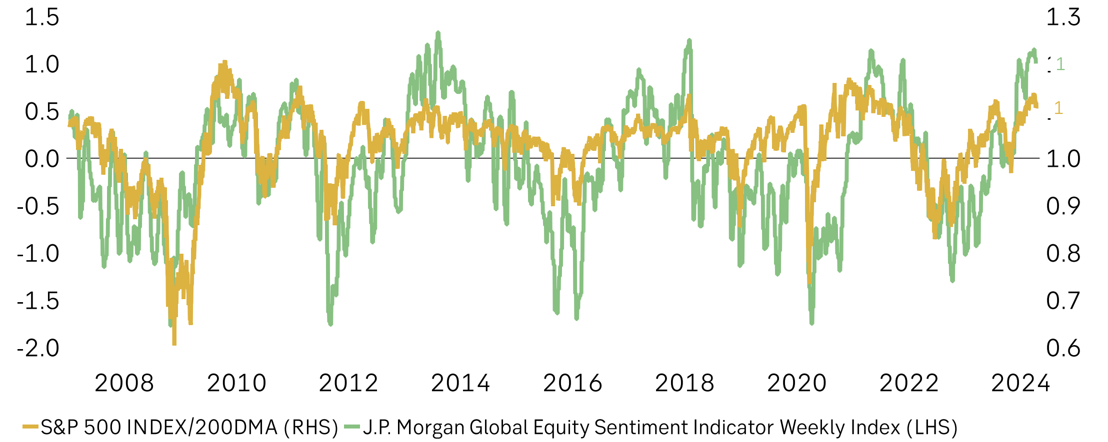
Equity positioning and sentiment are bullish

Figure 1: Asset managers are net long S&P 500 futures and are very long against its own history according to CFTC data, while hedge funds low positioned against their history



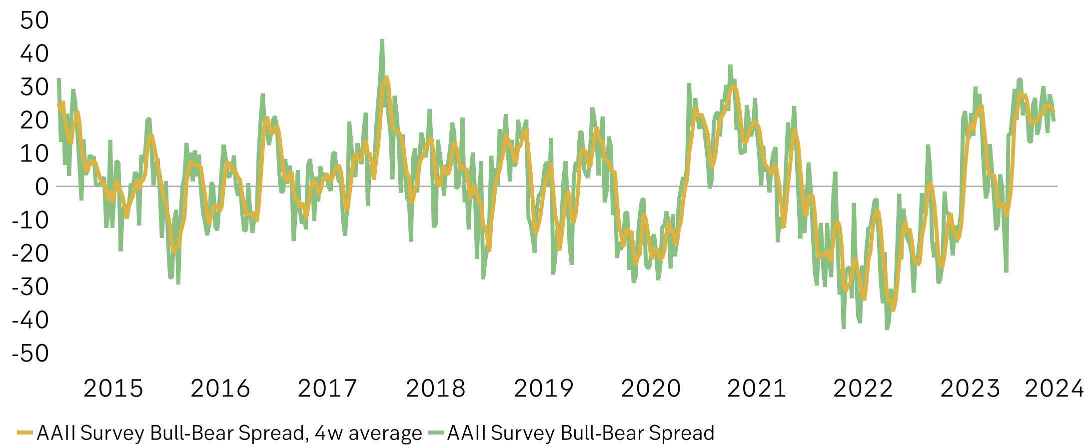
Source: Macrobond, SEB

Figure 1: J.P. Morgan's Equity Sentiment Indicator, which takes into account positioning, sentiment, flow, volatility and technical indicators, points to very bullish equity sentiment



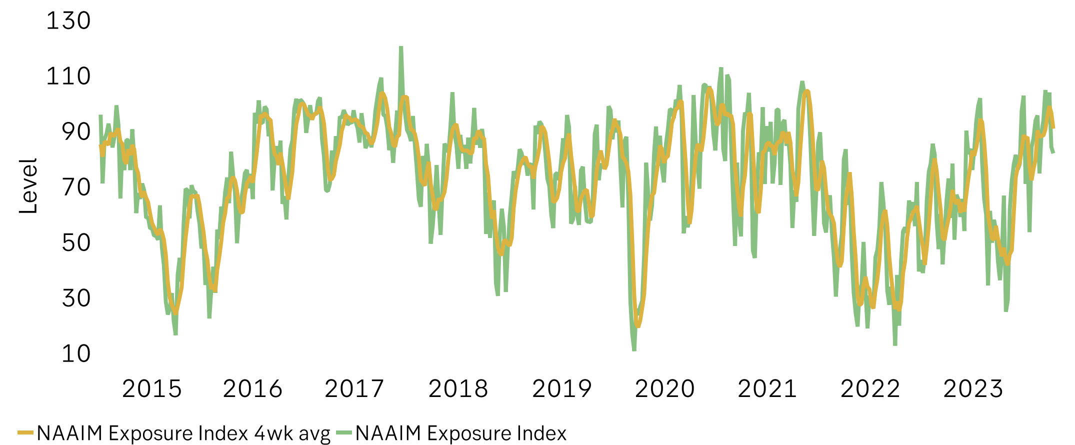
Source: Macrobond, SEB

Figure 2: Optimism among US individual investors about the short-term outlook for stocks have risen to the highest level in years as stock markets have reached new highs



Source: Macrobond, SEB

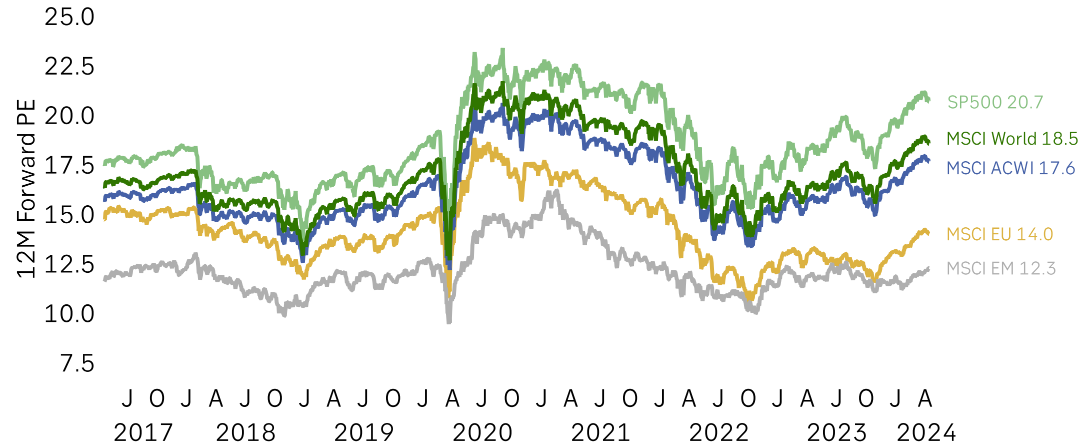
Figure 3: Active investment managers have increased their equity exposure, also indicating equity sentiment is increasingly bullish



Source: Macrobond, SEB

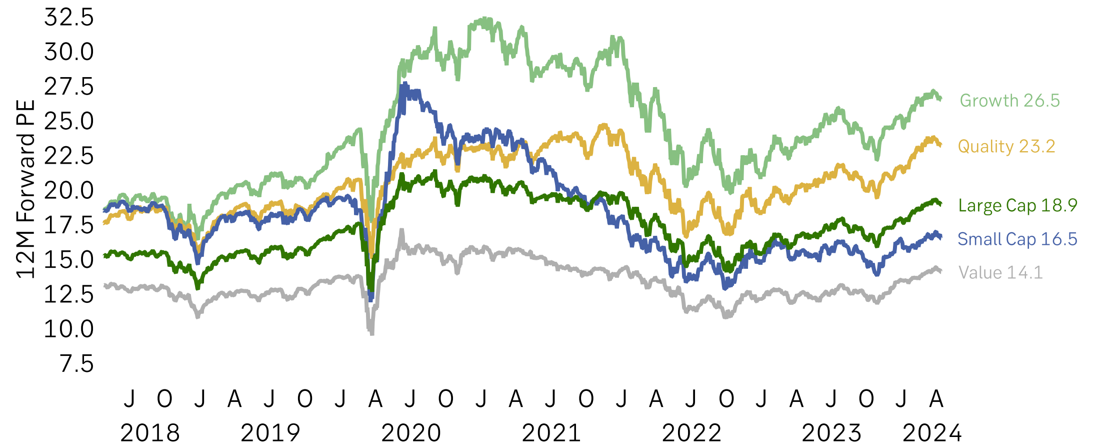
Valuations and risk premiums

Figure 1: Stock valuations have risen across most regions over the past six months, notably in developed markets. Valuations for EM stocks have yet recovered to pre-pandemic levels



Source: Macrobond, SEB

Figure 2: Growth and quality stocks have re-rated along with small-cap stocks. Valuations of rate-sensitive sectors, such as small-caps, should benefit from lower rates



Source: Macrobond, SEB

Figure 3: The US equity risk premium (forward EY minus real 10-year Treasury yield) has decreased, with the forward US earnings yield also falling below the US IG bond yield

Source: Macrobond, SEB

Figure 4: Corporate bonds offers carry, but the recent rise in bond yields in combination with tight credit spreads make the case for OW IG Credit versus UW Bonds weaker now

Source: Macrobond, SEB

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