HOUSE VIEW

PREPARING TO LAND

BancaMarch

PREPARING TO LAND

STRATEGIC POSITION

ASSET ALLOCATION

ASSET CLASS	-2	-1	NEUTRAL	+1	+2
LIQUIDITY			■		
FIXED-INCOME		■			
EQUITY			■		
ALTERNATIVE				■	
FIXED-INCOME	**-2**	**-1**	**NEUTRAL**	**+1**	**+2**
SOVEREIGN DEBT		■			
↑ *US*			■		
↓ *Euro*		■			
CORPORATE BONDS				■	
Investment Grade				■	
High Yield			■		
EMERGING DEBT				■	
CONVERTIBLE BONDS			■		
EQUITIES	**-2**	**-1**	**NEUTRAL**	**+1**	**+2**
EUROPE			■		
United Kingdom				■	
UNITED STATES				■	
EMERGING ECONOMIES			■		
REST OF WORLD		■			
CURRENCIES	**-2**	**-1**	**NEUTRAL**	**+1**	**+2**
DOLLAR			■		
STERLING POUND		■			

PREPARING TO LAND

Global economic growth continues to slow at a staggering rate. Inflation has been aggravated by further supply chain disruptions and has now hit unacceptable levels for central banks, which are determined to rein it in whatever the cost to economic growth. The situation has also deteriorated considerably in Europe, where Russian gas cuts are threatening to trigger a recession. China, on the flipside, is one of the few positive performers as lockdown measures come to an end, although the economic reopening has failed to avoid a slump in commodities. The US economy could already technically be in recession, but the real risk is that this contraction could drag out over the next few months as interest rate hikes start to make themselves felt in the labour market, consumer spending and investment.

With this in mind, as we prepare for the economy to land, we believe it is advisable to remain positioned more defensively. We recommend paring down exposure to small caps and increasing positions in US Treasuries with maturities of under 3 years to benefit from the inverted yield curve. These measures are in addition to decisions aimed at reducing the risk we have taken on over the last few months, including: cutting exposure to the cycle by reducing industrials in favour of health, eliminating EM currency risk, slashing exposure to a strict neutral position in December and, following the invasion of Ukraine, overweight the US versus Europe, increase positions in defence/aerospace, infrastructure and the European energy transition.

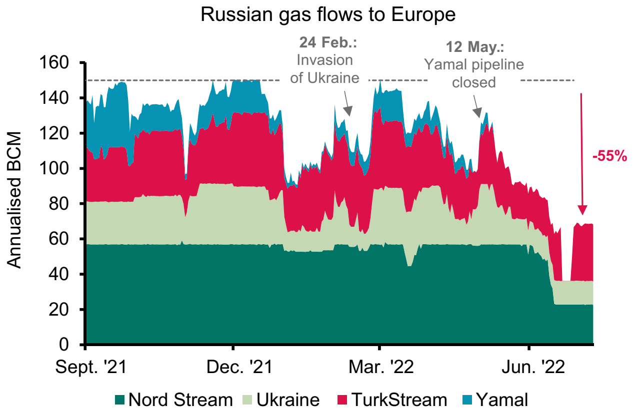
MACROECONOMIC LANDSCAPE

Europe is dependent on Russian gas

Moscow's decision to dramatically cut gas supplies delivered via Nord Stream has sounded alarm bells in Europe, with gas cuts now hitting 12 countries. These cuts have slashed Russian imports by 55% versus before the invasion, and the major risk now is that it will cut off supplies completely. Nord Stream is currently shut for annual maintenance work until 21 July, and there are fears that Putin may not open the pipeline after the work, plunging Europe into a further recession.

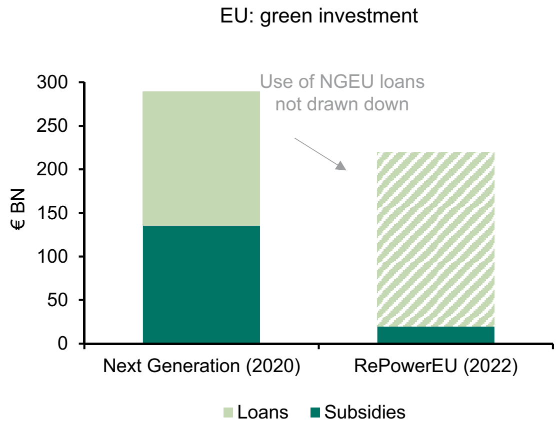
1. RUSSIA CUTS GAS SUPPLY TO GERMANY BY 60% AHEAD OF MAINTENANCE SHUTDOWN

Sources: Bloomberg and Banca March



2. REPOWEREU INVESTMENT FAILS TO PROVIDE SUBSTANTIAL CONTRIBUTION

Sources: European Commission and Banca March



In response to these cuts, governments in countries like Germany and Austria have ordered the reactivation of previously decommissioned coal plants to shore up gas reserves ahead of the winter, but these measures are still not a solution. For example, the 10 GW in capacity that Germany is planning to add to its grid will only replace, in the best case scenario, 20% of the recent cuts to the Nord Stream supply.

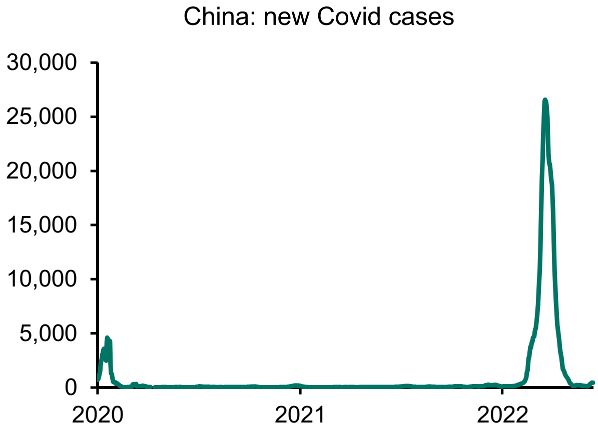
The EC is to announce contingency measures in July which could include a mechanism to ration power, as well as recommendations to delay nuclear plant shutdowns. Brussels had previously launched its RePowerEU plan, aimed at cutting dependency on Russian gas, but its long-term approach and limited budget – €20 billion in loans – mean it does not offer a solution to the current emergency situation. We believe Europe urgently needs to accelerate the energy transition to achieve two crucial goals – achieving energy independence and meeting climate targets – and this will necessitate greater investment.

Lockdown measures ease off in China

In addition to the Ukraine war, China has been a key source of instability over recent months. Since February, the authorities imposed lockdown measures on various cities including Shanghai to stem the worst wave of Covid since the pandemic began, shutting down factories and causing congestion at some ports. Following these draconian measures, the virus has remitted and allowed many of the restrictions to be lifted. The government has cut the quarantine period required for international visitors by half, from 21 to 10 days, in a small step towards normal activity.

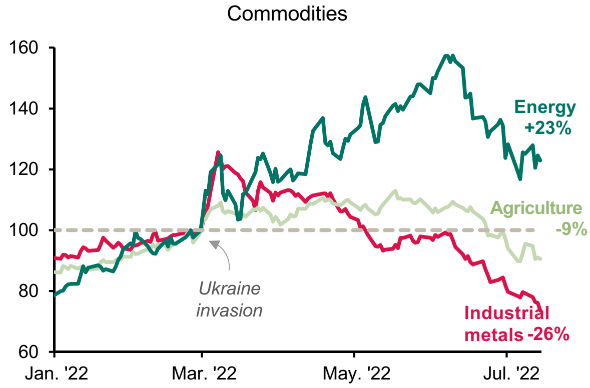
3. CHINA OVERCOMES FIERCE WAVE OF OMICRON

Sources: Bloomberg and Banca March



4. COMMODITIES POINT TO WEAK GROWTH

Sources: Bloomberg and Banca March



Commodities are pricing in weaker growth

The reopening of China has brought little relief for commodities, which have sustained even deeper losses as the global economic slowdown becomes increasingly evident. Industrial metals prices were down by over 25% versus the outset of the pandemic , with aluminium falling by 28% and copper by 26%. Energy prices also suffered a significant downturn: Brent is currently at $97 a barrel, versus a post-war high of $127. The downturn in agricultural prices should alleviate inflation in emerging markets, where food accounts for a significant proportion of shopping baskets, which will in turn contribute to political stability in the region.

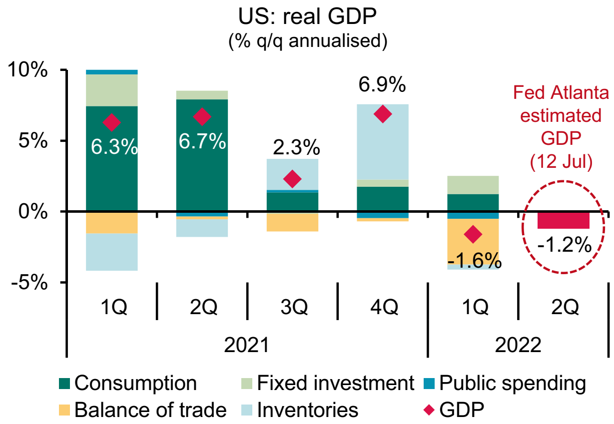
The US could already be in a technical recession

The US economy could already be in a technical recession, which is defined as a drop in real quarterly GDP for two consecutive periods. After an annualised quarterly drop of 1.6% in the first quarter of the year, the Atlanta Fed's real-time estimate points to a second--quarter economic contraction of 1.2%. However, it is important to note that the foreign sector had an exceptional, decisive impact on the Q1 downturn, whilst consumer spending and investment put in a positive contribution. We could see a similar pattern in the second quarter, when inventory levels are expected to bring another decline in GDP.

What's more, the National Bureau of Economic Research (NBER), which is officially responsible for determining when the economy is in recession, uses a more sophisticated formula than simply accumulating two quarters of negative GDP growth. Using this criteria, the NBER defines the cycle based on employment, industrial output, wholesale sales and real income, among others, and many of these variables are still in growth territory. In fact, it determined that a recession had begun in March 2001, despite the fact that there had not been two consecutive quarters of falling GDP. Beyond the label itself, what really matters is that a real recession in the next few months is looking increasingly likely.

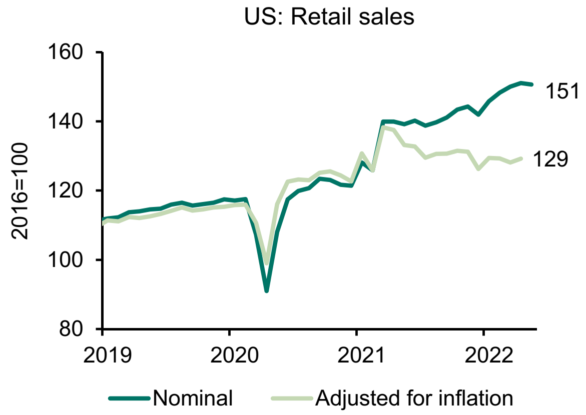
5. THE US COULD BE HEADING INTO A TECHNICAL RECESSION

Sources: Bloomberg and Banca March



6. FAMILIES ARE CONSUMING LESS PRODUCTS BUT PAYING MORE FOR THEM

Sources: Bloomberg and Banca March



Consumer spending remains under pressure

The increase in the cost of the shopping basket continues to weaken household purchasing power. US retail sales are a clear example; though they continue to rise in nominal terms, they have actually come to a standstill when adjusted for inflation: households are paying more money to buy fewer products than at the peak of the pandemic – figure 6. On the other side of the ledger, there are factors like excess accumulated savings and the arrival of peak tourism season in the northern hemisphere, which will cushion the blow from inflation and allow consumption to continue to fuel growth.

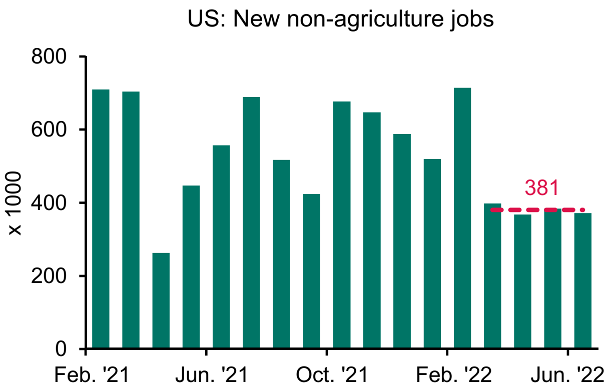
The strong labour market is not consistent with a recession scenario

The US labour market kept up the pace in June and created more than 370,000 jobs; this was slightly more moderate growth than earlier in the year but still not consistent with an economic recession scenario. Companies are still struggling to find the labour they need, and the number of vacancies is twice the number of people out of work. This lack of labour has driven up salaries, which are now 12% higher than they were pre-Covid.

The rigidity of the US labour market is not so much due to an overheated market - as employment has not yet recovered to February 2020 levels - but to companies' inability to attract workers back to the market. This has led to a record low participation rate which has improved in recent months, despite a slight downturn which could be anecdotal and attributable to the increased impact of Covid. The participation rate in the 25-54 age range improved substantially, so we could well see salaries start to come back down in the second half of the year.

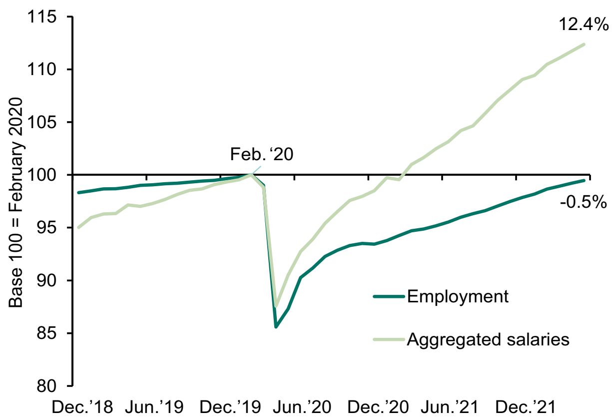
7. JOB CREATION KEEPS UP THE PACE IN THE US

Sources: Bloomberg and Banca March



8. SALARY GROWTH HAS SIGNIFICANTLY OUTSTRIPPED EMPLOYMENT GROWTH

Sources: Bloomberg and Banca March



Inflation hits new highs in the US and Europe

US inflation chalked up a new record of 9.1% in June, the highest figure on record since November 1981. In the eurozone, inflation also hit a new high of 8.6%, with records posted in Spain (10.2%) and Italy (8%). Energy accounts for a hefty proportion of the increase in both regions but particularly in Europe, where the proximity of the war and energy dependence both have a greater impact. The price of rents and vehicle purchases in the US also contributed noticeably over the last year in the US. For the months ahead, the drop in commodity prices should allow inflation to taper off somewhat on both sides of the Atlantic, especially if it lasts.

Second round effects are not relenting in the US

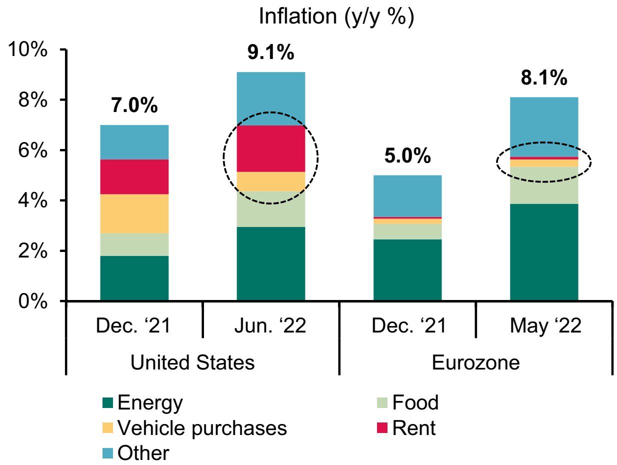
Unlike the general index, core inflation continued to decline in the US (5.9% in June) after peaking at 6.5% in March 2022. However, this trend masks the material drop in the contribution of pre-owned cars, which accounted for almost third of core inflation just a few months ago. Stripping out this component, the prices of the rest of the basket continued to rise, particularly rent, which accounts for 40% of the index and is registering an ever higher contribution. The particular way in which this indicator is calculated also means it is not very sensitive to the recent drop in house prices, so the impact of that could continue to rise over the months ahead. The Fed is aware of these details and will not drop its pace despite relenting core inflation.

Service prices are no longer climbing in Europe

Core inflation was also down in the eurozone, but in this case it was accompanied by a drop in the price of services (3.4% in June vs 3.5% in May). On the flipside, prices of goods continued to rise, albeit modestly, to 4.3% in June, up 1 tenth of a point versus May. Though the final data is yet to confirm these preliminary findings, the more moderate price of services at relatively low rates is good news, especially ahead of the spike in tourist service activity expected in the summer months.

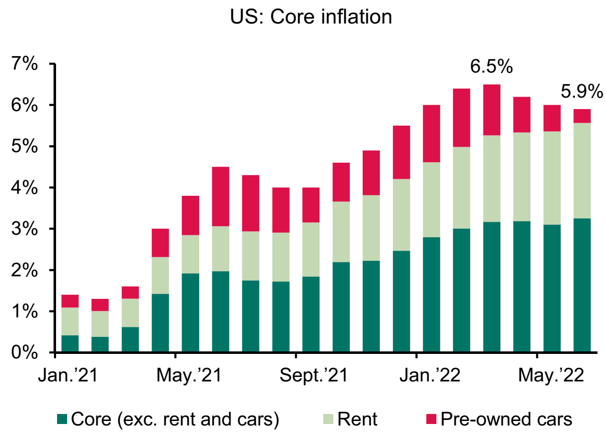
9. INFLATION HITS NEW HIGHS IN THE US AND EUROPE

Sources: BLS, Eurostat and Banca March



10. PRE-OWNED CARS MASK INCREASE IN CORE INFLATION

Sources: BLS and Banca March

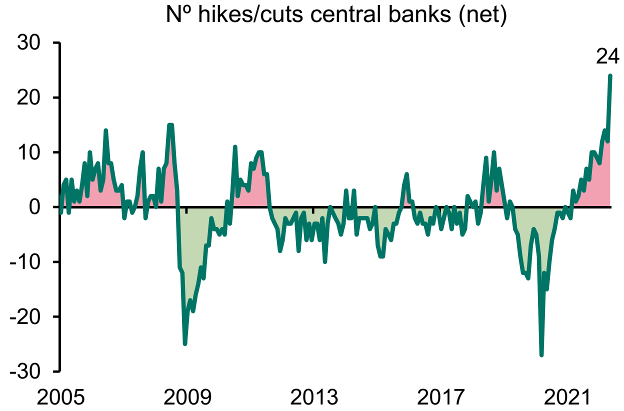


CENTRAL BANKS

Global central banks are stepping up the pace of rate hikes

11. CENTRAL BANK INTENSIFY RATE HIKES

Sources: BIS and Banca March



Central banks all over the world have gone all out in recent weeks, stepping up rate hikes and tightening up policy after the most expansionary fiscal and monetary efforts in history. 25 of the main 40 central banks raised benchmark rates in June, with the exception of Russia, which continued to slash rates to 9.5%, versus 11% in May. One of the latest additions to the list was the Swiss central bank, which surprised the markets by hiking rates – from -0.75% to -0.25% – for the first time in 15 years. The European Central Bank is still conspicuous by its absence, but is set to put rates up at the end of this month.

The Fed will bring interest rates into neutral territory before the holidays

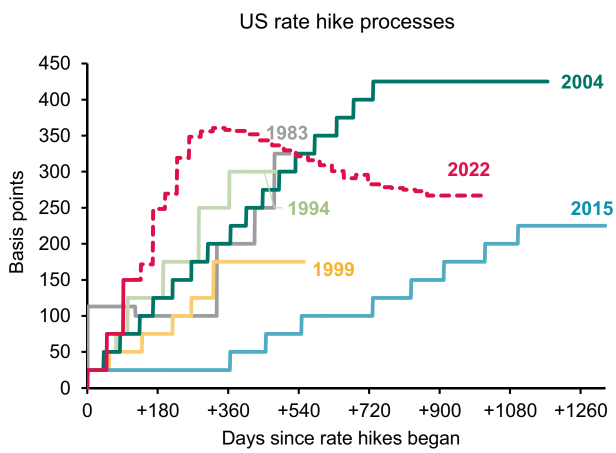
In recent weeks, the Fed has made it clear that it is determined to curb rising inflation through a highly restrictive monetary policy, implementing its most aggressive rate hike process for 40 years and paring down its $9 trillion balance sheet. At its latest meeting, the Fed hiked the benchmark rate by 75 bps, taking it to the range of 1.5-1.75%. Following the latest inflation figures, it looks likely that it will raise rates by another 75 bps at its meeting on 27 July, taking the high end of the range to neutral levels – around 2.5%, taking the Fed's estimated long-term interest rate as a proxy.

As of September, we believe the Fed will continue to raise rates at each successive meeting, albeit at a slower pace. The implied speed of rate hikes is so aggressive that the market is expecting that after hitting a benchmark rate of 3.7% in January 2023, the Fed may need to undo some of the hikes undertaken throughout 2023, and is pricing in a drop of three quarter of a point by the end of next year. As figure 13 shows, this would leave rate 1.2 bps above neutral, similarly to the policy applied in 1995-2000, when official rates reached a peak of 6.5%.

In any case, we do not believe that the current situation is comparable with the last Great Inflation in the early 80s. At that time, the Fed had to hike rates to 4 points about neutral to curb inflation and the core PCE price index stood at 10%, which is a great deal higher than the 5.3% registered in March 2022.

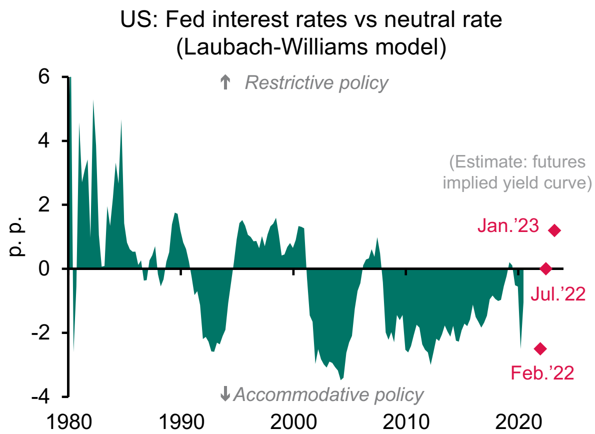
12. FEDERAL RESERVE: THE FASTEST RATE HIKE PROCESS SINCE THE 80S

Sources: BIS and Banca March



13. THE CURVE IS PRICING IN AN INTEREST RATE 1.2 P.P. ABOVE NEUTRAL

Sources: The Federal Reserve Bank of New York, Bloomberg and Banca March



European Central Bank: rates hikes ahead as expectations run high for new anti-fragmentation tool

On 21 July, all eyes will be on the ECB, which is set to hike rates - by at least 25 bps - for the first time since 2011. There will be heavy pressure on the central bank given the steep inflation levels – currently at 8.6% – and the recent gas supply cuts by Russia. The ECB's new anti-fragmentation tool will also draw a great deal of attention.

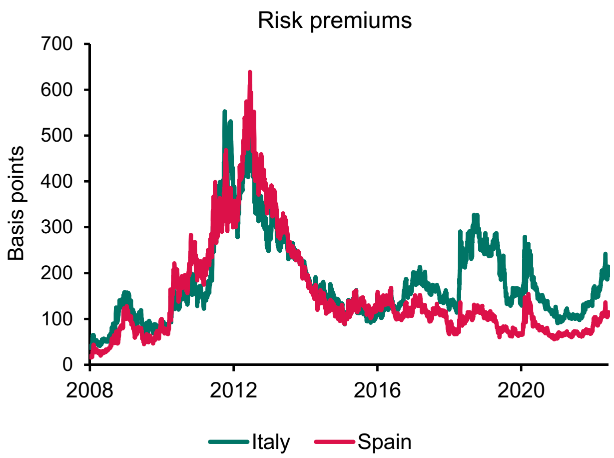
This new measure, which is expected to be dubbed the Transmission Protection Mechanism, will see the ECB buy bonds when risk premiums exceed certain thresholds deemed excessive by the central bank. Although the ECB could temporarily use maturities in northern countries to contain risk premiums, it cannot stray too far from a proportional allocation between the various EU members states due to restrictions stipulated in the EU treaties. The monetary authority will need to look at how to build a tool with extremely high purchasing power to stop risk premiums from widening and avoid the use of the mechanism itself.

However, there are a number of issues which look tricky to resolve. How will it convince northern members that this isn't an "open bar" for financing for the south? Will there be conditions attached? What does this mean for the trilemma of democracy, national sovereignty and global economic integration?

Given how difficult these questions are to answer, we have doubts around the ECB's capacity to act in time and bring a definitive solution to next week's meeting. Unfortunately, experience has shown is that in Europe, change is slow, and market pressures come first.

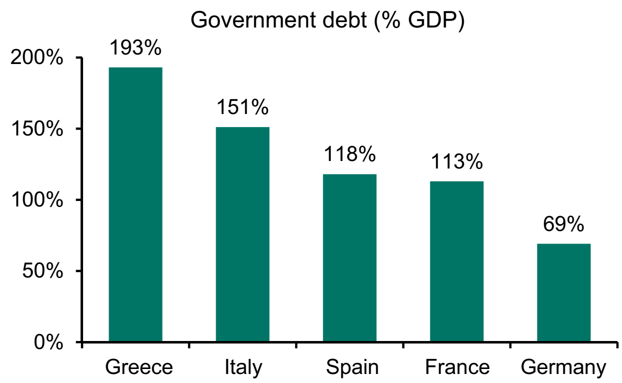
14. RISK PREMIUMS

Sources: Bloomberg and Banca March



15. DEBT-TO-GDP EUROZONE COUNTRIES

Sources: Eurostat and Banca March



FIXED INCOME

European risk premiums remain contained as the market awaits the ECB's anti-fragmentation tool

After a spike in mid-June when the Italian risk premium rose to almost 250 bps, long peripheral bonds remained contained after the ECB mooted its anti-fragmentation tool. The recent political crisis in Italy has put pressure on BTP Italian government bonds, taking 10-year yields to the region of 3.2%. In Germany, Bund yields corrected from a high of 1.77% to 1.17%, driven down by doubts around growth due to Russian gas cuts.

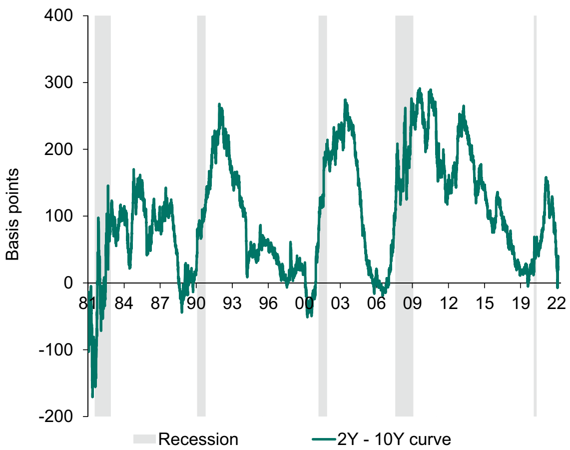
The US yield curve inversion has reached its widest point for 22 years, anticipating an economic contraction

The 2-year to 10-year spread is now in negative territory, reflecting the adverse impact that rate hikes will end up having on economic growth. This indicator is an accurate predictor of recessions, and as figure 16 shows, it is currently pointing to an economic recession over the course of next year.

In any case, it is important to note that although yield curve inversion is a necessary condition for a recession, it is not enough on its own. Since the 70s the yield curve has inverted on 8 occasions, not including the present, and only 6 have resulted in a recession – figure 17.

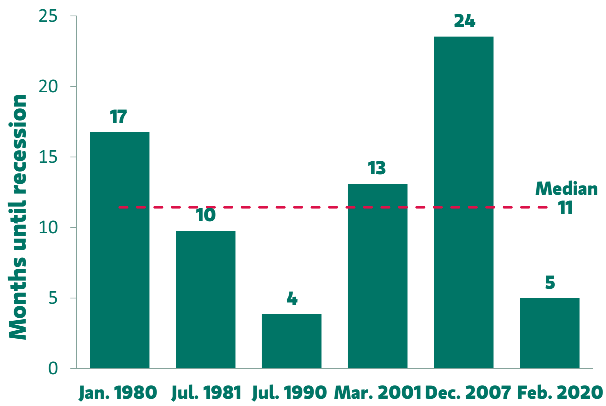
16. US: 2-YEAR/10-YEAR YIELD CURVE HAS INVERTED

Sources: Bloomberg and Banca March



17. MONTHS UNTIL RECESSION FOLLOWING INVERSION OF THE 2-YEAR/10-YEAR CURVE

Sources: Bloomberg and Banca March



We recommend raising exposure to US Treasuries

Against this backdrop, we recommend increasing exposure to US Treasuries, buying debt with maturities of under 3 years to harness the inverted yield curve.

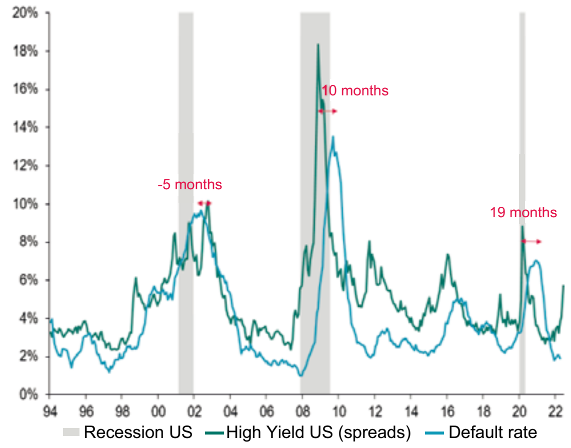
Credit: we continue to like higher-rated companies in view of the impending economic slowdown

The volatility of global equities is also reflected in credit spreads, which have widened to post-pandemic highs for both investment grade and high yield, standing at 170 bps and 658 bps respectively.

Spreads have widened further in the eurozone than in the US, with a spread of 30 bps between European and US investment grade and more than 100 bps between investment grade credit in the two regions, reflecting the potential geopolitical risk in Europe.

18. SPREADS VERSUS PROPORTION OF DEFAULTS

Sources: Moody's, Bloomberg and Banca March



The widening spreads in recent months suggests that tighter financing conditions will begin to weigh on the solvency of the weaker segment of the credit market. As the figure shows, defaults in high yield tend to start climbing at the dawn of a recession and peak thereafter, and spreads tend to be a step ahead.

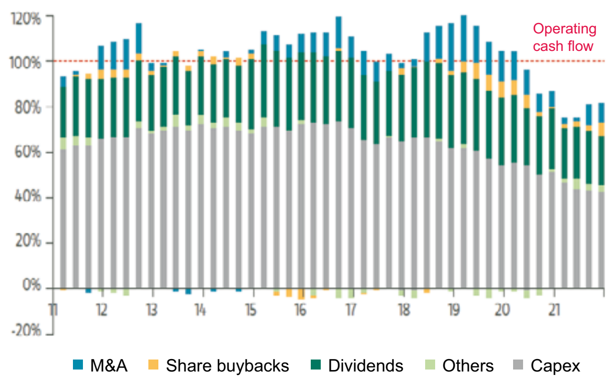
Although spreads have widened materially in high yield, they are a long way off the spreads registered in other recessionary environments.

Potential default increases aside, companies have harnessed the favourable conditions in recent months to extend maturities and pay down debt

On the positive side, companies are heading into the end of the credit cycle at extremely healthy levels, firstly because they have extended maturities on their debt – in 2022 and 2023 just 14% of IG debt and 8% of HY debt is set to mature in Europe – and secondly because they have harnessed extraordinary liquidity levels to reduce leveraging through a conservative use of cash. As figure 19 shows, following the shock of the pandemic, companies used less than 100% of their operating cash flow for investments and shareholder remuneration, using excess cash to pay down debt instead. In the quarters leading up to the crisis, when companies were using 100% of their cash flow, they were resorting to external financing.

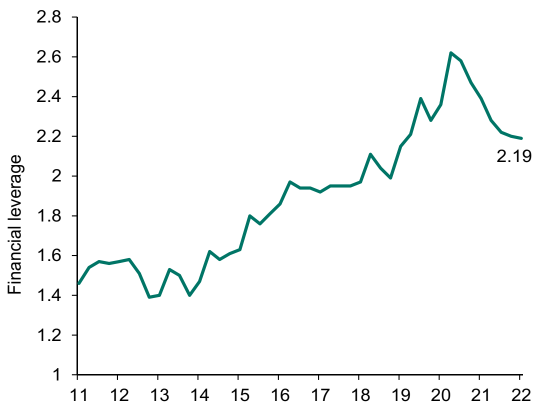
19. EUROPEAN IG: USE OF OPERATING CASH FLOW

Sources: Bloomberg and Banca March



20. EUROPEAN IG LEVERAGE RATIO

Sources: Bloomberg and Banca March



With all this in mind, we believe the highest-rated IG credit still offers an opportunity in terms of spreads versus Treasuries thanks to this increase in credit spreads, which is even more evident on shorter durations, where fluctuations in rates or in spreads themselves has less of an impact on total yields. For example, short-dated European credit could absorb a rise in short term rates of up to 121 bps without losing money, whereas the buffer for sovereign debt is only a third of that figure.

EQUITIES

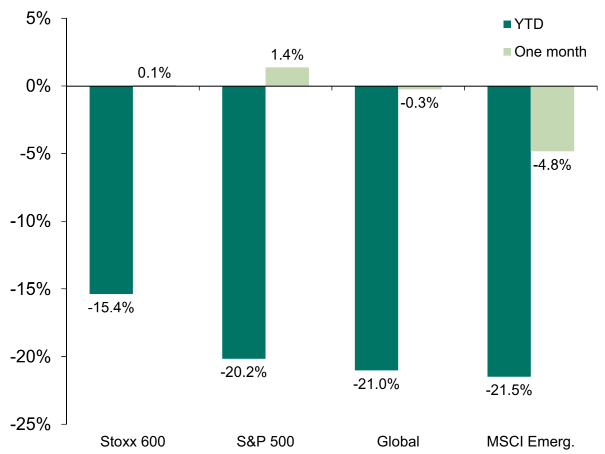
Abrupt tapering by central banks has put pressure on equities. The defensive sectors are outperforming, chalking up positive returns over the month and year to date

The S&P 500 is down 20% as we head into the second half of the year, the worst start to a second half since 1970. This weak start to the period was consistent across most global equity indices, with the Nasdaq tech index down 28.1% and the German Dax and MSCI EM index both down almost 20%.

Inflation driven to a forty-year high by spiralling commodity costs triggered by the Ukraine war, has caused the cycle to mature more quickly and made a soft landing for the economy increasingly less likely.

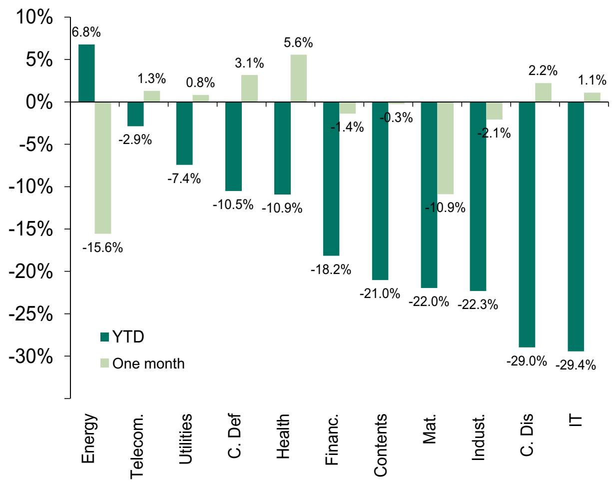
21. PERFORMANCE OF THE MAIN INDICES

Sources: Bloomberg and Banca March



22. PERFORMANCE OF GLOBAL ECONOMIC SECTORS

Sources: Bloomberg and Banca March



As for sectors, defensive sectors like health (+5.6%), consumer defensive (+3.1%), telecoms (+1.3%) and utilities (+0.8%) performed well on both sides of the Atlantic. The strong performance enjoyed by these sectors, supported by recurring earnings and consistent dividend payouts, allowed both health and telecoms stocks to post positive YTD returns in Europe. Energy also deserves a mention, after the recent correction in crude prices triggered losses of 10% in Europe and 17% in the US over the last month. Despite these losses the energy sector has chalked up year-to-date gains of 17% in Europe and 27% in the US, but the losses in the emerging markets have been steeper and the sector is down 29% year to date.

The worst first halves in history were followed by rallies, although in most cases these were not vigorous enough to recover the ground lost

Despite the bleak start to the year and more adverse risk landscape, it is worth considering that historically, four out of the five worst ever starts to a year on record were followed by an equity market rally in the second half - figure 23. Although it is risky to draw comparisons between such different eras and economic cycles, it is important to note that recoveries within bear markets, except in 1970, failed to recover all the ground lost within the same year. This observation, coupled with the breakneck speed of the losses registered this year, should remind us that we must not reduce equity exposure on downturns, but rather harness rallies to take a more cautious position.

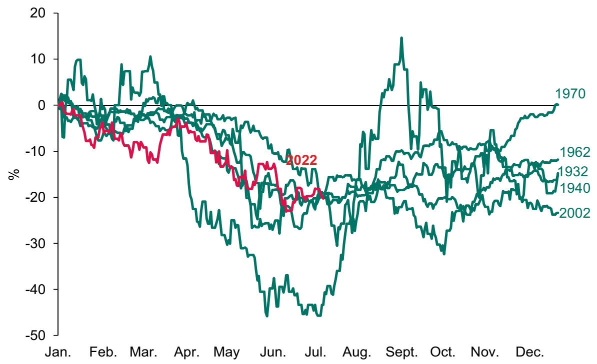
23. S&P 500: A BLEAK FIRST HALF...

Sources: Bloomberg and Banca March

Year	Return at 14 Jul	Rest of the year	Year-end
1932	-43.3	50.4	-14.8
2022	-20.2	¿?	¿?
1940	-20.1	6.3	-15.1
2002	-19.7	-4.5	-23.4
1962	-19.2	9.1	-11.8
1970	-19.1	23.7	0.1
2008	-15.6	-27.1	-38.5
1974	-14.8	-17.5	-29.7
1973	-11.8	-6.3	-17.4
1939	-11.4	7.0	-5.2
	Average	**4.6**	**-17.3**

24. ...BUT BAD YEARS CAN GET BETTER

Sources: Bloomberg and Banca March



Corporate earnings: downgrades are inevitable

Q2 2022 earnings season comes at a tricky time for the markets, which are waiting to see the impact on global growth of factors like inflation, a strong dollar, weaker Chinese growth, the Ukraine war and the aggressive tapering of stimulus measures by central banks. The outlook for S&P 500 earnings is still strong, with forecasts for 5.6% earnings growth and 10.6% revenue growth. These positive growth forecasts are set to intensify further as we head into H2 2022, accompanied by an improvement in business margins versus the previous year - see figure 26 - which is not consistent with the weaker global economic activity expected.

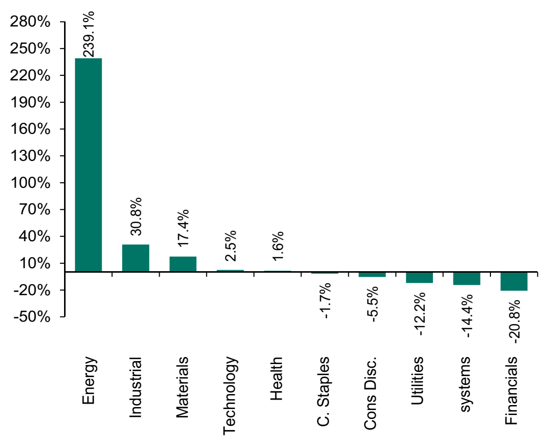
Looking ahead, then, the current outlook for full-year 2022 earnings and revenue growth of over 10% in both cases is, to our minds, excessively optimistic and does not reflect the macro-economic decline, which we expect to be ongoing. As a result, we believe we are likely to see a series of downgrades to these earnings forecasts; in fact, this change of tone could be observed within this quarter in the guidance put out by companies for H2 2022.

The significant contribution by energy sector earnings has distorted estimates for the quarter

By sectors, the energy sector offers by far the highest growth outlook in both earnings (+239%) and revenues (+59%), driven by high crude and gas prices. The sector's contribution to total earnings growth is such that if we strip it out completely, S&P 500 revenues would grow by just 6.6% and earnings would actually fall by 3%. The next best performers are the industrial sector (+30%) and materials (+17.4%), whilst on the flipside, the financial sector is headed for a drop in both earnings (-20.8%) and revenues (-5,2%). We believe this to be a pessimistic outlook for the financial sector given the rate hike process underway, even taking into account the initial potential in the forecast preparation process ahead of the expected decline in the cycle.

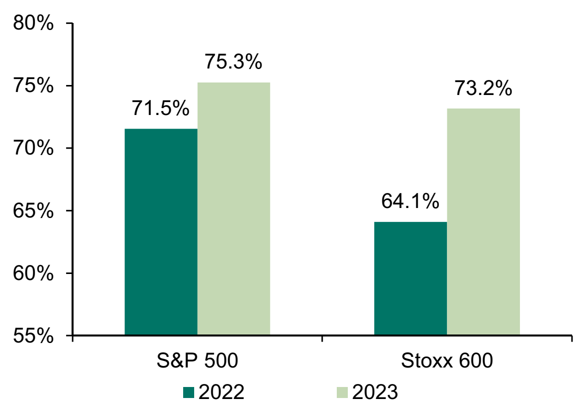
25. S&P 500: Q2 2022 EARNINGS (E) BY SECTOR

Sources: companies, ECB and Banca March



26. THE CONSENSUS EXPECTS MARGINS TO IMPROVE

Sources: companies, ECB and Banca March

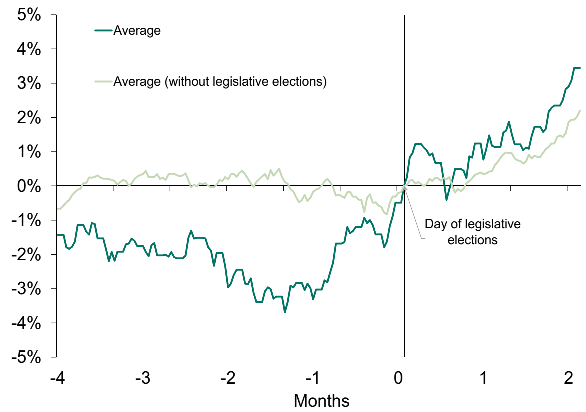


Equities have historically tended to outperform ahead of US state legislative elections

Monetary policy and inflation are monopolising the debate in the financial markets at the moment, but it is important to keep half an eye on the state legislative elections to take place in the US on 8 November. Biden will be facing a full replacement of the House and Senate at a time when his approval rating is at its lowest point ever, similar to the worst moments of the Trump era. The Democrats currently control both the House and the Senate, but the majorities are divided equally and the Vice President has the tie-breaking vote.

27. THE S&P 500 IN RESPONSE TO LEGISLATIVE ELECTIONS

Sources: Bloomberg and Banca March



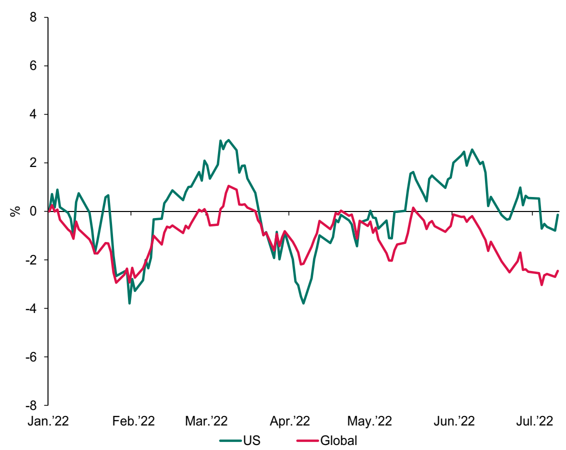
Political considerations aside, the S&P 500 has historically tended to outperform in midterm years versus normal years, especially as of the month before the elections take place. That said, every year and every cycle is different. In 2018, the last time the economy faced a slowdown with interest rates on the rise, the S&P 500 closed the year down 9% versus July that year. Whilst the elections may be a short-term driver of market gains, then, inflation and monetary policy will continue to be the direct market factors.

We recommend paring down exposure to small caps to adopt a more cautious position, as they are more vulnerable in an economic downturn

Small caps have performed in line with the market in the US and slightly underperformed in the case of global indices, but actually outperformed large caps at times of market stress thanks to their lower exposure to the tech sector - 22% for large caps vs. 11% for small caps – which was one of the hardest hit sectors at those times. However, we believe that towards the final phase of the cycle, small caps will offer more limited potential as their earnings are more vulnerable to downturns, just as they growth more vigorously in economic recoveries. With a view to taking a more cautious position, we therefore recommend reducing exposure to small caps.

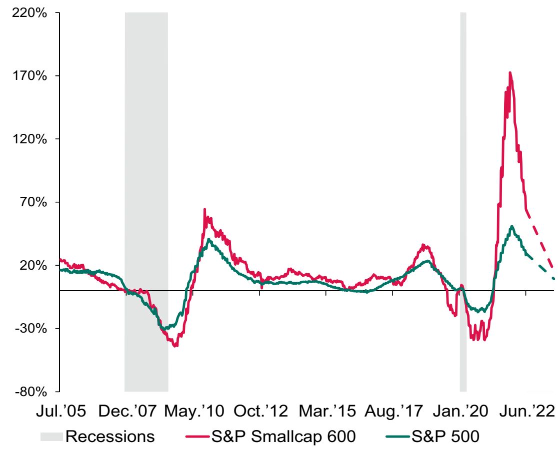
28. ANNUAL RETURNS SMALL VS LARGE CAPS

Sources: Bloomberg, Refinitiv and Banca March



29. YEAR-ON-YEAR CHANGE IN TTM EARNINGS

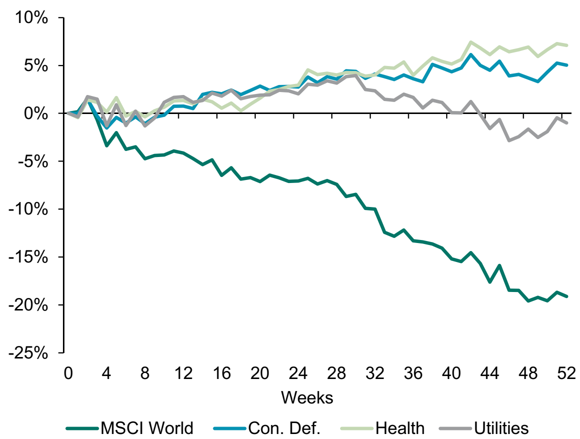
Sources: Bloomberg, Refinitiv and Banca March



Maintain a defensive position in the economic downturn and overweight exposure to the health sector in particular

30. AVERAGE EARNINGS IN THE LAST THREE RECESSIONS

Sources: Refinitiv and Banca March



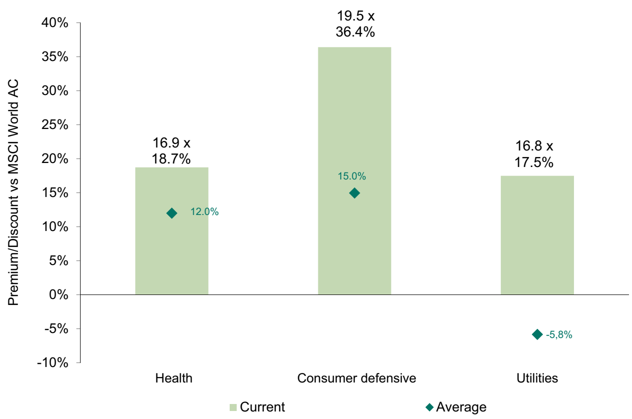
Against an adverse economic backdrop, we believe the best bet is to stay invested in defensive sectors, which can sustain moderate growth even in recessionary environments. As the figure shows, health, consumer defensive and utilities have managed to at least maintain profit levels a year after the last three recessions began – 2000, 2008 and 2020 – as global profits fell by an average of almost 20%.

However, among these different alternatives, we believe that high energy and commodity prices will have a greater impact on the margins of utilities and consumer defensive stocks than on health sector companies. Firstly, we foresee a potential risk of state intervention in the energy market - especially in Europe - which make utility companies' earnings harder to predict. In consumer staples, the significant proportion of raw materials in the cost structure of these companies leads us to believe that their margins will be impacted over the quarters ahead.

Secondly, from a valuations perspective, the premium at which the health sector is currently trading is still relatively compelling, as utilities and consumer defensive stocks are trading at more demanding valuations and further from their long-term averages. This comes on the back of a strong performance by the health sector, which has outperformed the index by 7 percentage points since June.

31. RELATIVE VALUATIONS OF DEFENSIVE SECTORS

Sources: Refinitiv and Banca March



Thanks to its resilient earnings and attractive relative valuations, we continue to believe that the health sector is the best way to position ourselves ahead of a second half in which the economic slowdown will be more evident.

Valuations in the financial sector are also attractive, but the impact of the economic slowdown will partly diminish the tailwinds afforded by higher interest rates

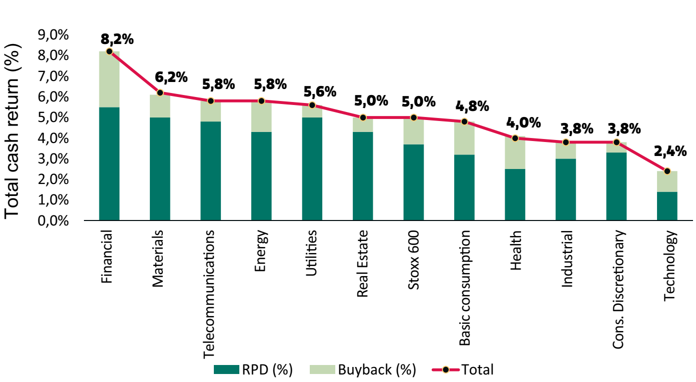
The financial sector put in a stellar performance in 2021, resuming dividend payouts - it is the leading sector by shareholder remuneration - and recovering pre-Covid earnings, thanks to improved revenue generation, cost saving measures and lower provision requirements once the worst of the pandemic had passed.

Currently, despite the fast progression of the economic cycle and fears around a possible recession, the sector continues to be backed by positive growth drivers. Rising interest rates will have a direct positive impact on net interest income and earnings improvement potential, for European banks, of up to 50% over three years. The sector is also well-positioned with low NPLs, high coverage ratios and attractive valuations, including a dividend yield of over 8% which could be increased through additional treasury share programmes.

From here onwards, the deterioration of the economic landscape will draw our attention, in relation to the financial sector, to lending metrics, the potential increase in NPL levels and the possible increase in provisions. Although we maintain a positive opinion and active presence in the market, we believe the tailwinds provided by higher interest rates could be offset to a degree by the impact of the economic slowdown. Given the current advanced stage of the cycle, we therefore prefer to overweight defensive sectors until we see future indicators of an economic recovery, at which point we will resume an active recommendation on the sector.

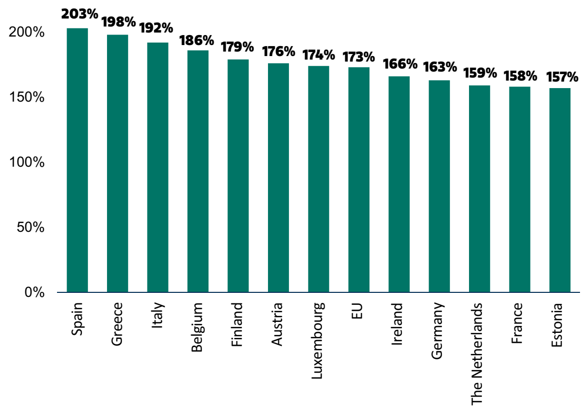
32. FINANCIAL SECTOR SPEARHEADS SHAREHOLDER REMUNERATION

Sources: Companies, ECB and Banca March



33. EUROPEAN BANKS: LIQUIDITY COVERAGE RATIO UP 25% VERSUS PRE-COVID LEVELS

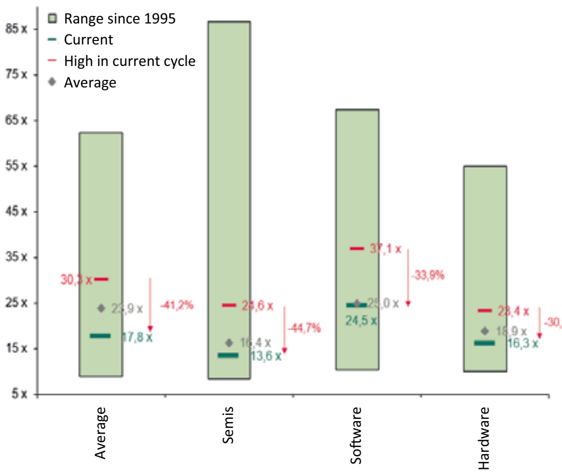
Sources: Companies, ECB and Banca March



Technology sector: valuations are below their historical average across all sub-sectors. We continue to like the resilience offered by software

34. GLOBAL TECHNOLOGY: 12M P/E RATIO (E) BY SECTORS

Sources: Refinitiv and Banca March



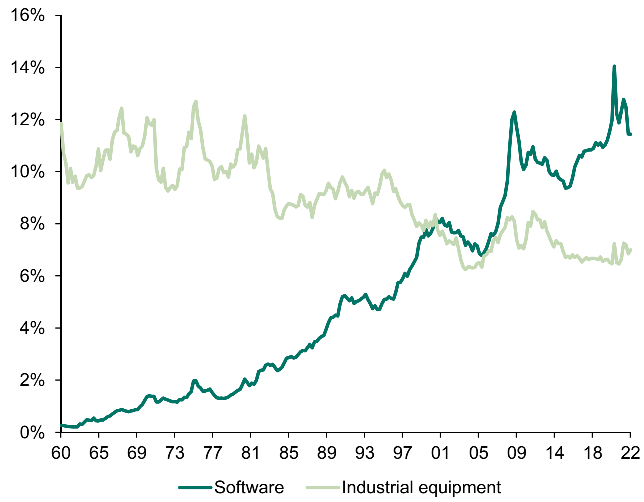
Although the sector continues to post positive results – Q2 earnings growth of 2.5% is forecast for US companies and 12.9% for FY 2022 – technology companies have suffered steep losses in recent months, particularly in the sub-sectors which are most exposed to the cycle, such as semi-conductors and media. However, the slowdown in the rise in long rates has offered certain support for tech sector share prices in recent weeks, as the market awaits Q2 earnings announcements.

Beyond the short term, we recommend holding exposure to the sector, in light of the irreversible digitalisation process currently underway. For example, the growing investment in software, which outstripped investment in industrial equipment in the US for more than two decades.

We believe that software companies, with recurring revenues of 81% on average, are the best bet to weather the current slowdown.

35. INVESTMENT IN SOFTWARE AND INDUSTRIAL EQUIPMENT OVER TOTAL INVESTMENT IN THE US

Sources: Refinitiv and Banca March



CURRENCIES

The euro has gained ground on the back of a more aggressive ECB narrative

Following the publication of the latest global economic data in June, which brought largely negative surprises, the markets switched tacks to price in a drop in activity and an increasing risk of global economic recession. This backdrop has buoyed the greenback, which has gained ground against the dollar in recent weeks to hit parity at 1.0 EUR/USD for the first time in two decades. Year to date, the dollar has chalked up swift gains against the euro, and is currently up by 11%.

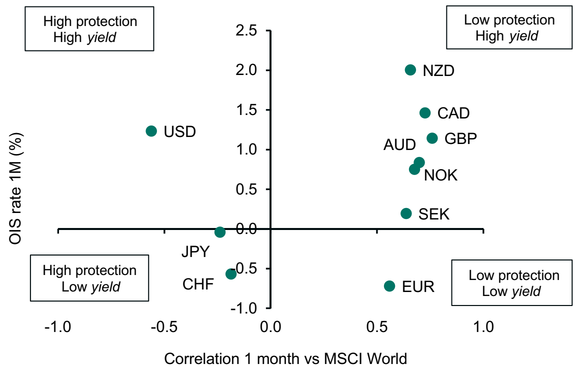
Despite its high valuation, the dollar will continue to enjoy support from its status as a haven asset until the downturn bottoms out and the expected rate hikes by the Fed reach a peak

The currency will also continue to be underpinned by a series of support factors which we have mentioned in the past. Firstly, the Fed is set to spearhead the rate hikes coming over the months ahead, raising rates by at least 75 bps at its July meeting and potentially by the same again at its next meeting. Official rates will therefore stand at over 2.5% in the US, widening the spread versus Europe. At the same time, the ECB has still not prepared the mechanism to protect peripheral spreads, which could make it difficult for the central bank to step up the pace of rate hikes, at least at the upcoming meeting in July.

What's more, despite trading at 2017 highs, the positioning of the futures market is not yet extreme and that could still play in the dollar's favour, especially in light of the Ukraine war. Finally, the recent upswing in risk aversion will afford further support for the greenback, thanks to its status as a haven asset and its negative correlation to risk assets.

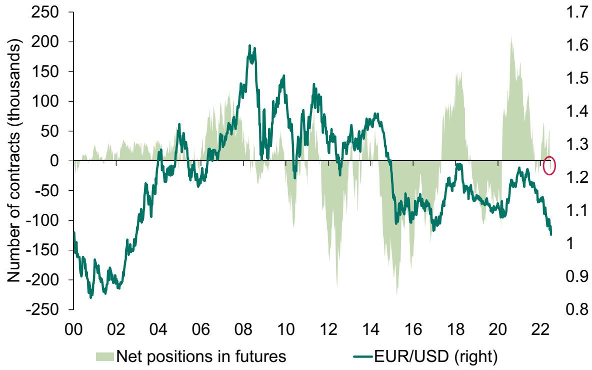
36. DOLLAR: A HIGH-YIELDING HAVEN ASSET

Sources: Refinitiv, Bloomberg and Banca March



37. DOLLAR: POSITIONING IS NOT EXTREME

Sources: Refinitiv, Bloomberg and Banca March



We remain neutrally positioned in the dollar thanks to its haven status and its stabilising effect on portfolios in fragile economic scenarios

Although in terms of purchasing power the dollar is overvalued by 17% versus the euro, we remain neutrally positioned thanks to its status as a haven asset and its ability to deliver diversification at times of uncertainty like the present. We would add long positions in the region of 1.07.

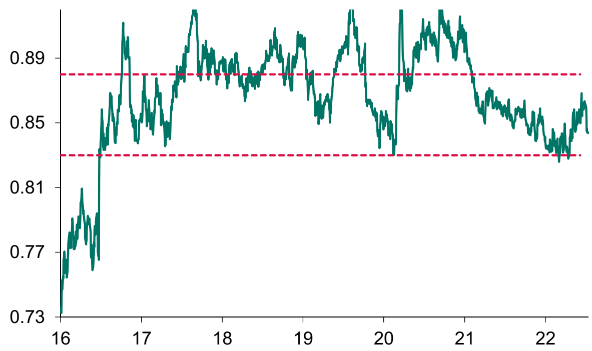
Boris Johnson's resignation has exacerbated political uncertainty, but the pound has responded with relative strength. We continue to hedge exposures as we await further catalysts for sterling

Boris Johnson has stepped down as leader of the Conservative Party, but will remain in place as Prime Minister until a new leader has been elected, which is likely to be in early September. Johnson resigned after a series of scandals came to light and two cabinet members quit, having narrowly survived a vote of no confidence just a month ago. Despite the uncertainty this move has triggered, the pound has posted hefty gains against the euro, hitting 0.845EUR/GBP.

There are two factors to keep an eye on in the short term. Firstly, the possible announcement of further fiscal stimulus measures in addition to the €15bn recently approved to help households with energy bills. The proposal, put forward by one of the strongest candidates to succeed Johnson, Economy Minister Nadhim Zahawi, is intended to kickstart the sluggish UK economy; inflation was up 9.1% year on year to a 40-year high in May and the UK trade deficit stood at almost £10 billion in the same month. Secondly, the choice of a new PM is significant in relation to Brexit, as the new leader, depending on their stance on Europe, could tie up the outstanding issues - like the NI Protocol - once and for all, which would generate tailwinds for the pound.

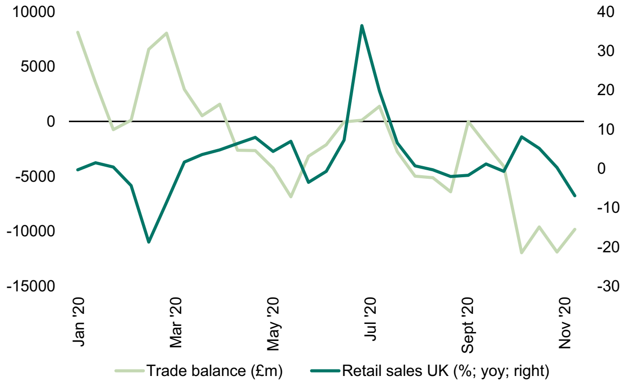
38. EURO-POUND CROSS

Sources: Bloomberg and Banca March



39. THE UK ECONOMY DETERIORATES

Sources: Bloomberg and Banca March



The announcement of a tighter monetary policy in the eurozone as of this month will also lessen the appeal of the rate spread to the UK's advantage, as the Bank of England has already hiked rates five times since December to the current rate of 1.25%.

At this point, we believe any tailwinds for the pound have been neutralised and in light of the political and economic uncertainty, we still see no upside potential for the currency. As we await further catalysts, our target range remains between 0.88 – 0.83 EUR/GBP and we continue to recommend hedging exposures in view of the current uncertainty.

Banca March Market Strategy Team:

Joan Bonet Majó
Pedro Sastre
Paulo Gonçalves, CAIA
Luis Coello
Adrián Santos

IMPORTANT REMARK: