HOUSE VIEW

BRAKING TO AVOID DERAILMENT

BancaMarch

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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		■			
United States			■		
Euro		■			
CORPORATE BONDS				■	
Investment Grade				■	
High Yield			■		
EMERGING DEBT				■	
CONVERTIBLE BONDS			■		

EQUITIES	-2	-1	NEUTRAL	+1	+2
EUROPE			■		
UNITED STATES				■	
EMERGING				■	
REST OF THE WORLD		■			

CURRENCIES	-2	-1	NEUTRAL	+1	+2
U.S. DOLLAR			■		
STERLING POUND		■			

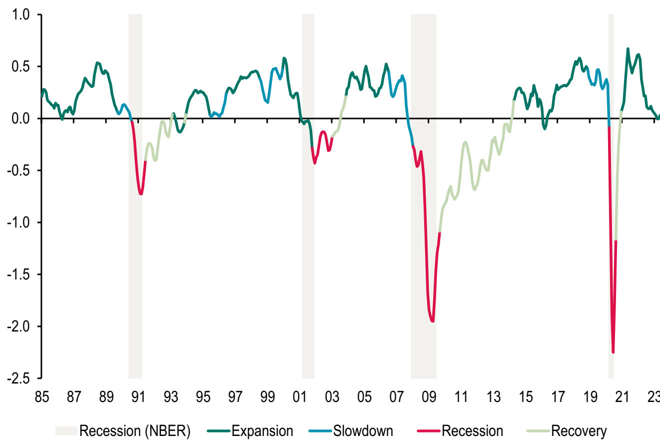
MACROECONOMIC OUTLOOK

We anticipate weak growth and lower inflation in the coming months. While worst-case scenarios have been avoided, the business cycle is moving into a mature phase.

We are currently traversing a complex macroeconomic environment. While labour market data remains strong, it is still too early to assess the impact on economic activity of the sharp rises in interest rates and, in particular, the tightening of financial conditions. Although the latest macroeconomic indicators are not conclusive, in our view the economic cycle is moving towards a mature phase in which we will see growth slowing and inflation slowly retreating, though still remaining high —especially core inflation—, leaving little room for manoeuvre for the central banks, which will continue to pursue a restrictive monetary policy.

1. AGGREGATE CYCLICAL MOMENTUM INDICATOR (US)

Sources: Bloomberg and Banca March



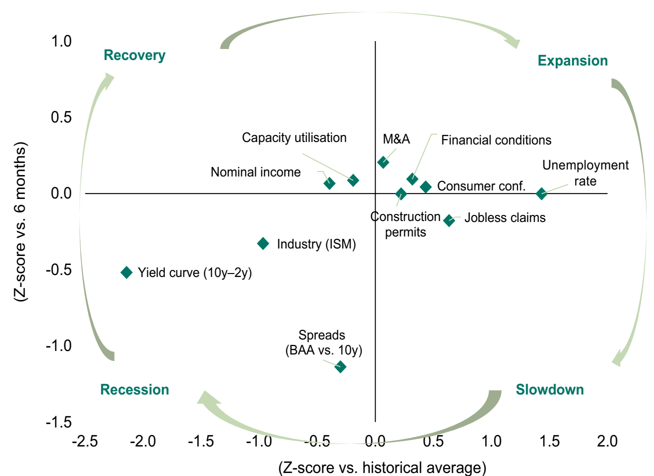
Our economic cycle indicator is still in expansionary territory and continues to follow the trend seen in the first half of the year: the US economy has exceeded expectations with GDP up 2% quarter-on-quarter annualised in Q1, while cumulative job creation in the first six months of the year exceeded 1.6 million jobs.

However, if we break down the trend for each of the components, it is plain to see that one third is already in recessionary territory.

Even certain leading indicators for the labour market, such as jobless claims, are beginning to slow in anticipation of an economic slowdown in the coming months.

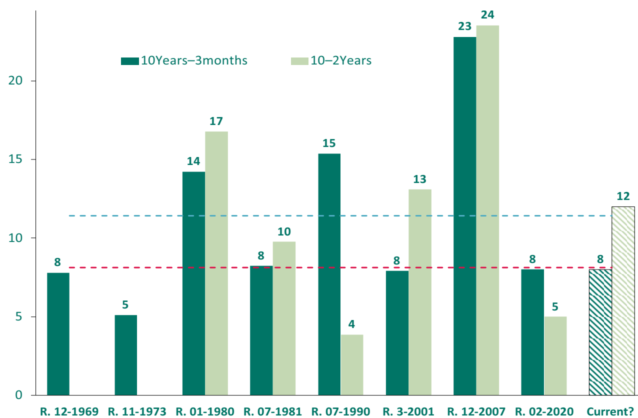
2. PHASE OF THE CYCLE BY INDICATOR COMPONENT

Sources: Bloomberg and Banca March



3. MONTHS TO RECESSION FOLLOWING INVERSION (US)

Sources: Bloomberg and Banca March



One of the best predictors of past recessionary episodes is the slope of the yield curve, especially the difference between the 3-month and 10-year rates. In the past, whenever these curves have inverted, a recession has followed within months. In the United States, we have just passed the average time from when the curves invert to when the recession strikes. That said, and as shown in Figure 3, there is a high degree of heterogeneity so this indicator should be read with caution.

Therefore, although we are still in the expansionary phase, many of the indicators that have historically been reliable indicators of the economic cycle now appear to be losing steam compared to previous months.

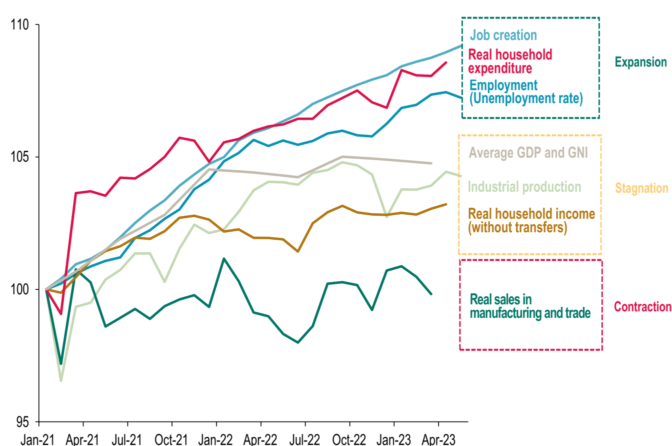
However, this scenario of weak growth and even "technical" recession in some economies should not be confused with the last two episodes of economic contraction: the last recessions were extremely harsh, in 2009 due to the financial crisis and more recently in 2020 due to the pandemic. In these last two episodes, the decline in US GDP was -4% and -9.6%, respectively, which contrasts with the average contraction of 2% since 1950 or the 2001 recession, where GDP dipped by just 0.4%.

How should we define an economic recession?

Interestingly, there is no single, official definition of a recession and, moreover, its beginning and end will only become known many months after it has occurred.

4. RECESSION INDICATORS – UNITED STATES (NBER)

Sources: Bloomberg, NBER and Banca March



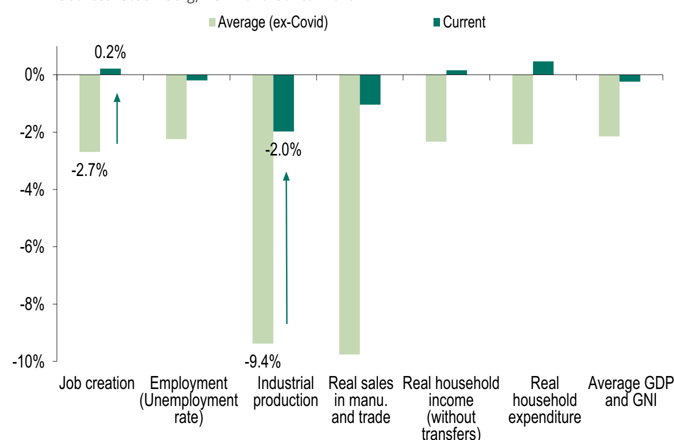
In the United States, the National Bureau of Economic Research (NBER) is the private body that certifies the existence of a recession based on the following criteria and broad definition: "A recession is a significant decline in economic activity that is spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators. A recession begins when the economy reaches a peak of activity and ends when the economy reaches its trough."

According to this definition, and as we can see in Diagrams 4 and 5, the US economy still has a long way to go before entering recession territory.

Employment and consumer spending continue to pick up and this is preventing the economy from taking a nosedive. However, we can also see that other indicators showing levels of real incomes have stagnated, while manufacturing and trade sales are already retreating.

5. AVERAGE DECLINES IN RECESSION VS. CURRENT SITUATION

Sources: Bloomberg, NBER and Banca March

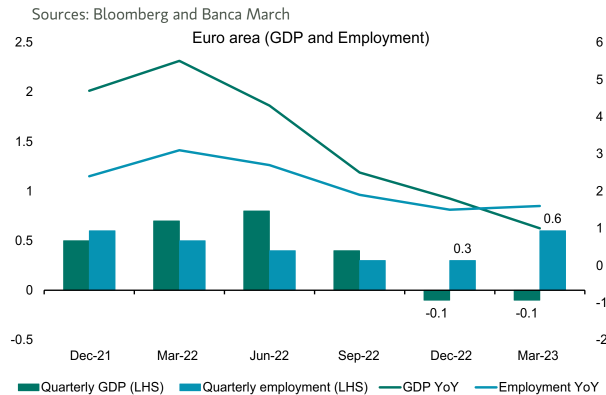


Some of the indicators therefore seem contradictory, which is perhaps unsurprising given the sheer number of metrics used, though it does make it difficult to determine whether the contraction is affecting all sectors of the economy. Similarly, an economy may show signs of weakening months before the onset of a recession, though in many cases it is necessary to wait for further releases of economic data to determine whether or not it is a genuine recession.

Another, faster definition —and indeed one that most analysts would agree constitutes a recession— is two consecutive quarters of contraction in real GDP. While this definition is certainly useful, it comes with certain drawbacks.

6 RECESSION WITH JOB CREATION?

Sources: Bloomberg and Banca March



Let us look at the latest data from the euro area. The region endured a "technical" recession during the winter, though at the same time job creation accelerated and wages increased.

Have company sales and margins really worsened to such a degree that this period can be considered a recession?

While growth has definitely slowed in the euro area, it just so happens to have occurred predominantly in the industrial sector and, most notably, in a country as significant as Germany, with greater exposure to gas imports from Russia and also a greater weight of manufacturing in its GDP.

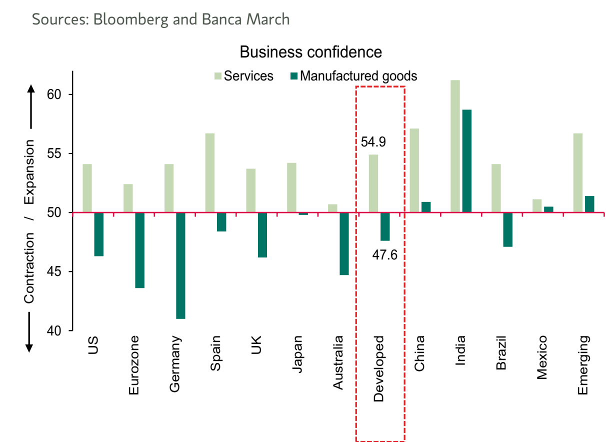
Other economies, such as those of Southern Europe and Spain in particular —which are more dependent on services and tourism—, have been less affected and are largely responsible for this improvement in job creation. To rely on GDP alone would be a blinkered definition of recession and it is therefore best to look at a wider range of indicators of economic activity.

The resilience seen in the first half of the year in employment and consumption are unique features of this cycle…

As can be seen from this analysis, the current economic cycle has its own unique characteristics and there are significant divergences between the components of GDP that make it difficult to interpret the data we are seeing.

7. PECULIAR DIVERGENCE IN BUSINESS CONFIDENCE

Sources: Bloomberg and Banca March



One of the main mismatches observed in recent quarters is the performance of the industrial and services sectors: manufacturing, which has been hardest hit by the rise in energy costs, continues to contract and there will be no let-up over the coming months for businesses operating within the sector.

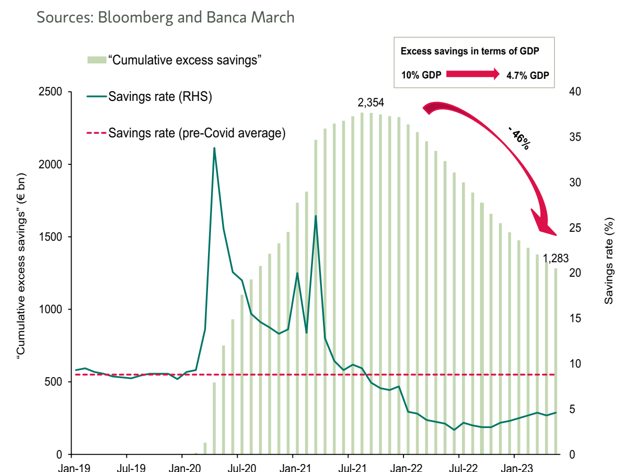
Meanwhile, the services sector continues to grow, supported by higher consumer spending.

Job creation and, above all, the savings buffer amassed during the pandemic have propped up household spending at a time when higher financing costs and inflation have diminished the purchasing power of families.

Notably, this is one of the main factors supporting the notion that this time around, the economic slowdown will be gradual despite the sharp rises in official interest rates.

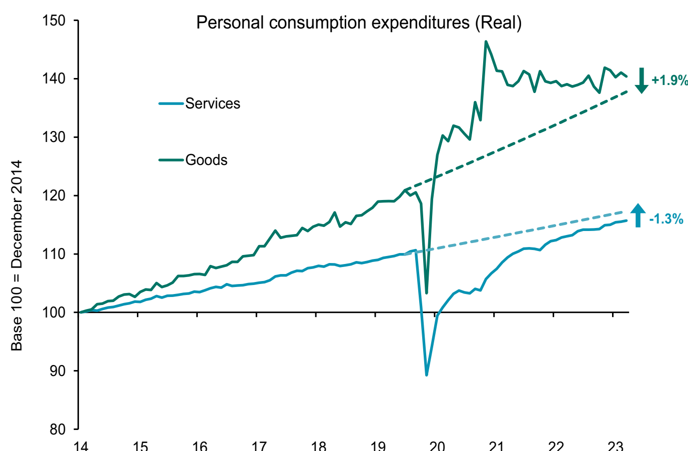
8. "EXCESS" SAVINGS SUPPORTS CONSUMPTION

Sources: Bloomberg and Banca March



9. SERVICES STILL HAVE ROOM FOR RECOVERY

Sources: Bloomberg and Banca March



The recovery in services spending has picked up in recent months, but is not yet complete (Diagram 9). We therefore believe that the revival of the tertiary sector will continue to support economic activity, especially over the summer months in the northern hemisphere due to a promising outlook for the tourism industry: to give an example, Eurocontrol estimates that flight numbers will return to pre-pandemic levels in the euro area over the coming summer months.

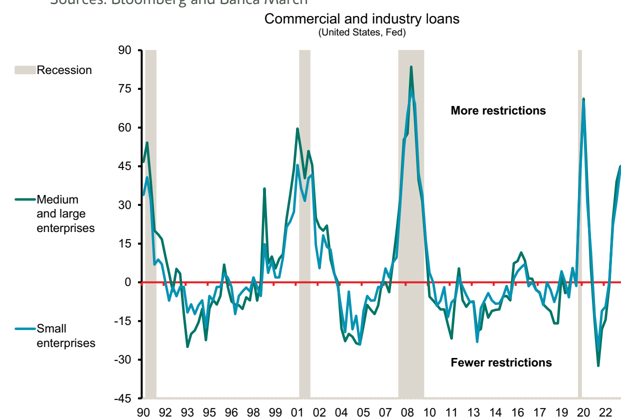
... however, other indicators have taken a turn for the worse and we have yet to see the negative effect on economic activity of rapid increases in borrowing costs.

While early signs of trouble in the financial system have been contained (failure of US regional banks and the bailout of Credit Suisse in Europe), the fact is that the rapid cycle of official rate hikes will ultimately hurt growth. Beyond these idiosyncratic problems experienced in March, in the medium term we believe that this turbulence will trigger a tightening of financial conditions. Surveys of credit conditions by both the Fed and the ECB (Figure 9) confirm that banks are already tightening lending and that borrowing has automatically become more expensive due to the higher price of money.

This is leading to a sharp decline in the money supply on both sides of the Atlantic (Diagram 11): in the United States, monetary aggregates are falling at an unprecedented rate of -4% year-on-year. It is a similar story in the euro area, albeit with a lag compared to the US. This slowdown in money supply growth is usually a leading indicator of slower growth over the coming months.

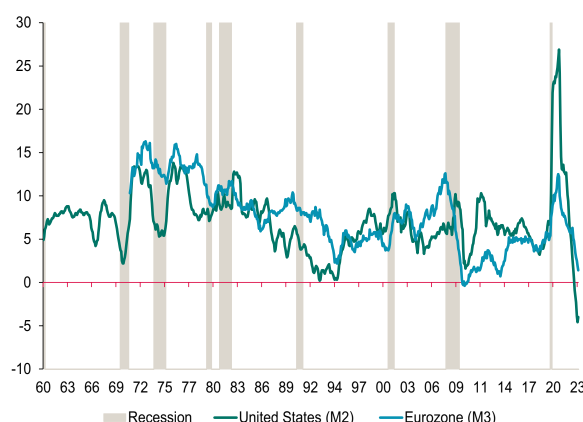
10. CREDIT CONDITIONS CONTINUE TO TIGHTEN

Sources: Bloomberg and Banca March



11. MONEY SUPPLY IS SHRINKING

Sources: Bloomberg and Banca March



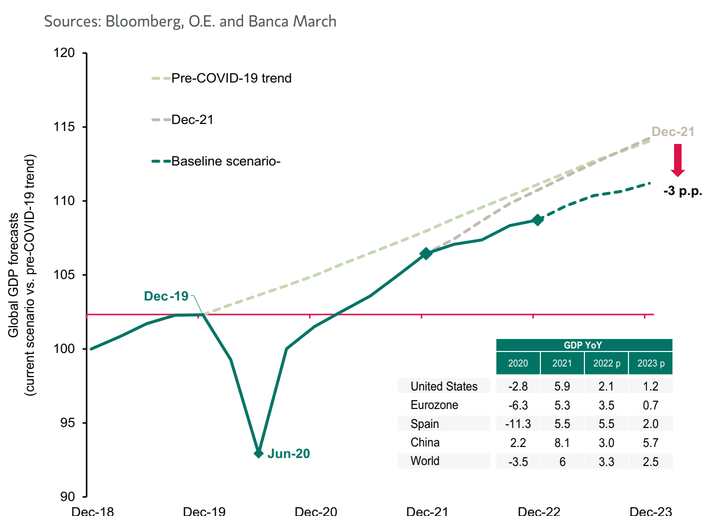
Weak growth for the second half of the year: recession can be avoided, but the tightening of credit raises the risks.

In conclusion, the latest growth figures confirm that economic activity in the main developed economies has remained resilient, although relentless interest rate hikes since the first quarter of 2022 and the recent increase in financial uncertainty will weigh on growth as we move through the second half of the year.

Financial conditions have deteriorated significantly and will affect economic growth over the coming months, increasing the risk of a recession in the United States and aggravating existing weaknesses within the euro area. Meanwhile, the strength of the labour market and a less indebted private sector than in previous episodes of rising financing costs (e.g. 2007) should go some way to countering this likely economic downturn.

12. GDP FORECASTS

Sources: Bloomberg, O.E. and Banca March



	2020	2021	2022 p	2023 p
United States	-2.8	5.9	2.1	1.2
Eurozone	-6.3	5.3	3.5	0.7
Spain	-11.3	5.5	5.5	2.0
China	2.2	8.1	3.0	5.7
World	-3.5	6	3.3	2.5

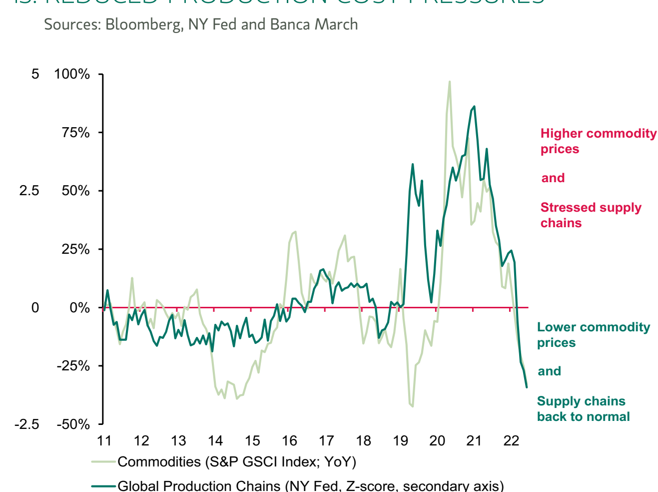
Although we are by no means overly pessimistic or prophets of doom, we continue to believe that the world economy is slowing and that growth will remain weak and certainly much lower than last year across most regions (Diagram 12).

Inflation is rapidly retreating on the back of lower commodity prices and improved production chains.

Inflation remains on track and headline rates have been quick to head down, driven by the base effect of lower energy prices. Since March, the energy comparison has been very favourable when measured against the prices that crude oil and gas reached following Russia's invasion of Ukraine a year earlier. According to the latest data, energy has knocked 1 percentage point off the CPI in the United States, while in the euro area this component has subtracted six tenths of a percentage point when in June last year it contributed 4.2 percentage points to inflation.

13. REDUCED PRODUCTION COST PRESSURES

Sources: Bloomberg, NY Fed and Banca March



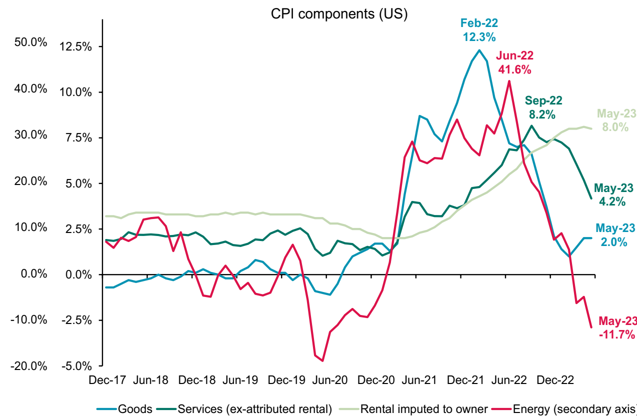
As can be seen in the diagram, two of the main factors behind the onset of the inflationary shock have since turned into tailwinds.

Production chain pressure caused by the pandemic and supply shortages has already dissipated, while commodity prices have since fallen well below the peaks seen last year (oil and gas prices are now at levels similar to those seen in 2021).

While energy prices are now having a directly positive effect on inflation, it is also true that last year's shock has had an indirect effect on the production costs of food, goods and even services (mainly transport costs). These effects will take time to subside and we therefore believe that we are now entering a new phase in which inflation will continue to head down, but at a more leisurely pace than in the first half of the year.

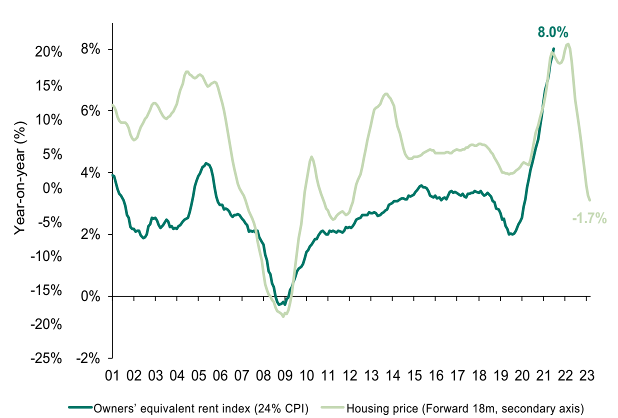
14. COMPONENTS OF INFLATION (UNITED STATES)

Sources: Bloomberg and Banca March



15. RENT CLOSE TO PEAKING

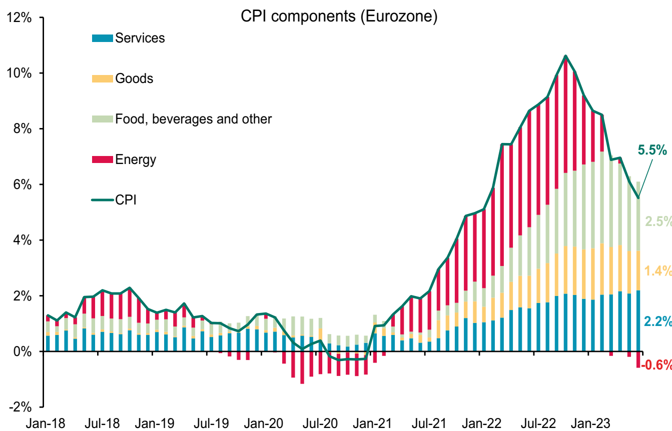
Sources: Bloomberg and Banca March



In the United States, the positive note is that most components of the underlying rate are now "disinflationary" (Diagram 14), which supports the outlook of lower consumer prices. The only exception was the "imputed rental" data, though given the trend in real estate prices and the historical relationship between them, they should also be peaking (Diagram 15).

16. EUROZONE CPI: BREAKDOWN AND PERFORMANCE

Sources: Bloomberg and Banca March



In the euro area, the headline inflation rate is almost 50% below the peaks seen in October (Diagram 16).

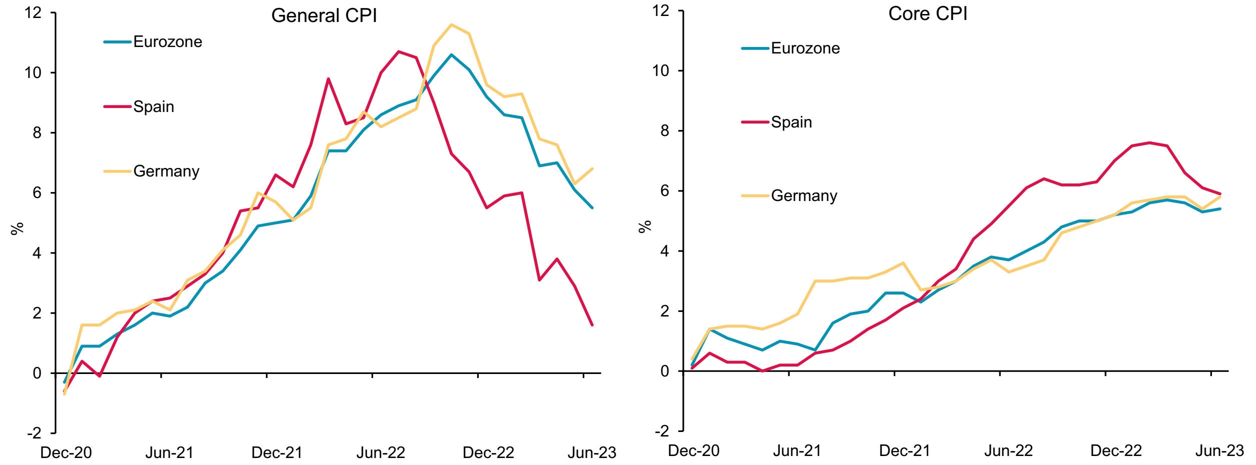
In June we saw further declines, with CPI growth slowing by six-tenths of a percentage point to +5.5%. Food tensions are also beginning to fade, as suggested by the slowdown seen in previous months in food prices at source.

Inflation: the importance of core rates. Core rates reveal that the differences between euro area countries are merely fleeting and the result of fiscal measures to stop energy prices from spiralling.

The latest inflation figures show an apparent divergence in the trend of inflation between the major economies in the region —while in Spain the CPI is already below 2%, in Germany it is still above 6%. However, these differences are mainly due to the effect of fiscal measures to keep a lid on energy prices. The best way to demonstrate that these are temporary and volatile effects is to look at the core rates —the ones that genuinely matter in the current scenario of high energy and food price volatility— because they show how inflation differences are fading rapidly and continue to reveal upward pressures on consumer prices across all euro area economies.

17. INFLATION IN THE EURO AREA

Sources: Bloomberg and Banca March



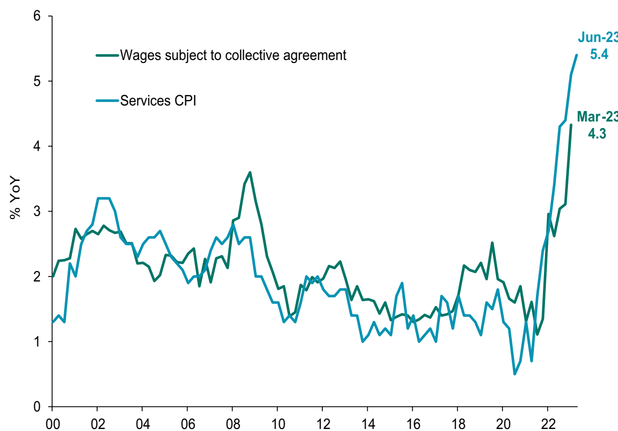
Core inflation will need more time to return to normal. We expect to see a somewhat less linear reduction in the second half of the year.

Notably, the greatest pressure has come from the prices of services, which have risen by four tenths of a percentage point to +5.4% YoY and are what caused core inflation to rise across the euro area in June.

Looking ahead to the coming months, we expect services prices to take a longer time in coming back down than goods prices have done. This is because the services sector is heavily labour intensive and therefore more sensitive to wage growth, which has been exceeding +4% of late (Diagram 18).

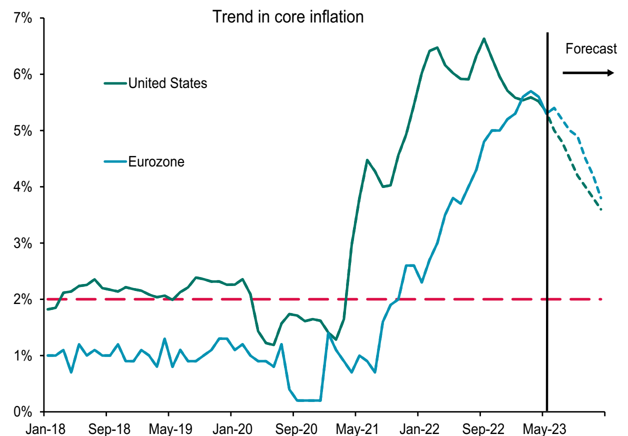
18. CPI, SERVICES AND WAGES

Sources:Bloomberg, O.E. and Banca March



19. CORE CPI FORECAST

Sources: Bloomberg, O.E. and Banca March



In conclusion, inflation is definitely heading back down, mainly due to the base effect of lower energy prices. Inflation will continue to retreat as we move forward, though it will be more gradual, as it will take time for the core rates to budge, as they are more closely linked to price developments in services and especially in wages. Central bank targets will not be met this year and, most notably, core rates will remain high.

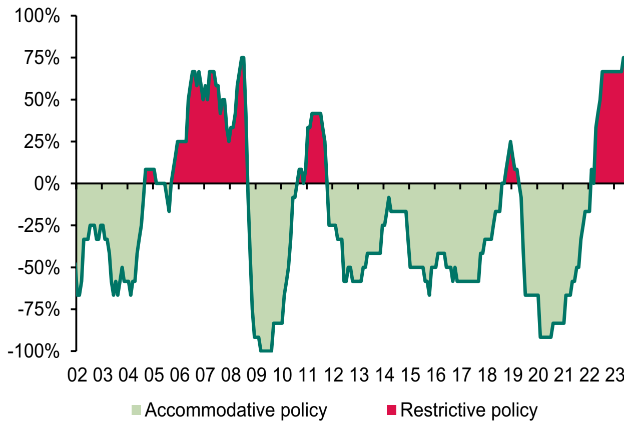
CENTRAL BANKS

Central banks have no intention of giving up in the fight against inflation.

While inflation is finally relenting, economic growth and employment remain strong, giving monetary authorities little room for manoeuvre and so their stance has remained hawkish.

19. PERCENTAGE OF CENTRAL BANKS HIKING RATES

Sources: Bloomberg, Refinitiv and Banca March



As it happens, the proportion of monetary authorities that continue to hike their official rates has increased. We need look no further than the recent decisions announced by the central banks of Canada, Australia, Switzerland and most notably the Bank of England, which raised its policy rate by a further 50 basis points and warned that there are several more to come.

Elsewhere, in the United States to be precise, the Federal Reserve did live up to expectations by taking its first breather in June to pause its interest rate hikes.

After 10 consecutive rate hikes in the last 15 months, bringing official rates to between 5%–5.25%, the Fed decided to apply the brakes to take stock of the hikes it has made so far. The surprise came in the subsequent press conference and also in the minutes of the meeting, which were distinctly hawkish and hinted strongly that it intends to make two additional hikes, according to its members' own forecasts.

In our view, this tougher rhetoric reflects their current concern over preventing inflationary pressures from becoming "entrenched" within the economy, and is not really based on a genuine need to raise the terminal rate much further than anticipated.

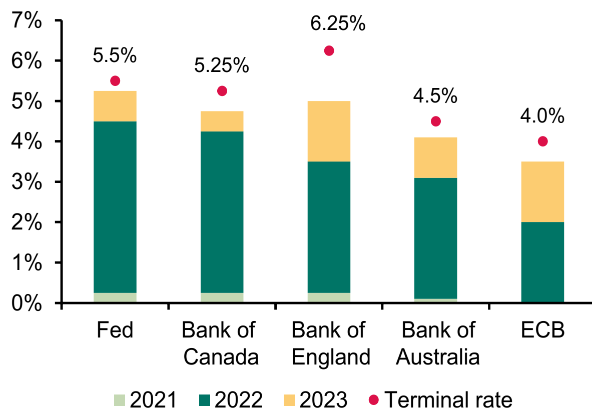
Federal Reserve: tough talking, though we still think that the end is nigh.

The hawkishness of Powell's recent statements suggests that the Fed will put off the official rate halt for at least another month: in July the US monetary authority looks set to hike its policy rates again by 25 bp, though as Figure 20 shows, this would be more of a final adjustment as most of hikes are now behind us.

This expectation that the end is drawing near for the Fed is based on the fact that real interest rates in the US are currently already in tightening territory. With an additional hike, the price of money will exceed inflation by 1.5 p.p. (Diagram 21), a situation that will now allow the Fed to move into a new phase, in which it will try to gauge the effects of this rapid rate hike cycle on economic activity and, above all, on the labour market.

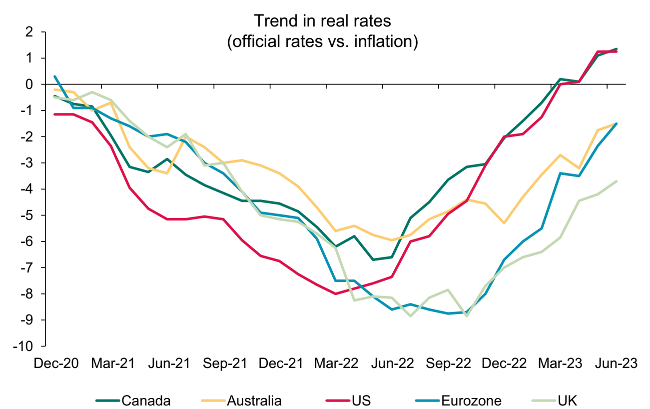
20. MOST OF RATE HIKES ARE NOW BEHIND US

Sources: Bloomberg and Banca March



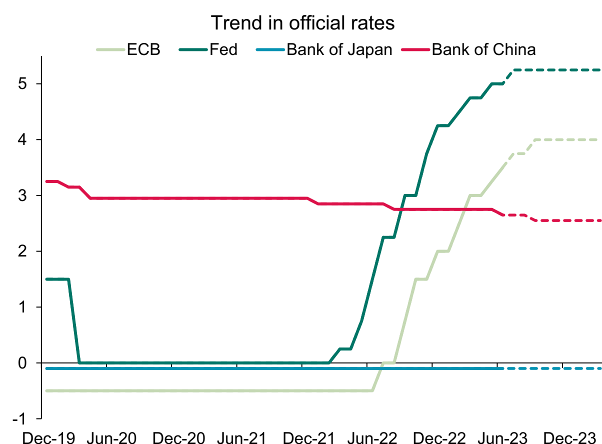
21. POSITIVE REAL INTEREST RATE TARGET

Sources: Bloomberg and Banca March



22. OUTLOOK FOR OFFICIAL INTEREST RATES (BY REGION)

Sources: Bloomberg and Banca March



In Europe, interest rates are not as restrictive as they are still below inflation, which we think will lead to additional rate hikes over the summer months. The ECB has at least two more hikes to go, one in July and one in September, until the deposit rate reaches 4%, at which point we also expect it to take a breather (Diagram 22).

In Asia, inflation is more subdued and this is reflected in a monetary policy that will remain expansionary.

In contrast to the global trend of tightening monetary policy, the two major Asian central banks will continue to roll out stimulus measures. As we can see in Diagram 22, in Japan, although inflation is at its highest level since the 1980s, the monetary authority has remained steadfast in its policy of negative interest rates, in the belief that this increase in prices is transitory.

In China, meanwhile, the post-Covid recovery is casting both light and shadow. Following a first quarter with strong GDP growth, the slowdown in business confidence in recent months, coupled with a still contracting real estate sector and manufacturing with growth rates that are frankly meagre by Asian standards, means that new monetary and fiscal stimuli will be needed to drive growth.

Moreover, in the specific case of China, one of the risks is that inflation is at extremely low levels: industrial producer prices are falling at rates of more than -5%, while the CPI has stagnated. Such low inflation, and the fact that despite the reopening of the economy there has been no change in this disinflationary trend, are factors that will support further monetary stimulus: after having cut 1-year benchmark rates by 10 bp in June, we expect China's central bank to cut policy rates again in the second half of the year, a move that will also be accompanied by reductions in banks' reserve requirements, which should help to kick-start lending activity.

While we will soon see a hiatus in the rate hikes, the balance sheet reduction process will continue at a relatively fast pace.

While the main central banks are already close to their targets when it comes to official interest rates, they will continue to reduce the size of their balance sheets over the coming quarters.

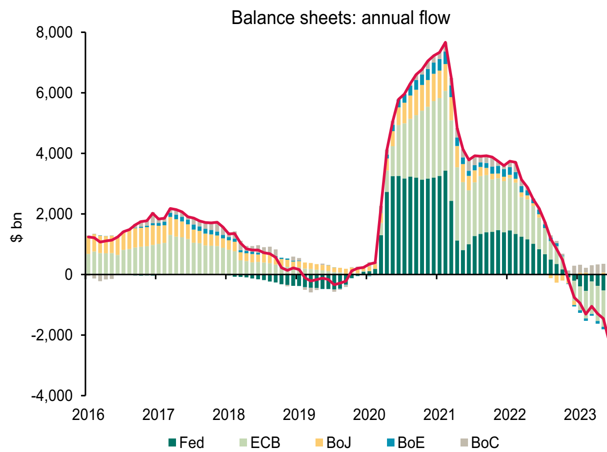
In the United States, the Fed will not switch course and will continue to let its bond holdings mature at a maximum pace of $95 billion per month ($60 billion in government bonds and $35 billion in MBS). At this pace, the balance sheet reduction will reach upwards of $1.1 trillion over the next 12 months, enough to bring it down by 14% from its current level of $8.3 trillion.

In the euro area, the reduction of the ECB's balance sheet has picked up as banks continue to repay their long-term loans: in the June window, the region's banks repaid more than €500 billion in scheduled maturities and early repayments. This was the window with the longest maturity of these loans and now only €597 billion or so will remain outstanding through to the end of 2024. Aside from these repayments by banks, the ECB will continue to pare back its balance sheet by letting the bonds it acquired under its asset purchase programme (APP) mature without reinvesting the proceeds, which on average will mean a reduction of €28 billion per month over the next 12 months.

The last year has witnessed the largest balance sheet reduction in history.

23. THE BALANCE SHEET REDUCTION PICKS UP

Sources: Bloomberg and Banca March



Following a brief hiatus due to the US regional banking crisis, as shown in Figure 22, the major Western monetary authorities have resumed the pace of their respective balance sheet reduction processes, led by the ECB and the Fed. The last 12 months have witnessed the largest ever reduction in nominal terms in the aggregate balance sheets of the main central banks, which together have shrunk by more than $2 trillion. Although this huge figure has been affected by the exceptional repayment of loans made by European banks (TLTRO), it also confirms that the monetary authorities are picking up the pace in normalising monetary policy by trying to drain excess liquidity from the system.

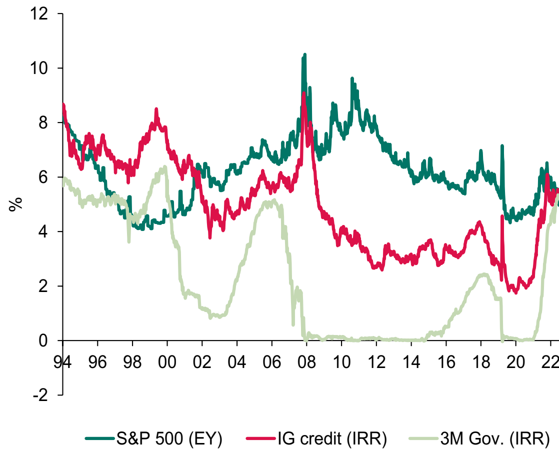
Despite this pick-up, there is still a long way to go in relation to this aspect of monetary policy: the balance sheets of the world's four main central banks account for 49% of GDP, a figure that is still more than 10 p.p. higher than before the pandemic.

FIXED INCOME

Fixed income securities now have the best relative value versus equities in the last 20 years.

24. FIXED INCOME: VS. THE STOCK MARKET (*)

Sources: Bloomberg and Banca March



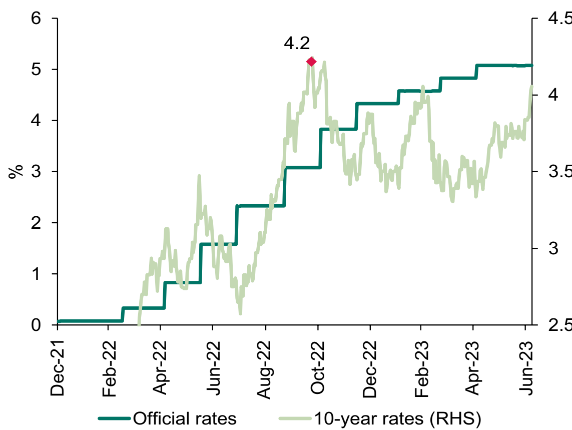
(*) EY = 1/PER.

As we have been pointing out since the end of last summer, the fastest official rate hike in 40 years is opening up new opportunities in the realm of fixed income. Indeed, the yields on investment grade bonds and short-term sovereign rates are already outpacing stock market earnings yields —a transformation of the traditional price-to-earnings ratio to make it more readily comparable with fixed income yields—; a phenomenon that has not happened for more than 20 years. These attractive bond prices, compared to equities, which offer less potential, already price in a strong earnings recovery for 2024. This, coupled with a rate hike cycle nearing its end, makes us hugely optimistic about fixed income in the coming months.

We continue to favour increased duration in the US. The incessant official rate hikes and hawkish rhetoric from the central banks have had relatively little effect on US 10-year bonds: IRRs have not returned to the wild levels seen previously.

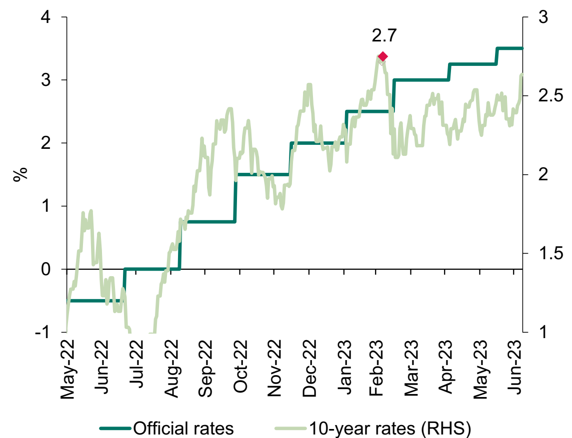
25. US INTEREST RATES

Sources: Bloomberg and Banca March



26. GERMAN INTEREST RATES

Sources: Bloomberg and Banca March



While long-term sovereign rates have grown in recent weeks in response to more hawkish central bank rhetoric, the impact of the recent rate hikes is slowing dissipating and 10-year bonds are showing no signs of returning to their previous highs. For instance, the US 10Y bond reached a record high in response to a cumulative increase of 200 bp in official interest rates since October of last year, but has since been happy to hover around 4%. It is much the same story for its European cousin, in that the bund is still below its February highs following a cumulative official rate hike of 100 bp.

Historically in the United States, increases in official rates are passed on at a lower rate as the maturity of the bond increases, with the average IRR on the 10-year bond being 30 bp for every 100 bp increase in official rates. In the current cycle, the pass-through has been 37 bp —above the average—, so even under the scenario of two further official rate hikes, current prices would already reflect much of the "surprise effect".

In our view, i.e. that while the interest rate hiatus is close, it has been delayed to some degree, current prices already reflect the healthy news on the macroeconomic front and allow us to build long positions in the US at the best prices since almost 2007.

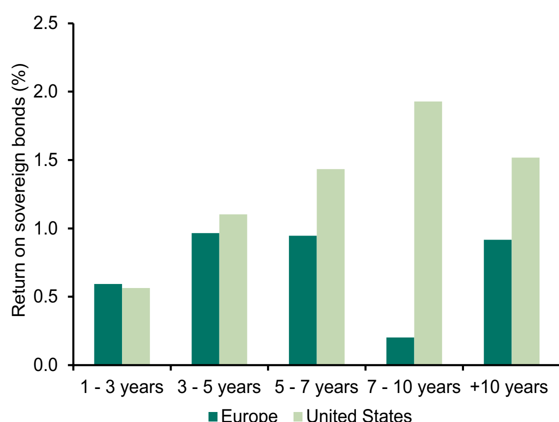
Credit continues to benefit from the limited downturn in the business cycle. We favour quality in anticipation of a weaker economy and rising borrowing costs.

Corporate credit continues to offer higher coupon yields than sovereign bonds and tighter spread compression in response to a resilient economy. Over the course of the year, investment grade (IG) bonds have offered a better return than sovereign bonds across all durations, particularly in the long US tranches, which have been offering up an extra 2 percentage points.

The high-yield (HY) segment continues to benefit from spread compression, despite the uncertainty surrounding the future course of the economic cycle. Interestingly, the differences between HY and IG are largely due to a reduction in credit risk rather than a differential coupon yield.

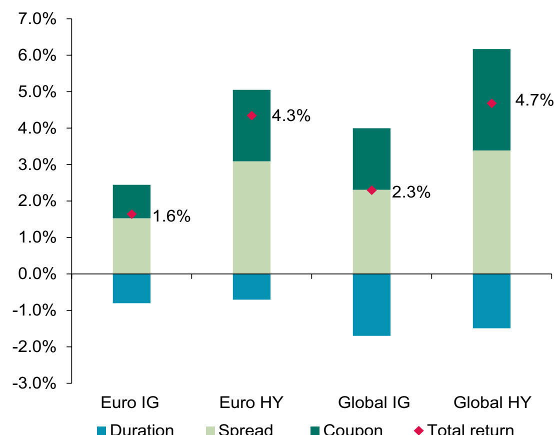
27. EXCESS RETURN ON IG CREDIT (YTD)

Sources: Bloomberg and Banca March



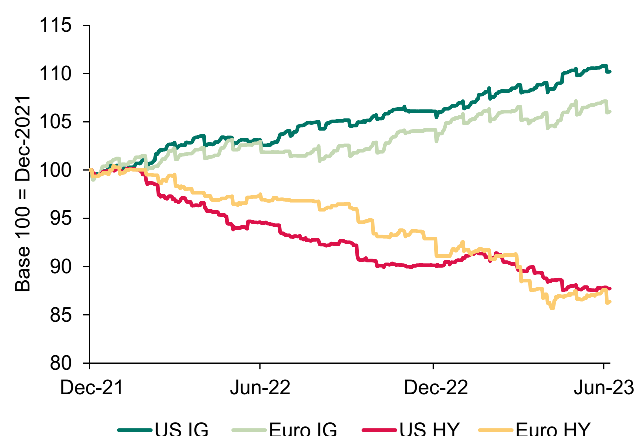
28. BREAKDOWN OF RETURN ON CREDIT (YTD)

Sources: Bloomberg and Banca March



29. TREND IN OUTSTANDING DEBT BY CREDIT SEGMENT

Sources: Bloomberg and Banca March

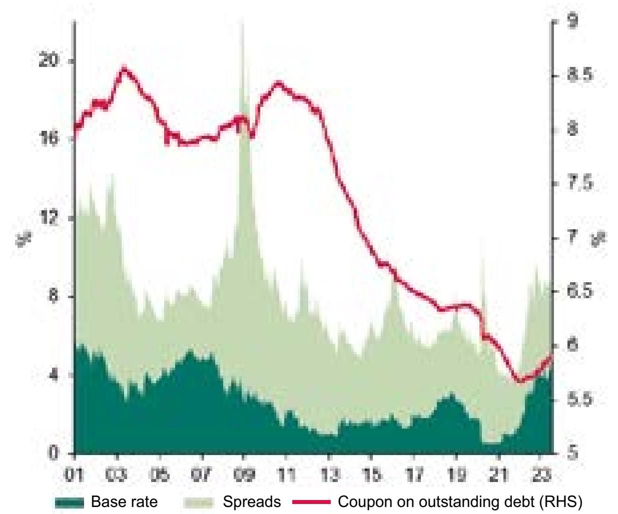


Notably, the improved return on HY bonds is also being supported by quieter levels of issuing activity, leading to a reduction in market size in both the US and Europe. For example, in the US, the nominal amount available within the index is the same as it was in 2016. The same cannot be said for the IG segment, where the total amount continues to rise in response to a still healthy primary market.

HY issuers are also doing their utmost to delay debt rollovers. This is because the cost of funding has been steadily rising due to the increase in official rates, and not because of a widening of credit spreads, which remain below average. We therefore continue to opt for credit quality in the face of latent refinancing risk and the prospect of higher policy rates for longer and a slowing economy.

30. US HY: IRR VS. COUPON

Sources: Bloomberg and Banca March



EQUITIES

Equities are oblivious to central banks and are driven by technology.

31. PERFORMANCE IN THE YEAR TO DATE BY SECTOR AND REGION

Sources: Bloomberg and Banca March

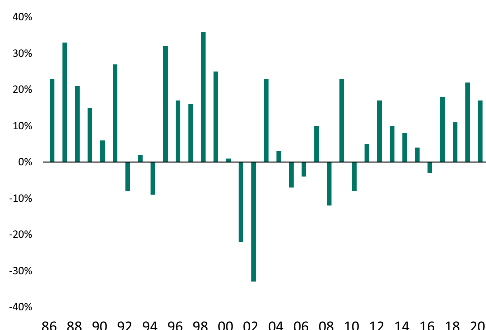
YTD	Global	S&P 500	Europe	Emerging	China
IT	34.2%	39.7%	22.0%	16.6%	-2.3%
Telecoms	23.3%	35.4%	4.3%	3.5%	4.1%
Con. Dis	22.2%	33.0%	17.4%	-3.9%	-10.6%
Index	**11.5%**	**15.2%**	**5.7%**	**2.7%**	**-6.8%**
Industrials	11.4%	10.5%	11.2%	2.2%	-6.6%
Materials	1.4%	5.0%	-2.9%	-3.2%	-9.4%
Con. Def	1.3%	-1.2%	1.5%	0.8%	-14.3%
Financial	1.0%	-0.7%	4.2%	1.1%	-6.9%
Health	-2.7%	-4.7%	1.3%	-8.7%	-19.0%
Utilities	-3.9%	-7.4%	4.6%	-9.8%	-6.5%
Energy	-4.3%	-5.3%	-5.7%	9.4%	14.0%

Western stock markets enjoyed an excellent half-year despite the rate hikes carried out by central banks and some tough talk of late. The gains were led by US technology, which included the Nasdaq's best period in 40 years and an all-time high for the Nasdaq 100, although overall the US stock market had the weakest market breadth in its history, with only one third of US stocks managing to beat the market (Diagram 33).

Technology is the clear winner, partly due to expectations of how artificial intelligence will contribute to the sector's future performance, followed by consumer discretionary and telecoms in the US. At the other end of the spectrum, and despite enjoying an excellent 2022, the energy sector was the biggest underperformer, enduring single-digit losses in both the US and Europe.

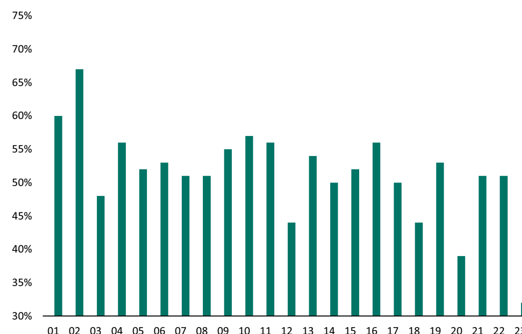
32. NASDAQ 100: A RECORD SIX MONTHS

Sources: Bloomberg and Banca March



33. US MSCI: % OF COMPANIES OUTPERFORMING THE INDEX

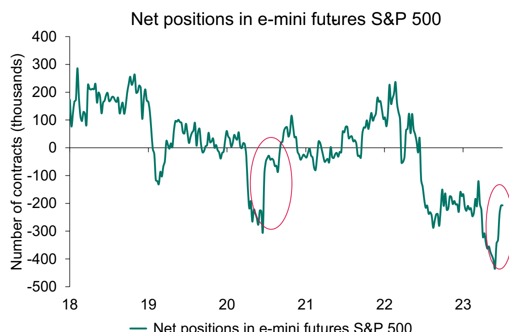
Sources: Bloomberg and Banca March



Highlights in the period include the perceived progress made in terms of price control, an economy that is resilient to rate hikes, and a regional banking crisis that has not engulfed the rest of the US financial sector, as shown by the strong results obtained by the big banks in the Fed's stress tests.

34. IN RECENT WEEKS, WE HAVE SEEN THE LARGEST CLOSING OF SHORT POSITIONS IN THE LAST THREE YEARS

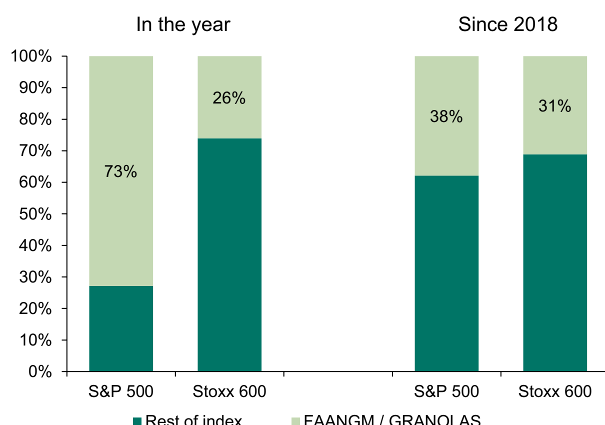
Sources: Bloomberg and Banca March



Concentration has been high in the S&P 500 in the year to date, although looking over the medium term this feature also extends to Europe.

35. CONTRIBUTORS TO THE RETURN

Sources: Bloomberg and Banca March
FAANGM: Meta, Apple, Amazon, Nvidia, Alphabet Class A and C (Google), Tesla and Microsoft
GRANOLAS: GSK, Roche, ASML, Nestlé, Novartis, Novo Nordisk, L´Oreal, LVHM, AstraZeneca, SAP and Sanofi



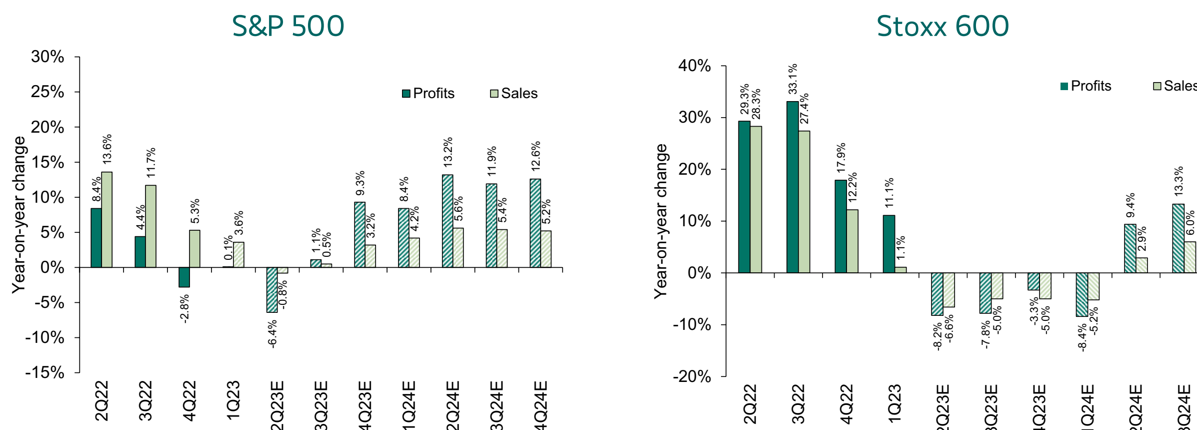
The S&P 500 gains are concentrated within relatively few stocks. Just eight members of the blue-chip index account for almost three quarters of the return achieved in the year to date. This phenomenon can also be seen in the European market, with a group of companies known as GRANOLAS. This acronym brings together the 11 fastest growing companies on Europe's stock exchanges. In contrast to FAANGM in the US, they are less related to the tech sector —with the exception of ASML— and have more to do with health and luxury. Although this year their contribution to the return has been lower than that of their US brethren, over the medium term —since 2018— their contribution to the Euro Stoxx 600 return is very similar to what the US giants have contributed to the S&P 500.

Therefore, we believe that concentration has little to do with how the markets are performing and is not enough in itself to cause us to abandon the US, which still has better fundamentals than Europe: higher return on equity, lower indebtedness and less energy dependent.

Corporate earnings contraction in Q2 and too much expected for 2024.

36. QUARTERLY EARNINGS PERFORMANCE

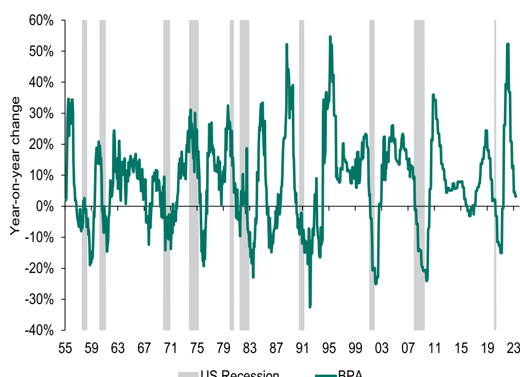
Sources: Refinitiv and Banca March



Both US and European stock markets are now entering the second quarter earnings season, with expectations of earnings declines in both regions. This is also set to be the first quarter of declines since 2020, as the surprise events we saw in the first four months of the year prevented the start of the earnings recession. In the United States, the declines are being seen in commodity-related sectors (-29% YoY) and energy (-45.5%), as industrial metals and oil prices return to normal. On the positive side we have consumer discretionary (+27%), driven by the normalisation of e-commerce earnings, especially at Amazon. In Europe, the underperformers have been led by the same sectors as in the US, including a sharp decline in the chemical industry, a major contributor to the -52% YoY decline within the basic materials sector. On the flip hand, we have the financial sector (+16%), which continues to profit from higher interest rates, and a resilient European technology sector (+43%).

37. S&P 500: TREND IN REALISED EPS, 12M

Sources: Bloomberg and Banca March



Meanwhile, expectations for the coming quarters still seem too optimistic, seeing as though corporate earnings have yet to actually fall. On a year-on-year basis, realised earnings up to May were still up 3%. Moreover, the broad consensus among analysts is that earnings will recover rapidly after the second quarter in the US, on the back of stable sales growth and margins, though this is incompatible with weakening business confidence.

The stock market has risen on the back of expanding multiples. We remain wary of getting too excited about equities.

Although 12-month earnings expectations have been slightly upgraded —a product of unexpected first quarter releases and optimistic growth prospects for 2024—, stock market gains have exceeded expectations, raising the global index multiple by 13% compared to the beginning of the year. The MSCI World AC has moved to 16.2x compared to 14.5x at the beginning of the year.

38. BREAKDOWN OF RETURNS

Sources: Bloomberg and Banca March

Sectors	YTD	EPS (%)	Multiple (%)
IT	37.2%	-0.9%	38.1%
Telecoms	27.0%	7.9%	19.0%
Con. Dis	22.4%	5.1%	17.3%
Index	13.2%	0.1%	13.1%
Industrials	12.1%	0.6%	11.5%
Materials	4.6%	-6.3%	10.9%
Con. Def	2.8%	2.3%	0.5%
Financial	1.8%	-3.0%	4.8%
Health	-0.1%	0.0%	-0.2%
Utilities	-1.6%	7.5%	-9.2%
Energy	-4.4%	-13.5%	9.1%

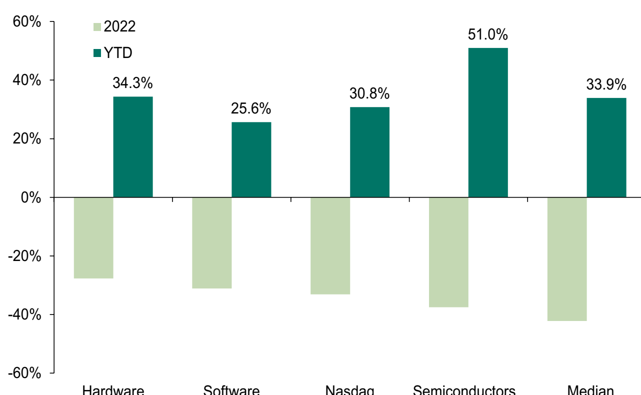
We continue to await cuts before we increase risk.

Although the economy has been successful so far in avoiding the worst-case scenarios, we prefer to wait for further corrections before increasing our exposure to equities. We believe that at current levels the stock markets have priced in an optimistic and near normal earnings growth scenario; a circumstance that makes it vulnerable to any change in expectations and provides little room for error.

The technology sector shrugs off the rate hikes and leads the economic transformation.

39. TECHNOLOGY: PERFORMANCE BY SUBSECTOR (YTD)

Sources: Bloomberg and Banca March

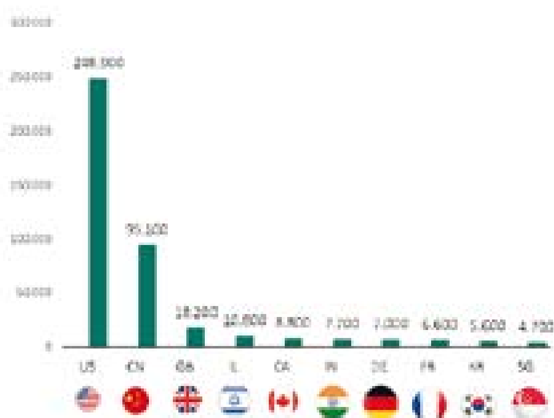


Following an eventful 2022, amid concerns about inflation and rising interest rates, technology share prices have been delivering a formidable stock market performance as we move through 2023 (+40% YTD in the US; +20% in Europe).

Two aspects will continue to support the sector. First, the imminent end of interest rate hikes, at least in the United States, and second, profit guidance among tech firms is being upgraded. This is a particularly relevant twist, as the sector generates a quarter of all S&P 500 earnings, allowing the market to justify higher valuations on the expectation of higher earnings and revenues.

40. 2013-22: INVESTMENT IN ARTIFICIAL INTELLIGENCE ($M)

Sources: NetBase Quid; Banca March



There is a growing consensus that artificial intelligence (AI) will play a bigger role moving forwards. McKinsey & Co estimate that AI, used by only a third of companies today, will spearhead the process of economic transformation in the coming years.

It is expected that generative AI —used to create new content from existing data or information— could add between $2.6 to $4.4 trillion in annual global productivity, thus allowing labour productivity to grow by 0.1% to 0.6% per year over the next two decades, partly offsetting population ageing.

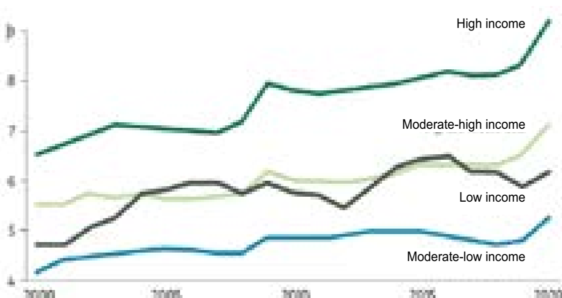
For all these reasons, we remain positive, albeit selective, on the sector. We are confident that it will benefit from the hiatus in rate hikes, although the opportunities do not affect all subsectors equally. Thus, and given the advancing economic cycle, our recommendation would target the more defensive side of technology —with the software subsector and its solid growth forecasts for 2023 (>+10%) being the main focus—, as opposed to the more cyclical part associated with hardware and semiconductors, both of which are readjusting following the post-pandemic boom but which have already recovered from lows of between 35% and 80%, respectively.

The health care sector: weak stock market performance but profitable and defensive.

The health sector is proving to be one of the stock market laggards as we move through 2023, especially in the United States (-5.1%), though also in Europe (+1.3%). In the United States, there is considerable uncertainty over the ongoing process of negotiating drug prices within the framework of the IRA (Inflation Reduction Act), which will allow, for the first time, Medicare —the government health plan for the over-65s and responsible for 20% of the country's healthcare spending— to negotiate the prices of certain high-cost drugs. This provision will initially apply to 10 drugs, starting in 2026, and will be extended to 20 in 2029, with a savings target of 25 billion per year until 2031. The regulatory framework is expected to be hammered out over the course of the year, and the negotiation process is likely to affect a relatively small percentage of drugs.

41. OVERALL HEALTH EXPENDITURE (% OF GDP)

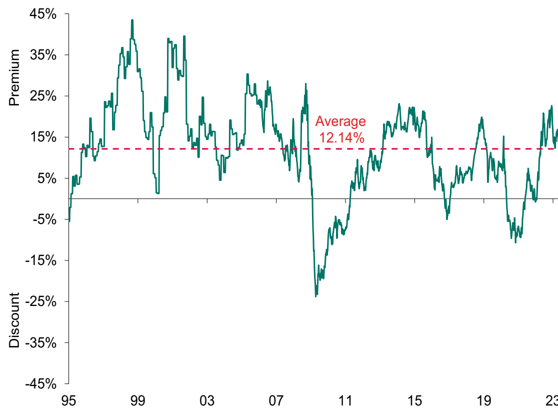
Sources: World Health Organization



Moreover, global health spending is likely to rise further in the medium term, with 30% of the population in countries such as China expected to be over 60 years old by 2050. This will be a positive development for the industry, as a significant proportion of spending will be on new health infrastructure, as well as new drugs and health-related technologies.

42. HEALTH: THE BEST RELATIVE VALUATION SINCE 2022

Sources: Bloomberg and Banca March



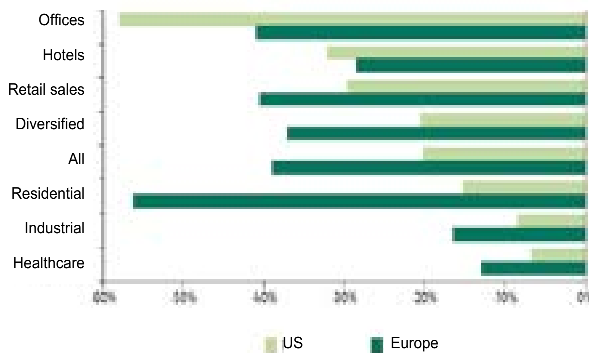
We remain overweight on the health care sector. We are aware that the increased appetite for risk of late has made the sector somewhat less attractive, and other factors such as its high sensitivity to the dollar do not help matters either. However, we believe that its positive traits will ultimately prevail, notably its defensive and counter-cyclical nature in the event of an economic slowdown, its high pricing power and a downside risk limited in the short term by the expiry of patents. Moreover, its poor performance in the year to date means that the sector is trading at a premium of 8% to the global index, the lowest level since April 2022.

REITs have priced in a very adverse market for the real estate market.

Real estate investment trusts, or REITs for short, are also having a hard time of things as they attempt to navigate the abrupt increase in interest rates. Monetary tightening, in place since 2022, has raised the cost of credit and put their balance sheets under pressure, especially in the Eurozone due to its higher proportion of 12-month paper —accounting for more than 15% of the total for offices and residential property. As a result, we are now witnessing significant price declines in both the United States and Europe, with three consecutive half-yearly dips of up to 30%.

43. DISCOUNT ON NAV BY SUBSECTOR

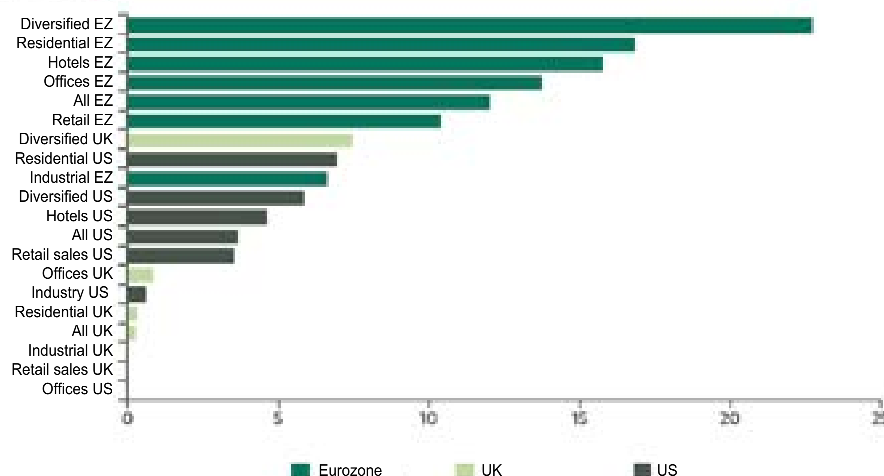
Sources: Oxford Economics and Banca March



As a result of these sales, the sector is trading at a significant discount to Net Asset Value (NAV); more than 50% in the case of the European residential subsector. So, while it is tempting to think that the sector has bottomed out in anticipation of an imminent hiatus in hiking interest rates, we believe that getting a lid on inflation and the subsequent fall in rates will still take time to materialise. This circumstance, coupled with rather unattractive fundamentals, including depressed income growth, makes us wary and we prefer to wait for opportunities to arise.

44. REITS: PROPORTION OF DEBT MATURING IN THE NEXT 12 MONTHS

Sources: Oxford Economics and Banca March



CURRENCIES

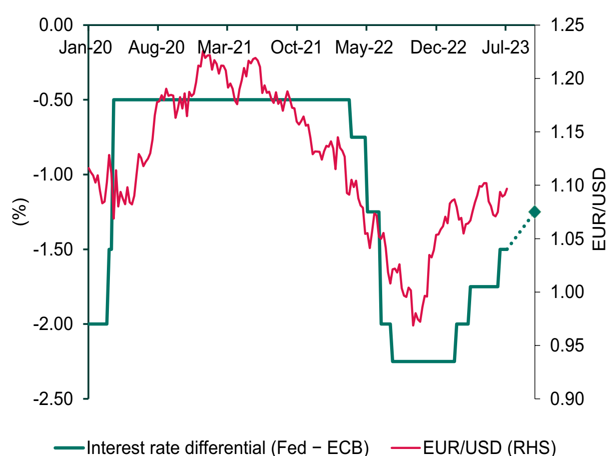
A weaker dollar ahead in 2H23; EUR/USD range of 1.05–1.15.

At the end of 2022, the greenback made it two consecutive years of gains against the euro, appreciating by more than 15% on the back of a faster economic recovery in the United States, a favourable interest rate differential and geopolitical uncertainty following Russia's invasion of Ukraine. The tables have now turned and so far in 2023 the dollar is losing steam and has ceded almost 3% to the euro.

We believe that this recent slump may pick up in the coming months. First, in terms of valuation, the US currency remains "expensive" against the euro in metrics such as purchasing power parity. More precisely, it is 11% overvalued. In our view, this "safety premium" on the dollar would only be justified in a scenario of heightened geopolitical tension or a resurgence of fears of an energy crisis in the euro area. A scenario that has been diluted following a mild winter and the successful approach to managing gas stocks (European gas stocks are now over 70%), which should take downward pressure off the euro in the short term.

45. OFFICIAL RATE DIFFERENTIAL VS. EUR/USD

Sources: Bloomberg and Banca March



On the monetary front, let us not forget that the dollar typically peaks right before the Fed signals a hiatus in interest rate hikes. Moreover, in the case of Europe, persistently high core inflation will force the ECB to continue hiking for longer than the Fed, thus narrowing the rate differential; a factor that we believe will weigh on the dollar.

In this context, we maintain our outlook for the pair and for we would wait until levels of 1.12–1.15 EUR/USD at least before buying the greenback. We would also take advantage of possible dollar appreciations to reduce positions at levels close to 1.05 EUR/USD.

The pound has been gaining ground on higher rate hike expectations, though we do not see any catalysts for further appreciation and we are maintaining our hedges.

The British currency rallied on the back of higher expectations of official rate hikes, which pushed GBP/EUR to trade at 0.85 EUR/GBP, the highest level since August of last year. However, economic imbalances continue to mount: the UK authorities are having a harder time keeping a lid on inflation, while the interest rate hikes are already punishing the real estate market, which heightens the risk of a further decline in activity in the coming quarters.

Consequently, we see no catalysts for further sustained sterling appreciation and would wait for a better time to unwind hedges. We maintain our target range for the pair between 0.84–0.89 EUR/GBP.

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