



HOUSE VIEW

NAVIGATING
CHOPPY WATERS

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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		■			
<i>High quality (AAA)</i>		■			
<i>Peripheral</i>			■		
CORPORATE BONDS				■	
<i>Investment Grade</i>				■	
<i>High Yield</i>			■		
EMERGING DEBT				■	
CONVERTIBLE BONDS			■		
EQUITIES	-2	-1	NEUTRAL	+1	+2
EUROPE			■		
<i>United Kingdom</i>				■	
UNITED STATES				■	
EMERGING			■		
REST OF THE WORLD		■			
CURRENCIES	-2	-1	NEUTRAL	+1	+2
U.S. DOLLAR			■		
STERLING POUND		■			

MACROECONOMIC OUTLOOK

Downside risks intensify as the economic cycle deteriorates at pace

We cannot yet accurately gauge the intensity of the economic impact of the tragic conflict in Ukraine or the lockdown measures in China, but the risks to global growth remain skewed to the downside, and second round effects on inflation will linger.

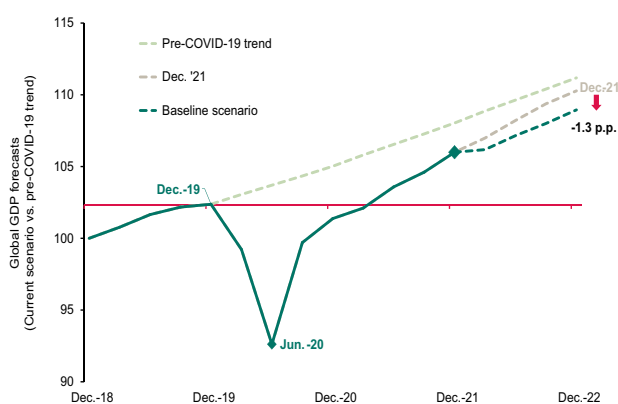
Like a groundswell from a distant event, these two exogenous shocks have made serious waves in the financial markets, where the lack of visibility will keep volatility levels high over the coming months and require the cautious approach honed by the most experienced, skilful seafarers.

The lack of clarity on a solution in Ukraine, high energy prices and more persistent inflation are all fuelling a quicker-than-expected tapering of monetary support measures by central banks and triggering a material weakening of financial conditions, which will act as a headwind for economic activity and increases the likelihood of a recession.

The combination of these factors has led us to downgrade our growth forecast to 2.9% for global GDP this year, reflecting the weakening of the economic cycle and the fact that the global economy continues to stray from the path of recovery. Specifically, estimated growth for this year will be 3 percentage points lower than in 2021 and 1.3 pp lower than was forecast at the beginning of this year, before the Ukraine conflict broke out and Chinese brought in new lockdown measures; for obvious reasons, these two factors have altered our economic outlook.

1. GLOBAL GDP FALLS SHORT OF INITIAL FORECASTS

Sources: Bloomberg, Oxford Economics and Banca March



2. DOWNGRADES TO GROWTH FORECAST (REGIONS)

Sources: Bloomberg, Oxford Economics and Banca March

	Year-on-year GDP		
	2020	2021 e	2022 p
United States	-3.4	5.7	↓ 2.9
Eurozone	-6.5	5.3	↓ 2.5
Spain	-10.8	4.9	↓ 3.9
China	2.3	8.1	↓ 4.0
World	-3.5	5.9	↓ 2.9

Although we have downgraded outlooks in all regions, we continue to believe that the greatest downside risks to activity are concentrated in Europe, which is more exposed to commodity imports and will struggle to replace Russian gas imports in the short term.

Ongoing geopolitical tensions continue to put pressure on commodity markets

Following the sanctions on Russian coal imports, the European Union has finally agreed to ban Russian oil imports too, although this will not come into effect until the end of the year and will only impact imports by sea - which account for around a third of the total - due to pressure from countries with high energy dependence, like Hungary. On the Russian side, Gazprom has stopped supplying gas to five countries – the Netherlands, Denmark, Finland, Poland and Bulgaria – for refusing to pay in roubles.

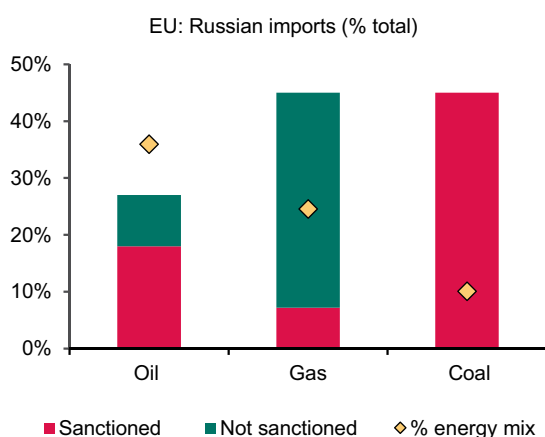
A complete halt in gas supplies is highly unlikely

In any event, a full-scale halt in gas flows to Europe – which the Bank of Spain says would drive down European GDP by around -3% – remains unlikely. In Europe, the agreement to ban crude imports - which are easier to replace than gas imports - was secured after several weeks of negotiations, with the significant nuances and concessions mentioned above. In addition, energy companies in both Germany and Italy – the EU's two largest importers – have opened accounts to pay in roubles. Russia still has no compelling incentives to cut off its government's main source of funding and its inflows of hard currency, aside from the fact that the gas cuts already applied account for a small proportion, just 16% of total exports to Europe – figure 3.

Russia cannot divert gas flows to China in the short term due to the lack of infrastructure; projects underway such as Power of Siberia and the incipient Soyuz Vostok project will allow the Kremlin to diversify more, but they will take years to come into operation and in the case of Power of Siberia, maximum transport capacity will not be reached until 2025 – see figure 4.

3. GAS EMBARGOES BY RUSSIA ON EUROPE ARE LIMITED

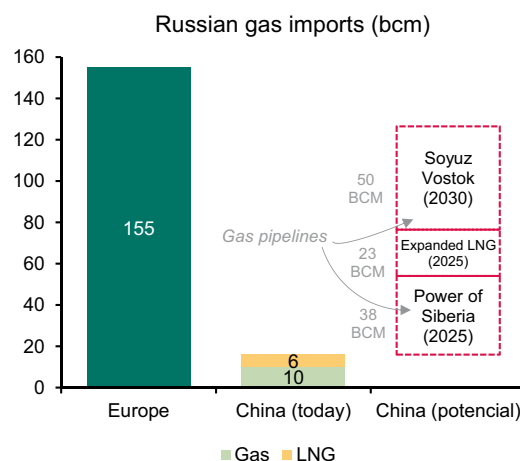
Sources: European Commission, media and Banca March



Western sanctions as a whole continue to disrupt commodity markets, driving up prices of agriculture commodities by over 20% year to date and fuelling a 60% rise in energy prices since the invasion of Ukraine. The performance of non-industrial metals has been more contained due to the drop in demand from China, the other major shock of recent months.

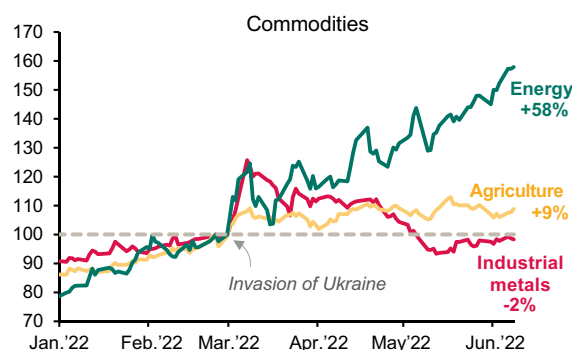
4. RUSSIA CANNOT DIVERT GAS SUPPLIES TO CHINA

Sources: European Commission, media and Banca March



5. ENERGY AND FOOD PRICES HAVE RISEN THE MOST

Sources: Bloomberg and Banca March



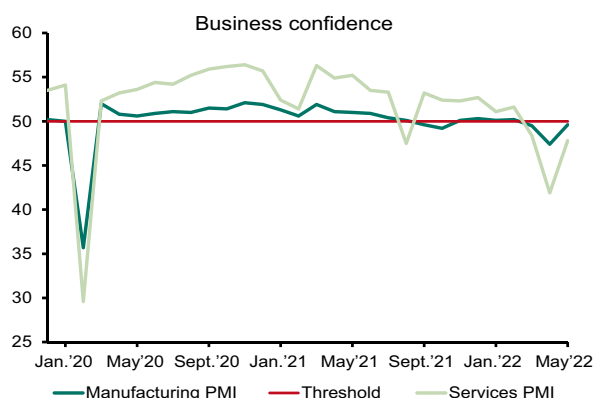
The worst is now behind China, but this year's growth will fall far short of target and further stimulus measures will be needed

The latest data shows that Chinese economic growth is bottoming out in Q2, but it also shows that the lifting of lockdown measures is not without risk.

The figures for April were negative, with retail sales down -11.1% year-on-year, falling for the second consecutive month to the weakest figure since the pandemic began. This is a clear reflection of the drop in consumer spending as a result of lockdown measures in major cities like Beijing, Shanghai and Shenzhen. However, restrictions on movement have gradually been lifted since the beginning of June, allowing for a recovery in the second half of the year. This trend is already evidenced by early indicators, such as the business confidence index, which has already begun to rally in May.

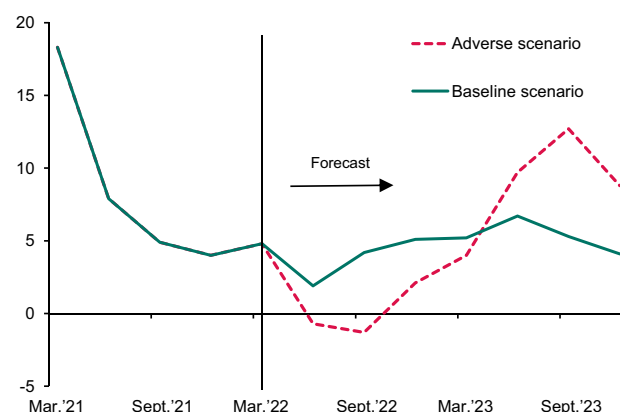
6. CONFIDENCE BOTTOMED OUT IN Q2

Sources: Bloomberg, Oxford Economics and Banca March



7. WEAKER GROWTH AND DOWNSIDE RISKS

Sources: Bloomberg, Oxford Economics and Banca March



China's "trilemma": a tough goal to achieve

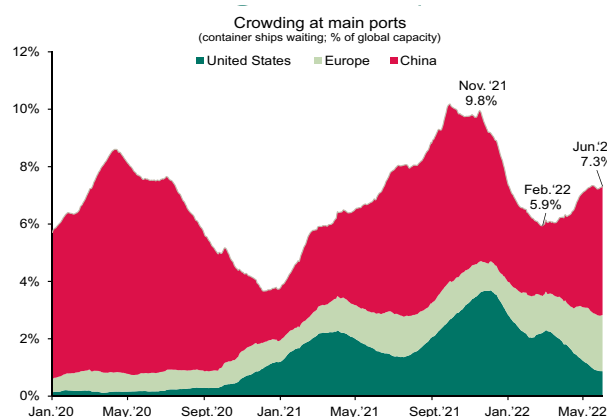
That being said, in the months to come, the main challenge facing the Chinese government is that it is simply not possible to simultaneously meet all three of its economic policy goals: 1) maintain a zero-Covid policy, 2) secure GDP growth of 5.5% this year and 3) ensure that monetary and fiscal stimulus measures do not trigger economic excesses that could throw off its financial stability or put greater downside pressure on its currency, as the interest rate spread versus the dollar would go negative as the Fed hikes rates over the next few months.

In light of the weak activity data already published, we have slashed our GDP growth outlook for the full year: we now expect growth of 4% for 2022, and it will not be until the end of the year that we start to see growth rates in line with the government's target of over 5% – see figure 7. Our outlook for a year of gradual improvement in Chinese economic growth therefore remains unchanged, albeit with a clear increase in risks to the downside.

The narrative upheld by Chinese leaders suggests that abandoning the zero-Covid policy is not an option in the short term, as China's elderly population does not yet have the same degree of immunisation as older populations in other countries. With that in mind, as figure 9 shows, we cannot rule out further adverse economic scenarios over the months ahead if new outbreaks lead to fresh lockdown measures.

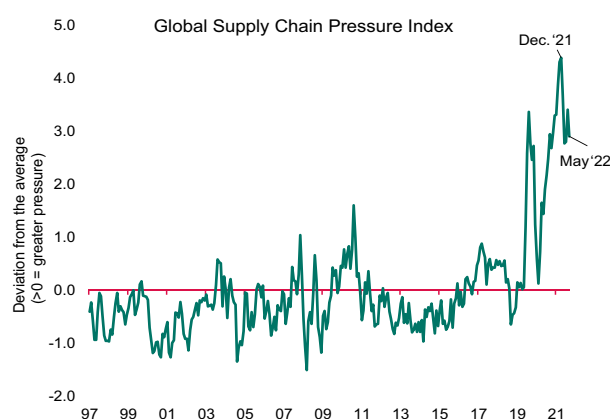
8. CROWDING AT CHINESE PORTS INCREASES

Sources: Bloomberg, Keil Institute, Fed and Banca March



9. INCREASED PRESSURE ON PRODUCTION CHAINS

Sources: Bloomberg, Keil Institute, Fed and Banca March

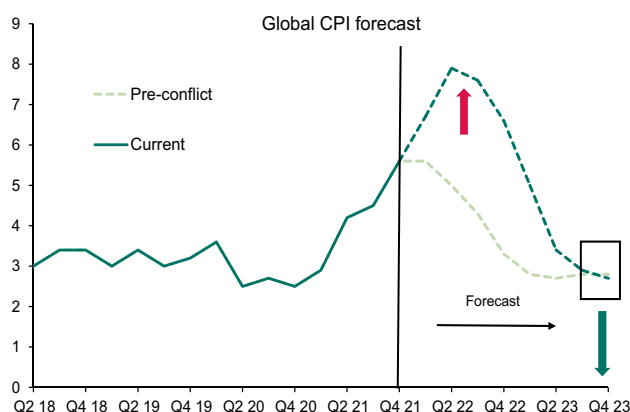


Another problem caused by the lockdown measures in China is the increased backlog in international maritime traffic. Globally, the backlog of ships waiting at the main ports is significantly better than at the worst points of last year – see figure 8 –, but the data coming out of Chinese ports is worrying, as the increased crowding will have a knock-on effect on the broader global economy. In fact, the Fed's global supply chain pressure index – figure 9 – is already reflecting this worsening situation and the increased registered in previous months tapered off in May.

Inflation: although we believe we are currently at a turning point in terms of rising prices, second round effects are now widespread and will take longer to normalise

10. INFLATION WILL REMAIN HIGH

Sources: Bloomberg, Oxford Economics and Banca March



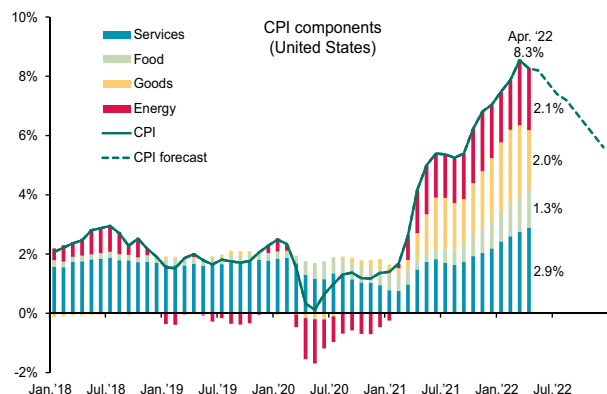
Difficulties in global trade and the distribution of goods will continue to disrupt supply chains and drive up prices. This situation means the possibility of a significant moderation in inflation in H2 is now more remote, and we now expect average inflation in Q4 2022 to remain at almost 7%.

This comes in addition to the material increase in commodity prices following the invasion of Ukraine due to supply constraints, the adverse economic impact of which will be two-fold: firstly, inflation will remain high for longer, piling pressure on central banks, and secondly, it will generate a significant loss in household purchasing power, which will trigger a reallocation of resources and hamstring the economic recovery.

In the months ahead, rather than confirming that inflation has spiked in Q2, it will be more important to confirm that inflationary pressures do not kick back in and extend to the broader economy, as the latest inflation figures suggest. In the US, after hitting a 40-year high, the increase in the annual CPI slowed by two tenths of a point to +8.3% in April, the first time its growth rate has slowed since last summer. However, the drivers behind the price hikes have changed; services now account for 2.9 pp of this increase in prices, equivalent to 35% of inflation – see figure 11.

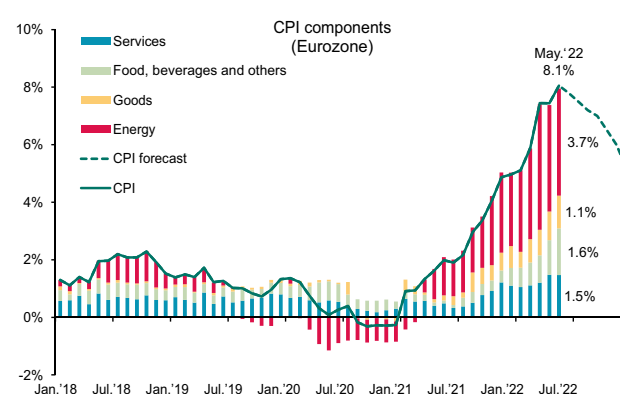
11. INFLATION WILL REMAIN HIGH

Sources: Bloomberg, Oxford Economics and Banca March



12. INFLATION WILL REMAIN HIGH

Sources: Bloomberg, Oxford Economics and Banca March



Service prices have soared in Europe, reflecting the indirect effects of higher costs

In Europe, it is true that spiralling energy costs are the main driver behind rising inflation; however, service prices are also beginning to climb more quickly. The annual CPI climbed to a new record high of +8.1% in May, with food prices up by +7.5% and the energy component up by +39.2%. Even more concerning, however, is the increase in service prices, which are traditionally more stable; they were up by an unprecedented +3.5% in May, which confirms that inflationary pressures are now impacting the whole shopping basket.

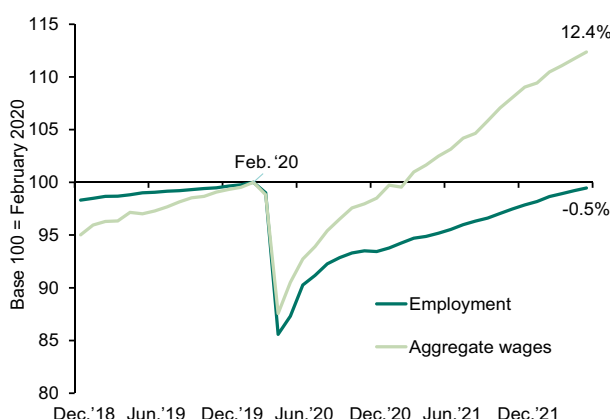
This data as a whole backs up our scenario that inflation is currently at its peak, but inflationary pressures have intensified and as a result, the moderation expected in the second half of the year will be very gradual.

Wage hikes overtake productivity

Labour markets on both sides of the Atlantic remain under pressure, with increasing vacancies and a lack of cheap labour. This suggests that wages will continue to trend upwards over the months ahead, albeit less steeply than current inflation rates.

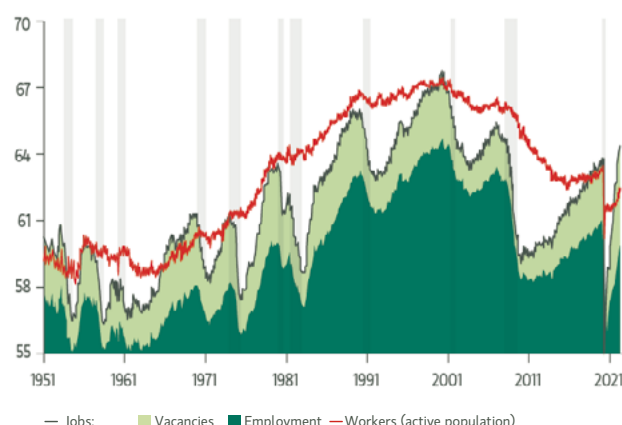
13. SALARIES RECOVER FASTER THAN EMPLOYMENT (US)

Sources: Bloomberg and Banca March



14. LABOUR MARKET % POPULATION (US)

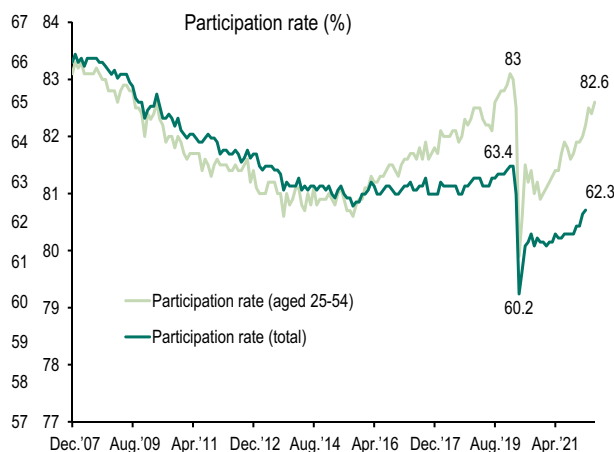
Sources: Bloomberg and Banca March



In the US, although employment is not yet back to pre-pandemic levels, salaries are now 12% higher than pre-Covid, due to the significant salary rises in lower value-added sectors. Another important point is that the ratio of vacancies to unemployed people currently stands at almost 2x, which shows how difficult it is to find labour and will continue to drive up wages. We nonetheless believe that the US labour market will begin to readjust gradually and rigidity will begin to ease over the months ahead, so this increase in salaries is likely to be reaching its peak.

15. THE PARTICIPATION RATE IS SET TO RISE (US)

Sources: Bloomberg and Banca March

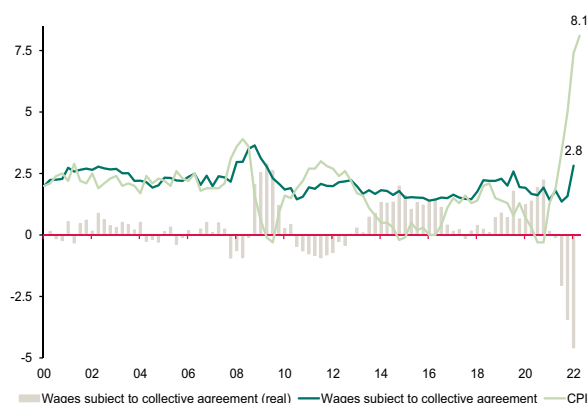


The aggregate participation rate is still a long way off pre-pandemic levels, but the specific participation rate for people aged 25 to 54 – which accounts for the bulk of the labour force – has already risen to 82.6%, just five tenths of a point below its peak. This encouraging indicator suggests that labour supply is improving and should allow salaries to be contained over the next few months. This trend became evident in May, when year-on-year salary growth slowed to +5.2%, which is still high but confirms that the peak has passed.

In the eurozone, salary hikes remained contained last year thanks – among other factors – to employment protection measures implemented during the pandemic, such as Spain’s furlough (ERTE) mechanism. These measures effectively avoided a drastic drop in household incomes, but unlike the situation in the US, they constrained salary increases when the economy reopened, as these increases tend to be observed upon changing jobs or when there is an increase in job offers.

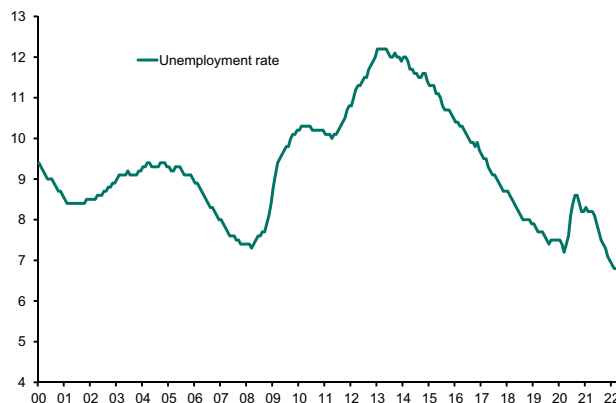
16. SALARIES ARE RISING IN THE EUROZONE

Sources: Bloomberg and Banca March



17. RECORD LOW UNEMPLOYMENT IN THE EUROZONE

Sources: Bloomberg and Banca March



However, over the course of this year we have begun to observe signs of rising wage growth in the eurozone: In Q1, salaries subject to a collective agreement have increased by +2.8% to the highest point since 2009 – see figure 16. We expect this trend to ramp up over the next few months, given the performance of the main factors that have historically determined salary growth: the unemployment rate, past inflation and consumer inflation expectations. Unemployment fell to a record low of 6.8% in April, whilst average inflation for the year will be the highest since the euro was created, which will also drive up consumer inflation expectations.

As long as economies continue to create jobs at pace, the lack of labour will generate labour market rigidity, which will cause rising salaries to threaten business margins and hamstring companies’ investment intentions.

Consumers are under pressure, although savings accumulated during the pandemic offer some breathing space

Globally, consumers are seeing their purchasing power diminished by climbing inflation. The next few months will see consumers face the dilemma of how long they continue to absorb rising prices and when they start to repress the desire to go out and consume after two years of onerous restrictions.

In our baseline scenario, we believe that consumer spending will be a source of resilience in the current economic cycle, thanks to the positive effect of the excess savings accumulated in previous years and particularly because we are approaching summer in the northern hemisphere, coinciding in addition with an economic reopening. Consumer spending will buoy growth and we believe it will stave off a global recession over the next twelve months.

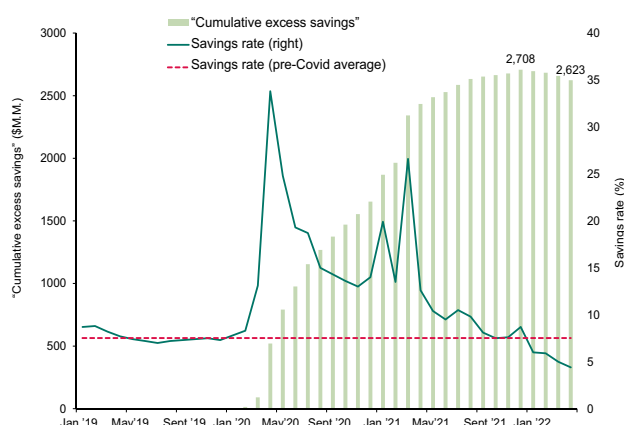
In the US, the first four months of the year confirmed the trend we expected, as households began to spend part of their “excess” savings, allowing consumer spending figures to remain buoyant. As figure 18 shows, savings are down by \$85bn year to April, which is 3% of the total, but we still estimate that there is a further \$2.6 trillion in additional purchasing power, so if the current pace is maintained only 9% of the total would be spent. This buffer will avoid a contraction in private consumption in the short term.

Spending on services is now recovering faster than spending on goods

In April, real US consumer spending on services increased at a rate of 5.9% year on year, whilst spending on goods was down by 3%; this was the fifth month running that spending on services outpaced spending on goods.

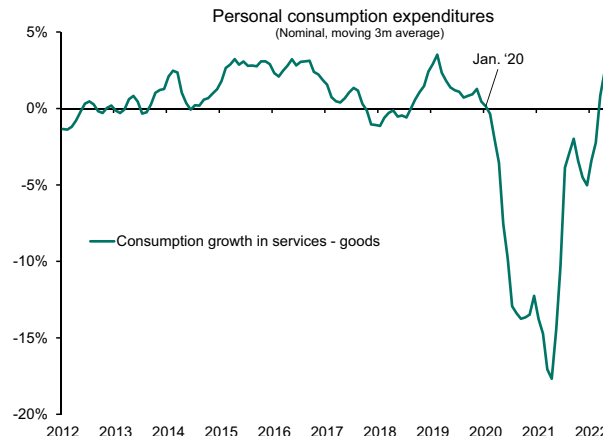
18. CONSUMERS RUN DOWN SAVINGS

Sources: Bloomberg and Banca March



19. SPENDING IS NOW FOCUSED ON SERVICES

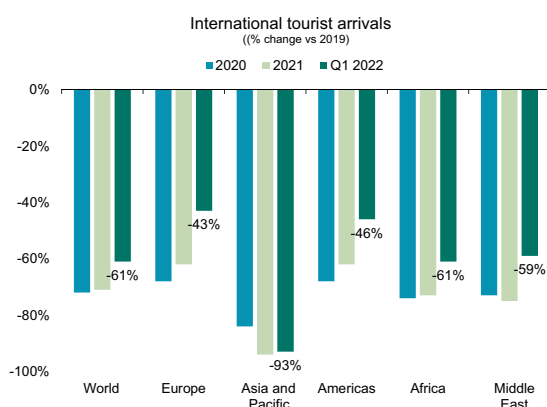
Sources: Bloomberg and Banca March



The arrival of summer will be another tailwind for consumer spending. Tourism continues to recover at a healthy clip; the latest World Tourism Organization (WTO) report shows that international tourist arrivals were almost three times higher in Q1 2022 than in Q1 2021, with Europe spearheading the recovery. Europe received almost four times as many international tourists (+280%) as it did in Q1 2021, driven by robust inter-regional demand. As figure 20 shows, in accumulated terms international tourist arrivals are still significantly lower than in 2019; however, it is likely that the upward trend will intensify over the months ahead thanks to contained Covid infection rates and the high proportion of the population who have been vaccinated. These should all be strong support factors for consumer spending and in turn for global economic growth, allowing for the recovery of economies which depend more heavily on the sector.

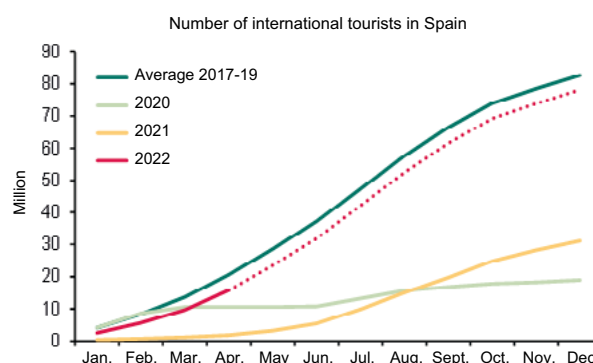
20. TOURISM IS RECOVERING

Sources: National Statistics Institute (INE), UNWTO and Banca March



21. SPAIN STANDS TO BENEFIT FROM THE INCREASE IN TOURISM

Sources: National Statistics Institute (INE), UNWTO and Banca March



This will be particularly evident in Spain's case; the latest figures are very positive and confirm a resounding recovery for the country's sizable tourism industry. As evidenced in figure 21, the recovery in international tourist arrivals year to April has been strong, and we believe this trend will accelerate towards the summer, when tourist arrivals could even outstrip average pre-Covid figures; as a result, international arrivals for the year as a whole would close just 5% lower than the average in the pre-Covid years of 2017-2019. Tourist spending figures are also looking encouraging. In the first four months of the year, spending by international tourists totalled an accumulated €18.75 billion, up +841% year on year and even outperforming the 2017-2019 average for the period by 1%.

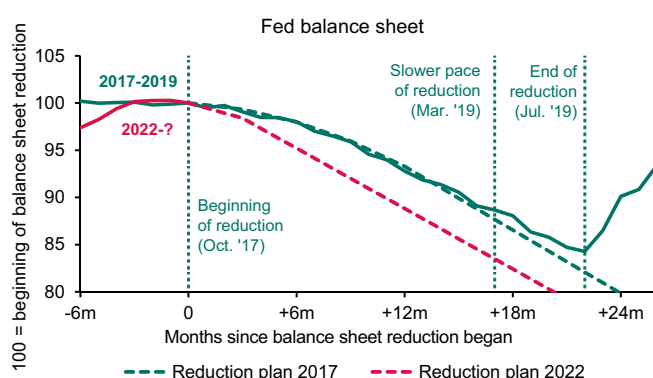
CENTRAL BANKS

A turning point for central bank balance sheets: Fed begins reduction and ECB will cease purchases in July

Following the greatest monetary expansion in history, with the five largest central banks injecting over \$11 trillion dollars or 19% of GDP into the system, July will see the Fed start to reduce its balance sheet and the ECB cease asset purchases. The Federal Reserve, which has swelled its balance sheet by the equivalent of 18% of US GDP, will begin to pare down its almost \$9 trillion in assets this month. To that end, it will allow a maximum of \$95 billion a month to roll off its balance sheet without reinvestment – \$60 billion in bonds and \$35 billion in MBS – following a transition period in June, July and August when the cap will be set at \$47.5 billion.

22. THE FED IS COMMENCING A MORE AGGRESSIVE BALANCE SHEET REDUCTION THAN IN 2017-2019

Sources: Bloomberg, Federal Reserve and Banca March



The Fed is starting the second balance sheet reduction in its history, almost five years after newly-appointed Fed Chair Jerome Powell oversaw the withdrawal of the stimulus measures implemented to recover from the 2008 financial crisis. Comparatively, the balance sheet reduction ahead is similar to the one undertaken in 2017 in terms of the speed of maturities: in both cases, the caps in place will see an annual reduction of 13% once the programme is fully operational. However, in 2017 the Fed introduced a more tentative, full-year transition period, rather than the three-month period announced to start in July.

There is also no clear roadmap in place this time in terms of the duration of the tapering process, which will evidently depend on the economic cycle and inflation. Last time, the Fed brought forward the balance sheet reduction process to July 2019, 21 months after the stimulus measures were brought in, having scaled back purchases four months earlier.

Against the current backdrop, this offloading of the Fed's balance sheet will trigger lower demand for treasury bonds and mortgage-backed securities in the US markets, straining financial conditions. According to estimates by the Fed itself, the impact of the reduction will be equivalent to an increase of 25 basis points each year.

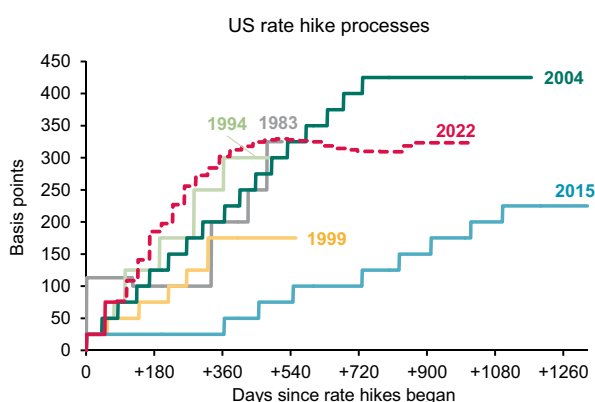
On the other side of the Atlantic, the ECB will wrap up its asset purchases this month, after two years of QE that have swelled its balance sheet to €8.8 trillion. The ECB has already substantially reduced its purchases in recent months, winding up the PEPP in March and transferring part of these purchases to the APP. This programme is now also set to conclude, paving the way for a new cycle of interest rate hikes.

These rate hikes will be ongoing, and particularly intense over the summer period

Since it wound up the asset purchase programme in March, the Fed has taken its benchmark rate to 0.75-1% with a 25 bps hike in March and another 50 bps hike in May. We expect this rate to close 2022 in the range between 2.5% and 2.75%, equivalent to 10 rate hikes over the year. This is among the fastest rate hike processes in the last 40 years, as figure 23 shows.

23. THE US IS POISED FOR THE MOST AGGRESSIVE RATE HIKE IN DECADES

Sources: Bloomberg and Banca March



24. EUROPE: THE MARKET IS PRICING IN 6 HIKES BY YEAR-END

Sources: Bloomberg and Banca March



The ECB is poised to step up the pace of its own rate hikes

Worrying inflation figures in Europe have triggered expectations of steeper rate hikes. The ECB has already announced a 25 bps hike for July. It has also been forced to open the door to stepping up the pace in September, with futures moving quickly (+50 bps in the last ten days) and pricing in 6 hikes for this year. At the same time, the ECB is set to wind up the special conditions applicable under TLTRO III – which have allowed the financial system to finance itself at -1% – in June, which will toughen up financing conditions for the banking sector.

FIXED INCOME

We remain cautious on duration. The short end of the US curve offers compelling yields for liquidity in dollars

Government debt has taken a breather in the last few weeks following steep losses in the preceding months, which drove 10-year Treasury yields to 3.12%. Although we are less negative than we were, we still recommend keeping durations short in light of the further losses expected at the long end of the curve – our target for 10-year Treasuries is 3.25%. We do, however, see greater appeal in shorter-dated US government debt; we believe the 2.75% yield on 2-year bonds afforded by the flattening curve offers a reasonable return for positions held in dollars.

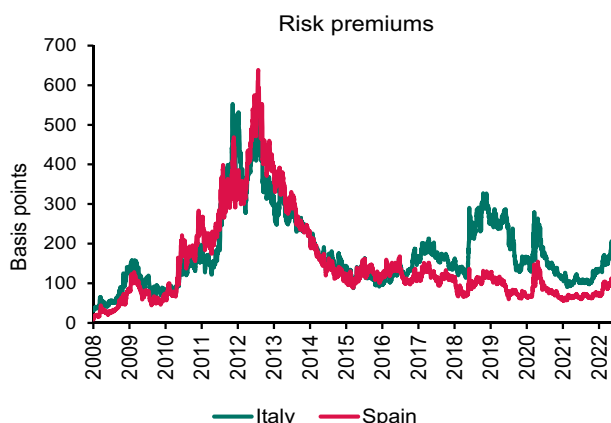
In Europe, all eyes are on periphery bonds. The ECB has warned that it will seek to deter any kind of “fragmentation”

The asymmetric risk we have highlighted in previous reports as regards German bunds has become abundantly evident, with a 50-bps upward shift in yields over the last month. The German bund now offers the strongest yields since 2014 (1.40%), thanks to the ECB's need to start normalising its monetary policy. Although our target for the Bund at year-end is 1.5%, there is more downside risk than there is for US Treasuries, given the less advanced phase in the economic cycle and the need for the ECB to normalise its monetary policy.

Despite the end of QE, institutional demand will remain high due to the “stock effect” of the ECB policy, as the central bank continues to buy back maturing bonds. However, we will need to keep a close eye on the performance of periphery bonds, where asset purchase programmes have had a greater impact and risk premiums have not even hit 2018 levels. In Spain’s case, for example, we expect government debt issuances to significantly exceed ECB purchases of Spanish debt, unlike in previous years – except 2018 and 2019 – when the reverse was true (see figure 26).

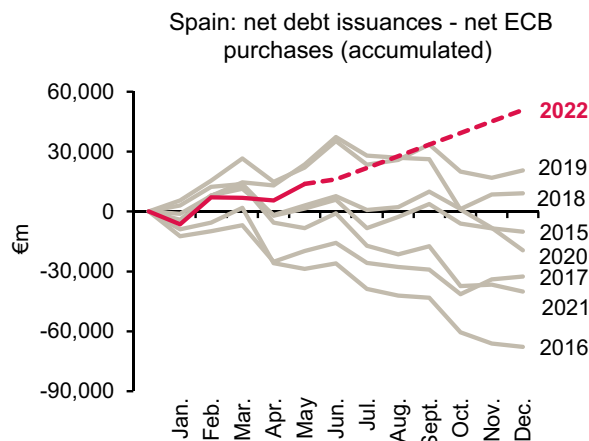
25. RISK PREMIUMS REMAIN LOWER THAN 2018 LEVELS

Sources: Bloomberg and Banca March



26. THE END OF QE WILL HIT PERIPHERY MARKETS HARDER

Sources: Bloomberg and Banca March



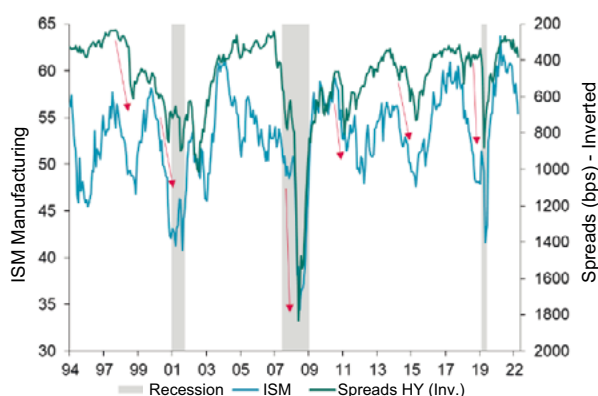
Credit: we continue to prioritise quality as the cycle deteriorates

Spreads have continued to widen in recent months due to the economic slowdown and climbing inflation. Specifically, global IG credit spreads have widened by 46 basis points year to date, and high yield by 103 basis points.

We believe that given the underlying risks for the global economy it would be a mistake to sacrifice credit ratings for higher yields, as the lofty yields demanded in the worst-rated segments, which stand at a global high since 2016 of 7.6%, mean taking on greater risk in a declining economic cycle.

27. ISM MANUFACTURING INDEX AND HY SPREADS

Sources: Bloomberg, ISM and Banca March

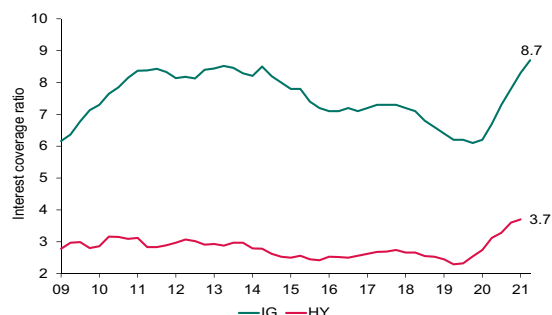


As the figure on the left shows, HY spreads are exposed to the economic cycle. A good way to gauge this is via the ISM, the US business confidence indicator, as it is one of the best indicators to show whether the US is in a phase of economic acceleration or decline; an increase in the ISM implies an improvement in the economic outlook, and vice versa.

In addition, if we look at companies’ ability to pay as measured by interest coverage ratios – operating profit over interest – the spread between higher- and lower-rated debt is significant. Although these ratios are at the top end of the range in historical terms, which reflects the strong financial situation currently enjoyed by companies, investment grade has a far broader safety margin than high yield – almost 3x higher in Europe – which offers greater protection in the event of an economic cooldown and worsening company fundamentals.

28. US: INTEREST COVERAGE RATIO

Sources: Bloomberg and Banca March



29. EUROPE: INTEREST COVERAGE RATIO

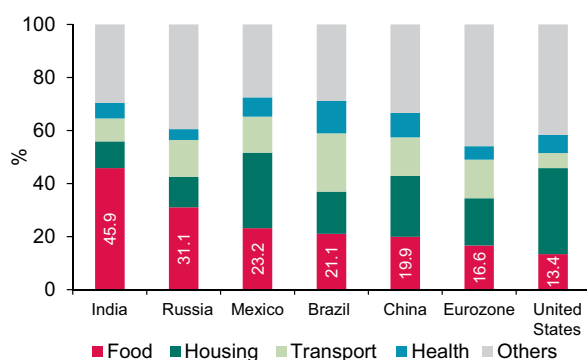
Sources: Bloomberg and Banca March



Inflation could generate political instability in emerging countries, although monetary authorities continue to raise rates to curb climbing prices

30. WEIGHTING OF INFLATION COMPONENTS

Sources: Bloomberg and Banca March



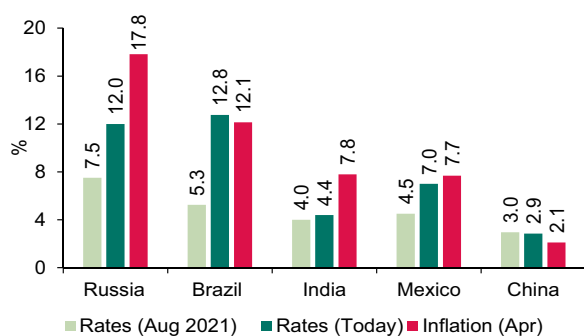
Spreads on EM debt have been affected by the economic slowdown, rising by 54 basis points over the year, although the spread for the aggregate index is still in line with pre-Covid levels at 373 bps.

Emerging countries are also facing climbing inflation. In addition to inflation fuelled by commodity and energy prices, the strength of the dollar versus EM currencies makes imported goods and services more costly.

The main concern in this sense is the significant weighting of food in the average shopping basket in these countries; an increase in these prices is a threat to the population's basic needs – the World Bank's agriculture price index is up 42% versus January 2021 – which could compromise the fragile political stability in certain markets; this is one of the main underlying risks for this year.

31. EMERGING MARKETS: OFFICIAL RATES VS INFLATION

Sources: Bloomberg and Banca March



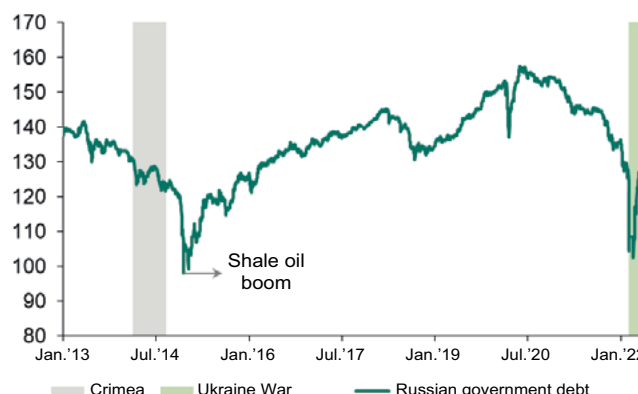
Emerging market central banks continue to react to these inflationary pressures with restrictive monetary policies, with the exception of China. Brazil, in particular, has hiked rates by more than 7 pp since August 2021, when the Fed made a decisive shift towards a more restrictive monetary policy.

Russia is a case unto itself; thanks to capital controls and a restrictive central bank policy, it has managed to buoy several of its local currency-denominated bonds to the levels at which they were trading prior to the invasion of Ukraine. However, there is intervention in the local bond market and pricing is not fluid.

Also, Russia 5-year credit default swaps (CDS) are trading at a premium of 10,000 bps, revealing a 100% implied probability of default.

32. RUSSIAN GOVERNMENT BOND INDEX (LOCAL CURRENCY)

Sources: Bloomberg and Banca March



What's more, in the last week of May we saw the first Russian government debt default, after the country failed to pay the interest accrued due to late payment of the principal on a bond maturing in April 2022. This initial incident did not trigger a cross-default across other instruments, as the default amount was under the threshold of \$75 million.

EQUITIES

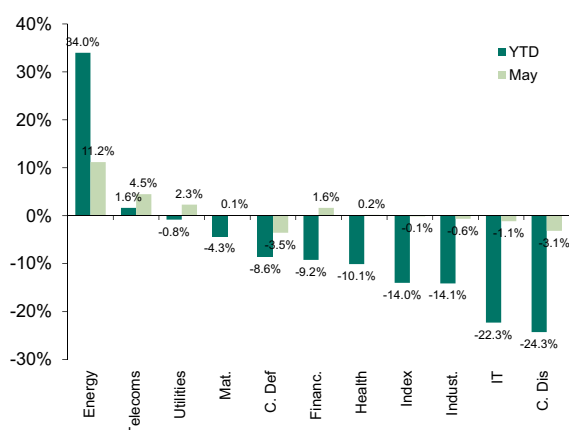
Us equities see fifth-worst start to the year in history

Equities have underperformed due to the relentless increase in inflation, the accelerated tapering of monetary stimulus measures, geopolitical risk from Ukraine and the sluggish Chinese economic reopening, with the negative knock-on effect on supply chains and global growth. In its first 100 days' trading this year, the S&P 500 chalked up its fifth-worst start to the year in history at -15.7%, underperformed only in 1932 (-43.7%), 1940 (-25%), 1962 (-18.3%) and 1970 (-17.2%).

We are now observing an incipient rally in over-sold equity markets of between 5.5% and 9%, but the year-to-date losses are substantial, standing at around 14% for the MSCI World, similar for the EM index and at 24% for the Nasdaq. By sectors, energy put in an outstanding performance in May (+11.2%), buoyed by the high crude and gas prices triggered by the invasion of Ukraine, accompanied by more defensive sectors in terms of corporate earnings and dividend payouts, such as telecoms (+4.5%) and utilities (+2.3%). Year to date, energy is still the best performer (+36%), with discretionary consumer discretionary (-24.3%) and technology (-22.3%) bringing up the rear.

33. MSCI WORLD: PERFORMANCE BY SECTOR

Sources: Bloomberg and Banca March



34. S&P 500: ONE OF THE WORST STARTS TO THE YEAR IN HISTORY

Sources: Bloomberg and Banca March

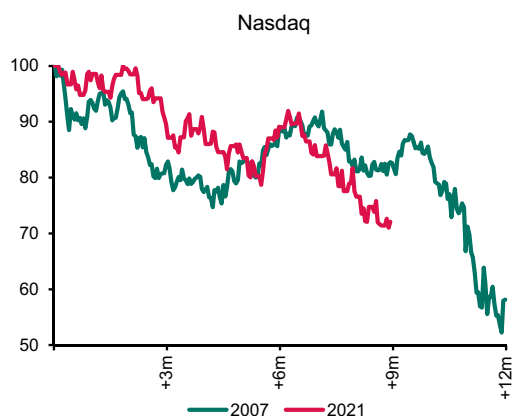


FAANGs hamper US indices significantly

In the technology sector, we would highlight the negative performance of major US tech players year to date. Just eight companies – including the FAANGs – which account for 25% of the S&P 500 market cap, were responsible for up to 50% of the year-to-date losses suffered by the index. The speed of the decline was also surprising; the Nasdaq 100 has plummeted at a faster pace than it did in the 2008 financial crisis.

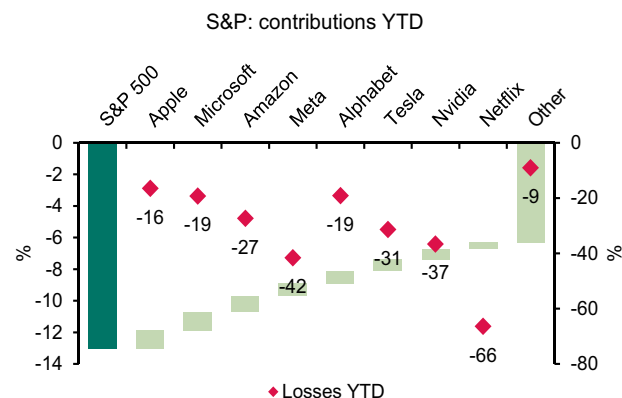
35. NASDAQ PLUMMETS MORE STEEPLY THAN IN 2008

Sources: Bloomberg and Banca March



36. S&P500 LOSSES DRIVEN BY JUST A FEW COMPANIES

Sources: Bloomberg and Banca March



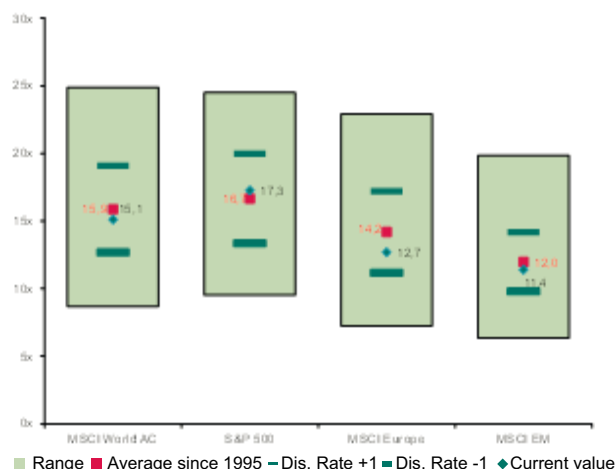
Valuations have compressed, but we still expect further adjustments, especially on the earnings side

Given the stability observed in corporate earnings (+10% US and +13.5% Europa), all of the losses to date have been at the expense of significantly cheaper valuations. The 12m P/E ratio for the US market has now corrected to its historical average, whilst Europe is trading at a discount of 10% and emerging markets of 5%.

Despite the fact that valuations are more attractive from a long-term perspective, we believe that corporate earnings will begin to suffer downgrades, factoring in the effects of the economic slowdown and the incipient turning point we are beginning to observe in margins.

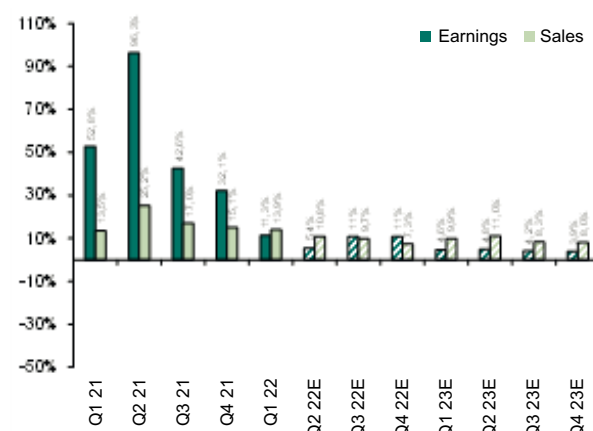
37. 12M P/E RATIO BY REGIONS

Sources: Refinitiv and Banca March



38. YEAR-ON-YEAR GROWTH IN EARNINGS AND REVENUES

Sources: Refinitiv and Banca March



In all severe slowdown processes, valuations compress first and then, in a second phase, earnings fall and P/E ratios expand.

Given that central banks need to continue to take all possible measures to contain inflation, we are convinced that the current situation is no different from its precursors and that we have not yet reached that second phase. In the hypothetical event that the situation were to deteriorate and trigger a recession, the average historical drop in earnings stands at 35.5%.

Although we could assume that the multiple has already priced in a severe slowdown – the S&P 500 P/E ratio has contracted by 31% since January 2021 highs, versus an average past contraction in recessions of 25.4% – we would still recommend not jumping the gun as we await earnings downgrades.

We recommend taking a more cautious stance in this phase of the cycle

Declining economic growth means we must take a prudent approach in the months ahead and limit risk to mitigate against the rapidly advancing cycle and the struggle by central banks to react as quickly as they have in recent years. We believe it is worth exercising additional caution until interest rates hit neutral levels or until there is significant evidence that inflation is falling fast. Meanwhile, diminishing central bank liquidity will act as a headwind for risk assets like equities.

US equities: a better position to navigate uncertainty

There are two reasons why we prefer US equities. Firstly, the US is less exposed to the energy shock triggered by Russia's invasion of Ukraine. Over the last decade, the US has gradually consolidated its position as a net energy exporter and become the world's largest oil producer, with an output of more than 11 million barrels a day. Though we do believe the US economy will be impacted by rising oil prices, it is better positioned strategically to weather the instability generated by the invasion of Ukraine than Europe, which is more dependent on energy imports, particularly from Russia.

Secondly, US listed companies are more defensive in nature. US companies significantly outperformed their European counterparts in terms of corporate earnings in the last four crises. In three of the four, the earnings posted by the companies comprising the US benchmark index fell just half as much as their European peers. What's more, the stronger quality of US companies means they offer a better ROE than European listed companies on average, which is one of the reasons why US indices outperformed in the last crisis.

Although these differences between the two regions do impact valuations, we believe they are justified, given the exposure of some European sectors to the Ukraine crisis. For example, the textile segment is heavily weighted in the European consumer discretionary sector, accounting for almost half of the sector in the Stoxx 600, and has been hit hard by business closures in Russia and rising raw material costs; the US consumer discretionary sector, however, is more dominated by e-commerce, at one third of the sector's total market cap.

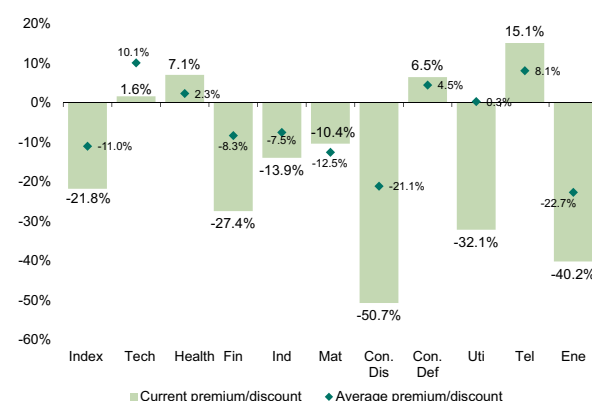
39. MAXIMUM DROP IN CORPORATE EARNINGS IN CRISES

Sources: Bloomberg and Banca March



40. VALUATION BY SECTORS: EUROPE VS US

Sources: Bloomberg and Banca March

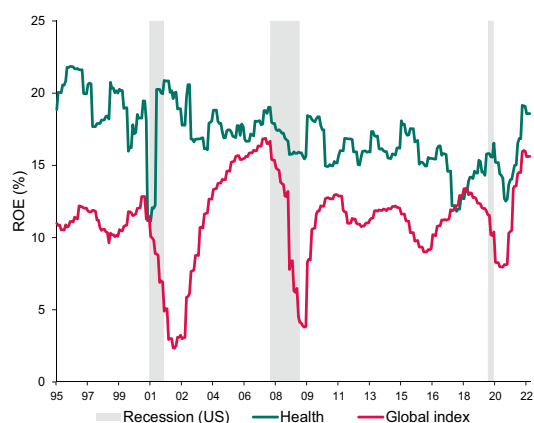


Health sector: growth to reasonable prices amid a broader economic slowdown

As we seek a more balanced positioning in terms of sectors, we maintain an overweight position in health. We believe it is one of the best bets at present, given its defensive nature, for two reasons. Firstly, it affords exposure to a long-term trend: increasing concern around health among society due to population ageing. And secondly, thanks to its lower dependence on raw materials – just 6% of pharma companies' total costs are raw material costs, and in the case of healthcare equipment providers, this figure is lower still – just 2% – versus 15% for the capital goods sector, for example.

41. HEALTH: A STRONGER ROE

Sources: Bloomberg and Banca March



Against a backdrop of widespread risk aversion, the health sector has outperformed the index, particularly pharma stocks, which are down by 7% versus 14% for the broader index year to date.

Once again, the defensive attributes of this sector have come into their own; not only does it offer a stronger return on equity than the index, but its earnings are less exposed than the rest of the market to periods of negative economic growth.

As one would expect, enjoying more stable fundamentals is an attribute that has traditionally been rewarded during tougher periods for the economy. As the figure shows, in all of the periods between market peaks – which are reached on average 6 months before the beginning of a recession – and the end of the recession, the health sector has outperformed the rest of the market, sometimes by as much as 50% in accumulated terms.

41. HEALTH VS. S&P 500: RELATIVE PERFORMANCE FROM RECORD HIGHS UNTIL THE END OF THE RECESSION

Sources: Bloomberg and Banca March



The sector also continues to offer attractive valuations in comparison to other defensive industries: a multiple of 17.2x 12-month estimated earnings versus 18x for utilities and 19.5x for consumer staples.

Technology: although valuations are lower than average, we still prefer more stable businesses with recurring revenues

43. S&P 500 TECHNOLOGY: 12-MONTH P/E RATIO (EST.)

Sources: Refinitiv and Banca March

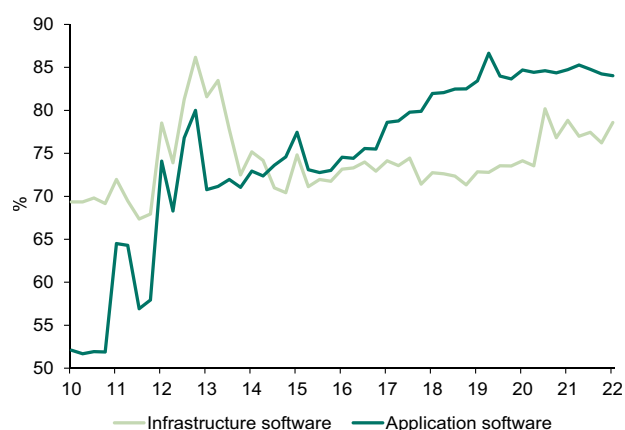


Given that the cycle is maturing and we are now in a more advanced phase, we would rather be positioned in more defensive sectors which will suffer less severe downgrades, such as software companies. This sector has transformed its business model from selling successive updated versions to offering Software as a Service (SaaS) through a subscription model, stepping up recurring revenues. The change observed over the last decade has been such that the application software business today boasts recurring revenue levels of 84%, versus just over 50% in 2010.

The technology sector is still undergoing an adjustment process. Long-term rate hikes have driven the sector's earnings multiple below its historical average. More cyclical subsectors like hardware and semiconductors are trading at discounts of 10.5% and 16.6% versus their historical averages, as sector earnings continue to price in high growth rates – 13% and 11% in 2022 and 2023, respectively.

44. PERCENTAGE OF RECURRING REVENUES OUT OF THE TOTAL FOR GLOBAL SOFTWARE COMPANIES

Sources: Bloomberg and Banca March



Microsoft is a great example of the resilience of software companies: it has increased its earnings by 68% since the beginning of the pandemic and its share price is up 44%, slashing its P/E multiple by 14.4% in a sector which offers stability.

We believe, then, that the most effective strategy in the tech sector is to build exposure to companies where recurring revenue depends less on the economic performance, such as software, and to combine these positions with long-term growth bets like cybersecurity, which is categorised as infrastructure software and will benefit from the current geopolitical landscape.

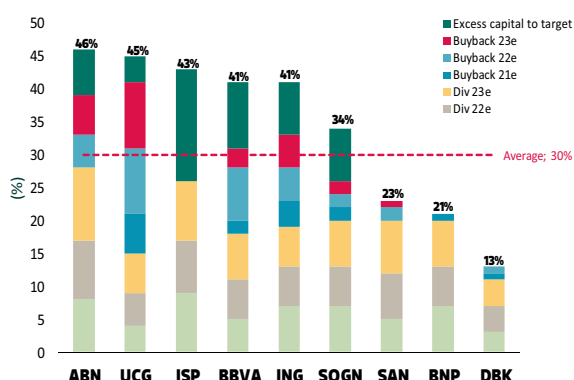
The financial sector remains attractive, although the mature phase of the cycle will offset part of the tailwinds from higher interest rates

In 2021, the sector brought back dividend payouts and saw earnings recover to pre-Covid levels thanks to the normalisation of the cost of risk on provisions and the increase in revenues linked to market activities – equity and bond trading, asset management and investment banking. The more advanced stage of the economic cycle, however, is more challenging.

Despite the weakening global economic landscape, the sector will enjoy support from its strong balance sheet position, which will allow it to harness the rate hike process underway by central banks. The sector also offers strong credit ratings, with low NPL levels and robust coverage levels. We remain particularly positive on the European financial sector, which is trading at an attractive P/E ratio of 7x and a discount of 20% versus its historical average.

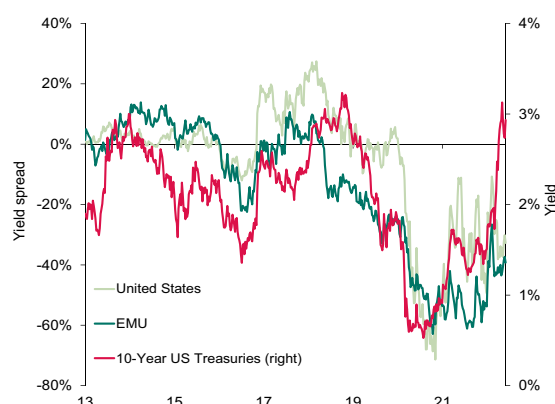
45. WELL-CAPITALISED EUROPEAN BANKS

Sources: Bloomberg, Refinitiv, companies and Banca March



46. FINANCIALS VS 10-YEAR BOND

Sources: Bloomberg, Refinitiv, companies and Banca March



CURRENCIES

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

Soaring inflation in the eurozone to levels not seen since the euro was introduced has triggered a clear change of tone at the ECB, which is set to hike rates for the first time in a decade and move out of negative rates in September. This shift in the ECB's bias allowed the euro to climb from 1.035 EUR/USD, its lowest point against the dollar in five years, to 1.07 EUR/USD.

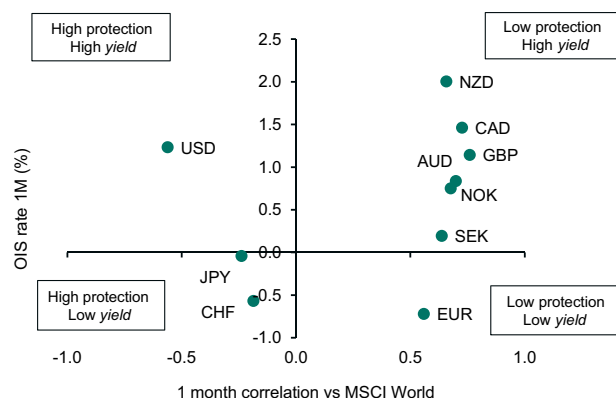
Despite offering minimal fundamental value, the dollar will be buoyed in the short term by its status as a safe haven

The dollar is currently up 6% versus the euro year-to-date and will benefit from various support factors in the short term. The Fed will continue to spearhead the rate hike process over the months ahead with an increase of 50 bps in the price of money at its next two meetings, which will further widen the interest rate spread versus the euro. Elsewhere, despite being at levels not seen since 2017, the positioning in the futures market is not yet extreme, and that could continue to play in the dollar's favour, especially in light of the Ukraine war: increases in risk aversion will continue to benefit the greenback, due to its status as a safe haven and that fact that it offers negative correlation with risk assets.

Less favourably for the dollar, the degree of overvaluation versus the euro remains high – around 10% in terms of purchasing power parity – which could well reverse once geopolitical tensions ease.

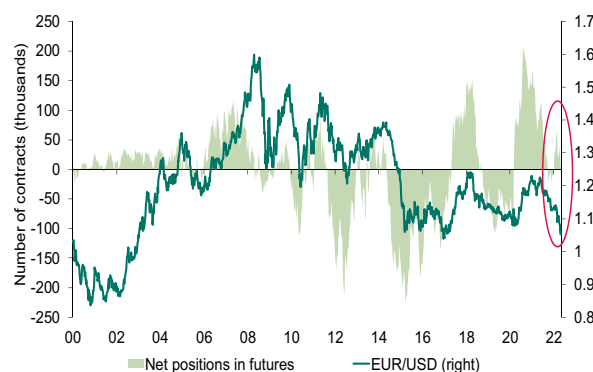
47. DOLLAR: A HAVEN ASSET WITH STRONG GAINS

Sources: Refinitiv, Bloomberg and Banca March



48. POSITIONING IS NOT YET AT EXTREME LEVELS

Sources: Refinitiv, Bloomberg and Banca March



We remain neutrally positioned in the dollar as we await more compelling levels to build positions

In short, although the dollar will continue to act as a haven in times of uncertainty like the present, we prefer to remain neutrally positioned as we await better opportunities in terms of valuation to increase positions. We believe a cross in the region of 1.12 EUR/USD would be a more suitable level to raise dollar exposure.

Weaker economic data and political uncertainty in the UK inflict more damage than the rate hike and fresh support measures. We still see no upside potential in sterling and continue to hedge exposures

The latest economic data reveals an increased likelihood of recession in the UK, driving sterling down to its lowest level in two years versus the dollar and in six months versus the euro. An annual inflation rate of +9% and the lowest consumer confidence since 1974 both clearly evidence a decline in the economic cycle in the UK.

The British government has just announced support measures totalling £15bn to help households cover the cost of rising energy bills. We believe the positive economic impact of this support, which will be partially funded with a 25% windfall tax on oil and gas companies' earnings, will be limited.

The ongoing political uncertainty in the country is another headwind; Prime Minister Boris Johnson was subject to a no-confidence vote in recent weeks and survived only by a narrow margin. There is also an increasing risk that the UK Northern Ireland Protocol will be overridden, which would trigger fresh trade tensions with the European Union. This highly uncertain political landscape will continue to weigh heavy on the performance of the pound.

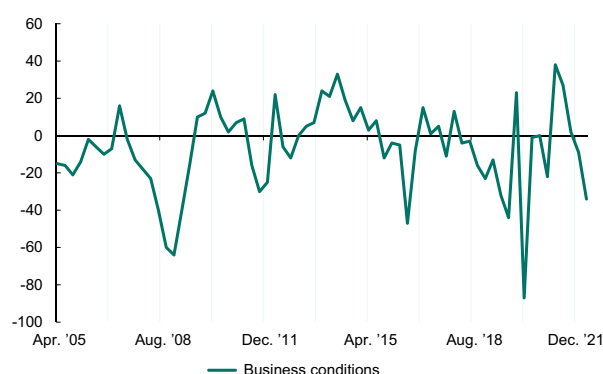
49. EUR-GBP EXCHANGE RATE

Sources: : Bloomberg and Banca March



50. UK: BUSINESS CONDITIONS

Sources: : Bloomberg and Banca March



At this point, we believe any tailwinds for the pound have been neutralised and we still see no upside potential for the currency. Although we have relaxed our outlook for depreciation of the pound slightly, with a target range of 0.88 – 0.83 EUR/GBP, we recommend continuing to hedge against the risk of further losses.

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