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MARKET *view*

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Europe's comeback and the hope for a near end to the interest rate hike cycle

> *Weighing up the different scenarios, we are more constructive overall, especially on European equities*

Financial markets got off to a good start in 2023. Since the beginning of the year, the broad US stock index S&P 500 has risen by more than 8% in US dollar terms and the Euro Stoxx 50 by more than 11% in euro terms. **Where are opportunities arising now that valuations have gone up? What risks loom?**

Equities - Europe more attractive than the US

In our main scenario, we expect a slowdown in global economic growth compared to last year, with the supply shock of 2022 likely to lead to stagflation in 2023. Inflation will remain high against a backdrop of low growth. However, the outlook for the eurozone has considerably brightened lately. A severe energy crisis will most likely be averted, at least this winter. Gas inventories in Europe are well stocked. In addition, the surprising decision by the Chinese government last December to end its zero-covid policy should have a positive impact on global growth. We currently prefer European equities over their American peers. There are several reasons to invest more in European stocks: with a price-to-book ratio of 1.7, European equities are trading close to their long-term average valuation levels, whereas equities in the US, with a price-to-book ratio of 4.1, are valued significantly higher than their long-term average. The euro is also likely to appreciate against the USD, as interest rate differentials between the dollar area and the eurozone are expected to narrow. The interest rate hike cycle in the eurozone will probably last longer than in the US, the ECB having only started raising rates in July 2022 - four months after the Fed. Moreover, purchasing power parity argues for an appreciation of the euro. The supply shock has led to a flight to the US dollar. With the end of the supply shock, this trend should reverse. European companies should also benefit disproportionately from the stabilisation of global supply chains.

Bonds - Gradual extension of duration

In our main scenario, we assume that inflation rates have peaked, although inflation remains well above the ECB's and the Fed's 2% target. At 5.2% in the eurozone and 5.7% in the US, core inflation (headline inflation excluding energy and food) remains too high. We expect the rate hike cycle to end earlier in the US than in Europe. The Fed will likely raise interest rates by another 50 basis points by May 2023. In the eurozone, we expect the deposit rate to rise from 2.5% to 3.5% by July 2023. Having kept duration short in 2022, we now see the time for a gradual increase in residual maturities towards neutral levels as the end of the rate hike cycle approaches.

We find investments in corporate bonds to be particularly attractive at the moment, as not only have interest rates risen significantly, but corporate bonds are again offering attractive risk premiums above the risk-free interest rate.

Alternative scenarios - opportunities & risks

It is often helpful to run scenario analyses: we assign a 70% probability to the above base case scenario. We expect a more negative scenario with a 20% probability, whereby the energy crisis in Europe would worsen again. Rising energy prices would put European companies at a disadvantage in global competition and rob consumers of additional purchasing power. In the wake of this, inflation would remain stubbornly high, forcing the ECB to raise interest rates more sharply than in the main scenario, triggering a full-blown recession. In that situation, "cash would probably be king" again. We also pay attention to geopolitical risks, which include an intensification of the war in Ukraine and escalating tensions between China and Taiwan. In the US, the dispute between Democrats and Republicans over the debt ceiling could also lead to a temporary credit default. The list of possible "black swan events", i.e., highly unpredictable events but with potentially severe consequences, is currently unusually long.

We expect a more positive scenario with a 10% probability. We all hope for an end to the war in Ukraine. Although we have been assuming a prolonged military conflict since the beginning of the war, the hope that human suffering in Ukraine will end in a timely manner cannot and should not be abandoned. We currently expect the world's second largest economy to grow by "only" 4.7% in 2023. However, China's reopening could lead to significantly higher growth should global supply chains settle and domestic consumption pick up strongly.

We have already switched back from an underweighted equity positioning, taken before the outbreak of the war in February 2022, to a neutral equity positioning in July 2022. Weighing up the different scenarios, we are more constructive overall. We remain in a neutral but more constructive equity positioning and, as active investors, rely on allocation decisions that we can justify well: we prefer European equities, we expect the euro to appreciate against the US dollar, we are gradually lengthening the duration of our bond portfolio in anticipation of a near end to the interest rate hike cycle, and we are increasingly focusing on corporate bonds, which again offer attractive risk premiums above the risk-free interest rate.

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