

Optimal Income Strategies

Major Central Banks Poised to Cut Interest Rates, Anticipate Unconventional Easing Cycle

- The ECB is easing its policy before the Fed
- Stocks indices rose to new highs and credit spreads tightened
- Portfolios remain overweight global equities

What's happening?

The global economy is softening with persistent inflation, prompting central banks to signal a more cautious approach to policy easing. In the US, household consumption is expected to slow due to a combination of slower real employment income growth, increased tax payments, and a rising saving rate. This should lead to economic growth decelerating to a below-trend pace, consistent with a soft landing. Recent inflation data showed a decrease in headline inflation and signs of significant easing in services inflation. Consequently, GDP growth is projected to slow from +2.4% in 2024 to +1.6% in 2025.

In the Eurozone, economic growth exceeded expectations in Q1, though the construction boosts in Germany and Italy are unlikely to be sustained, suggesting a slower pace for the remainder of the year. Inflation fell to 2.4%, but services disinflation was disappointing. Despite subdued growth, the GDP forecast has been raised to +0.6% in 2024, improving to +1.1% in 2025.

China's GDP growth was stronger than expected in the first quarter, but April's data was mixed. Industrial output continued to rise, driven by state-owned enterprise investment, while consumer spending weakened. House prices fell further, prompting authorities to introduce additional support measures. GDP growth is maintained at +5.0% for 2024 but is expected to slow to +4.2% in 2025.

Emerging markets experienced a better start to the year, particularly in Central and Eastern Europe, where growth had been slower, and in Asia, where growth rates converged. Policy easing in Latin America has slowed but continues, and it is expected to begin later in the year across most of emerging Asia, coinciding with key upcoming elections.

Central banks are adopting a more cautious stance in starting or continuing their pace of easing. The US Federal Reserve is anticipated to initiate rate cuts in September, with expectations reduced to only two cuts this year. The European Central Bank is still likely to begin easing in June, with a total of three cuts expected this year. The Bank of England is projected to postpone its initial cut until August, followed by another in November, while the Bank of Japan is expected to make modest adjustments.

Positioning & Performance:

	GLOBAL OPTIMAL STRATEGY			OPTIMAL STRATEGY			DEFENSIVE OPTIMAL STRATEGY		
	Dec-23	Apr-24	May-24	Dec-23	Apr-24	May-24	Dec-23	Apr-24	May-24
Net Equity	65,5%	81,8%	90,6%	54,1%	73,1%	75,4%	34,4%	32,4%	34,4%
Equities	63,0%	82,7%	86,7%	60,0%	74,0%	76,2%	33,7%	39,3%	40,3%
Equities derivatives	8,6%	6,4%	9,0%	-0,8%	0,3%	2,2%	0,7%	-6,9%	-5,9%
Risk Mitigation Strategies	-6,1%	-7,3%	-5,1%	-5,1%	-1,2%	-3,0%	0,0%	0,0%	0,0%
Fixed Income	21,3%	7,9%	5,3%	33,5%	20,4%	19,3%	28,5%	55,4%	55,2%
Govies	1,0%	0,0%	0,0%	1,0%	0,0%	0,0%	0,0%	0,0%	0,0%
Bond Derivatives	8,1%	38,5%	44,2%	9,4%	29,0%	31,8%	17,5%	39,9%	42,9%
High Yield Credit	1,2%	1,5%	1,0%	3,4%	3,6%	3,7%	10,5%	15,8%	15,9%
Investment Grade	17,3%	6,2%	4,1%	26,5%	16,6%	15,4%	17,9%	39,6%	39,3%
Emerging Debt	1,8%	0,3%	0,3%	2,6%	0,2%	0,2%	0,0%	0,0%	0,0%
Diversification	3,4%	1,5%	1,5%	1,5%	0,9%	0,8%	5,6%	2,7%	2,6%
Cash & Money Market	9,8%	8,8%	2,6%	10,7%	5,6%	4,4%	31,6%	9,6%	7,8%

Our portfolios continue to be overweight global equities. While we still favour the long-term growth potential of the technology sector, we also recognize opportunities in areas offering more cyclical potential. European trades offer lower valuations compared to the US market, and we are particularly interested in the banking sector, which presents solid earnings and generous shareholder returns in the form of high dividend yields and substantial stock buyback programs.

We also maintain exposure to duration through Eurozone sovereign debt, while we patiently await opportunities to expand into US duration, currently favouring the front-end of the curve (2-year).

Our stance on commodities remains neutral. Copper and industrial metals have exhibited signs of exuberance recently, with a surge in prices driven by a recovery in manufacturing activity in China and announcements of concrete measures to address the ongoing property crisis there. Gold reached new historic highs following its brief and shallow consolidation, and oil prices settled back towards the middle of the expected trading range (\$75-\$90 for Brent). We are awaiting more attractive levels before re-engaging with the commodity complex.

Outlook

The dark clouds hanging over financial markets dissipated, and May was a strong month for multi-asset portfolios. Stock indices rose to new highs, and credit spreads tightened markedly as interest rates fell across the board. Cross-asset volatilities made a U-turn and collapsed to the lowest levels seen this year. This sharp return to optimism is primarily attributed to a stronger than expected earnings season. Q1 earnings surprised to the upside, showing margin resilience across sectors in the US, while Europe exhibited the strongest EPS revision ratio trajectory among major global regions. The results of the 'Magnificent 7' came under a lot of scrutiny and chiefly reassured investors that the AI boom is very much alive and well. The strength of earnings upgrades revisions outside of the technology sector led us to broaden our equity exposure to the European market, particularly to more value sectors such as banks and to the more medium capitalization space, which has lagged large caps.

The second decisive element comforting financial markets in May was the assertion from the Fed's Chair, Jerome Powell, that monetary policy is sufficiently restrictive, ruling out the possibility that the next policy move will be an interest rate hike. While the Fed needs "greater confidence" that inflation is converging back towards 2%, calling for patience, the dovish tone was enough to prevent interest rates from rising any further. An unexpectedly weak print for April's US Nonfarm Payrolls indicates that the labour market is starting to ease, which we see as a prerequisite for the current sticky services inflation to finally resume a downward path. We welcome the recent wave of negative economic surprises in the US as a positive development for risky assets and believe that a certain amount of bad news is indeed good news in the US by allowing interest rates volatility to recede and support further multiple expansion.

The situation in Europe is different. A stronger level of economic activity, albeit from a low level, is a good omen as long as it does not derail the inflation outlook. ECB officials have been telegraphing very clearly the possibility of the first interest rate cut at the June meeting. Still, we expect the ECB to remain cautious in the forward guidance regarding the extent of policy adjustment available and on what horizon. Negotiated wage rates in the Euro Area (+4.7% YoY in the first quarter of 2024) are still growing at twice the speed of pre-Covid years, albeit driven exclusively by Germany. The risk of an increasingly self-sustaining positive services price loop cannot be ignored, while labour productivity remains stubbornly low. We do not feel current yields are sufficiently attractive to add to our long Eurozone sovereign debt position for now.

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