



BANQUE
ERIC STURDZA

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CONTENTS

MARCH 2024

1. Editorial

A Wild West Ride

2. Fixed-Income

US inflation muddies the waters.

3. Equities

The Magnificent Six

4. Asset allocation

Reserved for Banque Eric Sturdza's clients

5. Performances

1. EDITORIAL

A WILD WEST RIDE

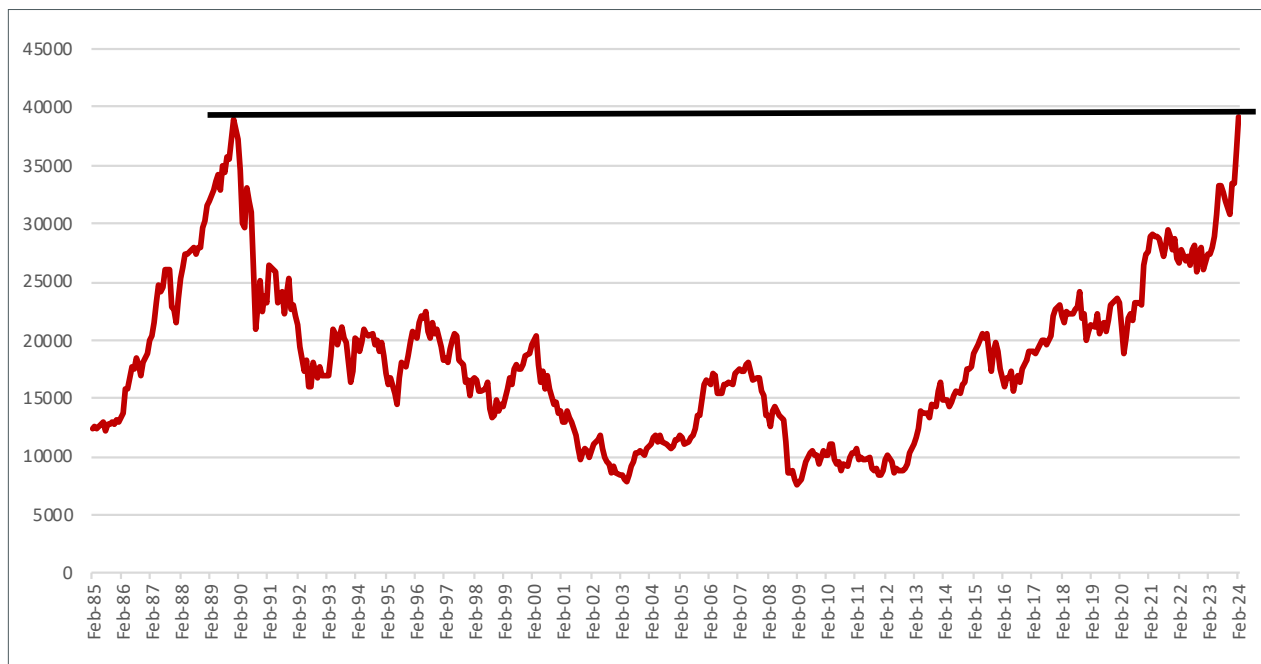
There are some parallels between the markets we've just lived through and the Wild West. February's equity markets extended the advances that started in November 2023.

In the United States, references to the Wild West and western style movies are not limited to the “Magnificent Seven”. On closer inspection, there are similarities between the long journey of pioneers in an hostile environment and the recent trajectory of the “Magnificent Seven” group. The term coined last year collectively refers to the seven stocks (Apple, Amazon, Alphabet, Meta Platform, Microsoft, Nvidia and Tesla) that drove most US equity gains last year and again since the beginning of 2024. Indeed, nothing seems able to stop the group's progression, even though macro signals are deteriorating, with plateauing inflation, long rates on the rise again, and dras-

tic adjustments to rate cuts expectations (from six to three cuts) in a matter of weeks. With the US politics still extremely polarized, the risk of a political mistake is also exacerbated: another government shut-down was just avoided for the fourth time in a row thanks to a last minute agreement in Congress. To these headwinds we could add already stretched valuations and sentiment indicators, as well as an historically high concentration in US stock indices, all of which we detail below in the equity section.

To date, while the concentration level has already surpassed the extreme levels reached in the early 2000s, this is far from true from a valuation standpoint. As the quarterly results of Nvidia remind us the development of artificial intelligence translates into outsized revenue and EPS growth, as well as outsized profitability.

G1 : EVOLUTION OF THE NIKKEI 225 INDEX



Source: Banque Eric Sturdza, Bloomberg, feb. 1985 to feb. 2024

February also saw the Japanese market continue to rise at a healthy pace. Here again, it's hard not to draw an historical parallel. By closing on the 40,000-point level, the Nikkei 225 index is almost back to its previous peak reached in 1989 at the time of the Japanese bubble. The parallel only goes so far. Valuations today are out of all proportion. Remember that in 1989, the value of the Imperial Palace alone was equivalent to that of the entire state of California. Reaching its previous peak has at least put the recent rise into perspective, but also reminded us that buying at the peak of the cycle carries the risk of losses that may take years to recover. After two decades of endemic deflation, its end is likely to continue to support the Japanese market. The Japanese economy's surprising technical recession, entered in Q4 should lift some of the pressure from the Bank of Japan's shoulders to become less dovish and as a side effect should limit the risk of the JPY appreciating too fast. Finally, some fresh and positive news came from China. While the Chinese markets remained on the sidelines in January, the Chinese New Year brought a new perspective and resulted in rebounding local equity markets against a backdrop of selective stimulus measures and support for the real estate sector. Whether this rebound occurred against a background of general market capitulation or marked the start of a new cycle has yet to be confirmed.

In this environment, maintaining a neutral but differentiated portfolio approach seems wise. Asia remains promising, with the rerating of Japan not complete and with China finally showing some signs of stabilization. In the United States, if some similarities can be drawn with the IT bubble, the strong results and outsized profitability of US tech champions also underline significant differences with today. With more stretched valuation and sentiment indicators, a short-term market pause would be healthy. Finally, as rate cut expectations have adjusted, fixed income looks a more attractive asset class compared with a few months ago.

2. FIXED INCOME

US INFLATION MUDDIES THE WATERS.

Federal Reserve: rate cuts are still a long way off

Despite the relief provided by the latest PCE Deflator and Core PCE inflation figures, the latest releases of the CPI and PPI inflation indices have cast some doubt. US inflation is not yet fully under control, and the Fed may yet surprise us again. The first eight weeks of the year saw a logical readjustment in market expectations towards those of the central bank. We went from “the Fed probably meant a minimum of three cuts” to “it will be three cuts maximum”, while a “zero cuts” scenario began to gain some momentum.

In the Eurozone, the ECB's situation is more tricky. The central bank is reluctant to cut rates too soon, for fear of sparking inflation, and would prefer to act after an initial easing by the Fed. Meanwhile, growth is taking a nosedive. Fabio Panetta, Governor of the Italian Central Bank, warned that it was already too late. The procrastinating result is that the ECB runs the risk of acting too late and finding itself forced to ease monetary policy even further. As a result, the German Bund's performance prospects are undoubtedly better than those of its US counterpart.

Duration in trouble

Inevitably, the part of the U.S. curve that has moved the most is the 2-year T-note, since short-term yield levels are mechanically dependent on the number of monetary rate cuts or hikes. However, high yield levels and the significant carry helped to cushion short term rates' rises pretty well, and losses were very limited. As far as long term rates are concerned, rebounds are less surprising but more painful, as is always the case when the curve begins a bearish flattening. However, the bond bull market is not over. We temporarily fell below 3.90% at the beginning of February following the bad news concerning certain US banks entanglements in CRE loans (commercial real estate mortgages). The CRE crisis is a black swan that is now turning grey!

Meanwhile, TIPS (Treasury Inflation Protected Securities) continue to perform, much to the satisfaction of their holders. TIPS are rather complicated instruments. Contrary to popular belief, their duration is roughly equivalent to that of Treasuries, and generally a little longer due to lower coupons. When real interest rates rise, long TIPS become a bloodbath. Remember that in 2022, the performance of TIPS indices was close to -13%, compared with -12% for traditional Treasuries indices, when some investors thought they had bought protection against inflation. This type of investment requires caution, vigilance and, above all, experience. But if used wisely, they can prove a highly attractive source of performance.

3. EQUITIES

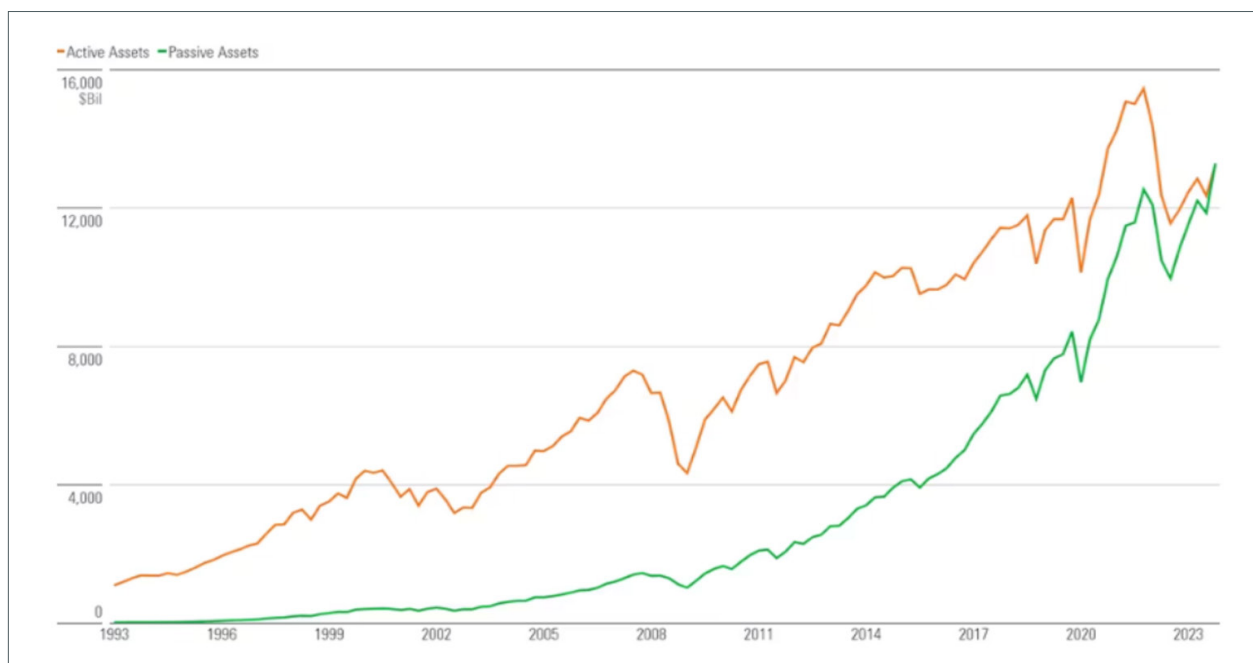
THE MAGNIFICENT SIX

There have been numerous publications about the concentration of performance in a small number of stocks in the US recently. Readers of the financial press will be surprised by the number six instead of the much-cited seven. Seven as in the famous mercenaries or seven as in the “technology heavyweights” who last year accounted for 73% of the rise in the Standard and Poor’s 500 index? With Tesla’s share price now half its November 2021 peak, its membership of this elite group is seriously challenged. Tesla is a carmaker with operating margins of barely 10% (a little less than Stellantis!) It’s not impossible that Tesla was just a temporary intruder among Microsoft, Nvidia and the rest.

The purpose here is not to determine whether the term ‘magnificent seven’, cleverly borrowed from American cinema, was appropriate or not, but rather to look at the possible consequences and risks of concentrating performance on a small number of stocks. Are the Magnificent Six or Seven forming an irrational bubble? Will they end up with three stocks (as in the film!), and is the rest of the market abnormally neglected?

Before trying to answer the question, it’s worth pointing out that the concentration of performance and weight in the indices is not confined to the US. If you are Danish and follow your national index, the concentration is even greater. Novo-Nordisk, thanks to its anti-obesity drug, now represents more than half the index! Closer to home, Novartis, Nestle and

G2: HISTORICAL FUND ASSETS – ACTIVE VS. PASSIVE



Source: Source Morningstar Direct

Roche Holdings continue to account for around 50% of the Swiss Market Index, despite the disappointing performances of the first two and various spin-offs from the latter's businesses. LVMH, with its string of double-digit publications, now accounts for 11.5% of the CAC. This is less extreme, but there is no doubt that the CAC is more concentrated than it was five years ago.

Concentration is not just an issue for stock managers trying to beat an index; it is an issue for all asset allocators. If we look at the components of today's best-known global stock index, 70% of it consists of US stocks. This is a consequence of the mega-capitalisation logic already mentioned. But it is worth remembering that the US accounts for "only" a quarter (in current dollar terms) of global GDP. Is a global index therefore really relevant?

Such situations have happened before. Anyone wanting to break into a cold sweat will recall that Nortel once represented more than a third of the capitalisation of the Canadian equity index (then the TSE 300). Nortel was the key supplier of hardware and software to the telecoms sector, until it lost more than 90% of its value in two years, finally filing for bankruptcy in 2009.

For an example of excessive 'country' concentration, we can of course look to the late 1980s. Japan, which represented 10% of world GDP at the time, accounted for half of the world index (according to Gavekal). Here again, the story does not have a happy ending.

There have been cases of concentration with happier outcomes, but these two examples are a reminder that choosing a benchmark index is not a trivial decision. At a time when passive management prevails over active management, a powerfully bullish spiral can be set in motion in the short term, which then turns deadly bearish in the long term.

Non-index managers (in orange on the chart) are underweight in the biggest names in the indices (the famous US 'Magnificents'). When allocators reduce their positions in these active funds and redeploy them towards 'index managers' (in green), the green managers instantly rebalance the top weights, making the 'Magnificent' even more so.

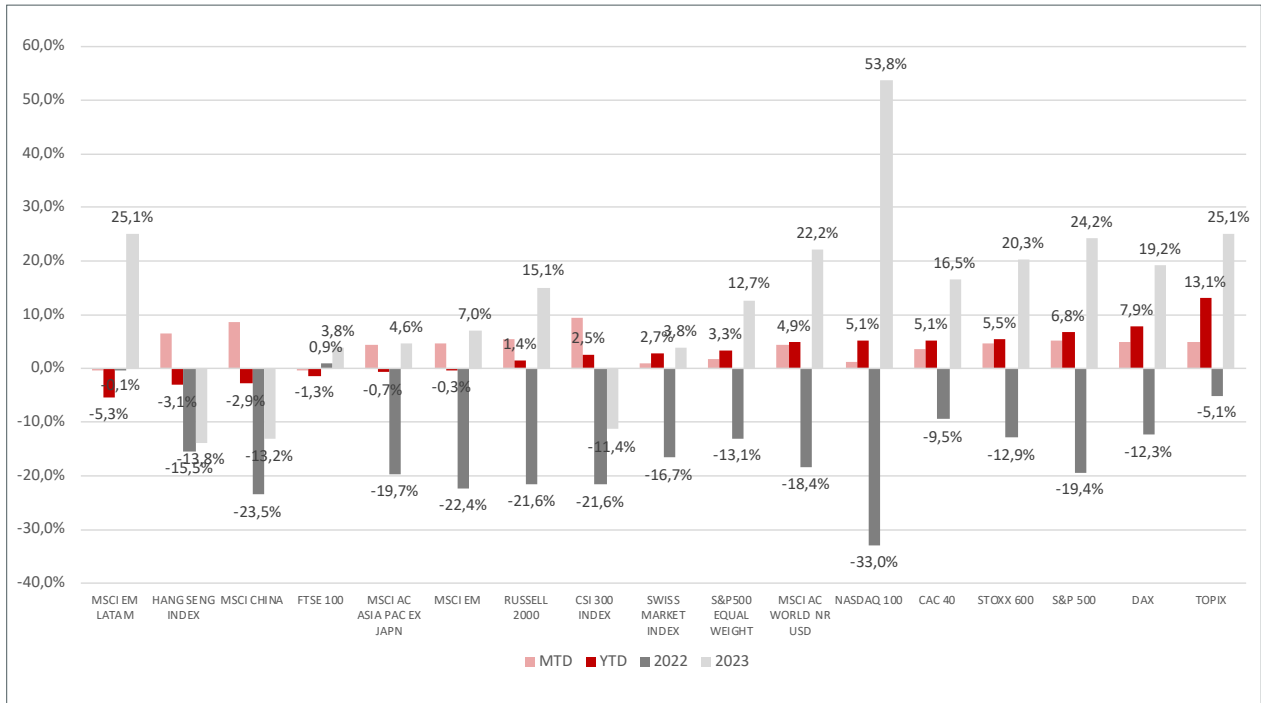
For those with bad memories of Nortel's fall, or the collapse of the Nikkei in 1990, rest assured, the average PE of the Magnificent Seven is now 30, according to JP Morgan. That's high compared with the Standard and Poor's average PE of 18, but in terms of their growth, we're not in the kind of Japanese-style scenario that we saw at the end of the 1980s when the PE for the whole market was 70!

This said, we need to keep a close eye on concentration for at least three reasons:

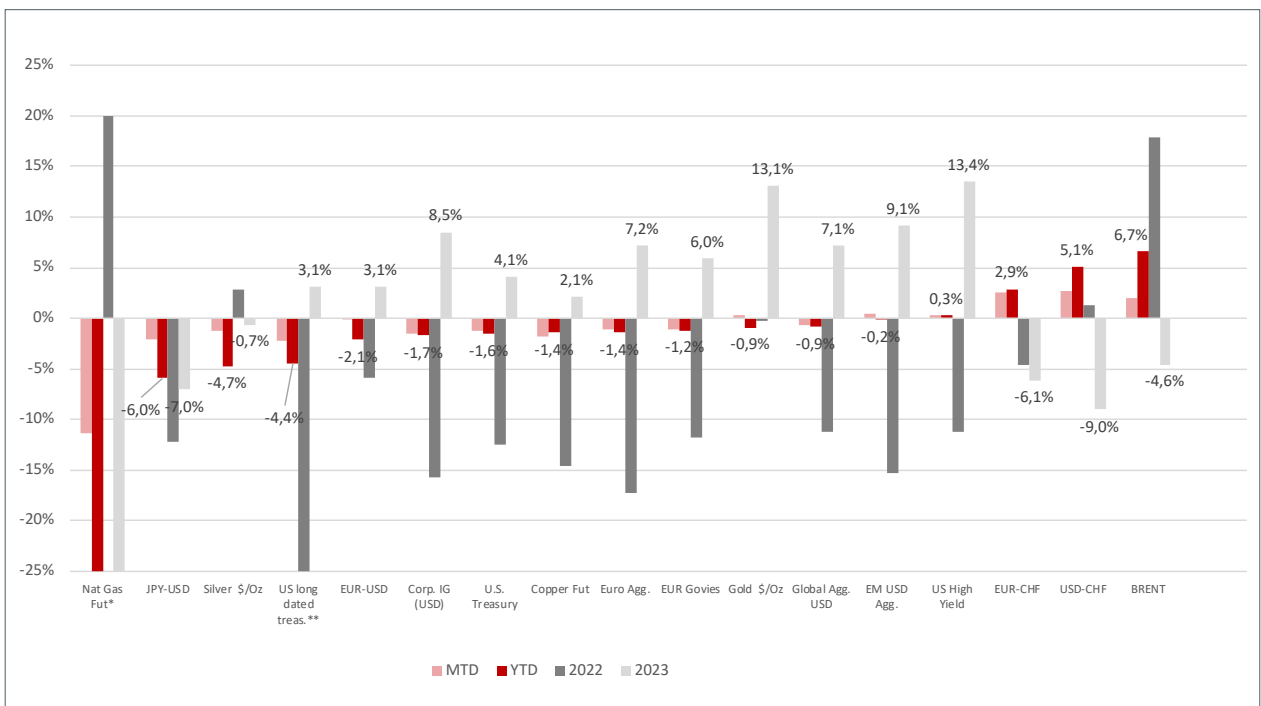
- 1. The mechanical indexation effect of passive management can send the machine into overdrive.**
- 2. Historically, too much concentration has led to many setbacks: Japan in 1989, but older investors will remember the Nifty Fifty of the late 1970s or the technology bubble of 2000.**
- 3. Finally, as the economist Harry Markowitz wisely said, diversification remains "the only free lunch", and this is what should guide our allocation today. We should not defy trends just because the behemoths are capturing the added value on stock markets, but we should keep an eye on other players and save money. There are, after all, still 2,993 smaller players on the Russell 3000, and even more in other geographies! All the more reason to respect Markowitz's cherished principle.**

5. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



FIXED INCOME, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 01/03/2024

* YTD: -26% , 2023: -43.8% ** -29.3% 2022

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Contributors

Edouard Bouhyer, CAIA – CIO

Marc Craquelin, Senior Advisor

Eric Vanraes, Head of Fixed Income AM

Pascal Perrone, Senior Portfolio Manager

Jeremy Dutoit, Head of Advisory

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Contact

Banque Eric Sturdza SA

Edouard Bouhyer

invest@banque-es.ch

www.banque-es.ch