BANQUE
ERIC STURDZA

MONTHLY NEWSLETTER
DECEMBER 2023

CONTENTS
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1. EDITORIAL

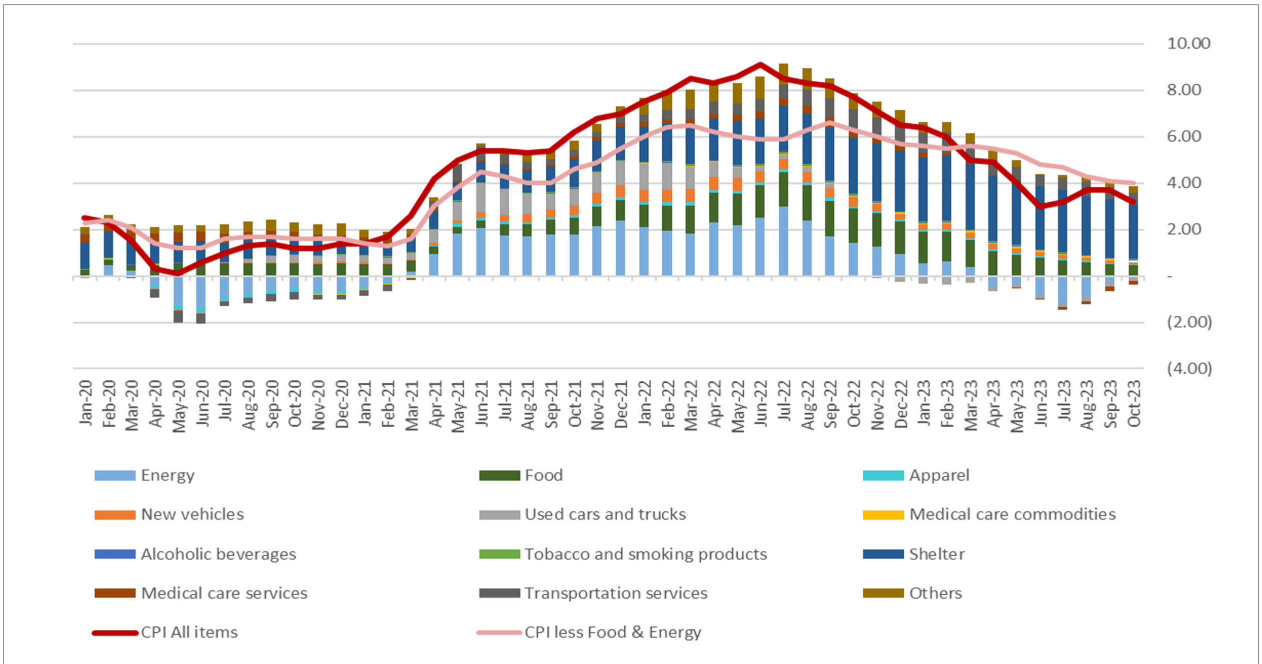
MIRROR EFFECT.

This is undoubtedly the image that springs to mind this November. After suffering in recent months from the rapid rise in US long-term yields (with the US 10-year yield even approaching the significant 5.0% threshold in October), financial markets are celebrating the easing in long-term yields seen this month. Financial markets like to surprise investors by swinging from one extreme to another.

As has often been the case over the last two years, inflation is at the root of these swings. The publication of a lower-than-expected consumer price index and that showed a modest 3.2% YoY increase served as a catalyst. While the disinflationary trend seemed to stall for several months, the slowdown in price rises has been welcomed by the financial community, especially since, excluding the contribution from "shelter", the price level would already be back within the Federal Reserve's target range. This is a good reason to hope that the Fed has completed its rate hike cycle, and even – for the more daring – to anticipate the first rate cuts.

Within a few weeks, the US 10-year yield fell from almost 5.0% to 4.4%, leading to a sharp rebound in fixed income markets most notably for long-duration bond positions. The other major adjustment variable is the US dollar which is overvalued vs. most G10 currencies and has therefore less reason to remain at a high level and is tending to fall, quite logically, as the Fed becomes more dovish. A weaker USD also translated into higher gold price. Equity markets are not immune to falling long-term interest rates, either, and are also rebounding, in particular growth stocks.

G1 : US CPI YOY AND ITS MAIN COMPONENTS



Source: BLS, Banque Eric Sturdza, 31/10/2023

While the easing in long-term rates will benefit both bond and equity markets in the short term, the medium term situation could prove more complicated. Indeed, if the fall in inflation were explained by a downturn in economic activity and a possible recession, the environment should remain favourable for long bonds, but probably much less so for equities. Another uncertainty remains the attitude of the Fed and a possible monetary policy reversal if inflation were to start rising again. Finally, while the trajectory of long-term rates is justifiable, the speed of the movement also calls for caution, as the risk of disappointment could be considerable if there is a slight reversal.

Other highlights of the month included the easing of oil prices, reflecting geopolitical risk perceptions, and in particular the diminished risk of regional conflagration in the Middle East.

We should also mention the tentative rapprochement between China and the US following the meeting between Xi-Jinping and Joe Biden. The business community is not indifferent to this thawing, given the two countries' economic interdependence. Although Chinese equity performance has disappointed again this year, this kind of news nonetheless bodes well for the 2024 propsects of Chinese equities. This is a point to which we return in more detail in our Equities section.

Although we indicated in our previous letter that we were becoming more favourable to the duration idea, the speed of long term rates' easing prompts us to keep the same calls, albeit with some caution.

- **Appetite for bond markets as a carry strategy, and also increasingly for duration, as the move into long rates seems to have run its course**
- **Maintaining a diversified equity portfolio: supplement US exposure with other geographical regions**
- **A "barbell" strategy that seeks to balance growth stocks with more value-oriented sectors.**

2. FIXED INCOME

DON'T GIVE IN TO FLEETING PLEASURES.

150,000, Sahm's rule simplified

During her time at the Fed, the brilliant economist Claudia Sahm found an ingenious and relatively simple way of predicting a recession. She took the three-month moving average of the unemployment rate and compared it with the lowest unemployment rate recorded over the previous 12 months. If the first result was at least 0.5% higher than the second, the US economy was expected to plunge into recession. And it worked! In the bond management community, we apply an even simpler rule: when job creation falls sharply to 150,000, expect a hard landing in the months that follow. The publication of Non-Farm Payrolls at the beginning of November was therefore even more important than usual, as we reached the symbolic figure of 150,000, synonymous with saying goodbye to a soft landing! The bond markets continued to hold up well after the publication of encouraging inflation figures (3.2% year-on-year). As a result, since the US 10-year briefly broke through the 5% barrier on 23 October, the bond markets have drifted. Is this a bear market rally?

For the time being, November's rise in fixed-income markets (the best monthly performance since 2008) is likely to invalidate our prediction of double-digit 2024 performance for Treasuries, unless we act in bad faith and consider that 2024 began on 23 October!

Duration is not dead

Be wary of ephemeral pleasures. This is how we now describe 'buy-and-hold' investments in money markets or very short bonds. It's always very tempting to lock-in attractive yields (though already much less so than in October). However, this strategy raises two problems. When these investments mature in six-to-twelve or 18 months' time, rates will be lower and not allow these investments be renewed at attractive yields. After that, the bond market's bullish train will have left the station and investors in short-lived pleasures will be left on the platform. We need to be ready to force ourselves to forgo returns that are certainly attractive in the very short term in favour of more dynamic strategies. Fiduciary deposits and other dated bond funds with short maturities are a thing of the past. They were the 'star' investments of 2023, but now it's time for duration!

3. EQUITIES

FOCUS ON CHINA: READY FOR CHINESE EQUITY TO SHINE?

China's economy growth is uneven this year

The export sector is struggling from weak global demand, the real estate sector remains a drag for investment growth, but the consumption is the bright spot, with the consumer service sector outperforming. After a broad recovery post-Covid, we see a split in recent months between high-end goods, which are largely doing well, and more price-sensitive segments. Consumers are more sensitive to price, and have traded-down to cheaper options. This is reflected in Q3 sale numbers of consumer companies. Good volume growth was often partially offset by weaker average selling prices. A prolonged property downturn and weak external demands are affecting consumer and business confidence in China.

China's reflation policy is ramping up

Chinese policy makers have taken a series of steps in recent months to stabilise economic growth, most importantly to restore confidence. They range from asset purchasing and increasing fiscal spending to supporting public housing and property developers.

In October, China's sovereign wealth fund has bought four big bank stocks as well as ETFs to strengthen their support for equity markets. The Chinese government, in a rare move, also sharply lifted its fiscal budget and approved 1 trillion yuan ($138 billion) worth of sovereign bonds for improving investments in urban infrastructure.

In November, specific measures were taken to stabilise property construction and growth, as well as support for property developers. The government plans to provide at least 1 trillion yuan of low-cost financing to the nation's urban village renovation and affordable housing programmes. This way, the government transforms some of the country's excess commercial property supply into public housing, helping young workers and migrants in large cities. Chinese regulators are also drafting a list of 50 developers who are eligible for a range of financing.

Constructive Xi and Biden Meeting

Within China's business community, US/China relations are the biggest concern. Presidents Xi and Biden's San Francisco meeting was seen as constructive, helping to reduce some of the geopolitical near-term uncertainty. Both sides have an interest in working together. There were a few signals about potential 'collaboration,' such as reducing trade restrictions, facilitating China's market access for foreign companies.

Both the US and China are preoccupied by their own economic priorities, rather than geopolitics. The US needs to find the right balance between growth and inflation going into an election year, while China needs to stabilise growth and its property market while restoring consumer confidence in the near term. This is despite the uneasy geopolitical relationship between the countries in the longer term.

Low valuations, reflation policy and improving geopolitics should set up Chinese equity outperformance

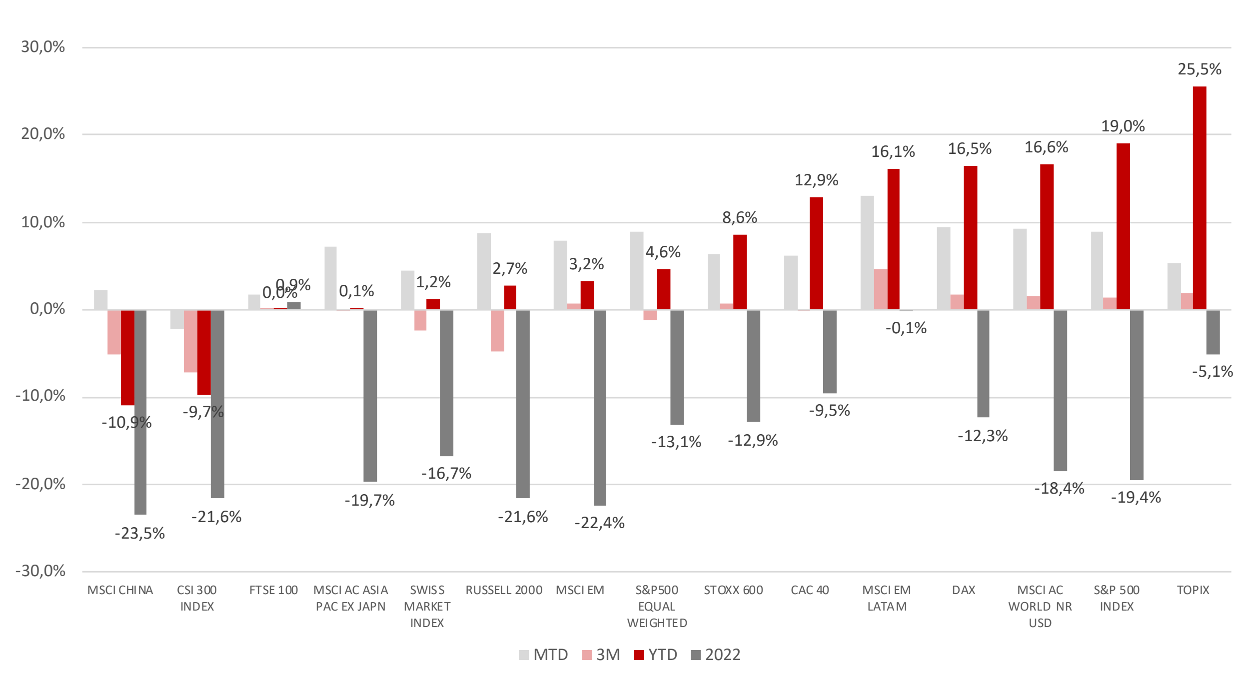
Chinese equities have the lowest valuations among the major equity markets globally (MSCI China trades x 10x fd P/E). The property downturn in China well-known, and restructuring is underway. China, with its 45% gross savings rate, is by far the highest saving country among large economies. The country now has USD 38 trillion in deposits.

If real estate is no longer an option for these savings, the equity market is. China's reflation policy and improving US relations will inevitably boost confidence. The latest economic data already point to improvements.

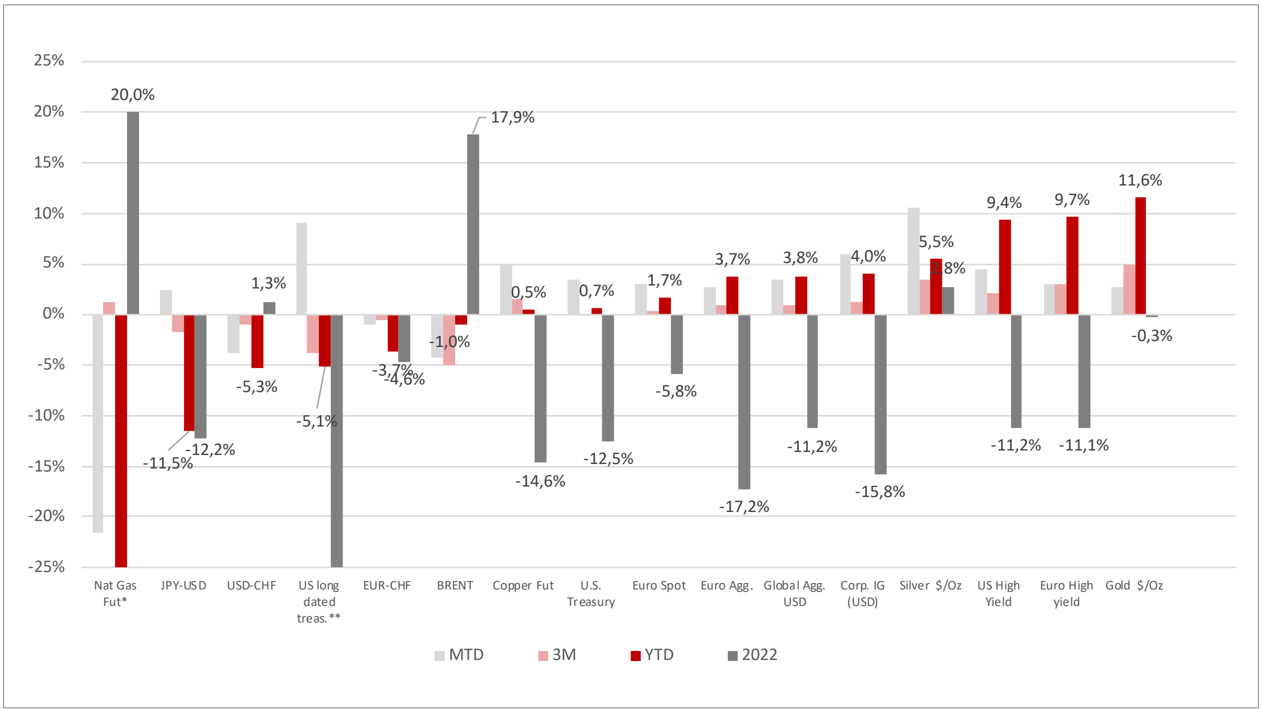
While Chinese equities have proved penalizing in recent years, the beginning of normalization in Sino-American relations, the voluntary policy of reflation and the low valuation of the Chinese market lead us to continue to consider China and by extension Asia as attractive investment areas.

5. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



FIXED INCOME, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 28/11/2023

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Sent to press on 28/11/2023

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