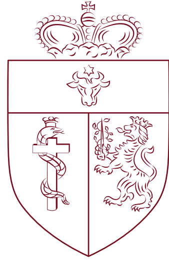

BANQUE
ERIC STURDZA

QUARTERLY OUTLOOK
4TH QUARTER 2023

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1. EDITORIAL

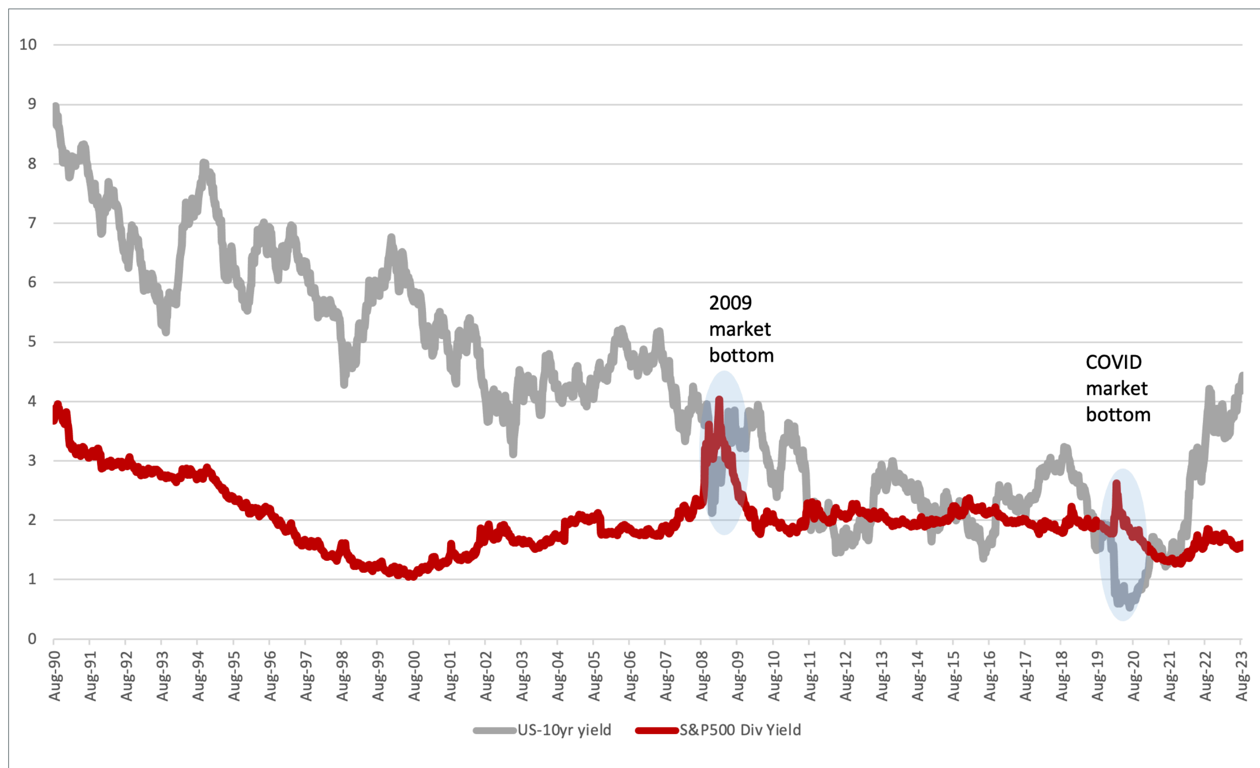
THE OLD AND NEW WORLD.

After quite an unsatisfactory summer for equity markets, September continued the sluggish downward trend, with significant declines even for the market's darlings. Even the flamboyant NVIDIA in the United States and LVMH in Europe are marking time. Nevertheless, the declines in the major indices remain reasonable: since the start of the year, the S&P500 is still up by 11.3% – but is flat in its equity-weighted version – and the STOXX600 by 5.2%. Analysts, most of whom had been overly cautious at the end of last year, are swallowing their hats and - more or less discreetly – raising their end-of-year targets for the equity indices.

After all, it has to be said that growth was slightly better than expected, and corporate results for the first half were satisfactory. The soft landing is very mild indeed, and the oft-touted recession seems to embody a paradox: it always comes closer but never reaches its target.

Nevertheless, a few signals are starting to flash: The pace of new payrolls in the US is slowing, default rates for private borrowers are rising, and default rates on high-yield bonds have risen from 1.6% to 3.2% (source: BOFA). These are not alarming figures technically speaking, but they do mark an inflection point.

G1 : S&P500 DIVIDEND YIELD VS 10YR BOND YIELD



Source: Bloomberg, Banque Eric Sturdza

As Jamie Dimon (JP Morgan's CEO) recently pointed out, *"tighter monetary policy has a lag, which means it's often unclear when rising interest rates start to harm the economy."*

Just a few days later, Johann Rupert (CEO of the Richemont group) made the point even more forcefully by declaring that inflation was beginning to impact demand for luxury goods. Signals from the micro-economy are therefore aligning with those from the macro-economy and point to a slowdown.

This type of configuration is usually accompanied by an easing in the interest rate markets, which are quick to anticipate a favourable shift in central bank policies. Nothing of the sort is happening at present. US yields are at record highs: 5.15% for the 2-year and 4.6% for the 10-year.

There are two possible interpretations of this divergence: either bond traders are optimistic and do not believe in a slowdown in the economy, or they are moving into a new world in which rates remain high because of persistent inflation. Rates would plateau, a different scenario from the start of the year, in which market participants were anticipating a bell curve with interest rates falling rapidly once they reached their peak.

Since the new world resembles the old world of double-digit interest rates, we'd be inclined to favour the second hypothesis. Nevertheless, we'd be wary of taking on too much by building portfolios around two strong ideas:

- **Renewed appetite for bonds for their carry, which as we reminded readers at the beginning of the summer, seem to us more attractive than the expensive' Standard & Poor's**
- **A 'barbell' equity portfolio: complementing growth stocks with more value-oriented sectors favoured by a higher interest-rate environment.**

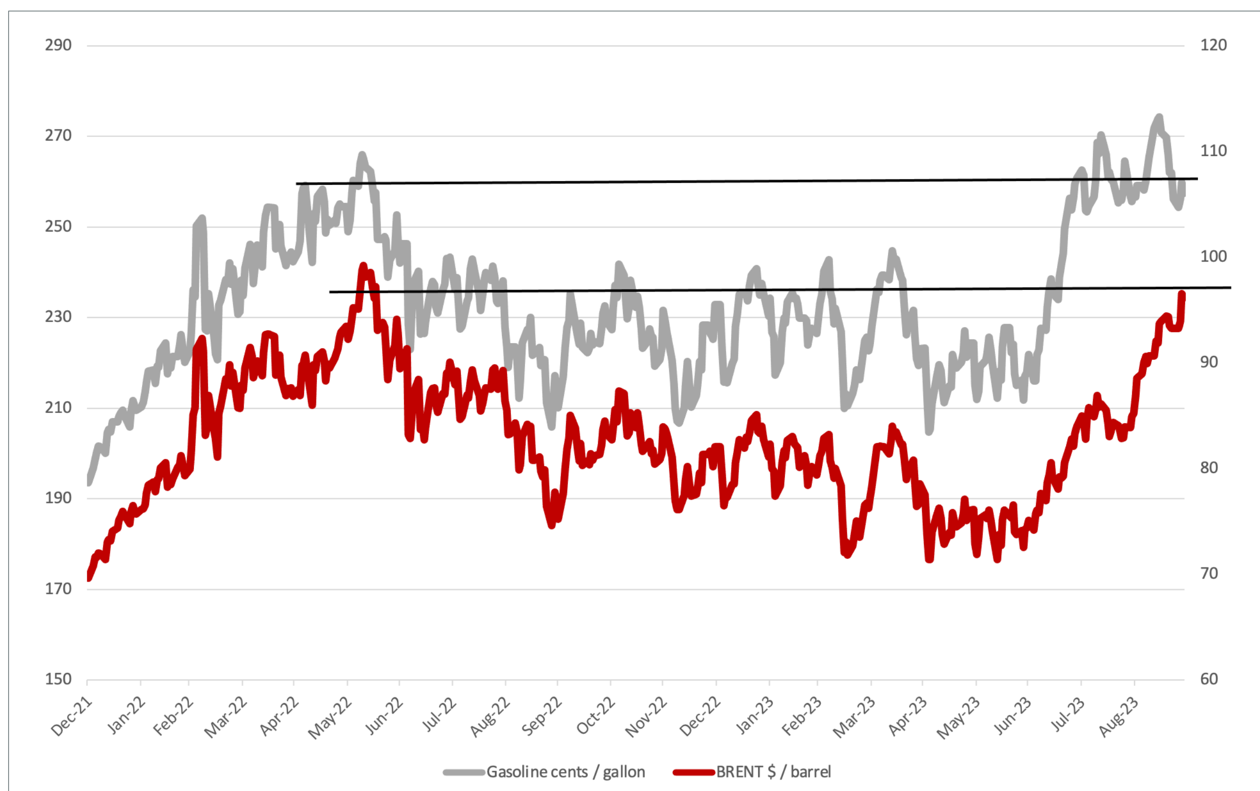
2. MACRO FOCUS

INFLATION, LONG RATES AND SOFT LANDING, THE Q4 COCKTAIL

In our previous macro chronicle and recent editorial, we returned to the paradox represented by the current situation. The US recession, foretold a thousand times, is taking a long time to materialise, confirming at least for the time being a soft-landing scenario.

A number of data point in this direction. GDP growth for the second quarter finally came in at 2.1% annualised, and the Fed's Nowcast, its instant forecasting model, even points to an acceleration in Q3. At the same time however, there are some doubts arising, with the sharp fall in job openings, student loan repayments that will start again in Q4 and the drying up of the savings pool accumulated during the Covid crisis. For now, growth is holding up as a result of a still tight job market, solid household consumption (albeit slowing) and still high public spending, but for how much longer? Unsurprisingly, financial markets are also showing some signs of weakness: equity markets are consolidating, and the 'Magnificent 7' (Apple, Amazon, Meta, Alphabet, Tesla, NVidia, Microsoft), though still sitting on significant year-to-date gains, no longer seem so untouchable. At 4.60%, the 10-year reached a high not seen since 2007, propelling some fears around the valuation of 'long duration' assets.

G2 : EVOLUTION OF BRENT PRICES (RIGHT SCALE) AND GASOLINE PRICES (LEFT SCALE)



Source: Bloomberg, Banque Eric Sturdza

According to the well-known adage "good news is bad news", good economic news that lends further credence to the soft landing thesis is far from reassuring investors. This is because it also reinforces the prospect that inflation may remain above the Fed's target and that rates may stay higher for longer. While the disinflationary trend seen since the summer of 2022 is real, a significant part of it stems from the fall in energy prices and very favourable comparison basis and base effects over the first part of the year. From this viewpoint, the OPEC-engineered oil price recovery over the past three months implies a tougher time on inflation. This is all the more true given that, excluding energy and food, the pace of consumer prices has fallen more slowly, which is hampering the central bank and making major rate cuts less likely in the short term.

While the disinflationnary trend seen since the summer of 2022 is real, a significant part stems from the fall in energy prices and very favourable base effects.

While inflation remains a major issue in developed economies, this is far from the case in China, which is flirting with deflation due to the persistent difficulties of the real estate sector. The warning was severe enough for the authorities to decide a month ago to introduce a series of measures aimed at restoring household confidence to support the sector, including lower down payment requirements for borrowers and reduced mortgage rates. While the measures are significant, they are targeted, and cannot be likened to a massive stimulus plan given the authorities' reluctance to unleash reckless behaviour, and trigger a new real estate bubble, given also their willingness not to increase the economy's dependence to this sector.

While these measures are likely to help support the sector, restoring Chinese household confidence in the real estate sector will undoubtedly take time, especially as real estate has often represented the main savings vehicle for the Chinese middle class. From this point of view, the pivot orchestrated by the authorities through measures taken in parallel to encourage financial savings and equity investing (lower stamp duty) is proving particularly interesting and likely to support Chinese equity markets in the long term.

While much has already been said on this subject, inflation is likely to remain central in the months to come, as the repercussions on long term rates and central banks' actions. Against this backdrop, the asset allocation repositioning work of recent months remains as relevant as ever.

3. FIXED INCOME

CENTRAL BANKS, THE INFLATION-RECESSION DILEMNA.

Is inflation governments' best enemy?

Since mid-September, central banks have been busy. The ECB led the way, followed by the Fed, BoE, SNB and Norges Bank, and finally the BoJ. The ECB set itself apart from the Fed by announcing that, barring an accident, this would be the last hike before a long pause on current rate levels. Inflation is high enough to justify this restrictive monetary policy decision, but the ECB is playing with fire, as the slowdown, which has already turned into a recession in some regions, could have caused it to hesitate and be cautious about passing this time. The following day, the Fed preferred to pause. The US central bank believes that a soft landing is possible, and that inflation will be brought down to around 2% after one or two more rate hikes, followed by a long pause that makes any hope of a rate cut in 2024 illusory.

Far from the rhetoric, it could be that some governments (and the US government in particular) don't take such a dim view of inflation over the past two years. Indeed, the mass of sovereign debt has soared to unsustainable levels. What's the best solution, short of default, to manage this burden? Inflation, of course! We are therefore likely to see a tug-of-war between central banks and governments, with the former continuing to press the brake pedal and the latter generously hitting the accelerator.

Fourth-quarter strategy

On the eve of a dangerous fourth quarter, let's remember what we were promised nine months ago: 2023, the year of bonds, 'bonds are back.' Credit and a few niche segments (corporate hybrids in particular) are doing really well, but the behaviour of the major government and aggregate indices has been disappointing so far.

We are now pursuing a strategy aimed at protecting portfolios in the short term (i.e. the fourth quarter) against any further unpleasant surprises. Thanks to portage and convexity, investors are relatively well protected. To lose money today on short 1-3 year rates, one would have to consider a correction of the order of 300bp! Similarly, investing in 10-year Treasuries offering a yield of 4.5% with high convexity means significantly maximizing your expected gain/risk of loss profile. We see three market segments to be favored in the short term. Firstly, 12-18 month US Treasuries at 5.3%-5.4%, then nominal and real rates (TIPS) in the 18-month-3-year segment, and finally good-quality Investment Grade credits with maturities of 2-5 years. The fourth quarter will be a complicated one on the interest-rate markets, which prompts us to remain cautious.

4. EQUITIES

WHAT IF IT WERE TRUE?

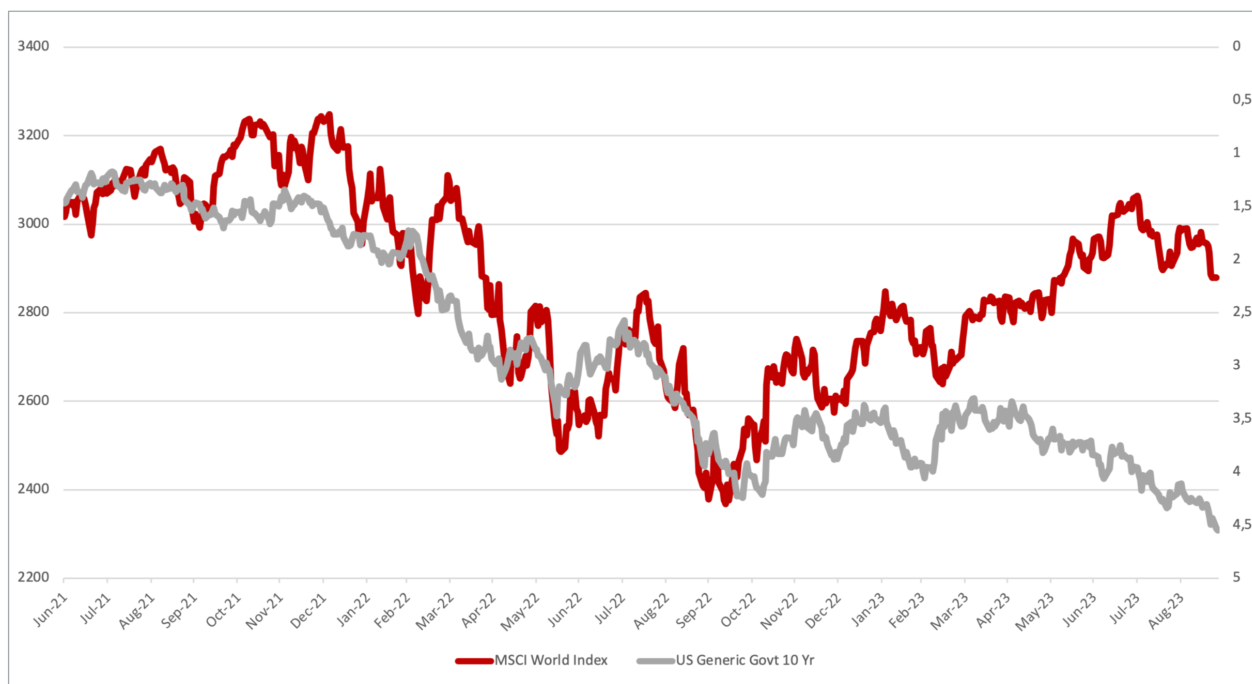
The first two quarters of the year left their mark, both in terms of the confirmation of certain bullish movements that had been little anticipated at the start of the year, and in terms of an optimism that seemed to stand up to every test, particularly in the US. Nothing seemed able to halt this mild euphoria, not even the US 10-year yield, which hit a record high to cross the October 2022 peak above 4.33%.

On July 31, the S&P 500 posted an annual performance close to 20%, the Nasdaq100 was climbing more than 40%, still driven by the same seven major technology stocks, and even the Dow Jones Industrial gained almost 9%. In Europe, the Stoxx 600 climbed 11%, buoyed by the Italian, Spanish, French and German markets. In China, the domestic market and Hong Kong were in positive territory, and in Japan, the Topix soared over +25%.

Since then, things have changed. The third quarter proved less linear. By the time of the big summer crossroads, in midsummer, a different market phase had emerged. Since 1 August, the S&P500 and Nasdaq have shed around 6-7%, the Dow Jones 4%, the MSCI China more than 10% and Europe 3.0%. The only bright spot in the picture is that the Japanese market continues its upward trend and, unlike the rest of the world, is positive over the period (+2%).

Second quarter results showed a consolidated drop in earnings, even if they exceed expectations, the return of worries about China's real estate sector and the downward revision of growth expectations, the

G3 : MSCI WORLD INDEX (LHS) VS. US 10-YEAR YIELD (INVERSED RHS)



Source : Banque Eric Sturdza, bloomberg

resurgence of inflation, and the US 30-year mortgage rate approaching 8%, PMIs dipping towards the 50 threshold in the USA (trend reversal level) and sinking towards 40 in Europe, dragged down by the manufacturing sector, the hawkish tone of the Fed, the stalemate in the war in Ukraine, the return of high tensions in Africa and around the China Sea - these were just some of the elements that disrupted the end of summer and prompted us to be more cautious for the start of September.

But what if it were true?

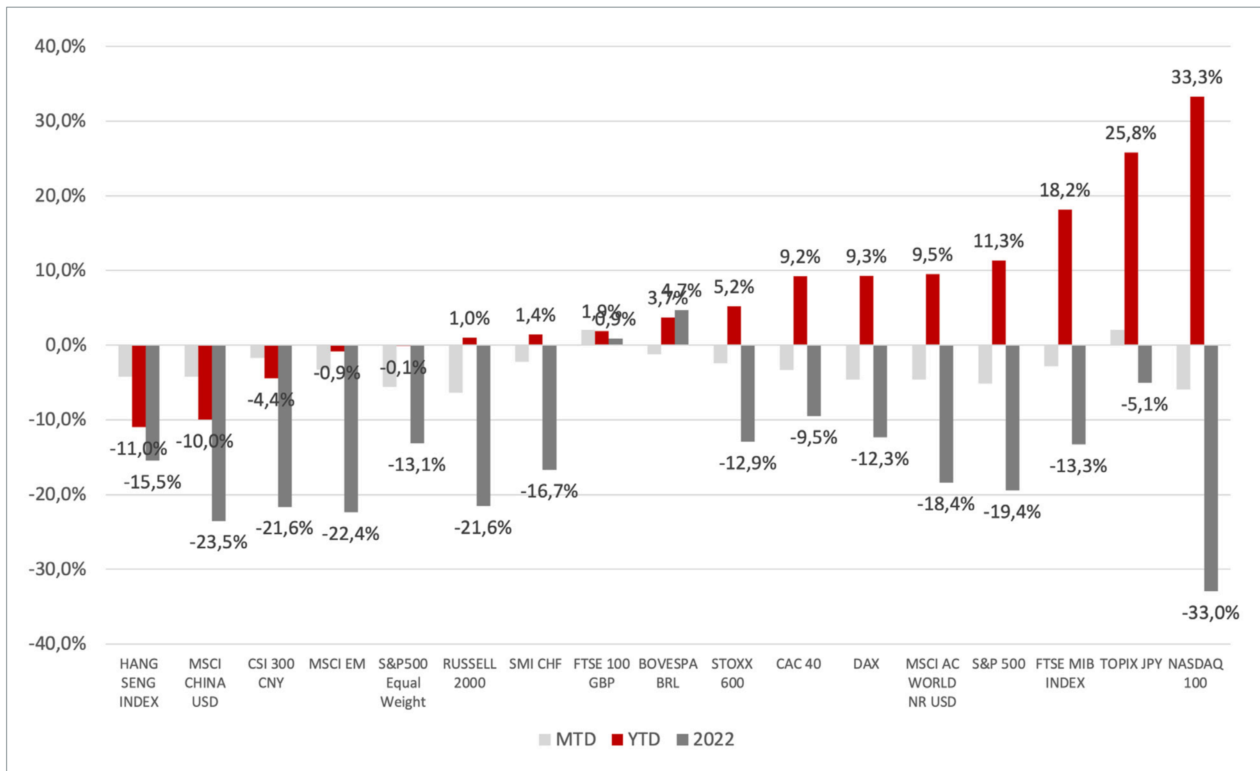
Optimism seems to be slowly fading. In our previous publications, we mentioned that base effects suggested a pick-up in inflation in September, linked in particular to oil prices. This has now happened, and the 2% target now looks very difficult to achieve in the short term. Inflation has picked up to 3.7%, and the figure excluding energy and food costs (core inflation) is down but still above 4% (4.3% in August).

This was all it took for Jerome Powell to reaffirm his restrictive policy, even though the central bank decided not to raise rates in September. The US yield curve adjusted in just a few sessions. Yields climbed, and the 10-year yield broke through a ceiling to stand at 4.60% at the time of writing. The market is nodding in agreement that rates could be higher than anticipated, and especially over a longer period. Let the world be warned, Mr Dimon is announcing a "worst-case scenario" with rates at 7% and stagflation.

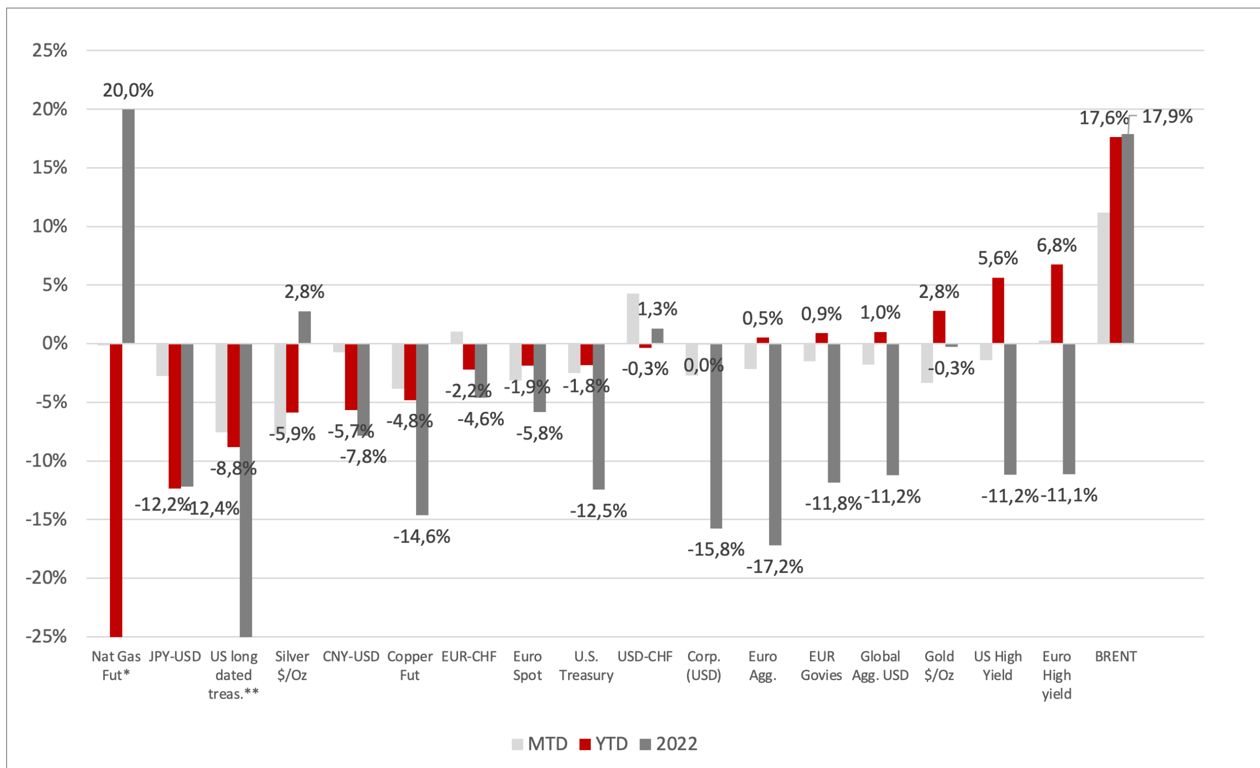
In such a situation, it seems justified to remain cautious on the equity asset class, where selective opportunities remain and where bond yields are asserting themselves as a strong competitor. Equity flows in Asia are also largely being redirected from China to Japan and other regions such as India and Vietnam. These major movements are causing disparities in performance, but without triggering massive stress. Volatility (VIX index) is rising, but remains relatively contained, at under 20% on both sides of the Atlantic.

6. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



FIXED INCOME, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 28/09/2023

** Natural Gas: -38.2% YTD*
*** US long dated treasuries: -29.3% 2022*

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