Monthly Update | Issue 87

27 September 2023

Cash & bond yields are significant competition for stocks

Key takeaways:

- After a strong first half of the year, the mood has shifted during the Summer as markets are adjusting to the reality of "persisting inflation & sticky rates", a narrative which is adding pressure on equities and valuations.
- While equity and bond market volatility could persist in the short-run, particularly through a historically choppy September/October, we expect more positive market conditions towards the end of the year. Indeed, with the US & global economy cooling down in the months to come, central banks are expected to pause their monetary policy tightening. This would be a positive for equity and bond markets over time.
- We remain neutral on equities, rates and credit. Cash and bond yields are a clear competition to equities and our multi-assets portfolios reflect this reality. We are negative on the EUR and CHF against dollar. We upgraded Swiss equities to positive. We are keeping Gold as a diversifier.
- We continue to favour 3 main investment themes: 1) Diversify into the lagging segments of the equity market that carry lower valuations; 2) Use volatility at our own advantage by buying on pullbacks; and 3) Use the bear steepening of the curve to extend duration within fixed-income portfolios.

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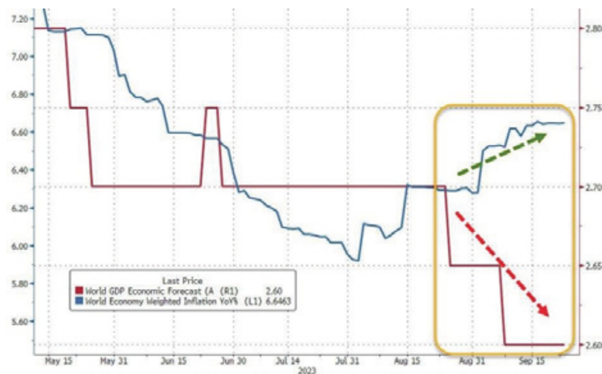
The big picture

The bull market which took place between October of last year and the month of July was driven by two strong trends: 1) Disinflation and; 2) The Artificial intelligence "mania". Markets were embracing the prospects of a new "goldilocks" scenario with a cooler economy but neither too cold nor too hot, leading central banks to pivot their monetary policy towards a gradually less restrictive stance.

However, the uncomfortable combination of rallying oil and US long end breaking up is disrupting this equilibrium and triggering concerns of another episode of "stagflation" fears.

This chart explains by itself why the market mood has been deteriorating over the last few weeks: growth forecasts moving down / world inflation going up



Source: Bloomberg, www.zerohedge.com

Indeed, projections by OPEC of a supply/demand imbalance close to 3 million barrels a day in the fourth quarter of the year has triggered a rally in oil prices. Meanwhile, the resilience of the economy and signs that inflation is stickier than expected have been pushing long-term bond yields to new highs. Indeed, the yield of the Bloomberg Global Aggregate Total return index is at its highest since the months that preceded the Great Financial Crisis.

Equity markets are now getting uncomfortable with those rate levels. We also note that the last leg up in yields has been accompanied by an outperformance of defensives over cyclicals. Key indices (S&P 500, Dow, Nasdaq) trade below their 50 day and 100 days moving averages. For the 1st time since March, the S&P 500 is down more than 5% from its high. Volatility is making a come-back with the VIX trading above 17. Global equities ex-US are faring even worse.

Interestingly, the pause by the Fed at the September FOMC meeting didn't provide the boost some were expecting. As anticipated, the Fed held rates steady at 5.25% - 5.5% at this meeting, but kept the option of an additional rate hike on the table, maintaining its outlook for a peak Fed Funds rate of 5.6%.

The message from Jerome Powell was clear: The Fed will continue to keep rates elevated until inflation moves more convincingly toward 2.0%. The Fed's new set of projections also reduced the number of potential rate cuts in 2024, from 1.0% to 0.5% of cuts next year – implying that the elevated interest-rate environment may last longer than expected. Meanwhile, the Fed continues to reduce the size of its balance sheet through quantitative tightening.

Another concern for investors is the lag effects of the rise of interest rates on the real economy. Renewed weakness by US banks stocks seems to indicate that the most aggressive rate hike cycle in recent history will not leave the economy and financial system unscathed. This might explain the surprising statement by Fed Chair Powell, who said he would not call soft landing a baseline expectation, hence sharing his fears that keeping real rates elevated for a long period of time is creating some downside risks for the economy and the markets.

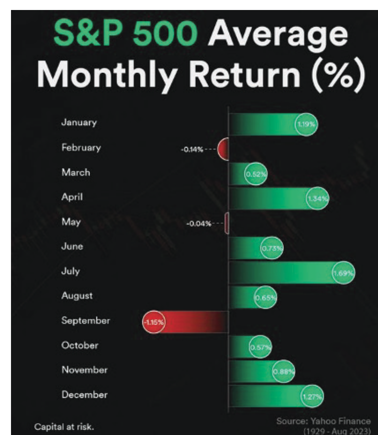
US 10y real yields (10y nominal yields - 10y inflation expectations) jumped to 2.11%, the highest since 2009

On a more optimistic note, US earnings revision trend remains positive. If consensus estimates prove true, the second quarter will mark the end of the earnings downturn. S&P 500 earnings are expected to turn positive in the third quarter and rebound further in 2024. The combination of positive earnings growth simultaneously with the Fed finally pausing could very well help equity markets to resume their uptrend.

We also note that the amount of shorting in US equities by hedge funds since mid-August is the largest in six months and ranks in the 98th percentile vs. the past decade (source: Goldman Sachs). Meanwhile, the level of short gamma is the highest in a long time. We need to keep in mind that these kind of moves work both ways, so a possible bounce from here would force hedge funds and dealers to buy back the stocks they sold recently.

Last but not least, seasonality will soon turn positive There are only 100 days left in 2023 and we are getting closer to the most favourable period of the year for stocks. Almost 80% of the time, the S&P 500 records gains during the last 100 calendar days of the year.

Based on history, the S&P 500 will soon enter the most favourable months of the year



Source: Yahoo Finance

In the next section, we respond to the frequently asked questions from clients. We present our latest asset allocation decisions based on the 5 pillars of our asset allocation process. To conclude, we suggest three investment themes for the months to come.

Frequently asked questions (FAQs)

FAQ #1

Where do we stand in our global growth scenario?

Recent months have delivered some surprises and some long-awaited confirmations on the global economic front.

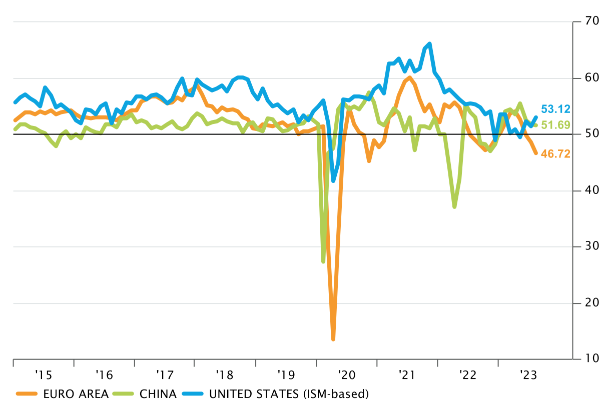
The US economy has continued to surprise to the upside, extending its streak of positive economic data surprises at play since the beginning of the year, thanks to unabated domestic demand for services.

The European economy has continued to surprise to the downside, with an unexpected sharp deterioration in economic indicators over the summer, as the impact of more restrictive financing conditions began to filter through economic data and added to existing headwinds already in place since 2022.

The Chinese economy has finally shown signs of stabilization, after a long period of slowdown and disappointing data over the Spring, when the post-reopening recovery failed to match expectations. The long-awaited stabilization in China's economic growth now appears to take shape.

Our take: The global economy is exhibiting unusual desynchronization at the moment, with very different growth dynamics between the main drivers of global growth. Such desynchronization cannot last for very long. While China can remain in a cycle of its own, the US will likely lose momentum at some point and narrow the existing gap with Europe.

Unusual desynchronization



FAQ #2

US economy: a "soft landing" after all? or a delayed recession?

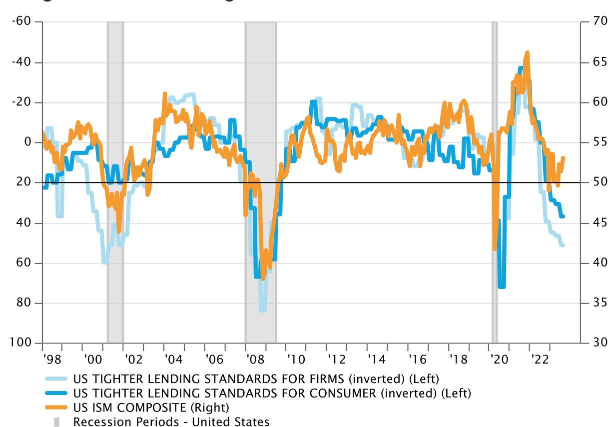
The US economy has proved to be surprisingly resilient throughout the summer, as the strength of consumer spending, supported by a still tight labor market, has defied expectations of a slowdown.

The scenario of a "soft landing" in growth, in which the US economy would gently slow down under the impact of higher rates, but without stalling or falling into recession, has therefore gained some credibility (being even adopted as their central economic scenario by a few large US banks).

The early "real-time" estimate of Q3 GDP growth currently pointing to 4.9% annualized GDP growth for Q3 only reinforce the sentiment that a US recession might be avoided after all, and that growth will gently converge toward its long-term potential of 2%.

Our take: The longer US consumers are able to extend their spending spree, the more likely a "soft landing" scenario becomes plausible as it allows for the ongoing correction in cyclical sectors (industry, real estate) to be absorbed without broader damages to the economy. However, several leading indicators continue to point to downside risks ahead and a recession in 2024 (not necessarily a very deep one) still appears as the most likely scenario.

US growth is more fragile than most think



FAQ #3

Europe: already in recession, but how bad will it be?

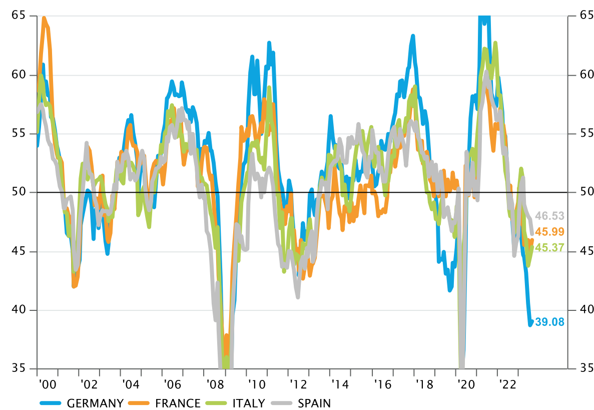
Economic indicators have been deteriorating sharply in the Eurozone over the summer, to the point where the question no longer appears to be "recession or no recession?" but rather "how bad is/will be the recession?"

Industrial and manufacturing activity was already under pressure since 2022 but the dynamic has deteriorated in the recent months, especially in the "powerhouse of Europe", Germany, where industrial activity is sharply contracting.

Service sector activity, that had continued to expand so far as low unemployment supported consumer spending, has recently turned negative as well and likely drove the Eurozone into recession in the course of the Q3. The tentative recovery in consumer sentiment from the "peak energy concerns" of late 2022 is now reversing down.

Our take: the Eurozone had been fragilized by the ripple effects of the war in Ukraine (energy prices, inflation in food prices, sanctions on Russia weighing on exports). The impact of rising rates appears to have "broken the camel's back" as activity in the service sector has turned south in the summer. With the ECB forced to maintain a restrictive monetary policy as it faces an uncomfortable combination of slowing growth and too high inflation, the growth outlook for the Eurozone appears bleak. Especially as rising energy prices are currently inflicting an additional blow to consumers already in a difficult situation.

Europe is facing serious headwinds



FAQ #4

Is China finally stabilizing?

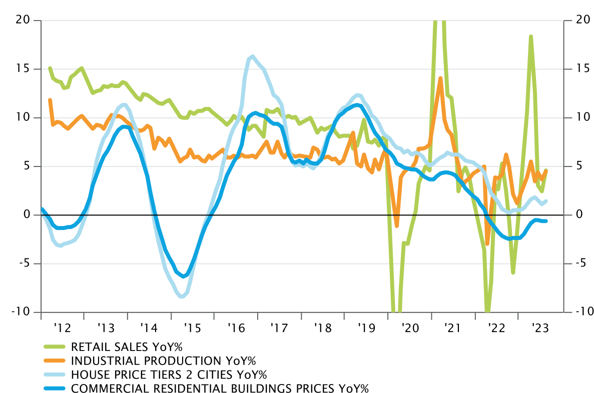
The Chinese economy had been on a slowdown trend for the past three years, under the successive and combined pressures of Covid-related restrictions, regulatory crackdowns on several sectors and a real-estate market correction.

For the past year, Chinese authorities have taken numerous gradual steps to stem this slowdown and prevent an economic crisis. But they have refrained from delivering large-scale stimuli as they wanted to avoid fuelling another credit-led bubble like in previous crises.

This approach eventually appears to bear fruits, as latest data on consumption, industrial activity and real estate prices point to a stabilization at levels that might be consistent with the government's goal of sustainable and balanced economic growth of 5%.

Our take: the combination of successive small rate cuts, selected easing in credit conditions and selective targeted government support appears to eventually succeed in engineering a stabilization in China's growth dynamic. An extension in recent trends would allow China's GDP to reach the government's 5% target for this year. Such stabilization in China's growth would remove a significant headwind having weighed on global growth in the past three years.

Signs of stabilization in China



Banque Syz, ©FactSet Research Systems

FAQ #5

Where do we stand in our expected «disinflation scenario»?

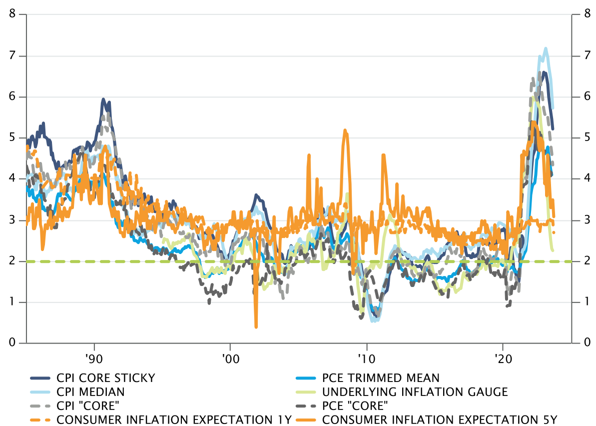
Headline inflation peaked in the second half of 2022 across large developed economies and has been slowing down since then as Good prices' inflation (coming from supply chains' tensions) and energy prices trended lower. The impact of those two drivers will gradually wane off from 12-month rolling inflation rates going forward.

"Core" inflation has followed with a lag but has only slightly slowed down in the US and Europe for now, as Service prices' inflation remained fuelled by firm consumer demand (especially in the US) and rising wages and labor costs. "Core" inflation is still clearly above central banks' targets.

Leading indicators and gauges of consumer and business inflation expectations have been trending lower recently on both sides of the Atlantic.

Our take: the scenario of a gradual slowdown in underlying inflation dynamics remains in place. The combination of labor market normalization, of higher rates and of slowing economic growth (especially in Europe) will gradually cool down upward pressures on prices. In this context, the recent rise in energy prices is more likely to be an additional headwind for growth than to trigger another round of underlying inflationary pressures.

A gradual slowdown in underlying inflation dynamics remains in place



FAQ #6

Is there a risk of stagflation?

The burst in inflation post-Covid was initially triggered by supply factors (scarcity of goods, commodity prices) that have mostly normalized. It then morphed into demand-driven inflation, led by strong consumption and tight labor markets, that a slowdown in final demand has recently started to dampen, as reflected by moderating "core" inflation indices.

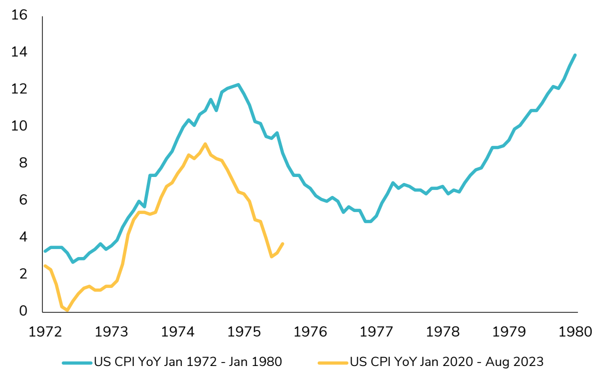
With economic growth already slowing down sharply in Europe, and expected to cool down in the US, this "disinflationary" trend should extend further and gradually bring back inflation rates toward central banks' targets of 2%.

Still, there is a potential alternative scenario: what if the successive shocks mentioned above, combined with new structural trends such as reshoring, unfavorable demographic dynamics (baby boomers' retirement, tighter control of immigration), result in persisting inflationary pressures, regardless of a slowdown in economic growth?

The economist's take: our central scenario (i.e. with the highest probability) remains one where economic growth slowdown will dampen inflationary pressures by easing labor market tensions and lowering demand for goods and services. However, the risk of a Stagflation scenario, where inflationary pressures would persist for structural reasons despite an economic growth slowdown, cannot be ruled out

at this stage. We have integrated this as a “tail risk” in our scenario and asset allocation.

The risk of stagflation is real but is note our core scenario



FAQ #7

Have we seen the end of the central banks’ rate hike cycle?

The past two years have seen the most violent and coordinated global rate hike cycle in recent history, across all developed and most emerging economies (China being the noticeable exception).

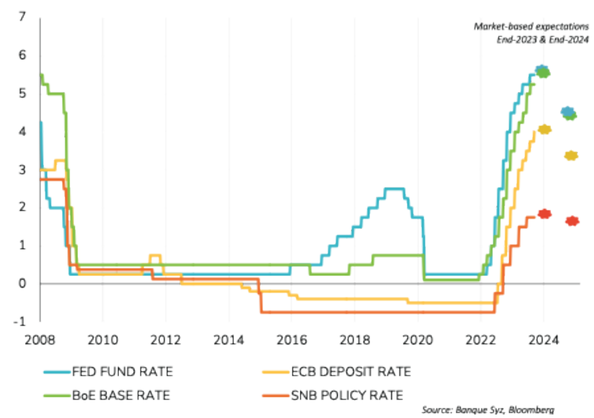
As inflation dynamics appear to be peaking globally, while economic growth is losing momentum or even deteriorating in some regions, it appears increasingly likely that the global cycle of central banks’ rate hikes has or is about to end.

The ECB, constrained by its single inflation mandate, has been forced to raise its key rate by 25bp in September despite a sharply worsening growth outlook, but is unlikely to continue on this path. The Fed, the BoE, the SNB all face situations where they either could pause already or deliver one last hike before pausing. Large EM central banks had been ahead of their DM counterparts and some of them (notably Brazil) are already reversing course.

Future markets are also pricing such “peak rate” scenario and assign a limited probability of one last hike before year-end for large DM central banks, before some rate cuts in 2024.

The economist’s take: The global rate hike cycle has reached its end in September. The ongoing growth slowdown across DM economies, and its impact on underlying inflationary dynamics, will not warrant additional monetary policy tightening going forward. Whether rate cuts will be implemented in 2024, and how many, will depend on growth and inflation developments.

The global rate hike cycle might have reached its end in September



The weight of the evidence

Our asset allocation preferences are based on 5 indicators including 4 macro & fundamental indicators (leading) and 1 market dynamics (coincident). The weight of the evidence suggests a neutral allocation to equities. Below we review the positive and negative factors for each of them.

Indicators review summary - our five pillars

	WEIGHT OF THE EVIDENCE (+)	WEIGHT OF THE EVIDENCE (-)	
MACRO CYCLE	The US economy remains supported by domestic consumption. Fiscal intervention continues to be a support to economic growth on both sides of the Atlantic.	Economic growth is slowing down globally. Europe is losing steam while China's weakness is a concern. Tighter financing conditions will ultimately impact growth.	NEUTRAL
LIQUIDITY	We are getting closer to the end of rate hike cycle.	Central banks might continue to keep QT and interest rates at elevated levels even during a recession.	NEGATIVE
EARNINGS GROWTH	Top-line growth and margins have been resilient in H1. Earnings revisions are positive and earnings momentum is expected to improve going forward.	AI-driven margins improvement are most likely overpriced. Positive earnings revisions are decoupling from PMI surveys.	NEUTRAL
VALUATIONS	Absolute valuations have improved recently. Excluding, P/Es are at or below historical average.	Equity risk premia are at or close to record lows. There is competition from cash and bonds	NEUTRAL
MARKET FACTORS	The trend remains a positive (but S&P 500 is now below 50 day moving average). High-Low is back to positive.	Breadth has been disappointing. Markets are not oversold yet	POSITIVE

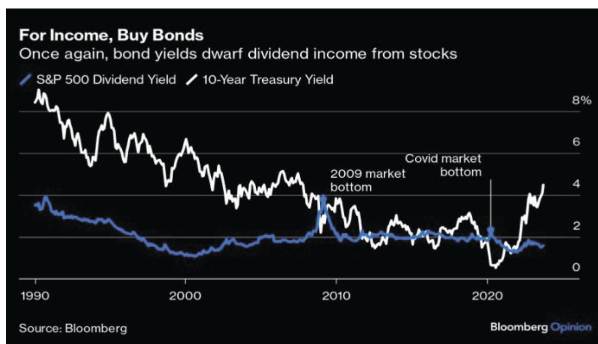
Asset Allocation

EQUITIES

We have a NEUTRAL stance on equities with a slightly positive view on the US, Japan and Switzerland (upgraded from neutral), a neutral view on the UK, EM Latam and China/EM Asia and a slightly negative view on Eurozone and other EMs.

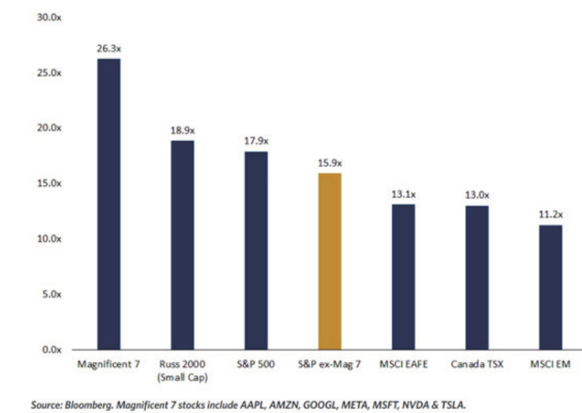
As mentioned earlier, earnings revision has been a tailwind for equities during the first 9 months of the year and if consensus is right, earnings momentum will turn positive in 3Q and 4Q this year. From a valuation perspective, US equities large caps remain expensive both on an absolute and relative basis. Importantly, cash and bond yields create significant competition for stocks. Treasury yields now surpass stock dividend yields by the widest margin since the Global Financial Crisis.

For income, buy bonds



But this relative expensiveness is mainly explained by the high valuation multiples of the "Magnificent 7". Valuations outside of this specific segment of the market appear less stretched (see chart below).

Valuations are more reasonable outside Technology (forward P/E ratio)



We are upgrading Swiss equities from neutral to positive due to their defensive characteristics and the fact the Swiss National Bank is probably at the end of its monetary policy tightening cycle.

FIXED INCOME

Within Fixed Income, we are maintaining a neutral stance on both Rates and Credit, with a slightly positive outlook on Investment Grade and a slightly negative view on High Yield.

While last year's rise in interest rates was primarily due to concerns about inflation, this year, higher yields appear to be driven by the market's improved perception of economic growth potential, resulting in real interest rate levels not witnessed in decades. Conversely, we recognize the potential for lower rates due to a global growth slowdown. In this rate environment, we recommend gradually extending duration, as there is an attractive asymmetry in long-term rates, supported by expected moderation in growth and inflation. The resurgence of oil prices could temporarily weigh on short-term rates but increases the case for a long-term growth slowdown.

Considering our concerns about the Eurozone's growth outlook and the potential conclusion of the ECB rate hike cycle, we are adopting a neutral stance on EUR rates. Within the credit space, our neutral stance emphasizes high-quality corporate bonds. We are avoiding the pursuit of higher yields in the High Yield sector due to overpricing relative to risk. In Emerging Market debt, we maintain a vigilant stance due to valuation and potential risk considerations. Higher oil prices and a strong US dollar pose challenges for oil-importing EM nations, especially Asian countries, while some Latin American countries may benefit.

The Bloomberg dollar index (DXY)

Source: TME, Refinitiv

FOREX & ALTERNATIVES

On the forex side, we remain negative on EUR and CHF (versus USD) and neutral on JPY, GBP and EM currencies (versus USD). The dollar index ($DXY) golden cross is now in place.

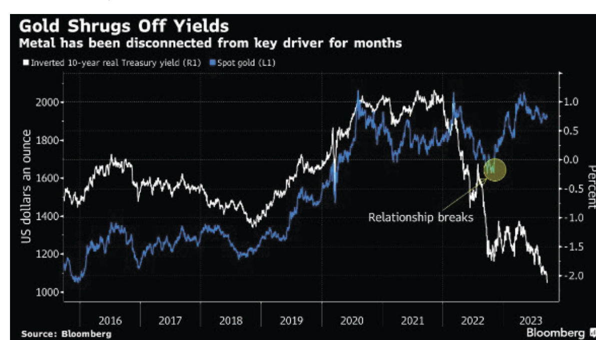
US 2- and 10-year Treasury yields moved to new cycle highs following the Fed meeting

Within commodities, we remain positive on gold, which continues to exhibit low volatility with other asset classes and should be a beneficiary of any tail risk event. We note that a significant gap has opened up between gold

and real yields. Why? 1) With debt sustainability having become an ever-increasing issue, the market anticipates that real interest rates cannot stay at this level for too long; 2) Investors buy gold as an insurance against adverse circumstances (inflation, recession, etc.). But for gold to appreciate in dollar, a drop in real yields is probably required. In the meantime, gold remains a true diversification asset.

We also maintain our positive view on Hedge Funds. We like well-established Global Macro funds that have a multi-portfolio managers approach. We cautiously like Relative Value funds but are wary of liquidity conditions. We like having a core position in a diversified systematic strategy with a long-term commitment. We prefer staying away from Equity long/short and directional funds as their beta is too high. We do not like Event Driven funds as we believe the merger & arbitrage landscape will be very challenging in 2023.

Gold shrugs off yields



Source: Bloomberg

Tactical positioning: our asset allocation matrix

	--	-	NEUTRAL	+	++
Portfolio risk			Equities Credit Spreads Rates		
Equities		Euro zone Other EM	United Kingdom China & EM Asia EM Latam	United States Japan → Switzerland	
Fixed Income		HY Credit	Government Bonds Subordinated debt EM Hard EM Local	IG Credit	
Yield curves			USD EUR “peripheral” CHF GBP	EUR “core”	
Forex (vs USD)		EUR CHF	EM currencies GBP JPY		
Commodities		Commodities		Gold	
Alternative Investments				Hedge Funds	

Change from last month → More attractive ← Less attractive

Source: Investment strategy group - 22 September 2023

Investment conclusions

A “goldilocks” scenario, with a cooler economy but neither too cold nor too hot, would be a welcome outcome for the Fed - and the markets.

However, the uncomfortable combination of rallying oil and US long end breaking up is disrupting this equilibrium and triggering a rotation into the “persisting inflation & sticky rates” narrative, adding pressure on equities and valuations.

Our core scenario remains unchanged. While market volatility could persist in the short-run, particularly through a historically choppy September/October, we expect the US & global economy to cool down in the months to come, leading to a Fed pause. This would be a positive for equity and bond markets over time. We thus keep a NEUTRAL stance on equities and believe that a market correction could provide opportunities to increase equity exposure. We are also keeping a NEUTRAL stance on credit and bonds.

A balanced allocation to the three main asset classes is justified by the fact that bonds currently offer attractive real yields while equity market remains our favourite asset class for the long run.

We continue to favour 3 main investment themes:

1) Diversify into the lagging segments of the equity market that carry lower valuations;
2) Use volatility at our own advantage by buying on pullbacks; and
3) Use the bear steepening of the curve to extend duration within fixed-income portfolios

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