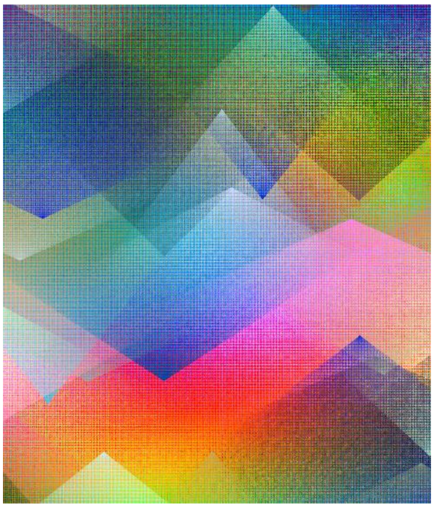
CBH | Investment Management

Quarterly Insight

Q2 2024

V31.03.2024

Creativity within Excellence



Zach Lieberman «Cone overlaps with noise» - 2023
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The New “R” Word: Resilience

Macro conditions showed signs of improvement in Q1, fostering moderate optimism in the risk outlook. However, many risks persist. This translates into well-diversified portfolios, allocating risk mainly to equities and alternatives.

In a Nutshell

The resilient US economy should bolster earnings growth and improve the prospects for the US equity market.

Although the timing is uncertain, the Federal Reserve (Fed) and the European Central Bank (ECB) are likely to start cutting rates during the summer.

We remain cautious on the outlook for China due to persistent weakness in the property market and subdued levels of consumption.

Monetary policy and macro forces should push government yields lower; meaning the opportunity to lock in carry and duration will likely fade.

The medium-term outlook for gold is supported by demand from central banks and the prospect of marginally lower US real yields.

Our stance on credit remains broadly neutral, waiting for moderate spreads widening to reallocate some exposure from investment grade to high yield.

For now, we are focusing our risk budget on equities and alternative investments.

What an eventful first quarter it has been! We have lost count of the number of assets that have reached all-time-highs since the beginning of the year: Nasdaq 100, S&P500, Europe Stoxx 600, Bitcoin, Gold, Nvidia… Without a doubt, financial markets are currently reflecting a rosy outlook. The recession that was much anticipated at the start of 2023 has not materialized, and we do not think it will, at least not in the US. Moreover, one year after the collapse of Silicon Valley Bank, which sparked acute fears of instability in the global financial system, concerns appear to have been overstated. However, have the risks really disappeared, or are we in a kind of “fear of missing out” (FOMO) euphoria that lifts all the boats at once?

For now, the key question for investors remains the same: when will the Fed start cutting rates, and what is the outlook for the policy rate? This question is equally important in Europe. Since the beginning of the year, the market has dramatically repriced its outlook for cuts, from 7 down to 3, after Fed speakers insisted that they were in no rush to ease monetary conditions and would rather be late than early. We argue that the exact timing of the start of the easing cycle is not what matters the most from a medium-term investment point of view. Will it really make a difference if the Fed starts cutting in June or July? As humble market participants, we believe that accurately predicting the direction of the next move would already be quite a feat. Our base case scenario errs on the side of consensus, but we acknowledge a plausible scenario in which the Fed maintains its peak policy rate steady throughout the year due to inflation becoming stickier than expected. Markets are ill-prepared for this outcome, which would dampen the upward trend of risky assets.

Of course, we need to acknowledge the role of artificial intelligence (AI), which has repeatedly proven itself to be a key driver for markets. While AI is not new, the introduction of generative AI last year truly unlocked its potential. We are very enthusiastic about its medium and long-term prospects. However, our concern lies more in human nature and its tendency to overreact to the emergence of a new technology. The hype of the narrative often follows a boom-and-bust cycle. We are not there yet, but the danger lingers in our minds.

In the camp of the known unknowns, geopolitics and the upcoming US presidential election are significant factors. We believe we have entered a new era of increased geopolitical tensions and regional conflicts pop up across the globe. Building an investment strategy around these hard-to-predict considerations is challenging. As for the upcoming US elections, it seems the match will be between Mr. Biden and Mr. Trump, but the market’s interest in this topic is not likely to intensify until later in the year.

Surely, we are ill at ease with the strong outperformance of momentum assets since the beginning of the year. With sentiment being overly complacent, the eagerness to continue chasing high fliers is not a sign of a healthy and sustainable uptrend. Strong bouts of momentum outperformance usually reset with a sudden reversal. However, beyond these short-term considerations, there are reasons to be moderately optimistic about the economic outlook in developed economies, which should benefit risk assets over the medium term. Corporate earnings are expected to grow by double digits in the US, monetary policy is anticipated to become more accommodating in many countries, and corporate and household balance sheets remain solid despite the most brutal increase in policy rates in 50 years.

We believe our current well-diversified positioning, with moderate overweight in equities and alternative investments, is well suited to seize the opportunities while managing the curves ahead of the road.

Global Macro Outlook

Resilient US economy

The US economy has shown remarkable resilience in recent quarters, and growth expectations for this year have risen from 0.6% last August to 2.2% (Bloomberg consensus). In our view, this resilience will continue in the coming months, and we believe the US economy will achieve a rare soft landing. This post-pandemic economic cycle continues to defy expectations, thereby rendering reliance on the old playbook somewhat obsolete.

While the US consumer can no longer rely on the excess savings accrued during the pandemic era, which are almost depleted, we still anticipate several tailwinds to boost household spending. First, despite decelerating wage growth, inflationary pressures are fading more quickly, resulting in positive real wage growth supporting purchasing power. Second, with a still robust labor market, consumer confidence is on the rise, as indicated by the University of Michigan Consumer Sentiment Index.

US real wage growth

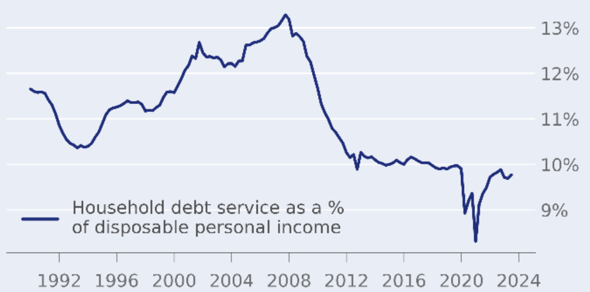
Real earnings growth a key tailwind for US consumers

Source: CBH Investment Management, Bloomberg

Although we acknowledge that some segments of the population, such as low-income earners and young people, are under pressure, as evidenced by the rising delinquency rates on credit cards and auto loans, the average household balance sheet remains healthy. The percentage of disposable income spent on debt service stands at 9.8%, a notch below the pre-COVID 10-year average. Thus, higher policy rates have not materially deteriorated household finances, partly because homeowners refinanced their mortgage during the zero-rate era, and only one-third are subject to mortgage rates above 7%.

US household debt servicing

The average US consumer's balance sheet remains healthy



Source: CBH Investment Management, Federal Reserve Bank of St. Louis

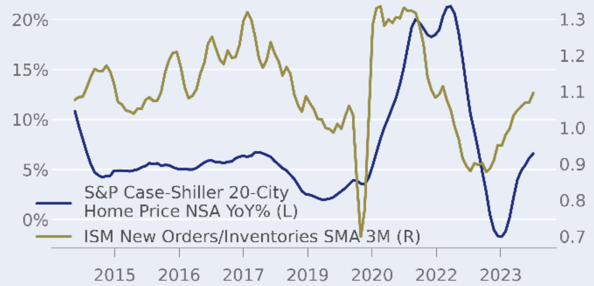
Additionally, the net worth of the average US household (excluding the wealthiest 10%) has increased by over 6% annually, thanks in part to buoyant equity markets at a time when equity holdings account for 40% of household financial assets, a level only marginally surpassed during the post-pandemic market rebound.

Even though still tight by historical standards as measured by job creation (non-farm payrolls), the labor market has started a gradual normalization that can be seen below the surface. New jobs are predominantly part-time, a record number of people are working two jobs to make ends meet, and the voluntary quit rate has dropped. In our view, the job opening rate rose so much in the aftermath of COVID-19 that the current softening in labor demand is merely a reduction of excess labor. Granted, this is a source of slowdown, but it should not tip the US economy into recession.

In the corporate world, services are showing remarkable resilience, with the six-month average of the ISM Services Index standing at 52.6. Manufacturing, which contracted earlier in 2021–2022, is showing signs of recovery, as indicated by the ratio of new orders to inventories in the ISM Manufacturing Index. Housing is also showing signs of life, with home prices up an 6.6% year-on-year on average in the 20 largest cities.

Manufacturing and housing

Cyclical sectors showing signs of early recovery



Source: CBH Investment Management, Bloomberg

One reason why the dramatic surge in policy rates has not triggered a recession is that corporate America has refinanced at long maturities during the zero-rate era, maintaining in aggregate financing costs reasonable. Furthermore, credit access has become less restrictive, with the percentage of banks reporting tightening lending standards, dropping from 50% at the end of 3Q23 to just 14% currently. When we factor in other elements, such as equity markets in composite measures, financial conditions are not restrictive by historical standards. In our view, this strongly supports the soft-landing narrative.

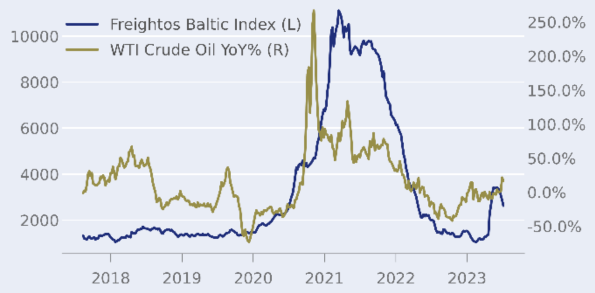
Contributing to the benign macro backdrop, overall liquidity in the US financial system has been on the rise since 2Q23. While the Fed is shrinking its balance sheet with its quantitative tightening (QT), the depletion of its reverse repo program (RRP) has acted as a liquidity boost. As the RRP comes to an end, there is a risk of reduced liquidity should the Fed continue its QT for an extended period. In this regard, we view the words of Chairman Powell at the last FOMC as reassuring, as he hinted that a decision on the future path of QT is imminent. For now, liquidity remains ample and continues to offer a macro tailwind to risky assets.

Despite occasional hiccups in the disinflationary process, we maintain our view that the Fed will start cutting rates in June or July. We therefore expect monetary policy to become supportive in the coming quarters. In addition, we believe that fiscal policy could also play a role here, as a potential tax cut that would add 0.5% to GDP growth in 2024.

Rents disinflation should bolster the Fed to cut

The "easy" disinflation stemming from the normalization of pandemic shocks (i.e., mainly supply chain disruptions and the surge in commodity prices) is well past. With the US economy remaining resilient and the labor market strong, we believe the last mile to the Fed's 2% target is likely to take some time. Recent data give credit to this hypothesis, with headline CPI ceasing its decline since June 2023 and supercore inflation even increasing from 3.75% in November 2023 to 4.3% in February 2024. Despite the fact that US oil production has reached its maximum capacity (expected to exceed 13.19 million barrels per day in 2024, according to the Energy Information Administration (EIA)), crude oil prices have surged back above $80, posing risks of renewed inflationary pressures in the short term. Moreover, shipping rates have recently risen due to tensions in the Gulf of Aden.

Disinflation could mark a temporary pause
Energy and freight could contribute to inflation stickiness



Source: CBH Investment Management, Bloomberg

Our base case scenario is that these are short-term hiccups, and we expect core CPI to continue to trend lower. Notably, shelter inflation, which accounts for about two thirds of CPI, has declined from 8.2% to 5.8%. Leading indicators, such as the Zillow Rent Index, indicate that rental inflation is expected to normalize to 3.5% over the next 10 months. While this timeline may be longer than what the market is pricing in, the direction remains toward lower core inflation. Hence, this should not derail the Fed from its plans to implement rate cuts this year. Our assumption is that the Fed will cut rates in June or July, barring any further upside surprises on inflation.

While the US economy remains resilient, we anticipate a slowdown in H2, which should exert a downward pressure on yields. Concerns regarding a possible supply/demand imbalance during Treasury auctions have now receded, and we believe that any movement in the US 10-year yield above 4.30% represents an attractive opportunity to lengthen duration.

Sluggish but positive growth in the Eurozone

The trajectory of growth expectations for the Euro Area (EA) economy has diverged substantially from that of the US, with the consensus for 2024 growth declining to 0.5%, compared with the rise to 2.2% projected for the US. That said, we believe the worst is behind us, as evidenced by the improvement in the Economic Surprise Index since last summer. While manufacturing remains weak, services have rebounded strongly since last September, with the Purchasing Managers' Index (PMI) services now back in expansion territory at 51. Even though wage growth is likely to have peaked, real wage growth remains (barely) positive as inflation has fallen at a faster pace. This trend should continue to support the recovery in consumer confidence and decent household spending. As we see some green shoots, we expect growth to pick up slightly towards the end of the year and into 2025.

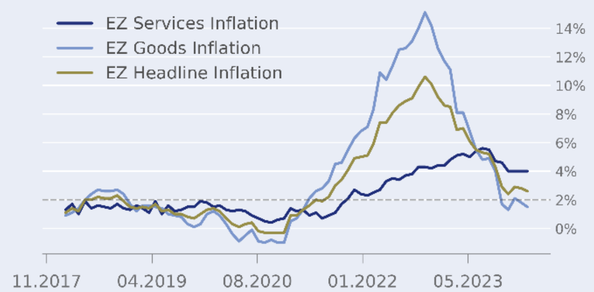
2024 est. GDP Growth
Growth in EZ has been revised downward

Source: CBH Investment Management, Bloomberg

However, any growth impulses in the Eurozone (EZ) should remain muted. While a measure of GDP-weighted unemployment rate for the largest EZ economies is at its lowest level since the 80s, the recent uptick in unemployment in core countries such as France and Germany does not bode well.

The disinflationary impulse in the EA is quite remarkable, as a large part of the early inflationary pressures stemmed from energy prices, which quickly normalized. All CPI components are on a downward trend, except for energy, which is still negative but has been increasing again since October. While headline inflation has ceased its decline since last November, we see signs that services inflation should be the last shoe to drop. We also expect that the headline CPI to move closer to the ECB's target sooner than in the US.

Eurozone inflation
Services inflation should continue to grind lower



Source: CBH Investment Management, Bloomberg

We believe the ECB should start easing its monetary policy sooner than the Fed, as inflation will likely reach its target sooner and the macroeconomic situation is less favorable. However, historical patterns show that the ECB has often refrained from acting before the Fed. With the Swiss National Bank (SNB) initiating the rate cuts party in March, displaying remarkable courage, we anticipate increased pressure on the ECB to start cutting rates as early as June.

China property market still in the doldrums

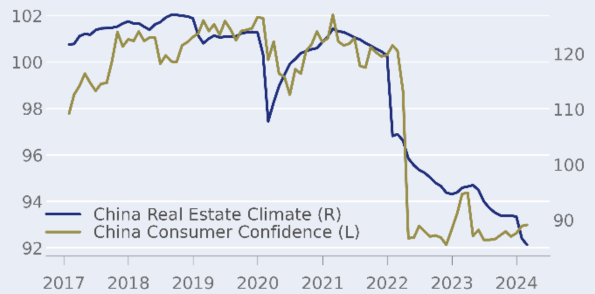
China finally achieved its growth target last year, reporting a real GDP growth of 5.2%. However, economic momentum faltered towards the end of the year, with a nominal growth of 4.2% in Q4 amid continued weakness in real estate and consumption, as well as lingering deflationary forces.

While macro data have been mixed over the past six months, as indicated by a rather flat Economic Surprise Index, Chinese authorities have ramped up support measures in Q1, most notably by cutting the mortgage rates to support a still-moribund property market. Investors reacted positively to this much-anticipated policy increase, with the CSI 300 Index rebounding by more than 10% from its February trough. That said, this bounce may be partially attributed to targeted policies to support the market, including government purchases of stocks and a ban on short selling. So, is this rally merely another dead cat bounce or a new cyclical uptrend?

We remain skeptical. Weakness in the property market persists, with declines in prices, housing starts, and new investments observed during 1Q24. Since real estate is the biggest component of the average Chinese household's wealth, its downturn affects the broader economy via the wealth effect and consumer confidence. The worst might be over for the property market, but the road to recovery is likely to be long and full of pitfalls.

China property market

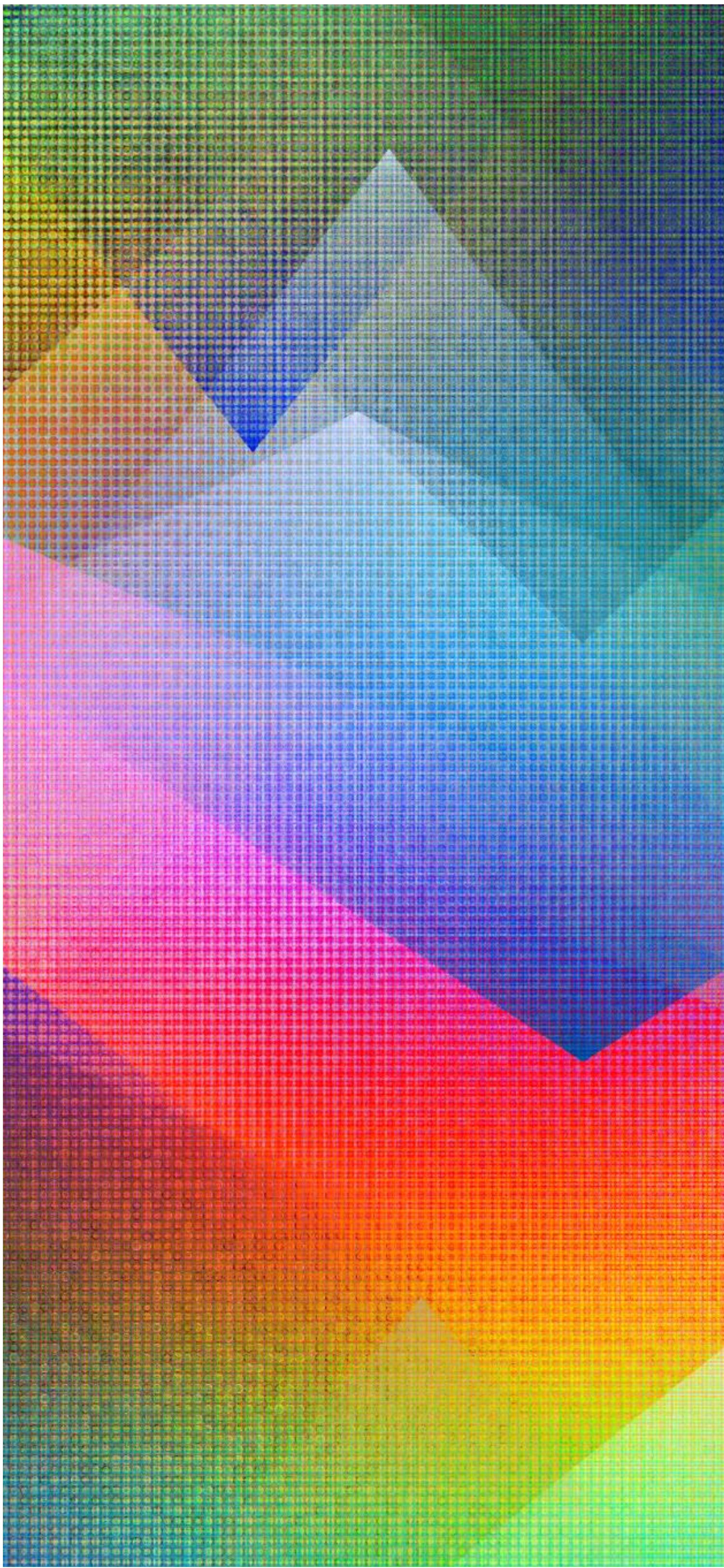
Real estate market continues to weigh on consumer confidence



Source: CBH Investment Management, Bloomberg

Deflation remains a risk if consumption stays weak and if the government responds by further stimulating manufacturing investment, which could aggravate the pressure on prices and margins for goods. Although the policy mix is mildly expansionary, policymakers have so far refrained from providing stimulus targeted at households.

Although the drag on growth from the real estate downturn should be smaller in 2024, the post-pandemic reopening economic boost has largely dissipated. On balance, therefore, we believe that lingering weakness in real estate and consumption will lead to lower growth, and the 5% growth target for 2024 looks increasingly ambitious. In our view, China's growth trajectory hinges crucially on policy support, particularly measures targeting the property sector and households.



Asset Class Views

	Less attractive	----------------------	Neutral	----------------------	More attractive
Sovereign Bonds					
			USD Long-Term	USD Short & Mid-Term	
			EUR Long-Term	EUR Short & Mid-Term	
Invest. Grade Bonds					
			USD Short-Term	USD Mid & Long-Term	
			EUR Short-Term	EUR Mid & Long-Term	
Other Fixed Income					
		Convertibles	Emerging Debt	Short-Term High Yield	
			High Yield		
			Financial Subordinated		
Equities					
		Europe	Emerging ex-China	United States	
		China		Large Cap Growth	
				Global Technology	
Alternatives					
			Gold	Multi Assets	
				HF CTA	
				HF Global Macro	
				HF L/S Equity	
Currencies					
		CHF	USD		
			EUR		

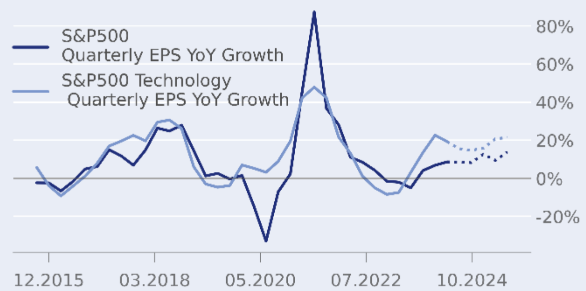
Asset Allocation

Upward EPS growth revisions boost stocks

At the start of 2023, the market was bracing for a seemingly inevitable recession. While it has not happened (yet), US earnings did experience a brief contraction in the first half of 2023. As the market began to price in the soft-landing narrative and the upcoming easing of the Fed's monetary policy, earnings started to recover in 3Q23. The market remains upbeat about the prospect for earnings growth, with analysts expecting around 10% EPS growth in the US this year. Even more remarkable, growth expectations have increased since the start of the year by 2.5% for the S&P500, a rare instance that highlights the optimism surrounding earnings growth. Expectations are particularly high for technology (+18.2%), communication services (+17.6%), and healthcare (+15.1%).

Optimistic earnings expectations

Analysts are particularly upbeat for the technology sector



Source: CBH Investment Management, Bloomberg

Last year, the advance in the US equity market has been driven primarily by multiple expansion (i.e., stocks becoming more expensive), as evidenced by the increase in the NTM PE for the S&P500 from 16.8x to 19.7x. Given the expectations for EPS growth, we now think that earnings have the potential to take over and support further upside in equity markets. While we do not expect margins to expand due to waning pricing power and increasing financing costs, we do expect revenues to post decent growth against the backdrop of a benign macro outlook. With the US economy is poised to avoid a recession and growth is likely to pick up going into 2025 as the Fed is anticipated to cut rates before year-end, the equity market has already factored in this path and this is one of the reasons why equities have been buoyant since last October.

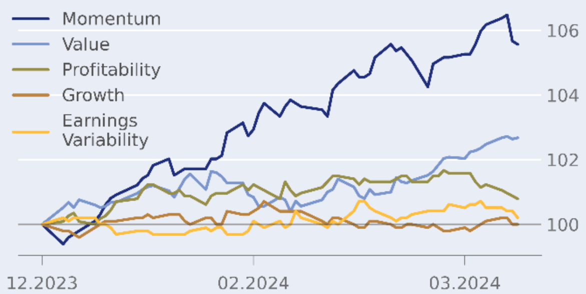
Of course, there are risks to this cautiously optimistic scenario. There always are. In our opinion, the biggest risk would be a sharp repricing of the Fed's monetary policy path. In the short term, this could lead to a repricing of economic growth and earnings expectations, dampening market sentiment. Although this is not our base case scenario as we expect the Fed to start cutting in June or July, we sense that a scenario in which inflation gets stickier-than-expected and the labor market remains more resilient for longer is plausible. Add to that the interference of the November elections, and the possibility of the Fed not cutting this year is not zero. Given the market's current high complacency and risk appetite, such a repricing could have detrimental effects.

Another key risk lies in market concentration and the AI narrative. While we are firm believers in the long-term potential of AI, similar to the introduction of the Internet in the late 90s, we are concerned that the narrative around AI has gotten a bit out of control, potentially leading to a market reset. This could be particularly damaging for the US equity market, where some of the optimism behind the stellar outperformance of mega cap growth and the Magnificent 7 (Mag7) lies in the generative AI narrative. Another source of concern regarding the Mag7 is that they contribute to more than half of the expected earnings growth for the S&P500 this year. As the bar is high for these stocks, any disappointment could trigger a repricing of earnings growth expectations, weighing on market benchmarks. However, for now, as we already wrote along these lines, as long as mega cap growth companies meet demanding earnings expectations, they are likely to continue supporting the market.

While we are moderately upbeat on the medium-term prospects for equities, we harbor short-term apprehensions. Developed markets have posted remarkable performance since the end of October last year, and even more so since the beginning of the year. The strong outperformance of momentum stocks reflects the willingness of market participants to buy recent outperformers regardless of valuation. Given the current global risk sentiment, which can be described as very complacent, we see this as an indication that the market is in a dangerous "FOMO" mindset. Long stretches of momentum outperformance usually end with a sudden reversal and a rotation into laggards.

YTD performance of US equity factors

Financial markets have been dominated by momentum in Q1



Source: CBH Investment Management, Bloomberg

We enter the second quarter with an overweight stance in equities. We are overweight US equities with a growth tilt (while neutral on the Mag7). We expect the benign macro backdrop to bolster positive earnings expectations and sentiment. We are also overweight in the tactical equity pocket, where we see a fertile ground for active stock picking with high stock dispersion.

Conversely, we are slightly underweight European equities due to concerns about macroeconomic conditions, and we believe that the low exposure to growth stocks is not the best use of our equity risk budget. Europe is a value market, and we do not yet see a lasting rotation into value stocks at this stage of the cycle. That said, we have been positively surprised by the recent performance of European stocks, which have been supported by their own mega cap "Granolas" stocks.

We are underweight emerging markets, as we remain cautious on China, which accounts for more than a third of the complex. Despite a compelling value argument, particularly for Chinese technology companies, negative sentiment prevails for the time being, and we think it will remain the underlying backdrop until the property market has convincingly started to recover. Nonetheless, we do see focused opportunities in emerging markets, such as Brazil and India, that may warrant inclusion in more granular equity exposures.

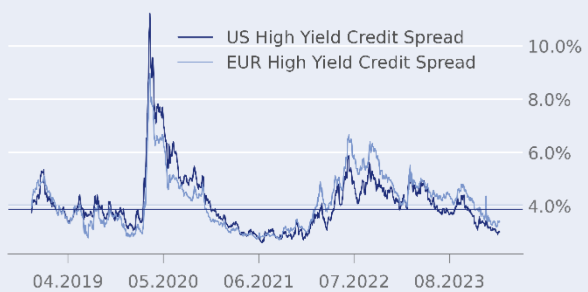
Japan remains an attractive market as the country emerges from a multi-decade deflationary period, with structural reforms in the corporate sector providing medium-term tailwinds. After the recent strong outperformance, we refrain from chasing the momentum as it has become a crowded trade. Moreover, it remains to be seen how the Japanese equity market will cope with the Bank of Japan's (BoJ) pivot and marginally higher rates.

Credit got even richer in Q1

The outlook for credit remains attractive on the surface, as declining inflation and a moderately positive growth scenario in developed economies provide strong tailwinds. However, our view on credit is the result of an arbitrage between fundamentals, valuation, and technicals. Fundamentally, the bulk of the credit market (i.e., the BB bucket and above) has improved in the aftermath of COVID-19. For now, higher financing costs due to tighter policy rates are mostly affecting the lowest-rated companies.

The credit market has long embraced the soft-landing scenario, and credit spreads are tight by historical standards. In fact, credit spreads tightened further during the first quarter in the wake of upside revisions to US growth. This begs the question: is credit priced for perfection? We tend to think that much of the positive news is already priced in, given that US and European high yield (HY), along with emerging debt, are among the top quartile of tightest spreads in history. Even the investment-grade (IG) segment looks rich.

High Yield credit spreads
High Yield looks rich on both sides of the Atlantic



Source: CBH Investment Management, Bloomberg

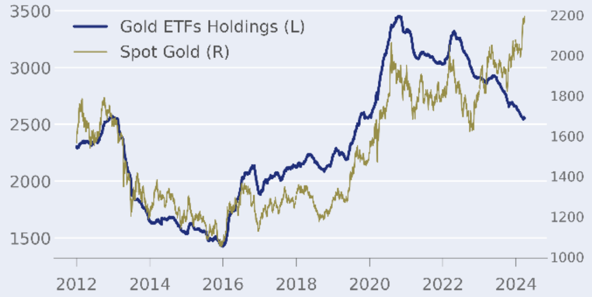
From a technical perspective, demand for credit remains strong as retail and institutional investors have piled into the asset class, drawn by the opportunity to lock in the very attractive all-in yields that are expected to decline over the medium term as central banks prepare to slash policy rates. On the supply side, both the US and European IG markets have expanded due to strong supply. In contrast, the size of the HY market has contracted as many issuers have upgraded to IG status (the "rising stars") and others have chosen to refinance outside the financial markets. This demand–supply imbalance is another technical factor that has supported the asset class in recent quarters.

Given these considerations, high yield appears to have more tailwinds than investment grade, but not at these tight spreads. Valuation in the HY market raises the bar very high and renders the market prone to disappointments that would eventually lead to moderate and temporary spreads widening. At this stage, we would consider decreasing our exposure to IG in favor of HY. For the time being, we are quite happy clipping coupons in quality bonds and focusing our risk budget on equities rather than on credit.

Gold to the moon?

Gold broke out to a new all-time high at the end of March. What is remarkable is that the recent strong uptrend happened in a context where the share of "financial gold" has declined substantially over the past two years, as indicated by the reduction in holdings in the biggest gold exchange-traded funds (ETFs).

Gold vs ETFs holdings
Outflows from gold-backed ETFs offset by central banks' demand



Source: CBH Investment Management, Bloomberg

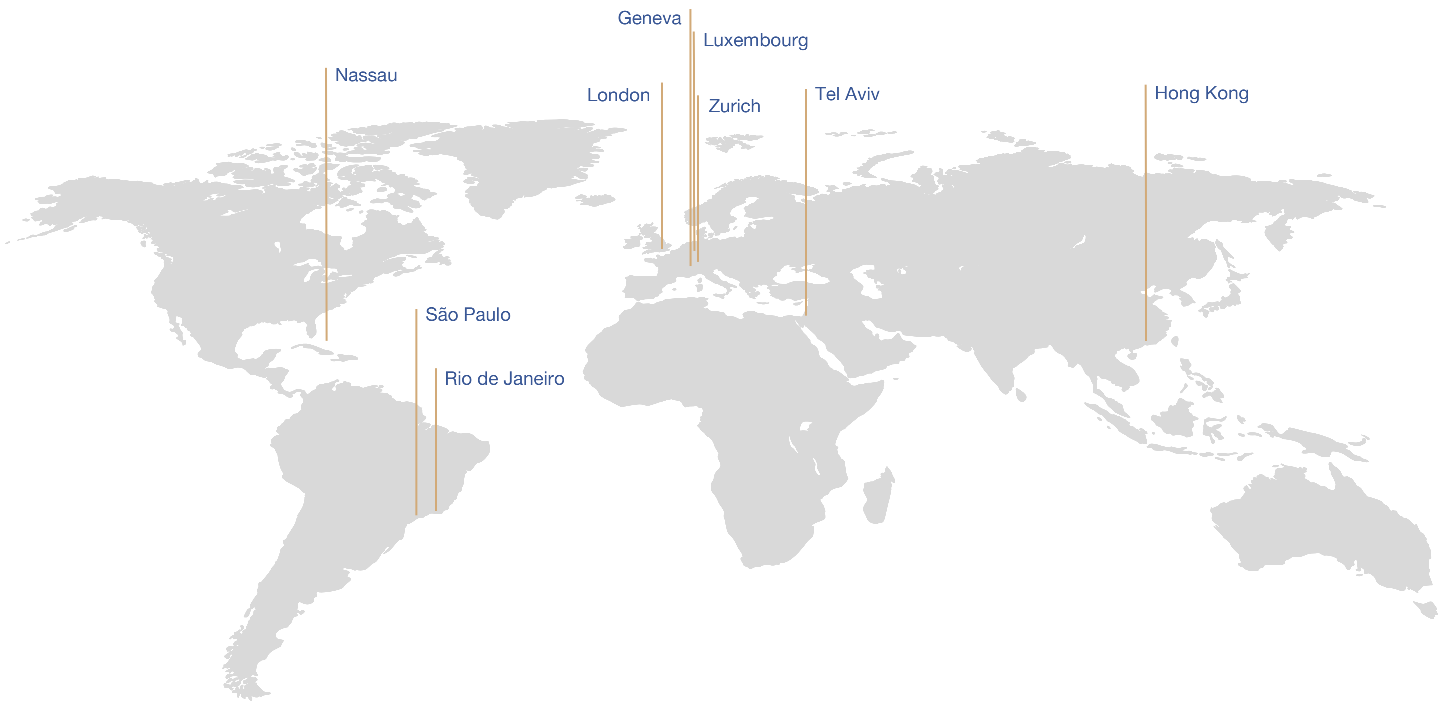
We see several key supports for the yellow metal. First, its negative relationship with real yields is back in place since real rates peaked last June. Second, one of the reasons gold broke out to new highs at the same time Bitcoin and other high-momentum assets reached new highs is not a coincidence. We suspect that capital flows from momentum-driven systematic market players might be a key driving force. Third, physical demand for gold from central banks has increased sharply since 2022, cushioning the outflows from gold-backed ETFs.

Physical demand has thus likely become again another structural driver for gold, alongside the direction of US real rates and the US dollar. Most notably, some emerging countries' central banks have increased the diversification of their reserves in a move to reduce their dependence on the greenback. From a geopolitical point of view, many countries wish to become less reliant on the US dollar to reduce the risk of sanctions or asset control. Moreover, there are growing concerns about the long-term solvency of the US government, fueled by the exponential growth of the US deficit and its rating downgrade by Fitch to AA+. To illustrate this trend, the Chinese central bank (PBoC) became the largest buyer of gold in 2023. According to a survey conducted by the World Gold Council, 24% of central banks plan to increase their share of gold in foreign reserves in 2024, and more than half expect USD-denominated reserves to decrease in the medium term.

We thus expect gold to benefit from the fundamental supports provided by structural demand for physical gold emanating from central banks and US real yields, which are expected to decline given the disinflationary trend. The recent technical breakout above $2100 provides additional reassurance that the path of least resistance is to the upside.

Geographical Presence

CBH is present in Geneva, Zurich, London, Luxembourg, Israel, Hong Kong, Rio de Janeiro, São Paulo and The Bahamas. Due to its international exposure, it is under the consolidated supervision of the FINMA in Switzerland and its affiliated companies are supervised by the CSSF in Luxembourg, the FCA in the United Kingdom, the Central Bank of The Bahamas, the SFC in Hong Kong and the CVM in Brazil



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All data as of March 31, 2024
Released April 2024

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