CBH | Investment Management

RESEARCH

# QUARTERLY INSIGHT

4th Quarter 2023

V30.09.2023

ENGLISH

Face Lift - Larry Otoo
2010. Acrylic on canvas 118 x 146 cm

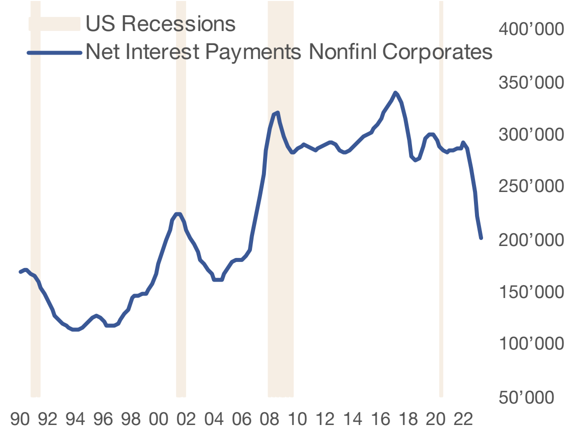
Photo: P. Bitz

# Contents

# Not Different, Just Longer

The current post-pandemic economic cycle is unique in many ways, and the resilience of the US economy has surprised financial markets when many pundits were calling for an imminent recession a year ago. While we have observed the sharpest tightening by the Federal Reserve (Fed) in the last 50 years, the economic aftermath of the Covid 19 shock has led to a longer transmission lag to the real economy. Could it be that this cycle is no different, but that it will take a longer time to discern the consequences of higher interest rates?

US corporate debt burden declined since 2021




We anticipate several pillars of the US economy's resilience to fade, which could curb household and corporate spending. We are only beginning to perceive some of the negative effects of higher interest rates on household finances and corporate borrowing. While the disinflationary trend is expected to continue in the US, albeit at a slower pace, the labor market remains tight by historical standards. Some cracks are appearing, but it could take a while before lower wages and higher unemployment are seen.

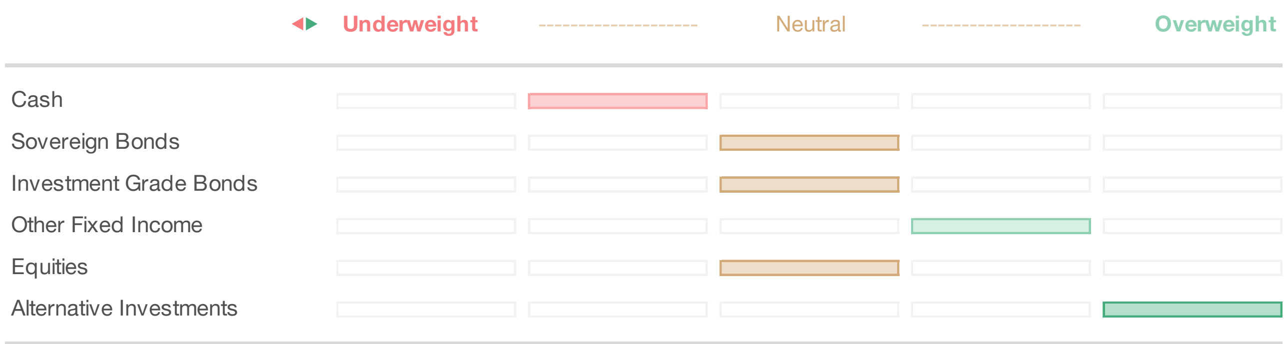
The Fed is nearing the end point of its exceptionally sharp tightening cycle, but is preparing the market for an era of "higher for longer" policy rates. Should the Fed maintain tight monetary conditions for an extended period, the likelihood of increased economic damage is high. Hence, although the US economy has remained robust, it may not continue to be immune to tighter monetary conditions going forward.

These are interesting times for asset allocators. Fixed income is again offering a decent yield and has regained some of its diversification virtues. Equities have already undergone a shallow and brief earnings recession, and market pricing of forward earnings is very optimistic. Moreover, the generative artificial intelligence (AI) hype is deeply influencing global equities as it affects the world's largest public companies, which now have an outsized importance in global equity benchmarks. The many macro and micro cross-currents and dislocations also provide a formidable opportunity set for alternative investments, such as hedge funds and private investments.

For our part, we remain neutral on equities. We continue to favor US stocks, despite the tension between the macro outlook, which favors defensives, and the unrelenting uptrend in mega-cap growth stocks. We are neutral on European equities, as the bleak macro outlook for the Old Continent is balanced by attractive valuations. We also remain neutral on emerging markets (EM) equities. However, recent macro developments are pushing us towards the downgrade point. During the third quarter, we have downgraded China back to neutral as the economic backdrop deteriorated and the price momentum further weakened. Although Japanese equities are back on the radar of global investors, we are not yet ready to re-enter this market after decades of underperformance.

For the time being, we are neutral duration on sovereign bonds, with a barbell approach. Going forward, the outlook for the steepening of the yield curve will dictate our positioning on the Treasury curve. Regarding credit, we remain cautious on high yield (HY), as credit spreads are not wide enough in the context of growing financial stress in the system. We continue to favor investment grade (IG) corporate bonds as the main source of income.

# Asset Allocation




*Indicates the last change. Number of triangles indicates the movement magnitude*

# Global Macro Outlook

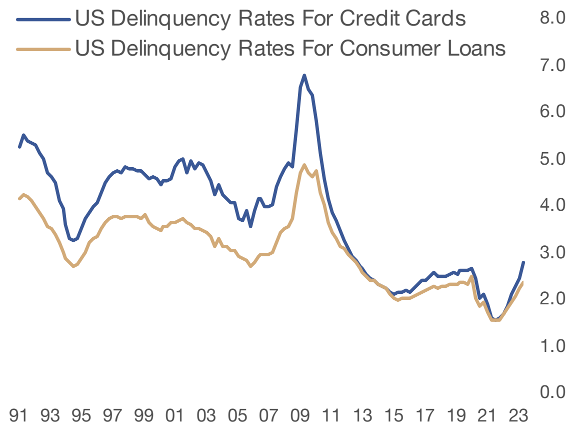
## US economy remains caught in cross-currents

The US economy again proved to be remarkably resilient over the summer, and the third quarter is likely to post strong growth again. Despite the most aggressive monetary policy tightening since the 1980s, this pandemic-induced cycle is unique and the transmission lag to the real economy appears to be longer than in previous tightening episodes. As a result, the American economy seems to have been less sensitive to higher interest rates and has been kept afloat by three main supportive factors.

First, households and businesses took advantage of the period of ultra-low interest rates (1Q20-1Q22) to aggressively refinance their debt at longer maturity, thereby significantly dampening the impact of rising policy rates in the short term. Second, the generous stimulus measures during the pandemic generated large household excess savings, providing significant buffers to absorb income shocks and fund consumption. Third, the pandemic led to unprecedented tightness in the labor market, and job demand is normalizing with fewer job openings rather than employment reduction, keeping labor income robust.

As the market gradually priced in the resilience of the US economy in H1, the consensus narrative shifted dramatically from a sure-thing recession to a soft landing. This optimistic view permeated all asset classes, as evidenced by tight credit spreads and rosy earnings expectations for US companies. However, as we head into year-end, this narrative could be dented as many of the factors underpinning the recent resilience are deteriorating. Simply put, we believe that Fed tightening will ultimately harm the US economy.

Mounting financial stress for US consumers



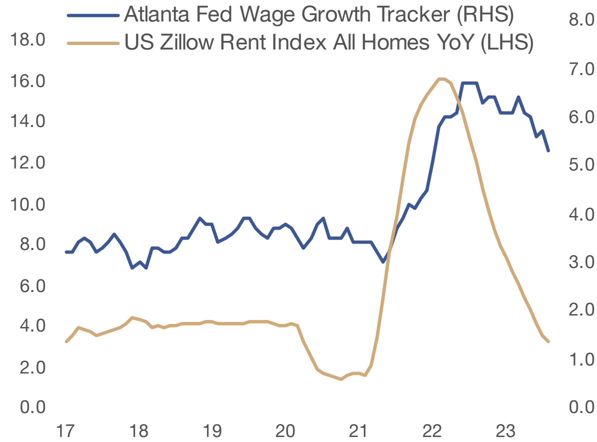

There is growing evidence that household financial stress is creeping up as higher rates continue to work their way through to borrowers, increasing debt service burden. This trend is evidenced by the increasing delinquency rates on credit cards and auto loans. Banks continue to report tightening lending standards, resulting in a significant slowdown in business loan growth. As corporates will need to refinance at higher rates, capex and labor demand will suffer. A recent Fed note reported that the share of non-financial firms in financial distress has reached levels higher than in previous tightening cycles since the 1970s. With more firms in distress, a default cycle has likely already started.

Excess household savings from the pandemic era are on track to be depleted in the coming quarter. Moreover, student debt payments (46 million holders totaling USD 1.77 trillion), which have been on hold since March 2020, will resume in October, bringing a negative cash flow shock to disposable income and adding to the forces that could drive spending down. We are also seeing signs of weakness emerging in the labor market. Demand for workers is falling at the same time as more people are joining the workforce, leading to a drop in the ratio of job openings-to-unemployed. We are observing a significant downturn in cyclical labor conditions (source: businesscycle.com), as evidenced by a 7.6% decline in temporary jobs since the 2022 high and a gradual decrease in the average weekly hours as employers adjust to weaker demand.

Nonetheless, some strong tailwinds remain in place that could sustain the US economic cycle. Despite the end of the “easy” disinflation stemming from normalizing supply chains and rapidly falling commodity prices, we expect more disinflationary forces ahead. Real disposable income should be sustained by inflation falling faster than wages, thereby supporting consumer confidence and household spending.

While the core Consumer Price Index (CPI) is declining at a slower pace than headline inflation due to strong services, leading indicators for rents and shelter point to easing inflationary pressures in this component, which accounts for 40% of the core basket. Private data from marketplace companies such as Zillow show that rents have already slowed significantly, but delayed government data still have yet to reflect this trend. We also see “supercore” inflation, i.e. core inflation excluding shelter and a favorite Fed inflation gauge, declining below 4% in the coming months. Wages, the largest cost for non-housing core-services companies, are expected to gradually decrease in the wake of labor market weakness.

Key components of core inflation point downward

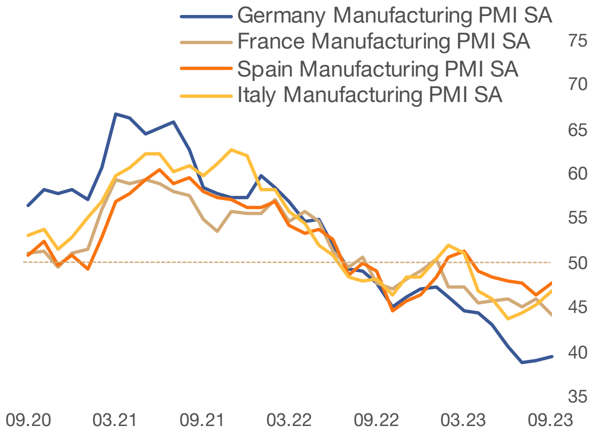



The Fed faces the delicate task of calibrating its monetary policy precisely enough to ensure a slowdown doesn’t slide into a contraction. However past experience shows that once the cycle starts to slow in response to higher rates, it tends to overshoot into recession. As firms cut costs in response to the lagged impact of monetary tightening, unemployment rises and households become cautious, leading to more austerity and layoffs, resulting in further household caution. Our view is that the probability of a US recession in the next 12 months is akin to the flip of a coin due to the balance of positive and negative factors.

## Slowing euro area economy

As the European Central Bank (ECB) monetary tightening starts to impact the economy, bank lending is slowing and money supply is shrinking. Moreover, previously resilient services weakened in recent months, likely pushing the euro area (EA) into contraction in Q3. Macroeconomic data deteriorated sharply in the EA over the summer, with Germany, France, Italy, and Spain flirting with recession. Some leading indicators are deep in contraction territory, and consensus GDP growth for 2024 has been revised down from 1% to 0.8%. In Germany, the region's historical growth engine, industrial activity is slowing markedly, with the manufacturing Purchasing Managers' Index (PMI) standing below 40, negatively impacted by the deteriorating cycle in China due to weak export demand. The key question for the EA seems to be how long and how deep the contraction will be.

Leading indicators in contraction territory




While headline inflation continues to move lower amid significant declines in food and energy prices, core inflation remains stickier, as the labor market remains historically tight and continues to be a driver of inflationary pressures. Wages continue to rise to make up for the losses in real income seen over the past eighteen months. Combined with increasing unit labor costs, this trend poses a challenge for the ECB as it strives to drive inflation back to its target level.

Consequently, the ECB hiked rates to 4% at its September meeting and hinted at a "higher for longer" scenario, resulting in a bleak growth outlook for the EA. We have long speculated that the ECB would hike to at least to 4%, as it was well behind the curve in its battle against inflation. The recent surge in oil prices adds fuel to the fire, and new energy price tensions over the winter remain a possibility.

## Chinese economy in a difficult spot

Our view of the macro situation in China has deteriorated significantly in the third quarter. Confidence, industrial activity, exports and consumption have slowed further. Moreover, youth unemployment is above 20% and the economy is flirting with deflation. With credit impulse turning negative again, Beijing's 5% growth target for this year appears less likely to be achieved. In addition, the property sector remains weak, and as it accounts for a third of the economy, the fragile situation has the potential to spill over to other parts of the economy. We are also uncomfortable with the fact that the government has stopped publishing many statistics that show negative trends.

China property market remains weak

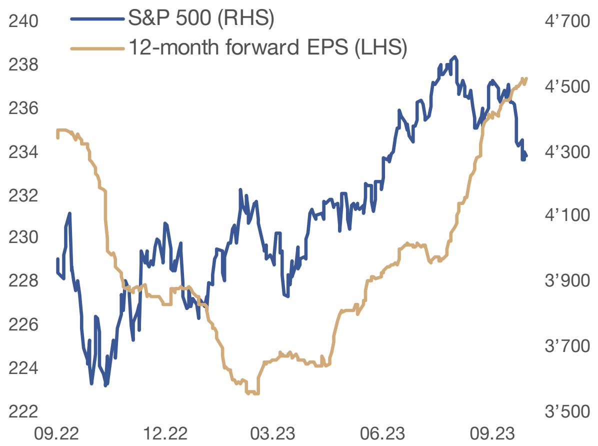

The China narrative continues to focus on supportive policy measures, but for now authorities seem to have adopted a policy of small-scale, targeted measures to avoid fueling new excesses. The "big bazooka" seems a long way off, as Chinese policymakers seem to favor the Japanese "Kaizen" principle.

# Asset Allocation

## Equities

US earnings have been fairly resilient in 2021 and 2022, as corporates took advantage of rising input costs to boost pricing power and increase profit margins. While Earnings Per Share (EPS) and profitability peaked last year, earnings subsequently only contracted for three consecutive quarters. This “mini” earnings recession likely troughed in 2Q23 with EPS declining by a mere 6% vs -23% on average since the 1990s. We observe that since February, earnings momentum has turned positive and 12-month forward EPS has trended substantially higher as the US equity market has gradually priced in a more benign macro outlook.

Earnings expectations were a key support

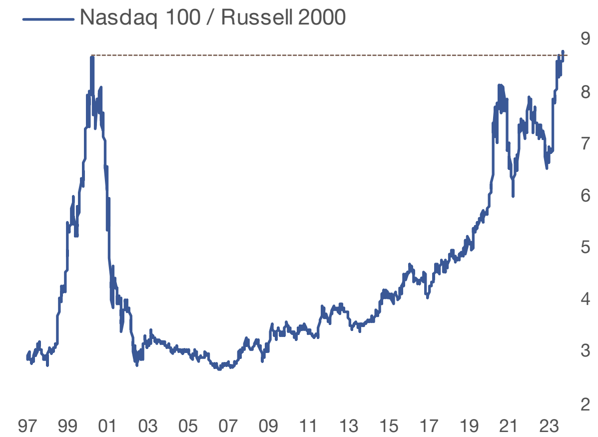



At 18x, the 12-month forward price-to-earnings ratio (P/E) for the S&P 500 looks stretched. Admittedly, the analysis is skewed by the lofty valuations of mega-cap growth stocks. At 14x, the 12-month forward P/E for the S&P 500 Equal Weight looks indeed more reasonable and below the 10-year median level. A more granular view reveals that more than half of US sectors are trading in the top quartile of their historical valuation range. In short, the valuation of the broad US equity market is neutral at best and not attractive enough.

Given that the US equity market largely progressed on the back of multiple expansion in 2023, it is paramount that earnings expectations be met in the coming quarters to sustain the rally. However, we believe that the 12% US earnings growth estimate for 2024 sets the bar high, putting the market at risk of negative surprises given the many macro challenges lying ahead. As monetary tightening works its way through to the real economy, we expect higher financing costs to weigh on profit margins in the coming quarters. From here, pricing power is likely to weaken as inflationary pressures recede and the macro backdrop remains challenging. Moreover, US companies might struggle to pass on rising input costs this time due to the recent surge in oil prices.

Our outlook for equity markets also takes into account the market structure. At the headline index level, US equities are having a great year, with the S&P 500 up 13.06% and the Nasdaq 100 up 35.37% at the end of the third quarter. However, under the hood, the S&P 500 Equal Weight is barely up 1.78%. It is now a fairly popular observation that the mega-cap growth stocks coined the “Magnificent 7[1]” (Mag7), have contributed by more than 80% to the S&P 500 gains in the first three quarters of the year. We believe that the magnitude of the Mag7’s outperformance largely results from retail investors’ focus on large and popular “top of the market” stocks. This enthusiasm has likely been put on steroids by the generative AI craze, which should strongly benefit these companies. The self-reinforcing dynamic has likely been worsened by large momentum investors.

Outperformance of the Nasdaq vs small caps at a new high




We do not consider this dominance by a handful of mega-caps a healthy backdrop. Moreover, investors need to factor in that popular US and global equity benchmarks now display a marked growth tilt. As rising real rates are expected to weigh on valuations and the leadership of growth stocks in particular, this is a key risk threatening the backbone of the current rally.

While we might witness some healthy profit-taking on the Mag7, this group displays a quality bias that should help its outperformance persist longer in the current context. In our view, this situation has the potential to cushion or even absorb macro and micro headwinds in the last quarter of the year. Given this balance of cross-currents for US equities, we expect global stocks to remain in a volatile sideways range going into year-end.

Regarding stocks outside of the US, we maintain our neutral stance on European equities. While valuations are attractive, the macro backdrop has recently soured. Moreover, as long as global growth stocks outperform, European equities will remain challenged due to their value tilt. We have downgraded Chinese equities to neutral as the Chinese growth model appears to be challenged. That said, we recognize that the Chinese equity market has a low sensitivity to local macro conditions. The silver lining is that valuations remain attractive with the 12-month forward P/E for the MSCI China standing below 10x. As

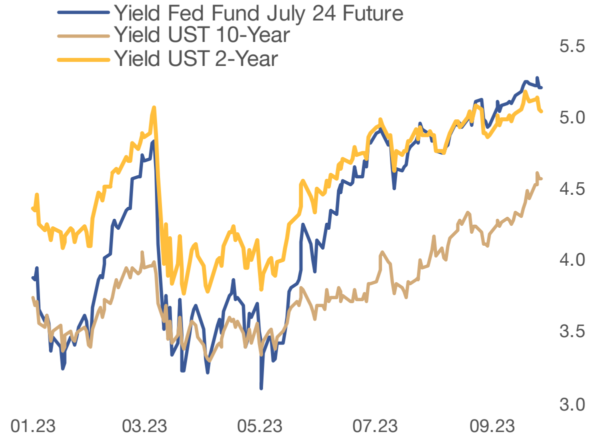
[1] Apple, Microsoft, Amazon, Nvidia, Alphabet, Tesla, Meta

the Chinese market has been the worst-performing equity market this year, sentiment is already very depressed.

## Rates

While the Fed is likely close to its terminal rate, it is likely to maintain peak policy rate for longer than in previous cycles, mainly due to the resilience of the labor market. As markets further adjusted to reflect expectations of a soft-landing and a “higher for longer” policy rate narrative, the yield on the July 2024 Fed funds contract surged from 3.1% in May to 5.2% at the end of September. Moreover, the 2Y/10Y yield curve has steepened substantially since late July, as the 10-year yield has surged while the 2-year yield has remained fairly stable. We believe that the breakout of the 10-year UST yield to a new cyclical peak is a significant macro development that ends the consensus view that previously saw peak yields in October 2022. This bear steepening is rather odd at this stage of the cycle and we believe it is driven by concerns over US fiscal dynamics, higher US bond supply and a downgrade of the US Federal government’s rating.

Sharp repricing of Fed path since May



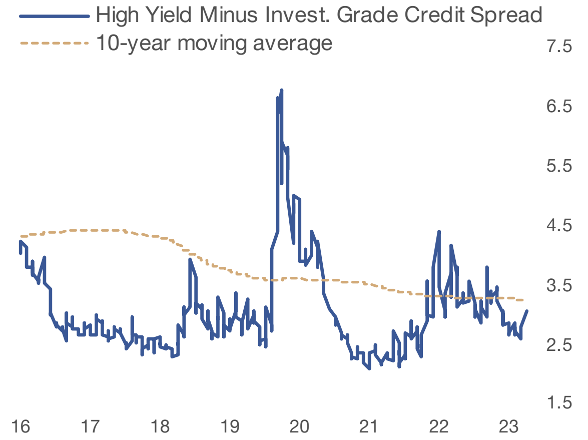

We acknowledge that it is tempting to add duration at this stage, since bond yields typically peak close to the last hike of a tightening cycle. However, given that we saw longer-term yields break out decisively in September and that the yield curve has more room to steepen, we believe that it is best to remain patient. Despite the “higher for longer” narrative, at some point the Fed will need to cut rates to cushion the blow of a slowdown that it has engineered. The US yield curve is thus likely to steepen as rate declines will likely be concentrated at the front end of the curve rather than at the back end of the curve, potentially leading to outperformance of shorter maturities. Short duration bonds also appear to be a better diversifier to equities in the current configuration, making them particularly attractive in multi-asset portfolios.

The evolution of ECB expectations has been less dramatic, rising only from 3.3% to 3.7% between the end of July and mid-September and remaining rather stable despite the surprise hike to 4% at the last ECB meeting. In our view, there is a higher probability that the ECB has reached the end of its tightening cycle in September and that there will be more pressure to cut rates before the US does as the economic cycle is tanking. In the interim, we maintain a short duration stance as the Eurozone (EZ) curve remains inverted and is expected to bull steepen, leading to a likely outperformance of short-term sovereign bonds. However, should the yield on 10-year German Bunds reach 3%, a barbell approach, i.e., investing in both short-term and longer-dated EZ government bonds, would be attractive, but we are not there yet.

## Credit

HY strongly outperformed in 2023 as the asset class benefited from the pricing of the soft landing scenario that propelled all risky assets. The bullish narrative for HY relies mainly on a still low default rate, stable operating income generation, and only distant refinancing needs in 2025-2026. While this outcome may explain the recent performance, the lay of the land may change going forward. Hence, we stick to our cautious outlook on credit, as the negative impact of monetary tightening is just starting to bite. As financing becomes more expensive, the more leveraged companies are becoming distressed, and we are observing a distinct increase in the number of bankruptcy filings as well as the default rate. Despite these macro risks, the HY market is deeply entrenched in soft landing territory and credit spreads remain too tight. In our view, global HY is expensive given the mounting macro risks, with credit spreads not wide enough to compensate for the risk. Even more so, HY appears expensive relative to IG as the difference in credit spreads remains below the long-term average.

US High Yield still looks expensive vs US Investment Grade




Hence, we continue to focus on quality corporate credit, primarily in the intermediate corporate IG space. The asset class offers an attractive carry for a longer period and should benefit from price appreciation if rates roll over. In addition, IG should be more immune to mounting financial stress.

We are less constructive about emerging debt (EMD) hard currency. Higher US interest rates and a stronger dollar have historically been key detractors to the asset class. Moreover, the complex is subject to portfolio flows, and we fear that it could suffer from the next risk off period. China’s economic woes reinforce our cautious outlook. Still, we believe there are some attractive idiosyncratic opportunities in EMD local currency because some EM countries, such as Brazil, are ahead of the monetary cycle and have room for monetary easing.

While we are cautious on global HY bonds, a case could be made for short-duration HY for income-seeking investors. We believe that the still inverted yield curve produces attractive opportunities at the short end of the high-yield market, as yields are at their highest levels in a decade and starting prices are still historically low. During the zero interest rates era, corporates issued bonds with low coupons that now trade at a large discount to par as yields have increased significantly over the past year. These bonds should benefit from the "pull to par" effect as prices converge to par at maturity, leading to capital gains irrespective of the fluctuations in interest rates or the economy. Short-duration HY bonds have a reduced probability of being negatively impacted by an economic slowdown, as bonds with short lives leave less time for defaults to occur. Another attractive feature is that the lower sensitivity to interest rates renders the asset class less volatile than aggregate HY.

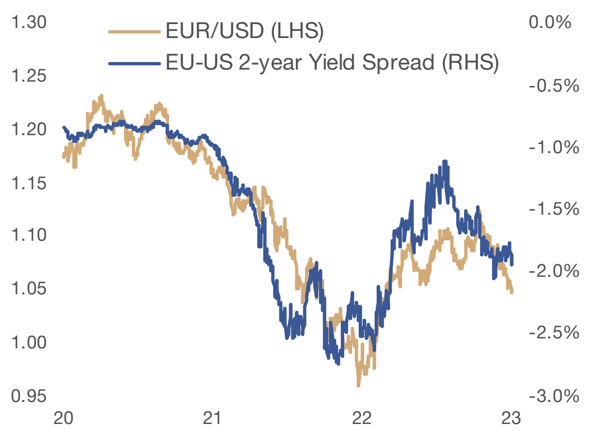
## Currencies

Since mid-July, the dollar gained almost 7%, benefiting from the twin tailwinds of stronger economic growth forecasts and a repricing of the Fed's terminal rate to a higher level. As the Fed's tilt remains hawkish, the USD vs EUR money market rates future spread for the end of 2024 has widened by circa 1% in favor of the greenback.

With the US economy proving more resilient than expected, the popular "US exceptionalism" narrative made a strong comeback in Q3 as the market focus shifted from the relative monetary policy path to the growth outlook. Testimony to this shift, EURUSD dropped in the wake of the ECB revising its growth estimates downward at its September meeting, despite posting a surprise hike.

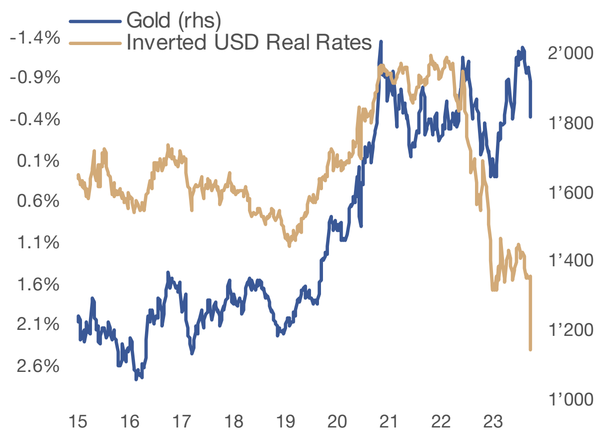
We expect the US economy to continue outperforming the EA in Q4 and the dollar to remain well supported through the end of the year. Still, after the recent drop of EURUSD, we expect the 1.04 handle to hold. The silver lining for the euro is that in a world where growth expectations are the biggest driver of exchange rates, Eurozone growth expectations are already dire relative to the US and likely well priced in. Hence, we expect the market to become more sensitive to positive macro surprises for the EA economy, putting a floor under EURUSD.

EUR/USD still driven by relative central banks expectations




Our cautious outlook for gold has not changed. Gold decoupled from real rates between November 2022 and May 2023, mostly due to safe-haven demand in the wake of the US regional banking turmoil and recessionary outlook. Since then, gold seems to have recoupled with real rates. We continue to witness receding inflation and thus a gradual increase in real rates, acting as a strong headwind. In addition, the renewed strength of the US dollar should further weigh on the yellow metal. Price momentum has turned significantly downward in late September with the breakdown below the key 1880 support. The broader technical picture points to a double top near 2050–2100. Investors continue to reduce their exposure as the outstanding shares of the largest gold bullion ETF have fallen to the January 2020 level when spot gold was trading below 1600.

Gold seems to have recoupled with real rates




**Macro Convictions**

- The Fed and the ECB are nearing the end of their tightening cycle and we expect peak policy rate to be maintained for longer than in past cycles.
- Expectations for Fed and ECB rate cuts in 1H24 will be pushed further out.
- Increasing stress in the financial system stemming from central banks' monetary tightening.
- Developed equities to remain volatile as they are caught between cross-currents.
- AI-related stocks to remain in the spotlight in Q4.

# Asset Class Views

| | Less attractive | ---------------------- | Neutral | ---------------------- | More attractive |
|---|---|---|---|---|---|
| **Sovereign** | | EUR Long Term | USD Long Term | USD Short & Mid Term | |
| | | | EUR Short & Mid Term | | |
| **Investment Grade** | | EUR Long Term | USD Long Term | USD Short & Mid Term | |
| | | | | EUR Short & Mid Term | |
| **Other Fixed Income** | | High Yield | Emerging Debt | | |
| | | Convertibles | | | |
| | | Financial Subordinated | | | |
| **Equities** | | | United States | US Large Cap Growth | |
| | | | Europe | | |
| | | | Emerging Markets | | |
| **Alternative Investments** | | Gold | | Multi Assets | |
| | | | | HF CTA | |
| | | | | HF Global Macro | |
| **Currencies** | | | CHF | | |
| | | | USD ▶ | | |
| | | | ◀ EUR | | |

◀▶ *Indicates the last change. Number of triangles indicates the movement magnitude*

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All data as at October 3rd, 2023
Published on October 6th, 2023

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