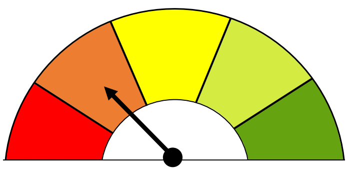
THE FINANCIAL LETTER

REVIEW, OPINIONS AND MARKETS' PERSPECTIVES

WINTER 2023-2024

Investment context

The economic and geopolitical contours of the new post-pandemic regime are slowly beginning to emerge. Less smooth, and freed from the usual restraining forces of previous decades. The task of political leaders and central bankers will be particularly complex over the next few years. Having bought a lot of time, encouraged financialisation, tolerated rising inequality and created debt at nauseam, they will now have to reinvent economic and societal models in depth. No wonder the financial markets have lost their natural tendency to revert to the (long-term) mean. To perform, we will also need to innovate in terms of portfolio construction to adapt to future shocks and uncertainties.

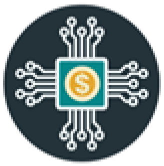


The transition between regimes is accelerating

Policy-makers are due to deliver creative solutions / policies

Main indicators in 2023
(on December 20th)

Indicators	Variation %
Eurostoxx 50	+19.0
Swiss Market Index	+3.7
FTSE 100	+3.2
S&P 500	+22.4
Short-term rate EUR	4.5
Short-term rate USD	5.5
EURUSD	+3.4
EURCHF	-4.7
Barclays Euro Bonds	+7.4
Barclays US Bonds	+5.2



¨Secular¨ Disruptions
- Climate / War efforts
- Technology / AI
- Inequalities

De-globalization
- Trade
- Re-onshoring
- De-dollarization

(Geo)-Politics
- New Multipolar World Order
- Emergence of Global South
- War at EU doorsteps

Economic Policies
- Sustainbility of positive real rates
- War economy
- From Wealth Effect to what?
- Central bank digital currenciers
- Debt Sustainability (Minsky)

Investment framework

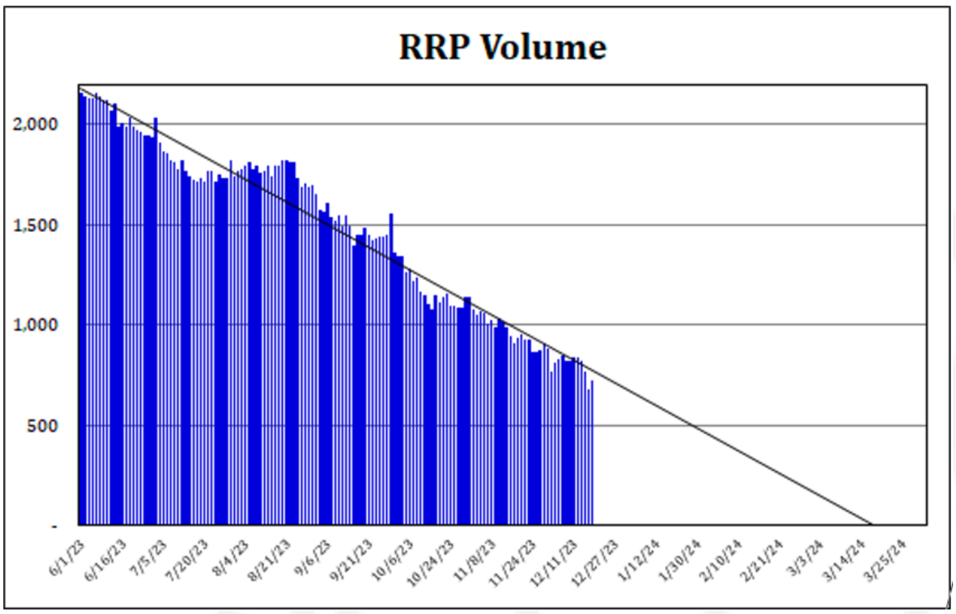
The toxic bear steepening ended in late Q3 thanks to a mix of liquidity injections, financial engineering, bargain hunting by long-only investors and short squeezes by speculators. The subsequent Q4 23 ¨everything rally¨ is now based on a belief in 2024 Goldilocks: lower inflation, resilient growth, China revival, reinforced by lower policy rates. This extremely benign scenario looks too rosy to be true.

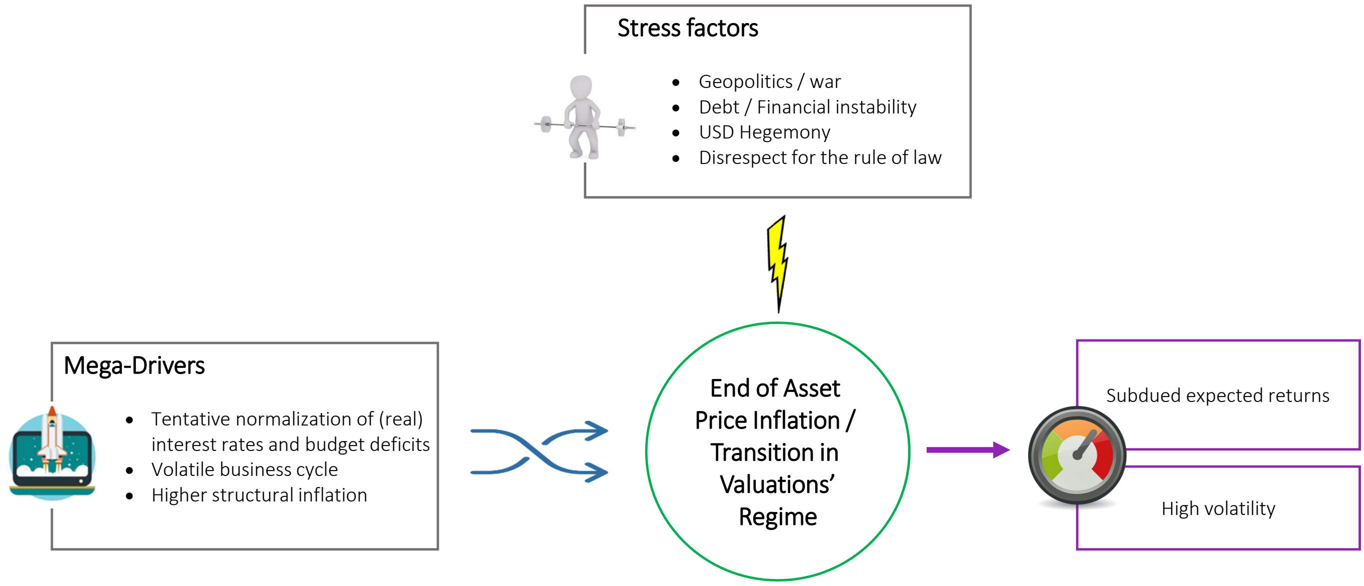
A virtous comeback of negative bonds to equities correlation is uncertain, as conditionnal to inflation developments, hence future economic policy... We would argue for a reasonably cautious approach to investing, as many adverse outcomes could occur.

End of cycles naturally spell elevated volatility

Expect asset repricing regime to continue

The liquidity buffer ¨tapped¨ by US Treasury (Reverse Repo) is draining fast





Long-term drivers

We consider <u>three secular disruptors.</u> 1) *Climate* change. Climate disorders are spiking because of El Niño. It tends to reinforce inflation. 2) *Technology.* The secular digitalisation and AI are transformational. This is a fundamentally disinflationary process that will ultimately improve productivity. 3) Macro-*Inequalities*. Financial repression aggravated it. Pandemic and LT economic drivers mark a sea-change as adverse demography, lower labor mobility, and societal factors (Great Resignation), reshoring reinforce labor. Increasing the bargaining power of labor is politically welcome, but inflationary through wages.

<u>Deglobalization</u>. BRICS / Global South are joining for a new Trade settlement order (Yuan, gold, etc.). *De-dollarization* is accelerating, and gold revival is for real.

<u>(Geo)-Politics.</u> The extremely tense situation on several fronts is likely to continue in the medium term. With the possible emergence of an Asian focus (North Korea, Taiwan). The outcome of the US elections could, if necessary, add to the unpredictability. The disruption of the Red Sea shipping lanes or a Chinese embargo on Taiwan would bring back the problems of supply chains and rising commodity prices.

<u>Economic Policies</u>. The dramatic comeback of bond vigilantes resulted from the inevitable normalisation of real interest rates. US policy-makers have so far proven proactive to contain contagion and mitigate the risks of a major breakdown / accident. Their measures, which look like financial engineering and time-saving, are temporary and technical. They provide no permanent solution. The problems of deficit and debt refinancing will return sooner or later, unless a new round of financial repression is imposed. In any case, volatility will resurface.

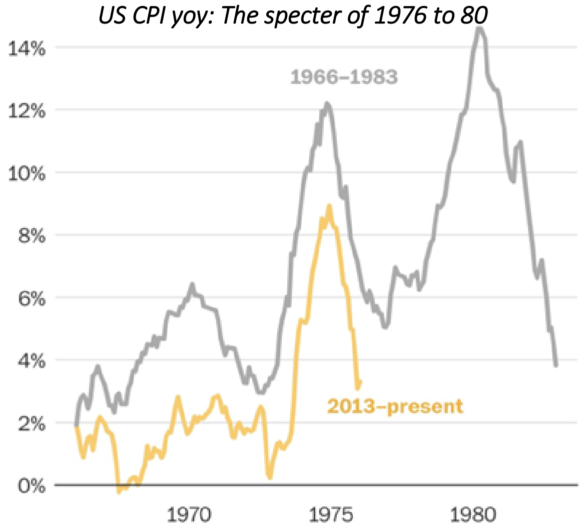
Medium term factors

Is the genie back in the bottle...?

The Fed - like the ECB - welcome the cyclical decline in inflation, which may continue for a few more months. We are approaching the central banks' targets. But still, in the US (unlike EU), it will be hazardous to cut policy rates sharply before inflation returns to 2%. Such a benign scenario will come true if the recession hits. A soft/no-landing would prove more delicate inflation-wise.

The next great unknown is the near future

US CPI yoy: The specter of 1976 to 80



Monthly data; seasonally adjusted.

Source: U.S. Bureau of Labor Statistics

A transformational AI boom ahead?

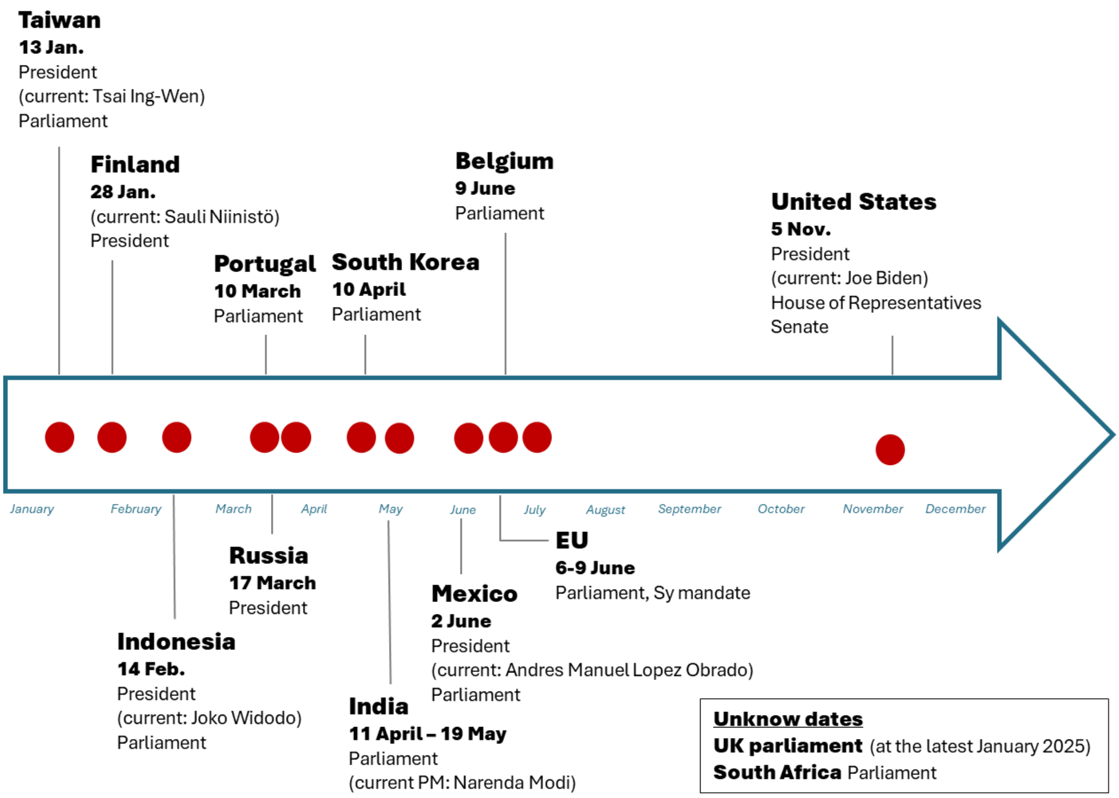
Productivity in the major industrial countries has been a huge disappointment in recent years. The emergence of ¨remote work¨, the accelerated retirement of baby boomers and the reduced mobility of workers have further confounded forecasters. We can see that AI will be disruptive, but at what pace? Will it increase GDP per worker (by increasing their efficiency), or will it encourage the replacement of humans by intelligent robots, etc.? In principle, it should improve productivity and reduce wage pressure. Nothing is certain. Nobody knows!

Thanks to a fortunate productivity boost, Greenspan delivered faster economic growth and increased prosperity without significant inflation. History may rhyme, or not! Inflation, and therefore the future direction of monetary policy, will depend (very much) on the - highly - unpredictable productivity cycle.

The unpleasant come-back of politics

The Fed hates election years, which inevitably disrupt its operations. It tries to a) avoid recessions, b) be as passive as possible around elections. Considering the two likely candidates, provided they extract from legal issues, 2024 could be particularly tricky year for Powell & Co!

The spending excesses of ¨Bidenomics¨ and the national political calendar meant that the Fed had to go fast and hard in 2023. To the point of near collapse. Ultimately, the rapid and spectacular rise in real interest rates in Q2/3-23, above the ¨unsustainable¨ 2% threshold in the US, will have marked a double turning point. The crisis of confidence and the return of the bond vigilantes were contained in Q4 thanks to a) J. Yellen's refinancing tricks and b) the Fed's - implicit - U-turn on the likely Fed Funds cut in 2024.



Taiwan (with the ¨independentist¨ candidate leading polls) India, and the EU in June are other important deadlines.

Investment regime

Complex and uncertain.

The rebound of US and Chinese liquidity contributed to a significant loosening of financial conditions in Q4. Which has been lately exacerbated by Fed's ¨pivot¨. While the odds of a severe hard landing have receded, those of benign inflation for 2025 too. Volatility may quit bonds to haunt currency / equity markets later in 2024.

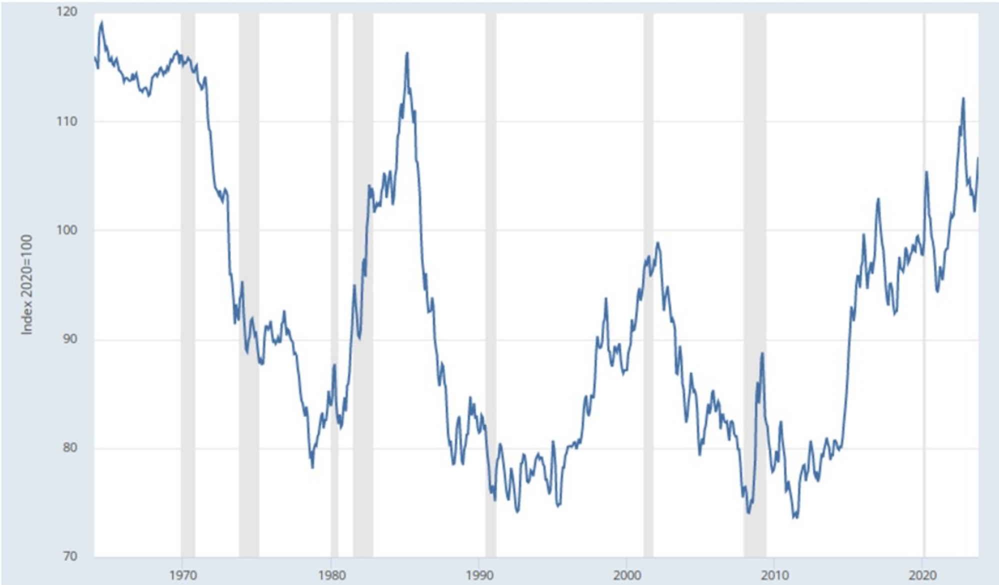
Currencies

Over slowdown periods, the USD strengthening is not systematic. It nevertheless remains the most overvalued currency.

The USD reaction into recession

Popular belief is that a hard landing is good for the USD. Really? A hard landing, as opposed to soft, triggers risk aversion and a capital flight into the safe/most liquid/reserve currency.

Dollar index, reel terms



- There have been 7 recessions in the US since the end of Bretton Woods agreement. The USD has rallied in 4 recessions and fallen in 3. The exact timing of the recession can wreak havoc with the outcome of the calculations. In 1973-75, the USD fall was slowed by the recession.
- In 1980, it fell in the recession before resuming a long rally that carried on through the 1981-82 recession and all the way to 1985 peak.
- The 1990-91 recession saw the USD falling before bouncing back.
- The USD rose during the 2001 recession. That marked the turning point.
- It fell from February 2002 until April 2008, 4 months after the start of the Global Financial Crisis.
- It then bounced, peaking in March 2009, before falling to its all-time low in July 2011.
- Finally, 2020 brief recession saw the USD rising sharply before the prospect of a Fed easing took it lower.

Overall, the dollar's direction does not correlate much with the depth of recession, or indeed with the fact there was a recession at all. 2008 and 2020 crisis certainly support the idea that a deep global recession can trigger risk-reversion and strengthen the USD. 2008-09 GFC only interrupted, rather than ended, the USD downtrend because the Fed adopted QE, sending it down in 2009. The USD sell-off in 2020 was engineered by the Fed policy before the underlying strength of the US economy reversed it.In short, the trend dominated, but also what happened

USD performance during recessions		
	REER	NEER
Nov73 - Mar75	-6.2%	-5.5%
Jan80-Jul80	-1.9%	-0.1%
Jul81-Nov82	+6.9%	+8.3%
Jul90-Mar91	-0.4%	+5.5%
Mar01-Nov01	-0.2%	-1.1%
Dec07-Jun09	+7.2%	+4.5%
Feb20-Apr20	+1.0%	+0.9%

elsewhere. And how policymakers reacted to recession was more important than how hard the US landing was. The USD rallied in 2021-2022 because US fiscal policies laid the foundations for a stronger recovery. It fell in 2009-2011 because the Fed kept policy accommodative in the absence of inflation and other central banks did not.

Fly to USD was the case at the height of recessions. But you must get your timing just right to exploit this phenomenon

What about valuations

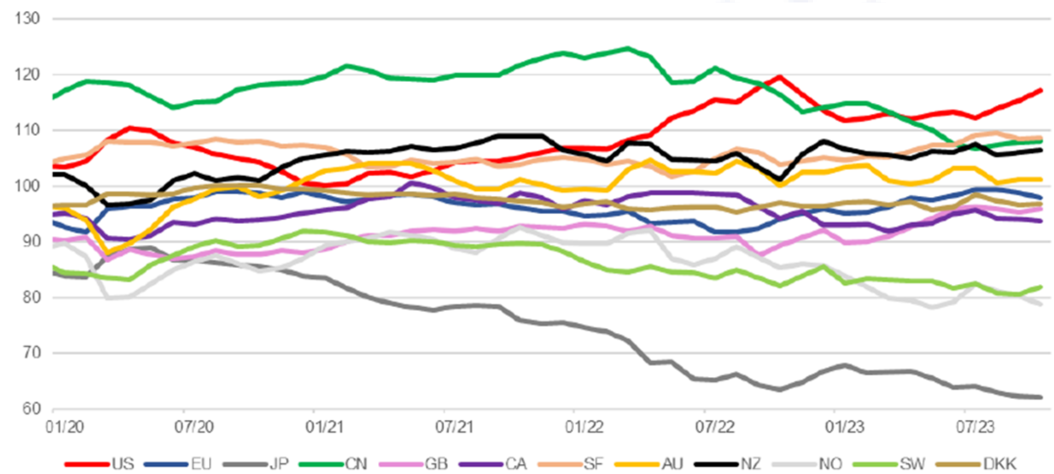
There are many ways of measuring currencies fair value, of which The Economist Big Mac Index is the best known. The OECD prefers more sober purchasing power parity indices: a comprehensive Worldwide Cost of Living Index. The most expensive currency according to the Big Mac model in the G10 + China universe is the CHF while the cheapest is the JPY. The CHF remains most expensive on the OECD calculations, but the EUR and Scandinavian are attractive and China overtakes Japan as the cheapest currency.

The caveat is that these indices will not tell you where exchange rates are headed, but highlights extremes

Currencies over/undervaluation		
	Big Mac	OECD
Switzerland	36.2	15.5
Norway	16.2	-14.2
Euro Area	2.4	-20.5
Sweden	2.5	-15.4
United Kingdom	-5.9	-9.0
Denmark	-0.6	-6.9
Canada	-8.1	-0.6
United States	-1.0	0.0
New Zealand	-11.4	-6.6
Australia	-12.6	-7.0
China	-38.2	-43.6
Japan	-46.3	-30.2

On Real Effective Exchange Rates basis, the CNY has lost its place as strongest currency to the USD. Most currencies are clustered within 10% of their average levels. So nothing too exciting. The currencies which stand out as being much cheaper or more competitive on that basis are the SEK, NOK and, by a huge margin, JPY. Furthermore, the Bank of Japan will exit the negative interest rate regime at a time its peers should cut borrowing costs.

REER as a percentage of their average value over the last 25 years



Source: SG Cross Asset Research, BIS data, author's calculations

JPY and Scandinavian currencies are the cheapest currencies, while the USD remains expensive

Bonds

A favorable environment for bonds. Real and nominal yields levels rarely reached over the last decade.

Still potential for bonds

After seemingly only heading in one direction (higher) as of late, US yields tumbled since October peak. Since touching 5%, the US 10-year Treasury yield has fallen by more than 100bps. After 6 consecutive months of negative returns, bonds have generated their best monthly return since May 1985.

Despite falling meaningfully, yields are still significantly above longer-term averages. So, the prospects for positive returns remain high. It would not take much of a sustained drop in yields to generate high single digit/low double digit returns over 12 months for high-quality bonds. A 50bps drop in yields would likely generate close to 7% return over 1 year. Moreover, if the economy slows and the Fed cuts rates more aggressively than currently priced in, these high-quality bonds could generate 10%+ returns.

Hypothetical returns over 12 months: Interest rate parallel shift

Segment perf/Yield change	-100bps	-50bps	No change	+50bps	+100bps
US Aggregate Bond Index*	10,9	7,8	4,6	1,5	-1,7
US Treasury Bond Index*	10,4	7,3	4,2	1,1	-2,1
US Invest Grade Bond Index**	12,3	8,7	5,2	1,6	-2,0
US High Yield Index (5% default, Recovery 30%)**	7,5	5,9	4,3	2,7	1,1

* Current US 10-year yield at 3.90%

** No spread widening hypothesis

Equally important, the elevated yields serve as a hedge. Higher rates level may decrease the probability of losses due to an increase in interest rates. Yields would need to increase by 1% to offset incomes.

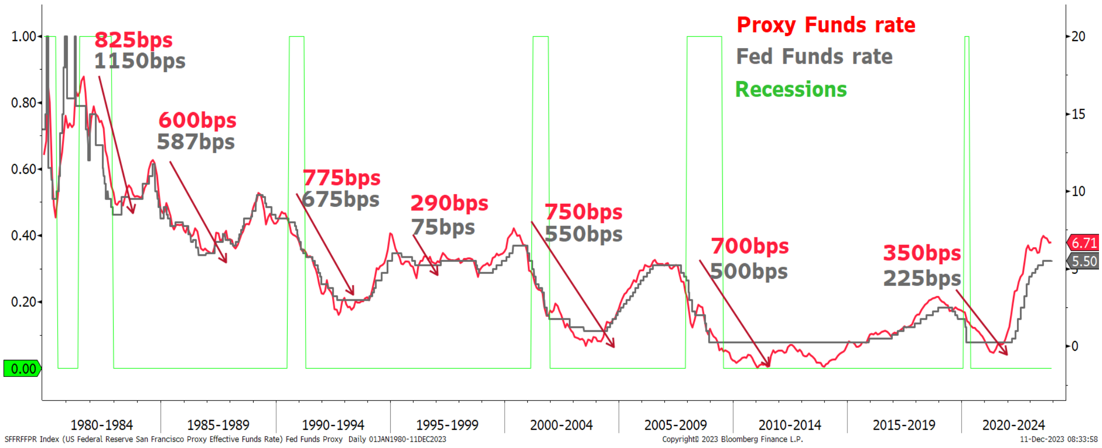
There is still room for Treasury to perform in 2024

Traditional Fed easing cycles

The Fed has announced its long-awaited pivot. Once the pivot begins, rate cuts are the next step. The scale of monetary policy easing differs in hard and soft landing cycles.

- In the 1990 cycle, the Fed rate dropped by 675bps to 3%.
- In the 2000 cycle, the Fed rate decreased by 550bps to 1%.
- In the 2006 cycle, the Fed cuts rates by 512bps to 0.125%. After hitting zero-bound, it launched QE equivalent to a further drop in rates by 188bps.
- In 2019 cycle, the Fed rate dropped by 225bps to 0.125%, and then resumed QE, which led to a further 125bps rates drop.

Fed Funds cycles



During the mid-1990s, the famous and sole mid-cycle slowdown episode, the Fed only cut rates by 75bps. However, the Fed Proxy rate was eased by 300bps. The market is currently discounting Fed Funds cuts of 135bps over the next 12 months and cumulative cuts of 150bps over the entire easing cycle.

The Fed pivot has set off a debate about how low yields can go. The US 10-year yied fell a minimum 178bps within 15 months of its peak in each of the past 8 episodes triggered by a Fed pivot. There was no direct relationship between the size of the Fed easing and the long-end yields decline. If the Treasuries latest rally conforms to historical norms, the rate would be at least 3.20% by 2024-end, maybe less.

Fed Funds peaks always translate into big yield decline				
US 10-year yield				Fed Funds Change
Peak date	Peak level	Max drop	Trought date	
févr-80	13.7	-418	juin-80	-550
sept-81	15.8	-545	déc-82	-700
mai-84	13.9	-409	juin-85	-275
mars-89	90.5	-179	août-89	-75
nov-94	8	-251	janv-96	75
janv-00	6.8	-203	mars-01	-50
juin-07	5.3	-191	déc-08	325
jov-18	3.2	-178	sept-19	0

Market is perfectly anticipating on a mid-cycle slowdown

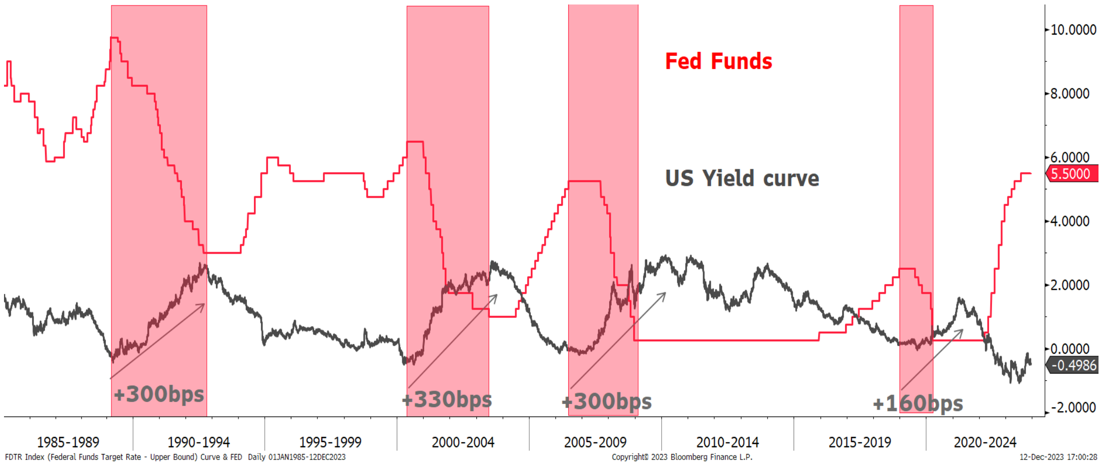
Long-end yields have room to decline further

Curve steepening ahead

Obsession with the yield curve in this cycle has been high. It indicates when to expose to bonds once the Fed cuts its Fed Funds. The last few hiking rate cycles have seen different terminal points for the curve. All were negative. The following yield curve steepening was between 160 and 300bps on the 2-/10-year spread.

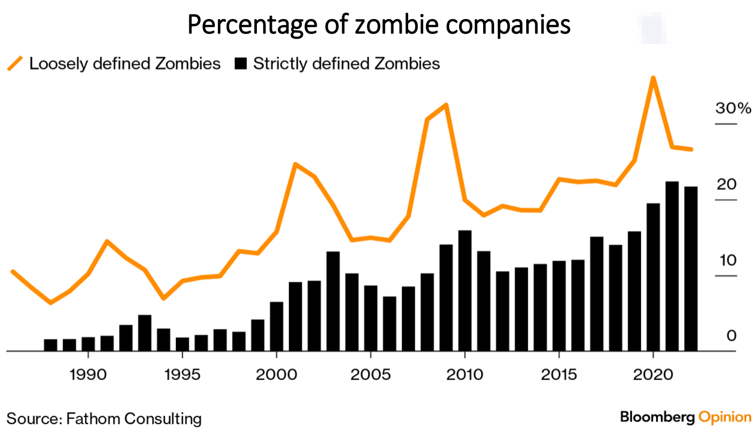
The theme for 2024 will be a push for lower rates. A traditional steepening lasts 3 years with an annual upward move of 80/100bps. The slope should turn back into positive territory. A cumulative 200bps curve steepening is more a risk for 2025 if the deficit pressures persist. A severe steepening looks unlikely. Pension funds and insurance companies have been missing most of the year. They should start accumulating bonds, avoiding a too pronounced yield curve steepening.

Yield curve steepening starts when the Fed pauses



Higher default risks

Financial strength has been declining since the early 90s. According to the Altman Z-score - a concept combining account profitability, leverage, liquidity, solvency, and activity ratios - less than 10% of listed companies look strong and healthy. The proportion of US companies being imminent candidates for bankruptcy or borderline has reached a new high. While the Altman metrics may be outdated, as intangible assets make up a far greater share of balance sheets, the idea that credit quality is degrading still stands.



Another key issue is the growing number of zombie companies. Corporates that are no longer able to grow or even produce enough profits to cover interest expenses but have survived because of low interest costs. More than 25% of US companies have an EBIT which did not cover their interest costs for one year, and for slightly more than 20% this situation has persisted for at least 3 consecutive years.

Equities

The positive factors for a good 2024 year are there. Economic developments will be decisive for stocks.

The year 2023 turned out to be excellent despite the pessimism of a large majority of investors during the first 4 months of the year (expectation of a recession and crisis in American regional banks).

The American stock market benefited greatly from the extraordinary performance of the Magnificent 7 (Apple, Microsoft, Alphabet, Nvidia, Amazon, Meta and Tesla). The Bloomberg Magnificent Seven index increased by 104%, however, in this performance there is a part of a catch-up after an excessively difficult 2022 year where their share prices were divided between 2 and 2.

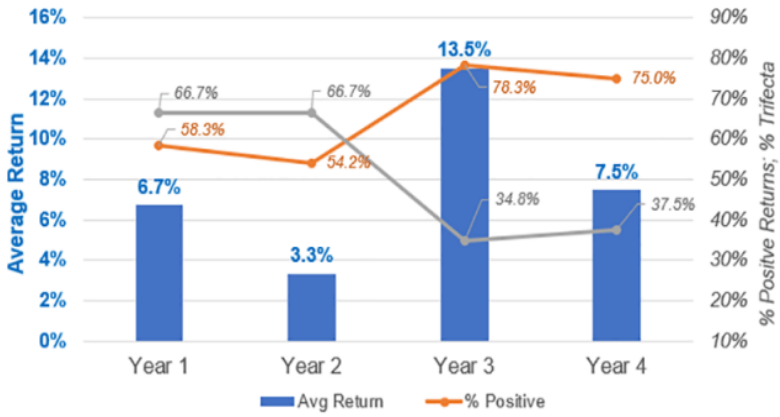
But the situation is not so clear: if the S&P 500 is up more than 20%, the S&P 500 Equal-Weight is still up more than 10%. The Euro Stoxx is up 20%, even though Europe is not particularly known for its techno stars. Europe benefited from good performances among in its luxury stars, as well as other Value and cyclical sectors such as construction materials, finance, automobiles (in particular Stellantis and Ferrari) and industry.

The 2024 year promises to be favorable for stocks with the 4th year of a US presidential cycle, the resumption of the profits cycle, the announcement by the Fed on December 14th of its Monetary Pivot and a potential flow of money coming from monetary funds.

The recession, the most anticipated in history, is still not here in the United States, although the inversion of the 10 years-2 years curve occurred in July 2022 and that of the 10 years-3 months in November 2022. On average, a recession arrives within 12-15 months after an inversion of the curve. We're still on time. The stock and bond markets anticipate a mid-cycle economic slowdown rather than a recession, which puts a damper on our analysis: in general, we are cautious on consensus.

The 3rd year of a presidential cycle (2023) is statistically the strongest and the 2nd (2022) the weakest. Since 1928, the S&P 500 has advanced 78% of the time (orange dots) in year 3 for an average return of 13.5%. The gray dots are the percentage of positive time with a *Trifecta* (one party controls the White House and Congress); clearly, years 3 and 4 prefer that a party doesn't control all which is the case today.

Le cycle des élections présidentielles et les rendements du S&P 500



The narrative of a US presidential cycle is based on this theory: Presidents do the heavy lifting in their first and second years in office, then prepare for re-election in the fourth year by being pro-market in the third year. Analysts did not find coincidental factors with fiscal and monetary policies. On the other hand, the degree of control a party has over the government and Congress is a critical factor.

Historical economic regimes and market performance

Economic regime	Average 3-month S&P 500 return during period	Average 3-month return relative to all periods	Statistically significant (>95%)?
Rising growth	2.99%	+0.81%	Yes
Falling growth	1.54%	-0.64%	Yes
Rising inflation	1.36%	-0.82%	Yes
Falling inflation	2.70%	+0.52%	Yes
Rising growth/ falling inflation	3.52%	+1.34%	Yes
Falling growth/ rising inflation	0.49%	-1.70%	Yes

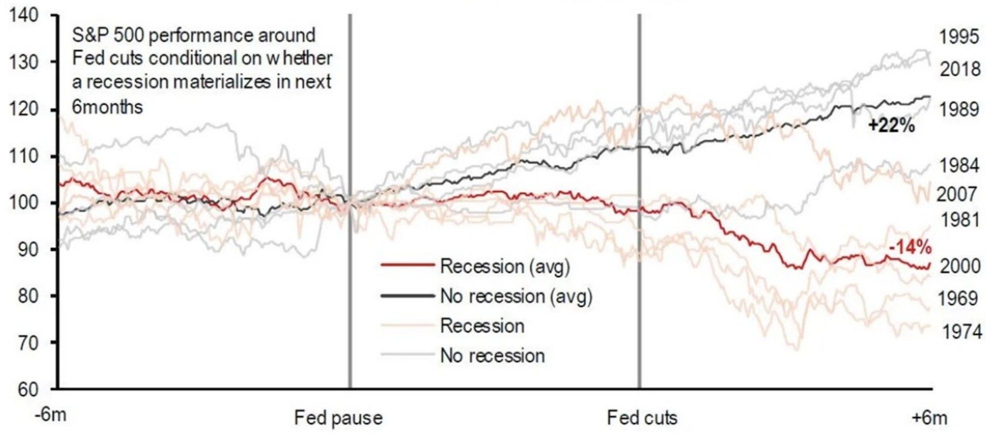
Source: U.S. Bank Asset Management Group.

Will 2024 be disappointing given the sharp rise in indices in 2023, well above the average of 13.5%? It's a risk.

The economic regime is important for the evolution of stocks. The table below shows (since 1948) the performances of the S&P 500 under different scenarios. Unsurprisingly, periods of economic growth and falling inflation are the best times.

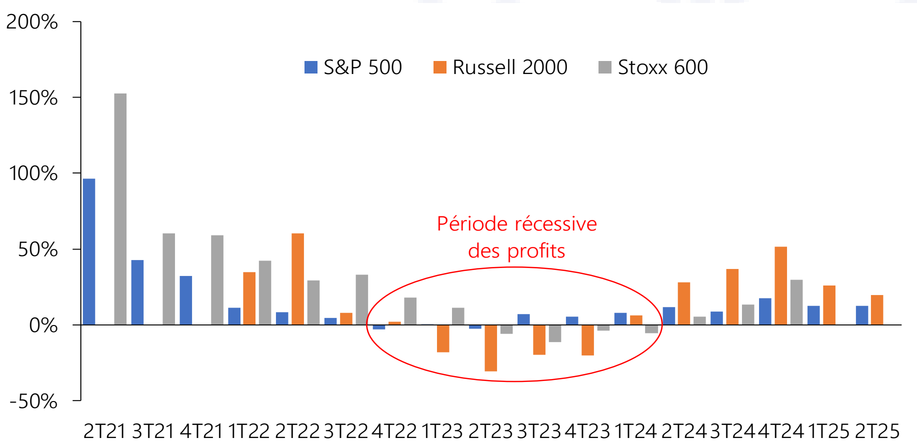
The Fed's action will be decisive. It announced possible cuts in Fed Funds in 2024, but the direction of the stock markets, of the S&P 500 in this case on the chart below, will depend on the cause: reaction to a recession (bad for stocks) or drop in inflation (good for stocks).

19. Performance of S&P 500 around Fed pauses and easing

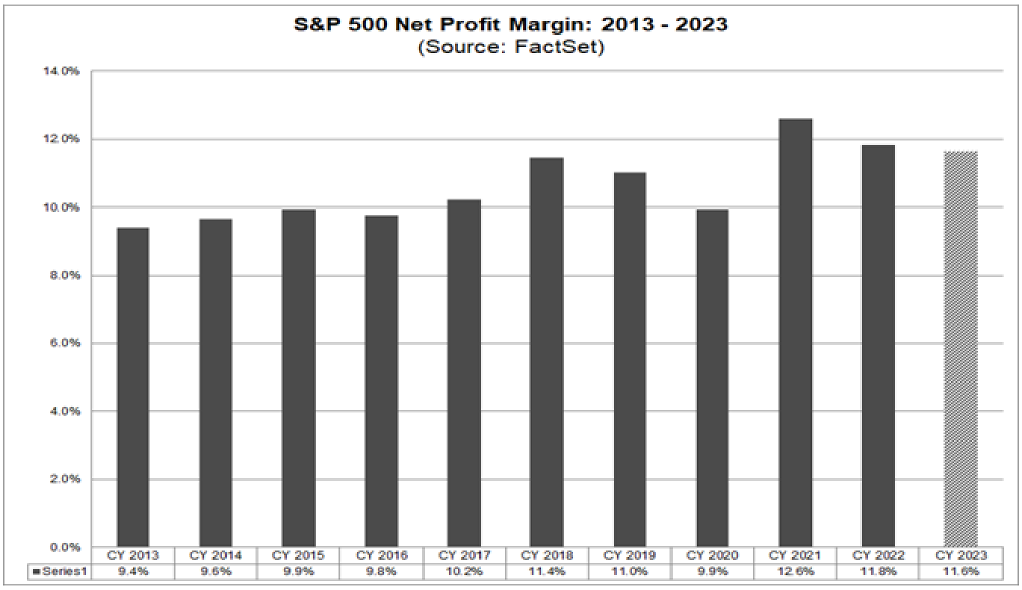


In conclusion, when the Fed announces a pause, the direction of the economy will be decisive.

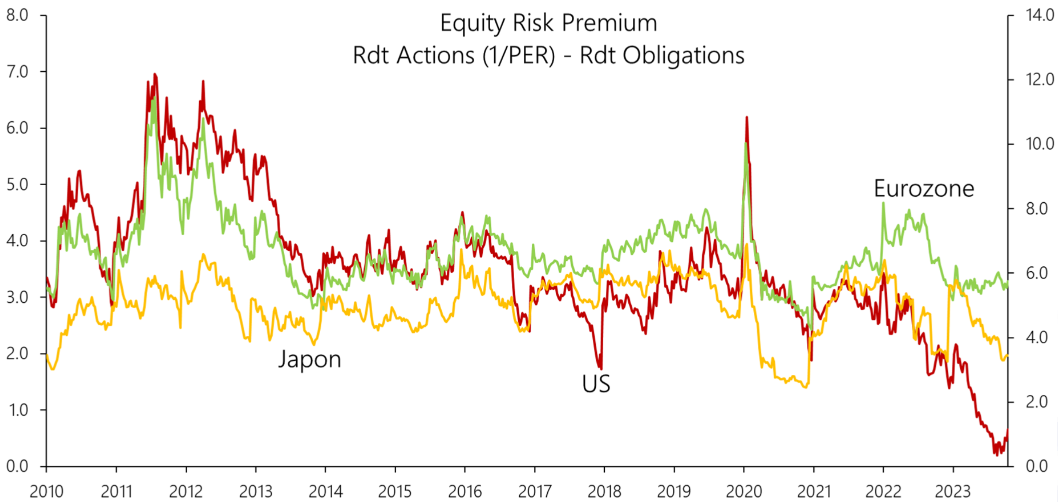
The latest bottom-up estimates from Factset and Lipper Alpha expect a recovery in the profit cycle after a recessionary period between 4Q22 and 1H23. Concerning the S&P 500, Factset and Lipper Alpha estimate for 2023 an increase in EPS of +0.6% and +2.5% respectively and for 2024 of +11.5% and +11%.



For 2024, the Energy and Health sectors receive the most positive recommendations, while in 2023 these two sectors are among the worst stock market performers. Technology and Communication/Media remain favorite sectors, driven by AI. For the last three years, companies have demonstrated strong resilience in terms of profits and margins.



Equity Risk Premium gives different results depending on the region. In the United States, we would overweight bonds compared to stocks in a tactical allocation. For Europe and Japan, the ERP is neutral.

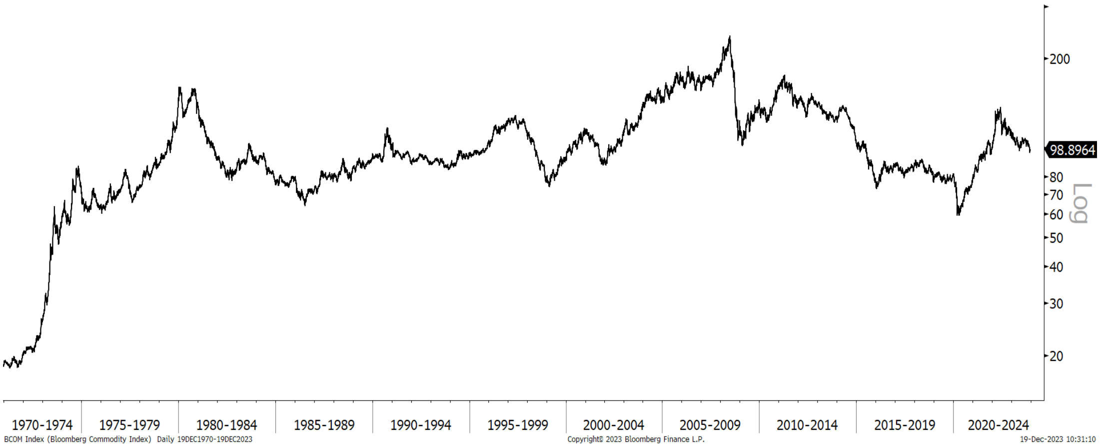


Commodities

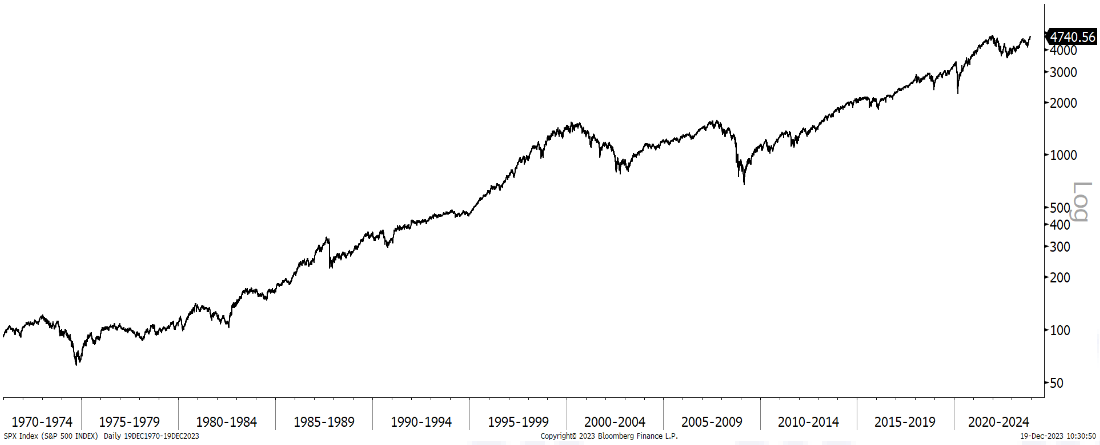
The Commodities Supercycle seems a long way off. Disruptions in supply and demand.

Unlike stocks, physical commodities do not create value for investors. It's a question of supply and demand. Demand fluctuates according to economic developments and supply adapts to match demand. In oil, part of world production is controlled by OPEC to try to control prices. Geopolitical shocks also enter the equation.

Bloomberg Commodity Index. Same level as in the 1970s



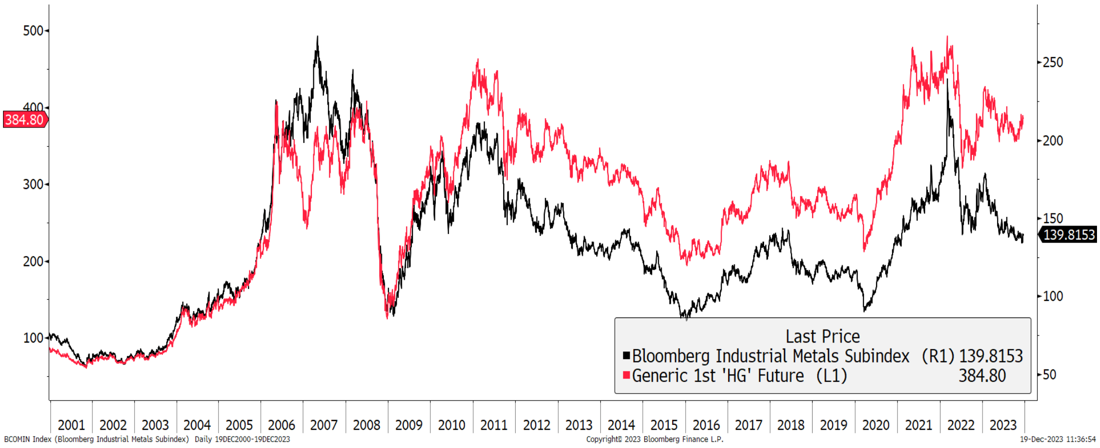
S&P 500. Creating shareholder value



In 2020, a sharp increase in demand for industrial metals from investments in the energy transition was expected, but the cost of the pandemic and the rise in energy and electricity prices due to the Ukrainian war have slowed down green investments. Governments no longer have such deep pockets and prefer a smooth transition where fossil fuels will not disappear as quickly as expected.

The economic and real estate crisis in China is weighing on demand for industrial metals. China has supported demand for the last 2 decades, but prices have not exploded thanks to the supply response. And demand decreases when prices get too high.

Bloomberg Industrial Metals Index and copper prices. Current levels are comparable to those of 2005 and 2010.



With the Israel-Hamas war and climate change, supply chains using maritime transport, which also concern raw materials, are under pressure. Two strategic corridors (17% of world trade) are threatened, the Panama Canal and the Suez Canal. This could disrupt world trade.

The Panama Canal has reduced boat traffic by 40% to 50% due to a historic drought caused by El Niño. The level of the canal, fed by two artificial lakes currently dried up, is no longer high enough. 40% of US container traffic crosses the Panama Canal. As for the Suez Canal, it is affected by Houthi forces, close to Iran, who target Western boats in the Red Sea. All major shipping companies, MSC, Moller-Maersk, CMA, CGM, have suspended navigation in the area.

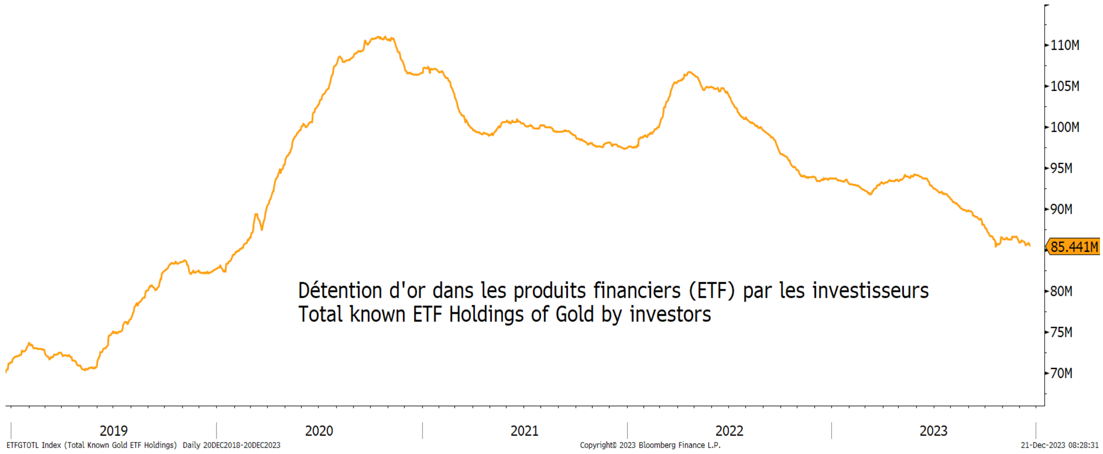
With the global economy already in a just-in-time situation, the transport of gas, oil, corn, wheat, soybeans and rice could be strongly affected, potentially pushing prices up.

We remain cautious on industrial metals, while oil and gas remain “interesting” in the current geopolitical situation.

Precious metals

On the way to a ¨secular¨ breakout?

Looking at flows into Gold linked products, large institutional investors and other asset allocators showed little interest in 2023, as interest rates rose. Normally, when the opportunity cost of holding gold rises, its demand falls. Except that in the post-pandemic economic regime, things have changed dramatically. Geopolitics, de-dollarization and the evolution of cross-asset correlations are no longer the same. Politics is going to make a spectacular comeback with about 50% of world population expected to vote for presidential and/or legislative elections. In any case, Emerging market central banks have become a secular buyer of last resort that did not exist before. With China as the key player. And there's probably more disruptions to come. The tail risks are getting fatter as times goes by…



The year 2024 will be crucial in terms of future economic policy, even simply in the US. Both Bidenomics 2.0 or a Trump comeback, if supported by a partisan Congress, would result in non-trivial macro outcomes. Would we rush to higher average inflation to digest the debt? Or experience a recession followed by the firing of the Fed boss, a collapse in interest rates, not to mention YCC if deficits soar? These extreme scenarios are no longer anathemas in current political landscapes: their mathematical expectation is - unfortunately – far from insignificant. In any of these three ¨extreme¨ scenarios, precious metals could really make new highs and act as a ballast in portfolios.

In the current consensus scenario of investors - a soft landing - and a return to pre-covid normality, precious metals will not shine particularly brightly and are more likely to be influenced again by trends in the USD and/or (real) interest rates. Nothing dramatic in principle! Particularly if global liquidity keeps rebounding, which seems likely.
One needs to maintain a strategic allocation to precious metals in any diversified (international) portfolio.