SELVI & CIE

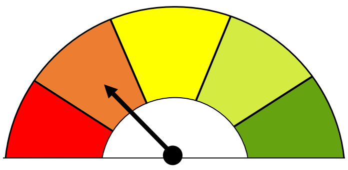
THE FINANCIAL LETTER

REVIEW, OPINIONS AND MARKETS' PERSPECTIVES

SPRING 2024

Investment context

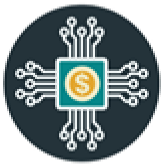
The economic and geopolitical contours of the new post-pandemic regime are slowly beginning to emerge. The task of political leaders and central bankers will be particularly complex over the next few years. The ongoing global geopolitical recession, characterised by two seemingly intractable conflicts, is unlikely to improve in a sensitive US election year. The likelihood of ultra profligate policies, fiscal dominance, central bank cooperation/collusion and ultimately higher inflation increases as major disruptions become more deeply rooted. The market party may continue as long as nominal growth is strong and global liquidity ample. But the clock is ticking, as complacency grows despite greater macroeconomic distortions and ¨accidental¨ risks than in previous decades.



The delicate transition between regimes is accelerating

Main indicators in 20284
(on March 28th)

Indicators	Variation %
Eurostoxx 50	+12.4
Swiss Market Index	+5.1
FTSE 100	+2.6
S&P 500	+10
Short-term rate EUR	3.8
Short-term rate USD	5.4
EURUSD	-2.2
EURCHF	-5.2
Barclays Euro Bonds	-0.3
Barclays US Bonds	-0.2



¨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

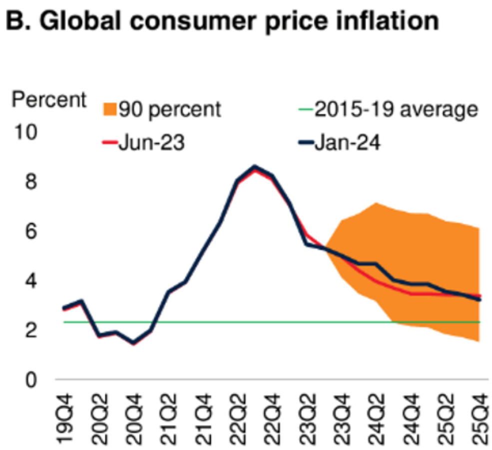
- Sustainbility of positive real rates
- War economy
- From Wealth Effect to what?
- Central bank digital currenciers
- Debt Sustainability (Minsky)

Investment framework

The benign macro backdrop of subdued growth and uncertain disinflation in a deeply decoupled world is set to continue. Not to mention dire geopolitics. Nevertheless, ample liquidity and the prospect of lower policy rates in the US have trumped fundamentals and supported risky assets. But the imminent confluence of slowing global investable liquidity and improving growth (inflation) should dampen risk appetite and tame financial markets. This perspective is reinforced by the current shift in market perception, i.e. the recent rotation in favour of commodities, their proxies and cyclically sensitive assets. The duration of the current a Goldilocks environment is difficult to predict. But the chances of less directional and more volatile markets are increasing, in line with growing speculation and complacency.

We expect a resurgence of volatility from Q2/3

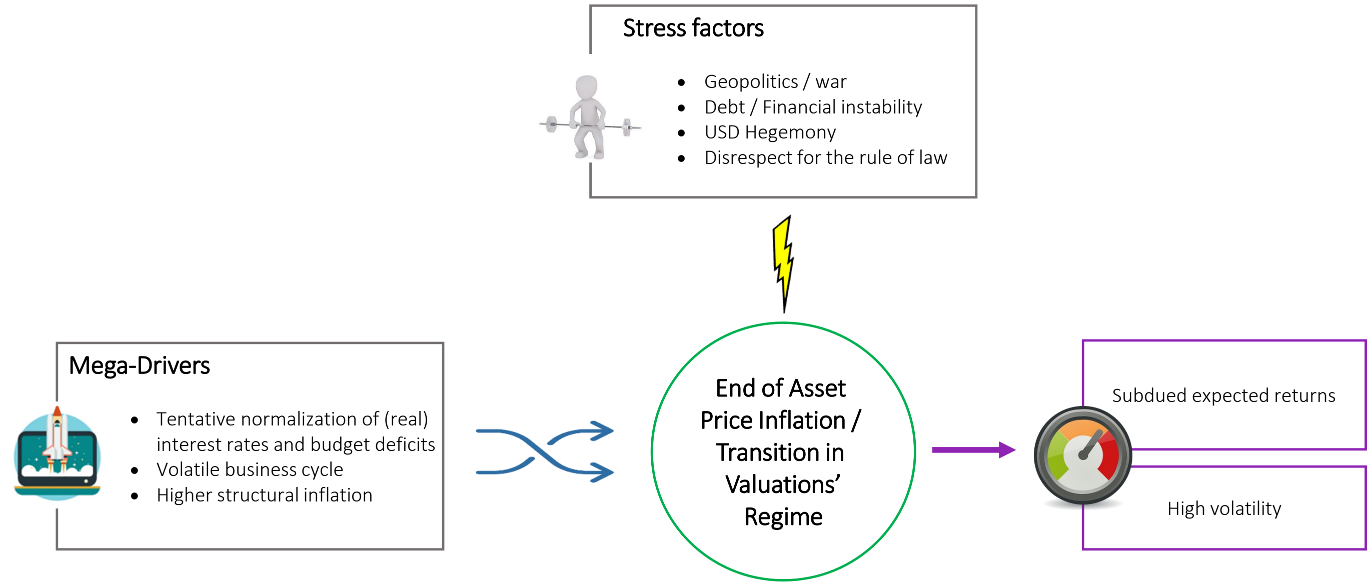
World bank inflation forecasts: a very broad spectrum of possible developments



Long-term drivers

We consider **three secular disruptors.** 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.

Deglobalization. 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.

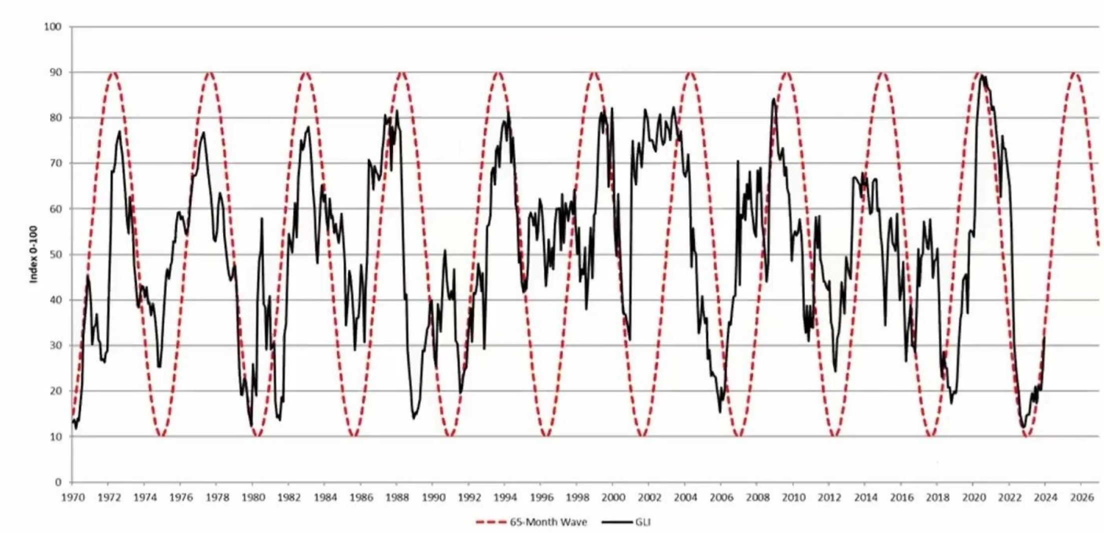
Medium term factors

Watch for liquidity developments

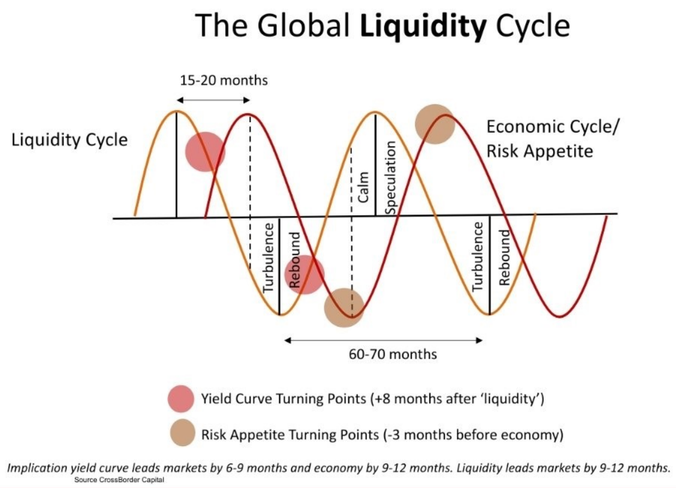
US policymakers have done an excellent job over the past 12 months of tackling the looming crisis with engineering and gimmicks from Yellen's Treasury, combined with a proactive Fed. First, the BTFP program saved regional banks from a full-blown crisis of depositor confidence. Second, the focus on Treasury bills allowed for the mobilization of huge amounts of capital sitting in the Fed's RRF. In a magic trick, the US managed to simultaneously a) raise policy rates and reduce its balance sheet, i.e. QT, but more than sterilize the negative impact on USD liquidity. Hats off to the performers!

¨Modern¨/algorithmic financial markets are particularly responsive - addicted - to changes in the liquidity framework. In a broad wave - the so-called ¨everything rally¨ - they have therefore performed very well in recent months. The question is how they will react to the eventual change in the liquidity framework that is looming. Indeed, the BTFP program is winding down and the RRF war chest has fallen by over 70%. Japan will also become less of a serial printer in the coming months, even more so if it must intervene in the FX markets to boost the yen. The likelihood of a pause in global liquidity creation, which is likely to come very soon, is increasing. Even more so if oil and commodity prices rise, with higher USD costs for holding inventories…

Liquidity: A remake of 70-72 and 91-92?



There is a hierarchical relationship between the major cycles. The sequence starts with liquidity, followed by macro/ business. Yield curve and market developments tend to come in between. Returning to the global - and US - cycles, we see that indeed a liquidity recovery started first in early S223, followed by significant yield curve and risk asset reactions. It would herald a global growth rebound this spring/summer, supported at this stage by the green shoots observed in global manufacturing.



As far as the near future is concerned, the eventual slowdown in liquidity creation, coupled with the resumption of growth, should tame ¨speculation¨. Ultimately, this would lead to higher volatility and hence greater uncertainty in the direction of financial markets. A liquidity *squeeze*, which is unlikely unless there is a significant rebound in inflation, would cause serious market turbulence.

Investment regime

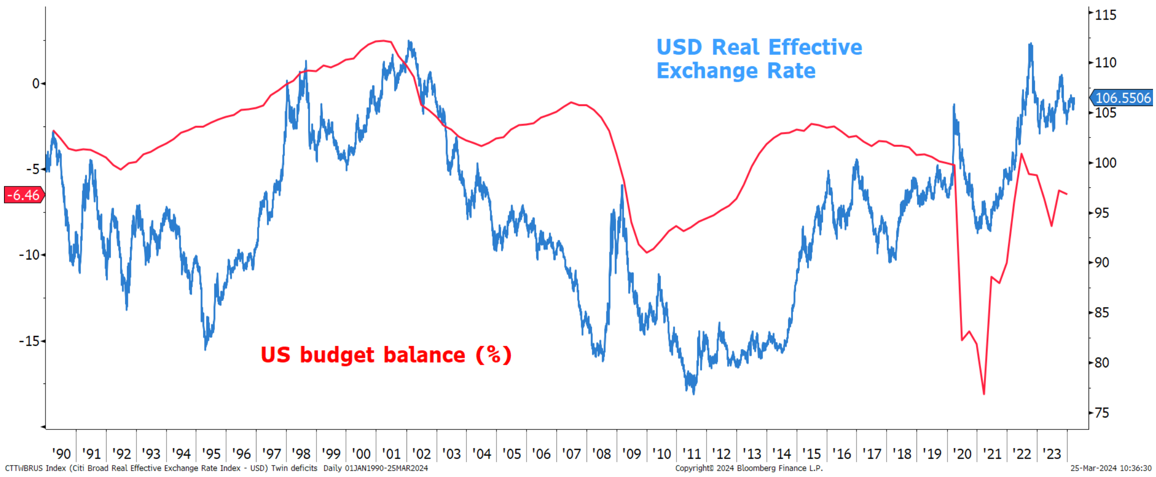
So far, so good. But things are likely to get complex and uncertain very soon. Upcoming transitions in liquidity and economic cycles, coupled with the dire geopolitical situation, argue for some caution in looking ahead. The current robust animal spirits of investors should soon be tested.

Currencies

The current USD bull market started in 2011 and was driven by US growth outperformance. Private sector outperformance drives capital flows into the USD. Other factors like higher US rates, technology leadership and energy independence have played important roles too. The rest of the world experienced a weaker growth. The European economy was languishing, and China trajectory turned lower. A strong contrast relative to the US.

There is a distinction to be made over the course of the USD bull run. The dollar advances in 2011 and 2019 were driven by private sector dynamism in the US, tremendous US equity performance and expansion of household net worth. However, things changed post-COVID. The US economy outperformed largely because of huge fiscal policy support. There are elements reminiscent of the early 1980s, when there was an easy fiscal/tight money dynamic. The Reagan tax cuts set the stage for Fed Chair Volcker to tighten monetary policy further, and that dual combination propelled the USD higher.

Fiscal position explains the USD dynamic



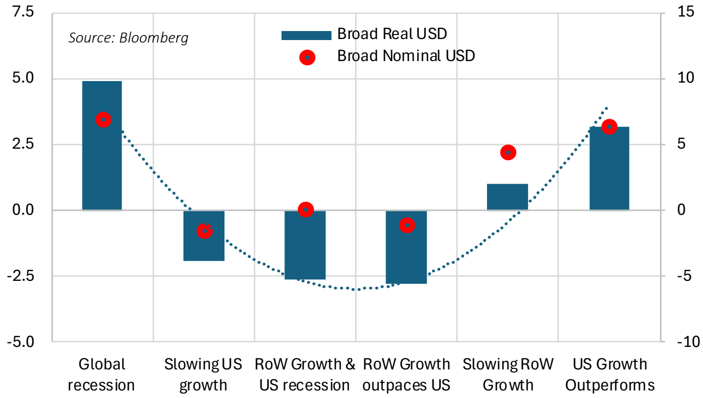
The US fiscal policy response was remarkable and bigger than most other parts of the world. And because it was so much bigger, the Fed had to respond more aggressively. One striking data point is household net worth. From 2013 to 2019, household net worth expanded sizably. At the same time, government debt levels drifted higher, but only minimally, suggesting a lot of pure private sector wealth creation. Over the last 3 years, the net worth expansion has roughly equaled the expansion of government debt. There has been a transfer of wealth from the government to the private sector. This is not true growth, or at least not sustainable growth.

We attribute the USD recent years advance to this fiscal story more than to true private sector or tech-led stories. However, this view of the USD does not mean the US is somehow significantly less exceptional than it has been.

Most of the significant fiscal policies the US has employed over the last several decades were countercyclical. The government increases spending or cuts taxes when the economy is weak. Since 2018, there has been a shift to using fiscal policy even when the economy is strong, making the Fed job harder. Going forward, rate of change of fiscal policy expansion should slow. It seems fiscal policy has reached an inflection point and likely will not offer the same support. Additionally, the Fed has not cut interest rates yet. So, there are reasons to think the US economy will slow relative to last year as fiscal support wanes. One risk is a Trump presidency potentially would bring further protectionism. So, higher US tariffs would tend to depress other currencies as they adjust to the relative expensiveness of their exports to the US. However, Trump also has complained about the strength of the dollar, he wants a policy supportive of US competitiveness. Raising tariffs along with a strong USD does not achieve that objective. One possibility to get a weaker USD is through the Fed and his Chair replacement in 2026. Another risk is the takeover of the federal debt on a structural basis. This would require cutting fiscal expenditures or raising taxes, but a significant change seems unlikely on that front.

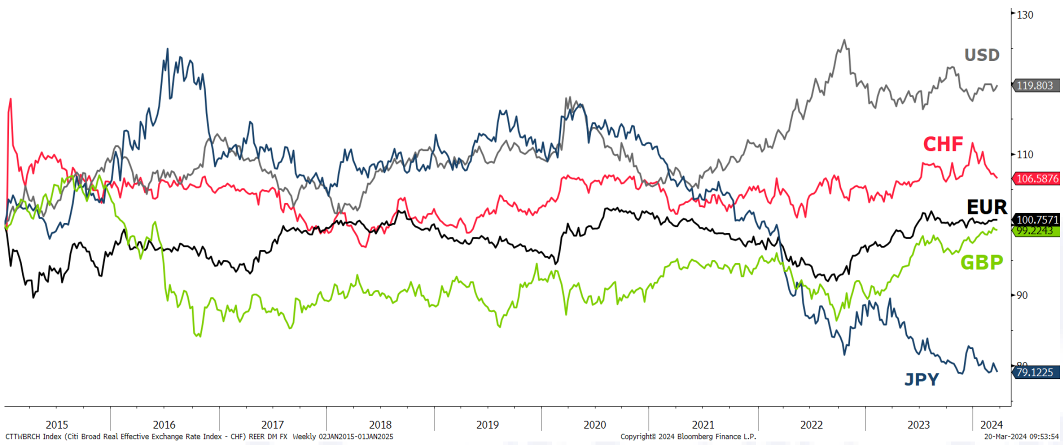
The USD smile refers to the idea that at the extremes, the USD does well

Reality shows relative US-RoW growth regimes do matter the USD



If the economy is too hot, the Fed must be more heavy -handed on monetary policy. On the other hand, a hard landing that causes risk assets to struggle also tends to lead to safe-haven flows into the USD. The dollar struggles in the middle, when global growth is benign, resulting in less of a reason to hold safe-haven assets. This has been the environment of the last 18 months. The dollar is down, despite the US growth outperformed. Over the last year, the US outperformed much of the developed world. But currencies have not responded as one might expect in that context. The most notable example is the EUR. It has rallied over the last 18 months, even as US growth has outperformed European growth. That might speak to valuations as the dollar is more expensive at this stage.

Long term valuation models still highlight a rich USD



The currencies that have struggled most are currencies closer to China. It is there we have had the biggest growth disappointment. The yen has been one of the worst-performing currencies over the last several years. As the world has raised interest rates, the Bank of Japan hasn't. This stark contrast in monetary policy has weighed heavily on that currency. Japan is in a different stage of its cycle. While inflation and wage growth are slowing in most parts of the world, the opposite happens in Japan, and policy may need to change quite significantly. The yen is a very cheap currency.

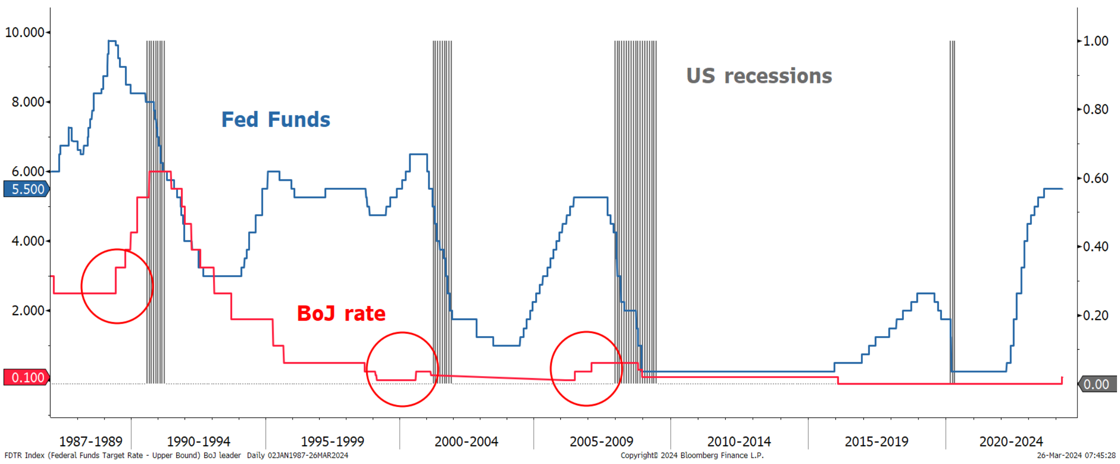
Bonds

Yields remained rather volatile in February and March, reflecting uncertainty about the actions of central banks and the ongoing upside data surprises. However, the market volatility remains on the decline. The MOVE index has reached its lowest level since Q1 2022.

The countercyclical player

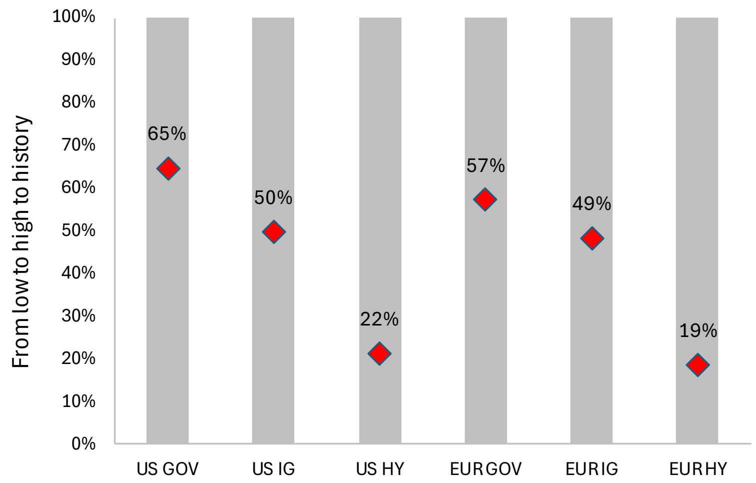
Since 1999, the Bank of Japan has provided de facto zero interest rate funding to Japan and the world. Governor Ueda has hiked rates and 25 years of 'capitalism at zero funding' comes to an end. In the history, no single indicator has done a better job of predicting when the next global recession will start than when the BoJ starts raising rates. Obviously, there is no causal link between Japan raising rates by 25bps and the global economy going down in flames. It is just that Japan has a habit of hiking rates towards the end of business cycle expansions.

Desynchronized policy actions



Not all the fixed income valuations are still compelling

Yield as a percentage of the historical yield range



Source : Bloomberg

The fixed income valuation picture remains distorted. Fixed income valuations are relatively attractive for investors with a long-term horizon, looking for carry. This is particularly true for total yields on top quality bonds, which are attractive by historical standards.

Looking at the percentile rank of current total yields since early 2000s, most asset classes rank in the 50s, at the exception of the US government bonds. It is true that credit spreads look stretched. The picture looks worst when looking at the percentage of the total yields instead of the ranking. The High Yield market offering a below 8.00% yield is clearly closer to the lows than the highs.

Entry point matters

Given the attractive level of high-quality bonds yields, the outlook for forward returns has improved. This is because there is a strong relationship between starting yields and subsequent returns. At a starting yield of 5.00% for US IG, the median return for the subsequent 5 years stands at 5.9%, with a return range of 3.3% to 7.1%.

In addition, the prospects for fixed income expected returns have been strengthened by the signals of gradual future rate cuts. Analyzing the history for high quality bonds, the likelihood of higher forward returns has moved up.

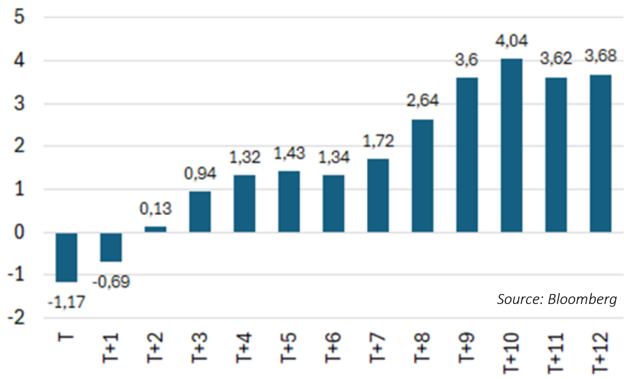
Yields vs. subsequent 2-year returns

What is more impressive is that the entry yield above the 8.0% hurdle in the HY does not guarantee a positive return over the next 2 years. While for top quality bonds (Govt & IG) the historical distribution shows a lower proportion of negative returns over the next 2 years.

Time to move away from cash and back to fixed income

Cash allocations continue to be significant. We stand at an important inflection point, however. Typically, shortly after the peak of the central bank policy rate has been reached, cash starts underperforming credit. This is precisely where we are right now. Going forward, the probability of cash outperforming credit is likely to drop, especially given the expected rate cuts in the pipeline.

Short term credit (1y3y) relative performance against cash after Fed Funds peaks (months)

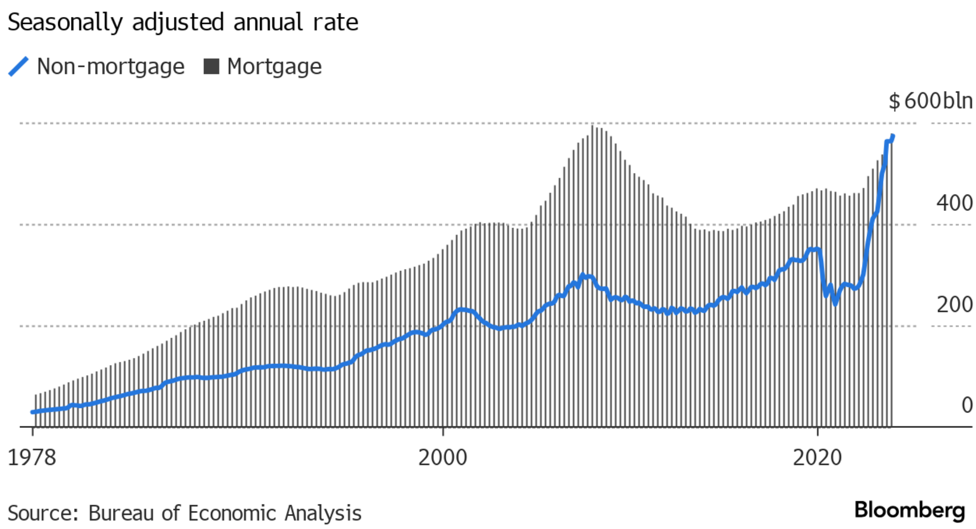


More Americans are defaulting, and no one is paying attention

More companies have defaulted on their debt in 2024 than in any start to the year since the global financial crisis. Inflationary pressures and high interest rates continue to weigh on the riskiest borrowers. This year global tally of corporate defaults stands at 29 in February, the highest count since the 36 recorded during the same period in 2009. Furthermore, non-mortgage debt moves with rates unlike mortgage debt which is long-term fixed. So, the Fed tightening is working. For the first time in history, US interest payments on non-mortgage debt are equivalent to interest on mortgage debt, at $575bn. Furthermore, 3 years ago interest on non-mortgage debt was half of interest on mortgage debt at $250bn.

Americans are fighting inflation with high interest rate debt

Interest payments by US households



It is easy to think about US consumers as a hardy, resilient force. They have continued to spend and drive the economy even as inflation and rate hikes made almost everything more expensive. But there may be trouble brewing under the surface. Credit card delinquencies could be the worrying new plot twist. Delinquencies are sitting at 3%. Historically, a figure that is hardly worth losing any sleep over. Delinquencies at smaller banks have catapulted to nearly 8%, hitting levels never been seen before. There is an unmistakable sense of foreboding, nonetheless. The initial impacts have been absorbed by more vulnerable consumers. Credit card interest rates have been hopping to dramatic new heights, nearly 22%.

In such a context, US High Yield spreads surprisingly dropped below 300bps. The index has only seen spreads drop below 300bps a handful of times over the past 30 years. It was in 1996, 2004, 2006, 2021 and 2024. In a few instances spreads remained below or near 300bps for quite a while. Historically, once spreads dropped below 300bps, excess returns were modestly positive, on average, over the next 3 and 12 months. And more importantly, excess returns were generally negative, on average, over the next 24 months. The average excess return was -10% over 2 years.

American consumers fuel over 70% of the US economy and look more fragile than they appear

Spreads could stay low for a while after dipping below 300bps

Forward excess returns are tilted to the downside

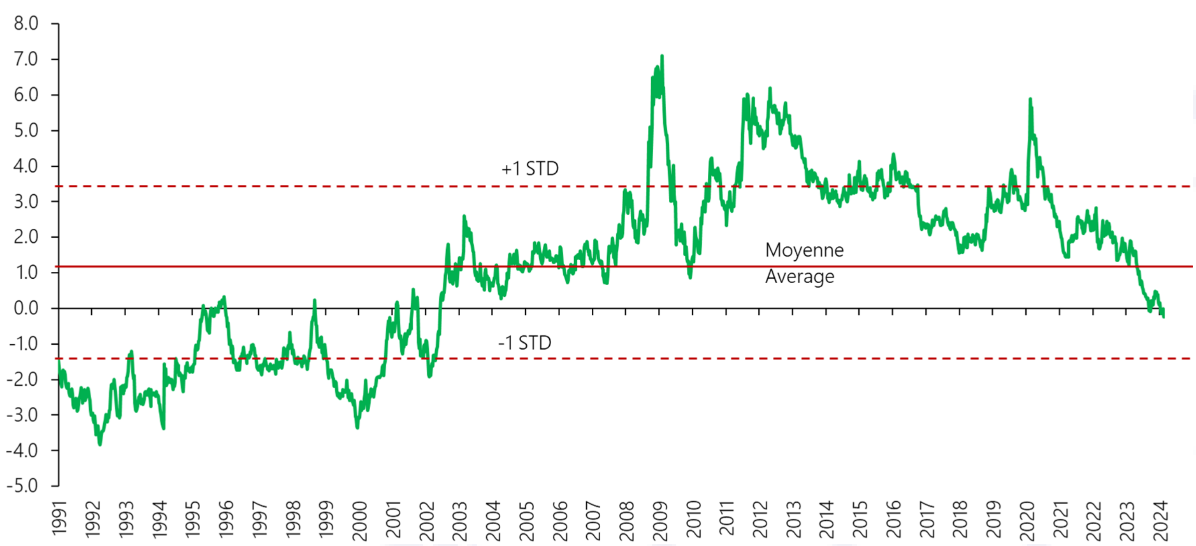
Equities

Records are made to be broken

Indices break their all-time highs. The fundamental, technical and statistical environment is favorable. Despite geopolitical and climatic upheavals, the global economy is resilient, but held together in part by the rising debt and budget deficits necessary for the economy of “war”. The textbooks tell us that we have to invest in difficult times and return to reasonable management (reducing debt and deficits) when everything is going well. Historically, stock markets rise after a period of central bank rate hikes. We have been at a plateau since the summer of 2023 and the Fed and the ECB are expected to lower their reference rate in June. The prospects for improving productivity through generative artificial intelligence are positive for stocks. Sam Altman, boss of OpenAI, says that generative AI will create general artificial intelligence that will outperform humans, with considerable productivity gains for businesses. AI would rather be deflationary. In October 1996, Alan Greenspan, Chairman of the Fed, highlighted the tremendous productivity gains thanks to technology, fiber optics and a radical transformation of production processes. We know the rest of the story with a sharp rise in stock market indices until 2000.

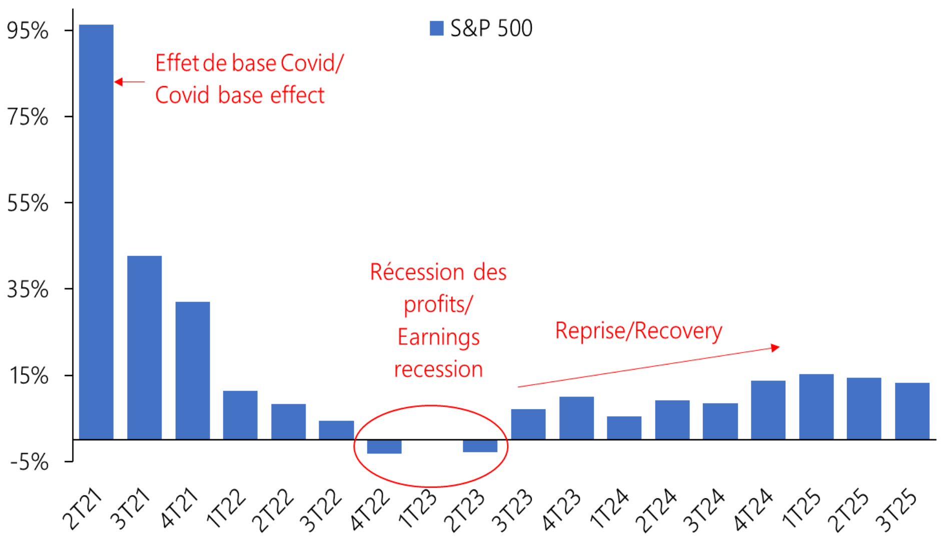
Defensive sectors underperform. Investors are investing in technology and industry, which is rather cyclical. Large companies pay attractive dividends, have significant share buybacks program and boast strong free cash flow, although some might be tempted to make comparisons with the dot-com bubble of 1998-2000. Investor confidence is such that there is little volatility and demand for downside protection is low. However, the relative caution of investors can be seen in the marked positioning on large companies to the detriment of small and medium market capitalizations; another major difference with the 98-00 internet bubble where small market capitalizations strongly outperformed. The only black spot could be the Equity Risk Premium of the S&P 500 which is in an unfavorable zone for stocks compared to bonds. This is less true for Japan and Europe.

S&P 500 Equity Risk Premium



Corporate profits are beginning a resumption of an upward cycle. Those of the S&P 500 are 2 quarters ahead of the Russell 2000 and Europe.

S&P 500 quarterly profit growth

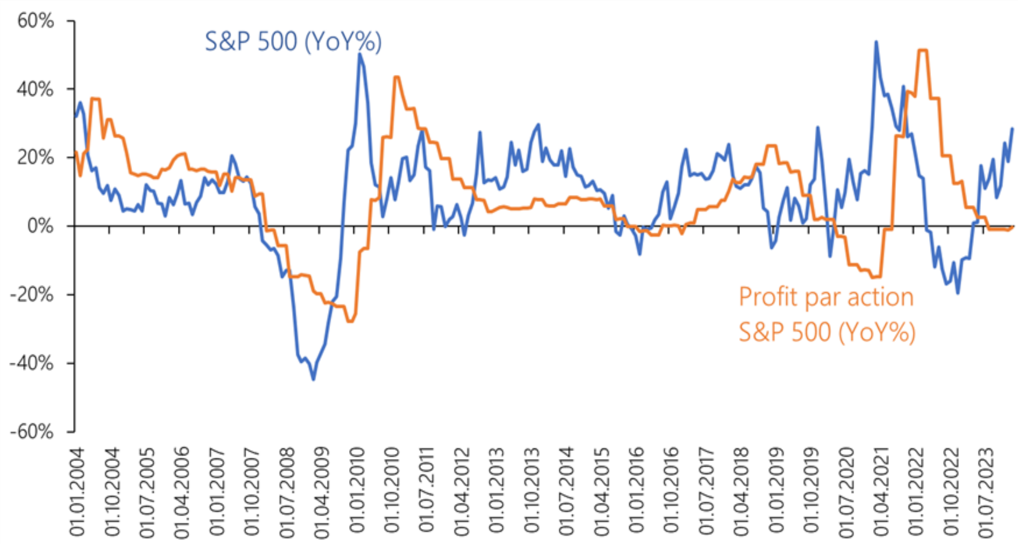


Stock market valuations are in line with the inflation cycle. At 21.8x 2024, the S&P 500 remains in the historical range.

Historical relationship between PER and inflation

Inflation vs. Valuation				
	S&P 500 forward P/E			% of time
CPI (y/y % change)	Average	Lowest	Highest	
-2 to 0%	16.4	13.5	17.8	1%
0 to 2%	17.8	11.9	27.2	27%
2 to 4%	16.9	10.0	26.4	39%
4 to 6%	15.1	9.0	24.4	16%
6 to 8%	11.8	7.2	22.7	7%
8 to 10%	11.4	6.6	20.1	3%
10 to 12%	8.8	6.7	11.0	3%
Above 12%	8.0	6.8	9.4	2%

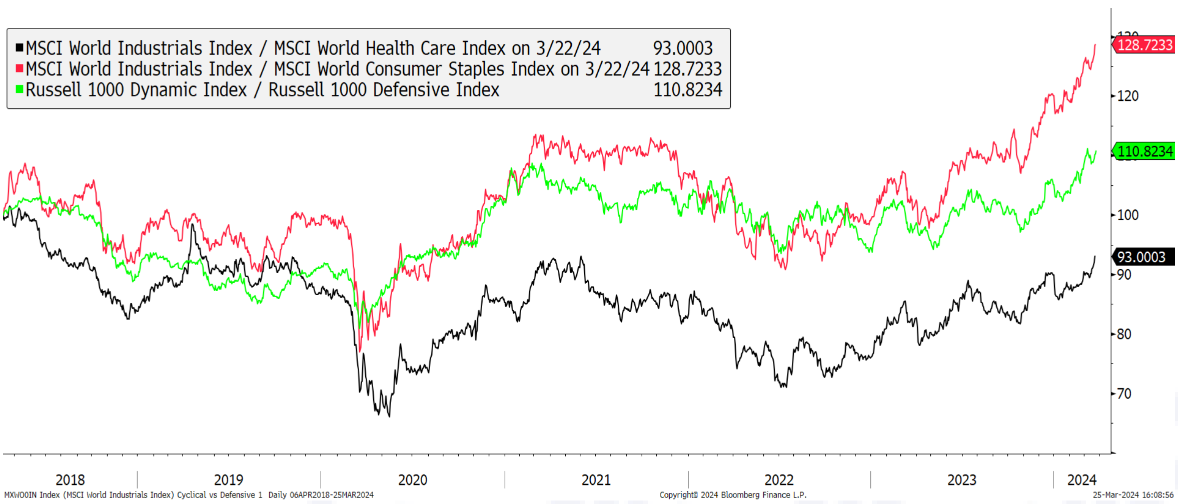
Stock markets are rising thanks to a resilient economy and improving leading indicators like those of the OECD. On the chart below, the S&P 500 anticipates the resumption of the profit cycle and it anticipates a reversal of the cycle. As we are at the start of the earnings cycle, the S&P 500 will continue to perform well and validate the current bull market. At this stage, there is no reason to consider a bear market.



Technology and industrials should continue to drive the stock markets. At its latest conference, Nvidia announced new ultra-powerful chips. OpenAI boss Sam Altman spoke about the future GPT-5, online this summer, and generative AI and their limitless development. Demand for electronic chips will continue to be very strong to rapidly increase computing capacities that are currently considered too limited.

Industry will continue to outperform in an economy of “war”: deglobalization, near/re/onshoring, reindustrialization, electrification and defense.

Heavy underperformance of defensive sectors

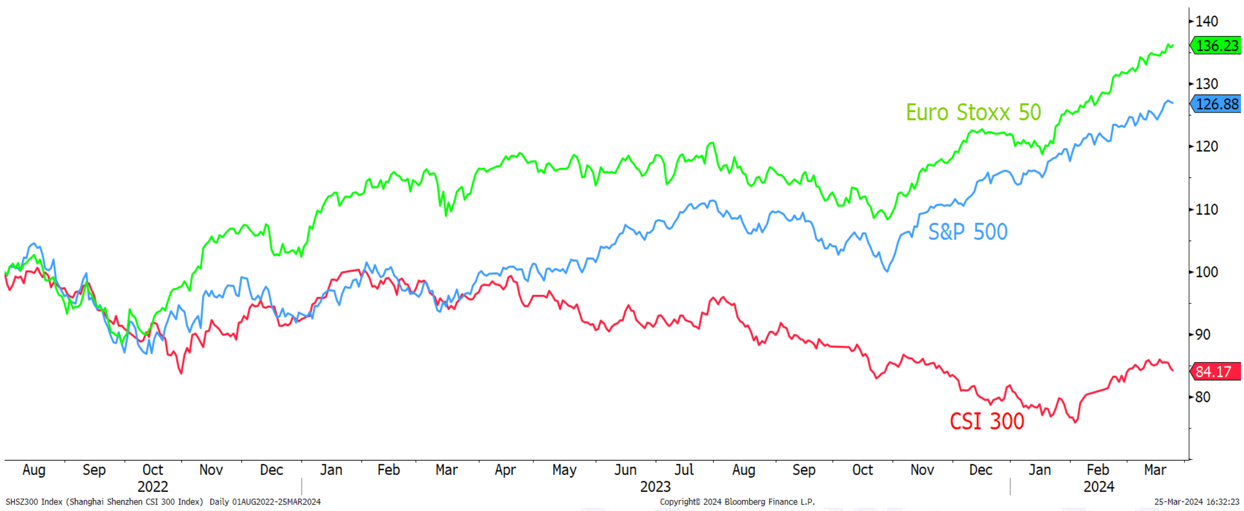


Many investors are looking to return to Chinese stocks, highlighting their low valuations. This is not a valid reason. We have seen so many cheap assets that stay that way for a long time. We believe that the Chinese stock market is a “Value trap” (no catch-up for a supposed undervaluation). At the beginning of February, the market finally believed in a rebound with a stimulus of €260 billion to support stocks, but it was mainly state companies that were buyers, and very few individual domestic investors caught in the real estate turmoil. On average, 70% of Chinese household wealth is in real estate. The market was hoping for good news coming from China with the Two Sessions, the

Chinese government's two annual plenary sessions of the National People's Congress and the Chinese People's Political Consultative Conference, both of which are typically held each March at the Grand People's Palace in Beijing on the same dates. Nothing unexpected came out of this: a GDP growth target of around 5%, a budget deficit of 3% (3.8% in 2023), a plan to launch a bond debt of $138.9 billion to finance major works and an increase in military spending of 7.2% to $235 billion. Not enough to have a powerful rebound in Chinese stocks. The Chinese real estate crisis is by far not over: according to the Minister of Housing and Urban-Rural Development, we must not support real estate companies and developers in distress; they must be made bankrupt according to the law and market principles.

So, no stimulation-bazooka. Then two major events happened: the tightening of the security law in Hong Kong and the return to the Mao Zedong era. The Communist Party and Xi become all-powerful; the government only becomes an executor. From Deng Xiaoping (1978-1989) to Hu Jintao (2002-2012), the leaders of the Communist Party had worked to modernize China and bring economic and political reforms, in order to properly separate responsibilities between the CCP and the government. With Xi Jinping, return to Mao Zedong, that is to say the omnipotence of the CCP. China's very aggressive position in the China Sea and on Taiwan is a geopolitical risk that investors should take into account.

Performance in local currencies and base 100



Commodities

A more favorable environment

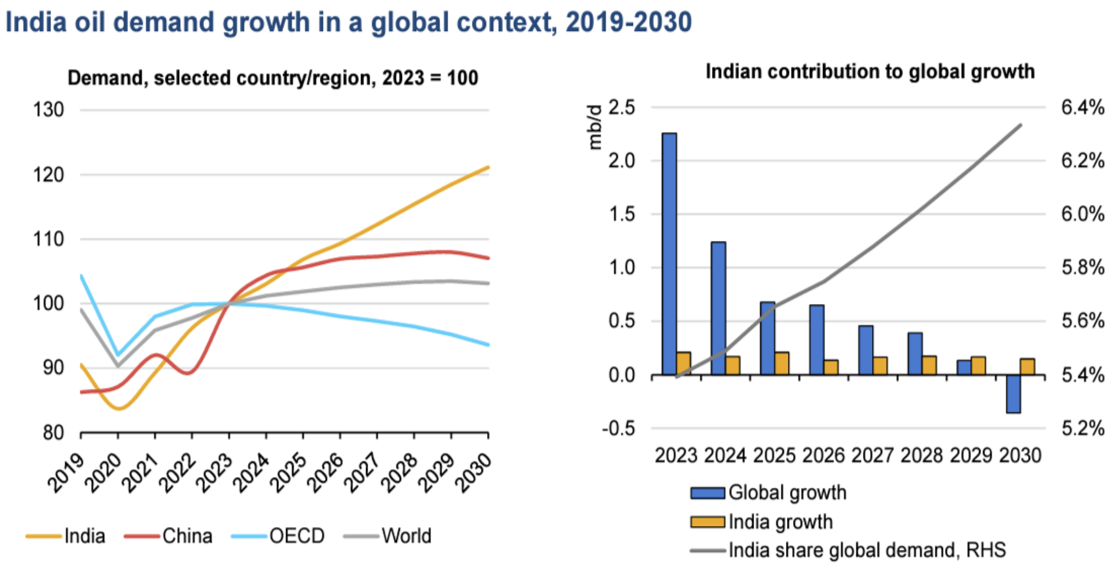
Gold and copper prices have broken important technical resistance, bitcoin is at all-time highs and oil is on the verge of breaking through an important resistance. What are the messages? China's economic rebound? Resilience of the global economy? Supply/demand imbalance? Persistent inflation? Geopolitical risks? Probably a bit of all of that.

Historically, commodity prices rise before and after the Fed's first cut in Fed Funds in a non-recessionary environment. We are in this pattern.

Some analysts believe in a “super squeeze” in commodities, resulting in higher prices coming from supply constraints, rather than an increase in demand. Disruptions are geopolitical and climatic. Climate plays a more important role in agricultural products.

Oil. Analysts expect an oil deficit in 2Q24 due to OPEC's voluntary oil production cuts, while overall demand increases. Repeated Ukrainian drone attacks on Russian refineries have pushed oil prices higher. Difficult navigation in the Red Sea due to Houthi attacks is weighing on crude prices.

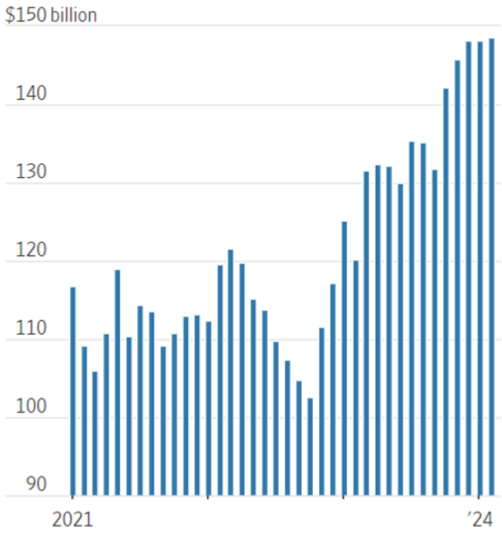
According to Eurasia Group, the growth in Chinese oil demand will be divided by 2 compared to pre-Covid 2019 demand. But India will gradually replace China as the driver of demand growth. India is investing heavily in refining capacity.



Gold. Gold broke major resistance at $2,070, which could take it to $2,500 and beyond. The positive contributors are mainly the central banks, with China, Poland, Singapore and the Czech Republic in the lead, as well as the opaque OTC market. The PBoC is at a record gold level, representing 4.3% of its foreign reserves. Chinese households are also buying gold, nervous about the economic and real estate situation. Gold purchases by Chinese individuals increased by 24% during the Lunar New Year compared to 2023. Gold is also awaiting a decline in Fed Funds. There is also protection to the global geopolitical situation and de-dollarization. The structural trend is solid: for a year and a half, gold has been disconnected from outflows from physical Gold ETFs by individual and institutional investors and from real interest rates.

Copper. Copper is under bullish pressure. Chinese copper smelters have decided to reduce their production to meet a copper deficit. In 2023, foundries were running at full capacity for the energy transition such as electric vehicles, solar and wind power. The common point of the good performance of commodity prices is the anticipations of rate cuts by Western central banks. Supply issues grew with the December closure of the Cobre Panama mine run by mining company First Quantum; the problem is legal concerning the contract between First Quantum and the State.

Gold reserves at China's central bank



Source: Wind