SELVI & CIE

THE FINANCIAL LETTER

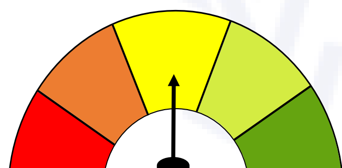
REVIEW, OPINIONS AND MARKETS' PERSPECTIVES

AUTUMN 2024

Investment context

The new macroeconomic and financial regimes of the post-pandemic era are taking shape. A window of opportunity for a delicate reflationary phase is opening up, thanks to cyclical disinflation. Improvement in global liquidity conditions are set to continue over the next few quarters. The global geopolitical recession will continue with the looming / critical issue of US elections.

A transitory/temporary alignment of the stars will benefit financial markets



Main indicators in 2024
(on September 30th)

Indicators	Variation %
Eurostoxx 50	+10.8
Swiss Market Index	+9.4
FTSE 100	+6.9
S&P 500	+20.3
Short-term rate EUR	3.3
Short-term rate USD	3.6
EURUSD	+1.3
EURCHF	+1.6
Barclays Euro Bonds	+2.4
Barclays US Bonds	+4.1

¨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

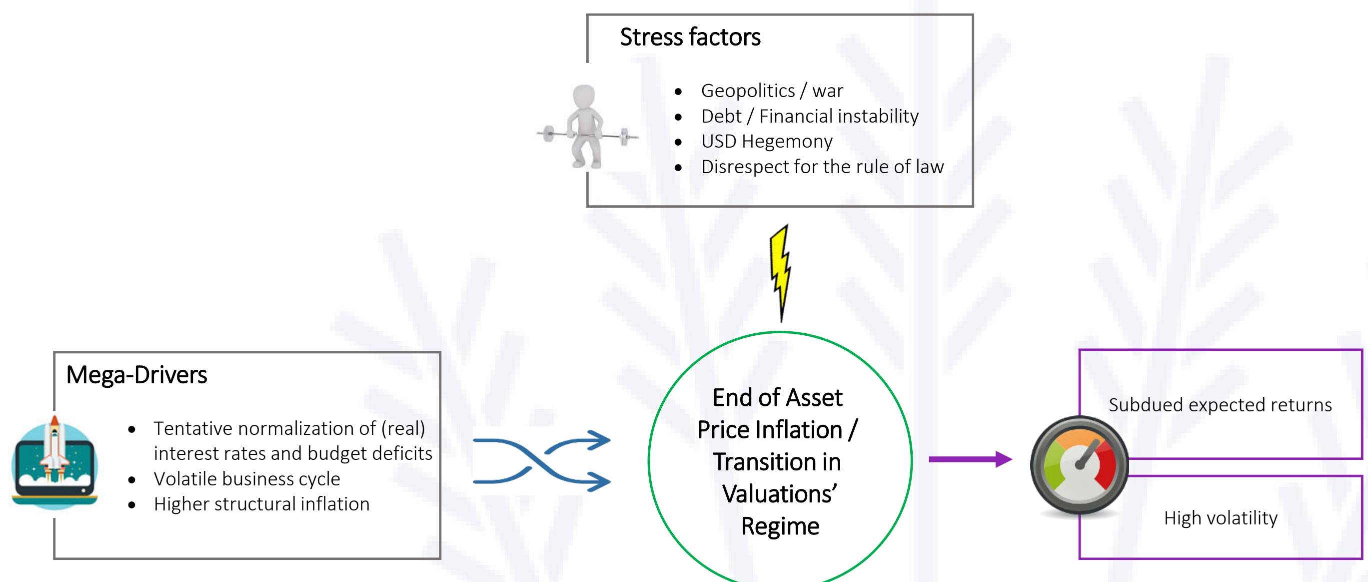
Economic Policies
- Sustainbility of positive real rates
- War economy
- From Wealth Effect to what?
- Central bank digital currenciers
- Debt Sustainability (Minsky)

Investment framework

In the next couple of quarters, we expect a benign macroeconomic backdrop coupled with reflationary efforts to unfold. It will be supportive to risky assets. The alarm for markets from the rapid unwinding of the carry trade highlights the serious challenges facing Japan on its - long and gradual - path to an inevitable exit from ultra-accommodative monetary policy. The exit from deflation means a re-convergence of Japanese cycles with those of the leading economies, with the exception of China. The behaviour of domestic institutions/savers in terms of the destination of their capital flows/investments will be key to global financial market developments.

While a US sovereign debt crisis is unlikely in the short term, a ¨Liz Truss-like moment¨ will eventually occur over time. Namely if the Republicans win the presidential and congressional elections. Very close monitoring of political/ macro developments is required in the coming months to assess the durability of the current supportive investment landscape

Regime in transitions



Long-term drivers

We consider **three secular disruptors**. 1) *Climate* change. Climate disorders are spiking. 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.

(Geo)-Politics. 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 is adding 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.

Economic Policies. Fiscal dominance has spread across the world and is entrenching itself as a new normal. It aggravates the issues of deficit and debt refinancing. This unsustainable policy paves the way for unpleasant outcomes medium term, like higher inflation and/or a new round of financial repression. In any case, a regime of high macro volatility is likely in the foreseable future.

Medium term factors

A new reflation cycle

The pandemic has disrupted economic and financial cycles. Its differentiated impacts resulted in very different policy responses among countries. Fortunately, the risks of a renewed global sanitary crisis appear very low, thanks to the spectacular outbreaks/solutions provided by pharmaceutical companies. According to the World Bank, global real GDP growth has stabilised post-pandemic at around 3%+ and will continue at this sub-par pace over the medium term.

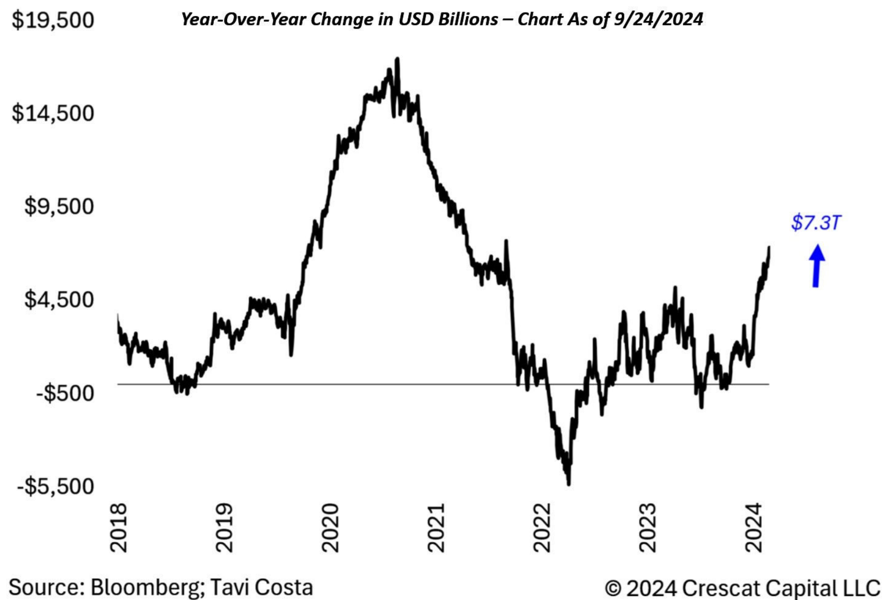
Despite the sustained improvement in the outlook, excessive fiscal stimulus is expected to remain in place for the foreseeable future. Courtesy of a fading cyclical inflation, the time has come for a shift in monetary policy. Indeed,

central banks around the world have been gradually shifting into an accommodative mode for some months now. With the Fed's latest move, this has now become stunning / unquestionable.

Expect simultaneous fiscal and monetary stimulus

A global reflation cycle has just started

Rising M2 acknowledges for central banks U-Turn



Asian juggernauts trade places

For years Japan and China have played the respective roles of ¨serial printer¨ and ¨guardian of Orthodoxy¨. But their quasi-ideological/unshakable stance has recently evaporated. Secular deflation has finally been defeated in Japan, while deflation has taken over in China.

Japan has no choice but to continue normalising its monetary policy, albeit at a slow pace. The inevitable end of yield curve control and the rise in Japanese policy rates will be in sharp contrast to the monetary policies of other leading economies. All the more so given Beijing's recent U-turn on accelerated reflation and liquidity injections. Let's face it, Japanese real interest rates remain negative and the BoJ hasn't reduced its balance sheet, it's just reduced its support for the JGB market. It's a long way to a neutral stance, let alone a tight one. The path to it will prove hectic and dependent on external conditions.

Pressure on China has eased thanks to the Fed rate cut. A strong JPY and Yuan allowed the PBoC to ease and take a ¨bazooka¨. Targeted measures for the housing sector (-50bp on mortgages) will ease the pain, but prove insufficient. Consumer spending will remain sluggish in the wake of weak wages and deteriorating employment conditions. Central bank financial engineering - QE-like measures - will improve market sentiment and create some temporary

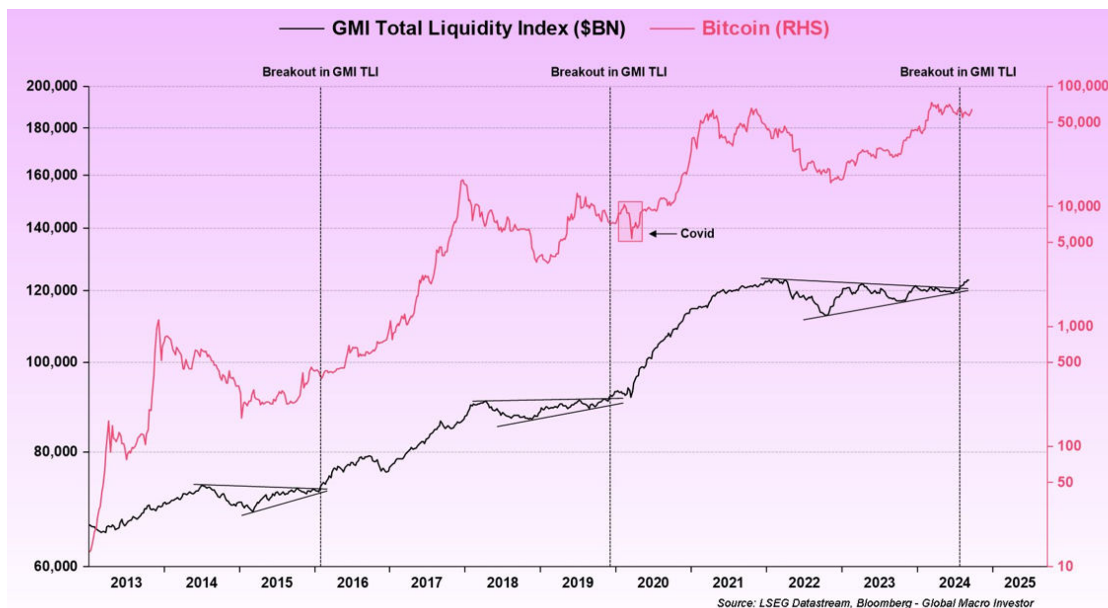
wealth effect. But bolder measures (write-offs/debt restructuring) and a broad/targeted fiscal stimulus are needed to a) address housing price decline and b) revive consumer spending.

Deflation has migrated from Japan to China

This will create volatility in Asian capital flows

The net impact on global liquidity is expected to be positive

Improving liquidity benefits to risky / volatile assets



The ongoing slowdown in G3 growth is virtuous. The resulting cyclical disinflation is opening a window for a global reflation cycle

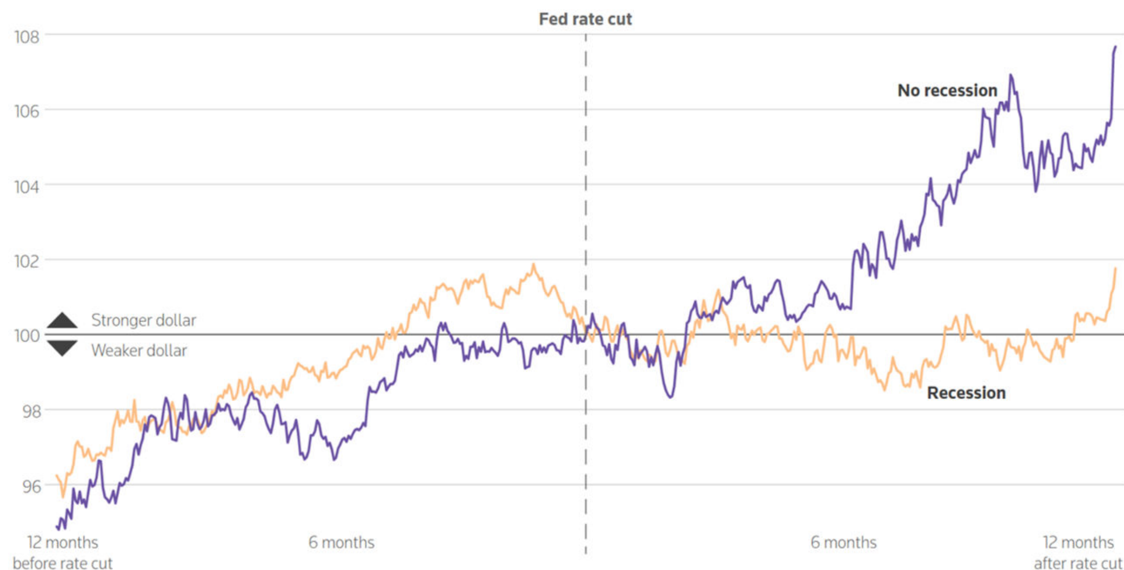
This favourable investment landscape would end when secular inflation re-emerges. In our view, the probability of such a scenario is around 50% from early/mid 2025

Currencies

Rarely has the Fed been so far behind the market

The Fed started its easing cycle with a bold 50bps rate cut. In easing cycles, much of the USD shift takes place before the first few cuts. This is the case today. Therefore, subsequent cuts will have less impact on the USD, especially as the market has largely priced in consecutive cuts in 2024 and 2025.

Median USD change points for at least stability after the first Fed cut



The USD index has weakened since the end of June. US growth is still somewhat better than in most other countries. The US economy and the actions of other central banks are important elements in determining how the USD will react. Recessions often require deeper cuts from the Fed, which reduces the appeal of the USD for yield-seekers.

Historically, the USD tends to outperform other currencies when the US cuts alongside several central banks. Conversely, when the Fed cuts alone, the USD tends to underperform. The scenario of the Fed cutting alongside several other central banks now seems to be in play.

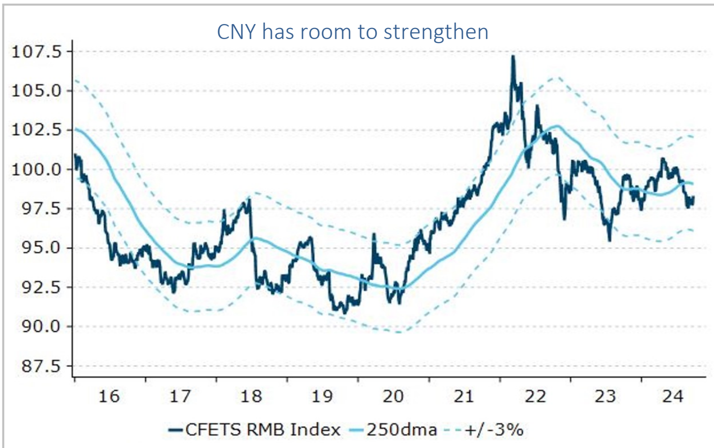
The USD has gained 8% one year after the first rate cut when the economy was not in recession during the previous 10 rate cut cycles. It has only gained 2.0% when the US was in a recession.

We expect a consolidation to a strengthening of the USD. This could change if US growth falters

The US election on 5 November will add complexity to the medium-term outlook for the USD.

A possible second Trump presidency could lead to a relatively stronger USD. CNY, EUR and JPY would be the most negatively affected currencies in this scenario due to trade tensions and higher border taxes.

China wakes up



The yuan has continued to strengthen and is now almost 4% higher than its June 2024 low. The market has reacted positively to the PBoC's stimulus measures. Normally, the combination of interest rate cuts and reserve requirement ratio cuts is negative for the CNY. This time around, the additional measures to support China's stock market sparked a rally, improving investor sentiment and likely leading to a return of foreign inflows. In addition, the 10-year yield has risen. All of this is supportive for the yuan.

So far, the authorities have not reversed the yuan's gains. The currency is still undervalued and not at levels that threaten China's export competitiveness. The CFETS index is within the range the authorities seem comfortable with. The PBoC can only become uncomfortable when the CFETS index reaches 102, 3.7% higher. In terms of the real effective exchange rate, it is back to 2014 levels. As China is exporting deflation, the nominal exchange rate can appreciate to keep the real exchange rate at the same level.

If the authorities feel that the yuan has appreciated too much, the PBoC has 3 tools at its disposal to rein in the currency. First, it can reintroduce the counter-cyclical factor in the daily fixing by setting it on the weaker side. Second, it can reduce the risk reserve ratio for forward foreign exchange transactions from 20% to 0%. This was introduced in August 2015, when the yuan was under pressure. It was reduced to 0% in September 2017 and October 2020. Third, it can raise the RRR on foreign exchange deposits (currently 4%) to force banks to hold more USD.

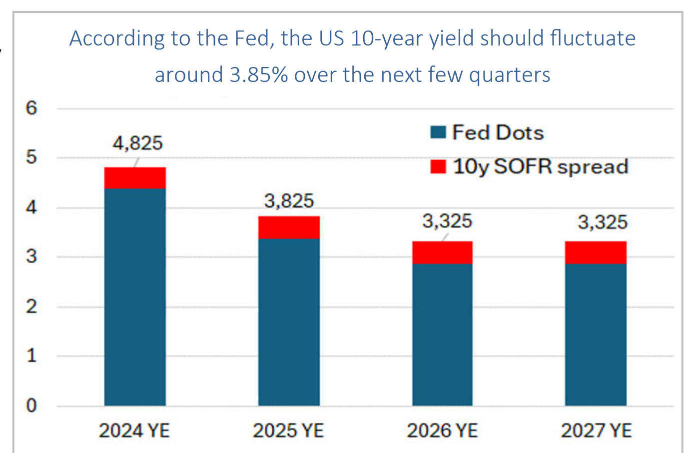
If the PBoC uses any of these measures, it will mean that the yuan's strength has gone too far. We are not there yet.

Bonds

The neutral rate guides Treasury yields

In theory, the neutral interest rate is the rate at which monetary policy neither stimulates nor restrains economic growth. The debate about the neutral rate will influence central bank easing. In the long run, central banks want their policy to be consistent with what they think the neutral rate is. It also guides their short-term thinking. Policymakers are still trying to set interest rates high enough to bring down inflation, but not so high as to avoid an economic recession.

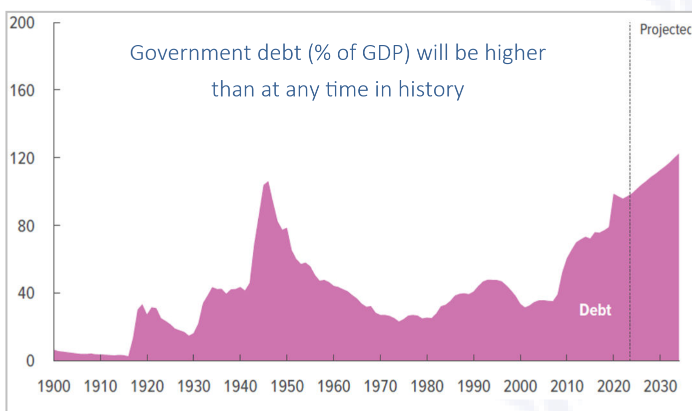
The Fed has estimates. Long-term trends in productivity and demographics dictate where it is. In 2012, the Fed began publishing its estimates of the neutral rate on a quarterly basis. It was set at 4.25%. It has been steadily lowered over the years. Since 2019, it has been unchanged at 2.5%. But they know they are dealing with unusual circumstances. The economy is adjusting to a post-pandemic world. Most Fed members have already acknowledged that it has grown.



Between March 2022 and July 2023, officials raised the Fed Funds rate rapidly to get inflation under control, pushing it above 5%. Now that inflation is falling rapidly, they are cutting the rate. Their latest projections show that the median official expectation is for inflation to reach the 2% target by the end of 2026, with the Fed Funds rate at 2.875%. However, the range around the median is wide and skewed to the upside.
Without taking into account the Fed's and Treasury's maneuvering, long-term yields look fairly valued.

Reckless politicians

Once upon a time, the record level of US debt was a major talking point in presidential elections. The final debate between Trump and Clinton (2016) included a 12-minute segment on the topic. Obama and Romney (2012) clashed over it. But in 2024, the debt is apparently no longer an issue. In 2012, the national debt was $11 trillion (70% of GDP); today it is $28 trillion (99%). The Congressional Budget Office projects that it will exceed $51trn (122%) in the next decade. Both candidates' promises will make the situation much worse. The non-partisan Tax Policy Center estimates that Harris' policies would increase the deficit by $2.6 trillion over the next decade, while Trump's proposals would increase the deficit by $2 to



$3.1 trillion. The Penn Wharton Budget Model estimates that the deficit would increase by $4.1 trillion under Trump and $2 trillion under Harris.

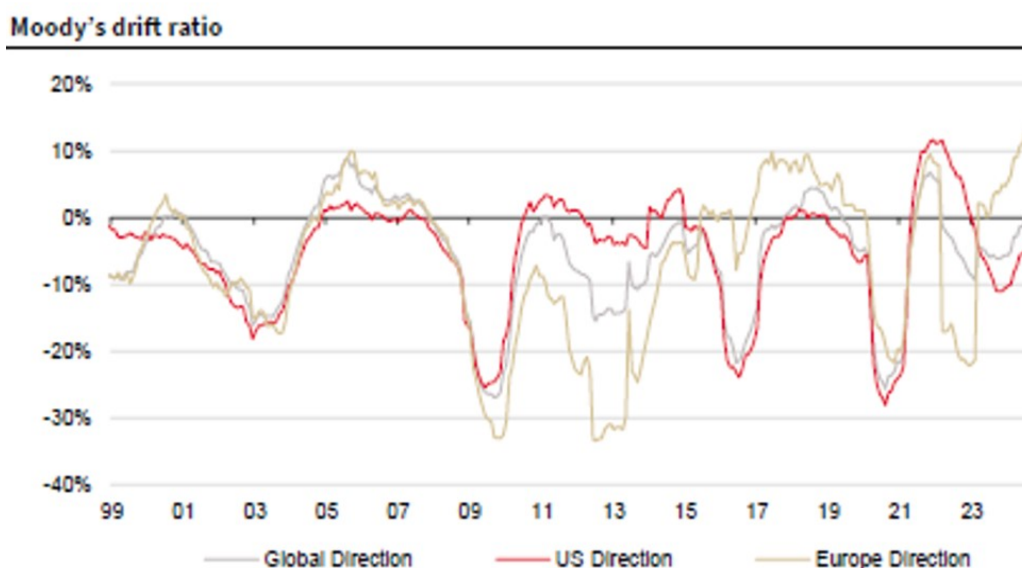
At the same time, the US Treasury is doing its best to push down US long yields. First, by shifting more of its issuance into T-bills. Second, buying back older long bonds. T-bill issuance has exploded since the debt ceiling was suspended in 2023. The amount of T-bills outstanding jumped by $2 trillion in 12 months to $6 trillion in March 2024. Under the program, the Treasury buys back older "off-the-run" securities with the proceeds from issuing new ones. This is a swap, not money creation. But it adds liquidity to the market. The larger portion of T-bills, starting in S2 2023, took pressure off the US 10-year yield, which peaked in October 2023. The buybacks started in April and yields have fallen since.

In an era of populism, politicians have little incentive to talk about tough choices. Higher deficits and higher tariffs under Trump suggest that inflation will be slightly higher under his presidency.

The Treasury's engineering should lower mortgage rates and encourage leverage. But its efforts are inflationary and in direct conflict with the Fed's objective.

Credit quality remains essential

Speculative default rates peaked in January in Europe and in April in the US. Since then, they have been slowly declining. According to Moody's, the global default rate has fallen from a peak of 5.3% in April to 4.6%. It would fall to 4% by the end of the year and to 2.8% in a year's time. In addition, credit quality continues to improve. The global drift ratio (upgrades minus downgrades) turned positive for the first time since February 2022. The US ratio remains negative, but has risen rapidly since last December. In addition, the European ratio has fallen from its all-time high in July, but is still at 12.4%, the second best level on record.



Credit fundamentals remain solid and largely explain why spreads should remain tight. Overall, the quality of credit markets has improved over time, with bonds moving towards higher ratings. This should continue.

Hard or soft landing, a consistent story for High Yield

As the specter of excessive inflation has largely receded, market concerns have shifted to the weakening labor market. This shift has fueled calls for aggressive Fed cuts. While market participants debate the pace of cuts and the Fed's ability to engineer a soft landing, the US high yield and EM markets continue to deliver solid returns.

Historical performance in the first year of the easing cycle

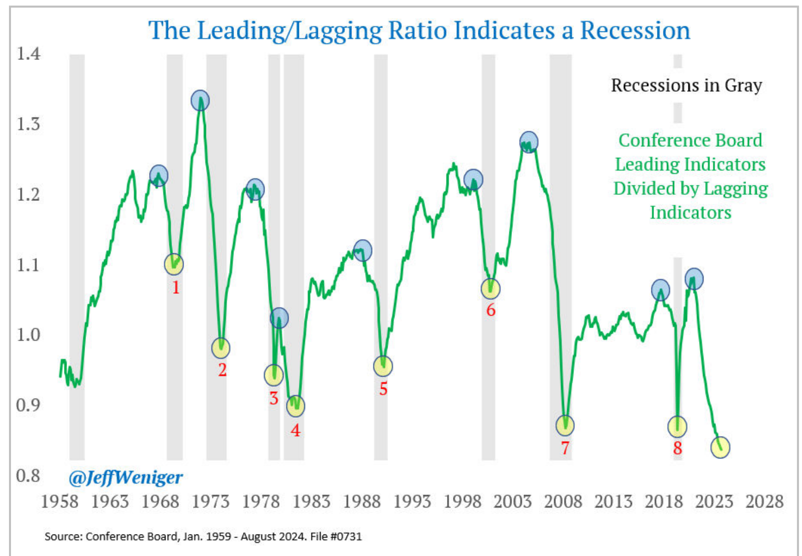
	Yields			Perf (%) 1 year after the 1st cut				Perf over coupon (%)		
	US HY	EM	US 10y	US HY	EM	US Agg	S&P	US HY	EM	US Agg
June 1989	13.4		8.1	-3.0	N/A	-2.9	14.1	-16.4	N/A	-11.0
July 1995	9.9	14.2	6.4	9.8	33.1	9.8	24.1	-0.1	18.9	3.4
Jan 2001	14.1	11.5	5.1	4.5	4.5	4.5	-13.0	-9.6	-7.1	-0.6
Sep 2007	9.1	6.7	4.6	-1.4	7.0	-1.3	-11.0	-10.5	0.3	-5.9
Aug 2019	6.0	4.8	2.6	3.2	3.4	8.0	13.0	-2.8	-1.4	5.4
			Average	2.6	12.0	3.6	5.4	-7.9	2.7	-1.7

If you look at the 5 previous easing cycles, no two are the same. There are some differences. HY quality is higher than in previous cycles. The initial yield has never been this low in previous cycles. Yields tell a different story. Sometimes the HY and EM markets have performed well, sometimes not. At its best, the HY market has paid its coupon; at its worst, it has delivered negative returns. The same goes for the safest part of the bond universe, the US aggregate. The only stable conclusion is that the US Aggregate segment performed at least as well as the HY market in the first year of the easing cycle.

Favor US aggregate over High Yield in the first year of an easing cycle.

Equities

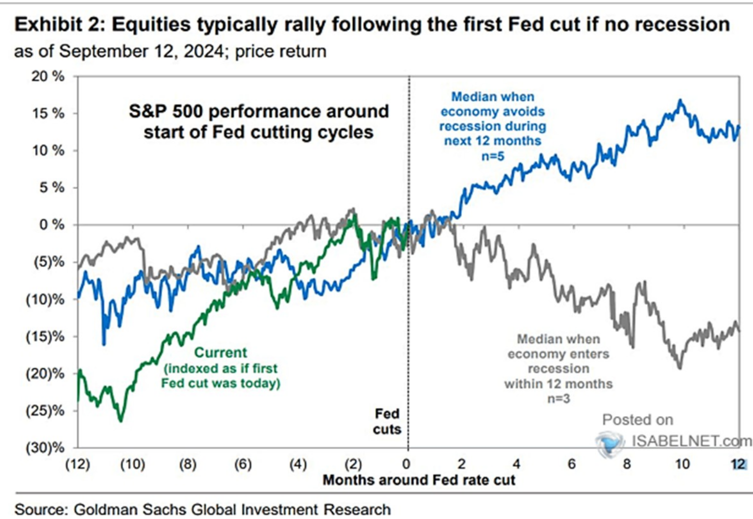
History is against us. Will next weeks be more difficult ?



For the past two months, fears of a recession have resurfaced. But this is not the market scenario, which still believes in a soft landing. A recession would obviously be bad for equities. The accommodative monetary policies of central banks and China's recent efforts to support its economy, estimated at $560 billion by Bank of America CIO Michael Hartnett, could avoid a recession.

The re-steepening of the US 10Y-2Y yield curve and the shift to a positive slope in early September have alarmed investors. Historically, a recession usually occurs a few months after a re-steepening. The start of a Fed funds cut is still most often followed by a recession. Employment is also a worrying point; according to Sham's rule, the US economy has entered a recession. Another indicator supporting the recession scenario is the Conference Board's leading/lagging economic index, which is at its lowest level in more than 60 years. See chart above.

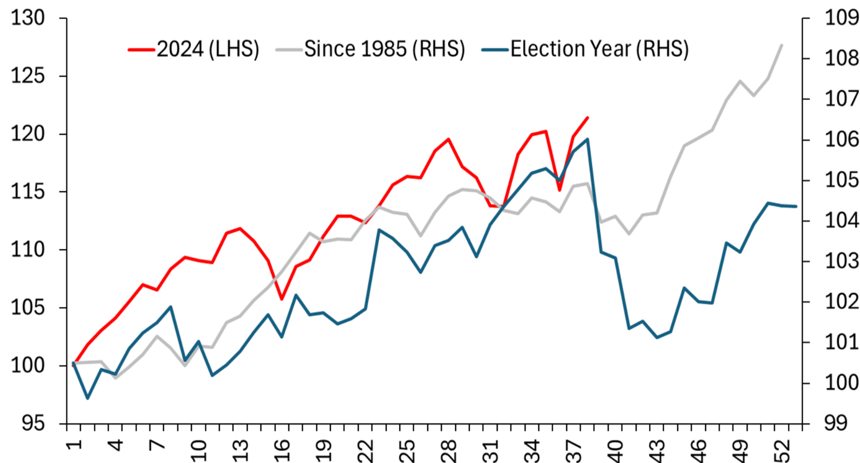
Historically, when the Fed cuts rates to avoid a recession, it is negative for stocks, with an average decline of 15%, but when the Fed intervenes in a non-recessionary situation, it is positive for stocks, with an average gain of 15%. See next chart. Typically, the market needs 2-3 months to position itself, time to move forward in the economic cycle to see if the recession is confirmed or not. As history seems to be against us, we would adopt a more neutral sector allocation during this period, especially after 2 years of rising indices. The MSCI World started its bullish trend on 12 October 2022.



However, there have been rare occasions when the Fed has managed to cut its rate without causing a recession in order to ensure a soft landing, such as in 1995 and 1998 under the Greenspan era, and it worked. The stock market reacted very well, prompting Greenspan to use the term "irrational exuberance" in December 1996 at the start of the IT bubble. The market seems to be stuck in this perfect scenario.

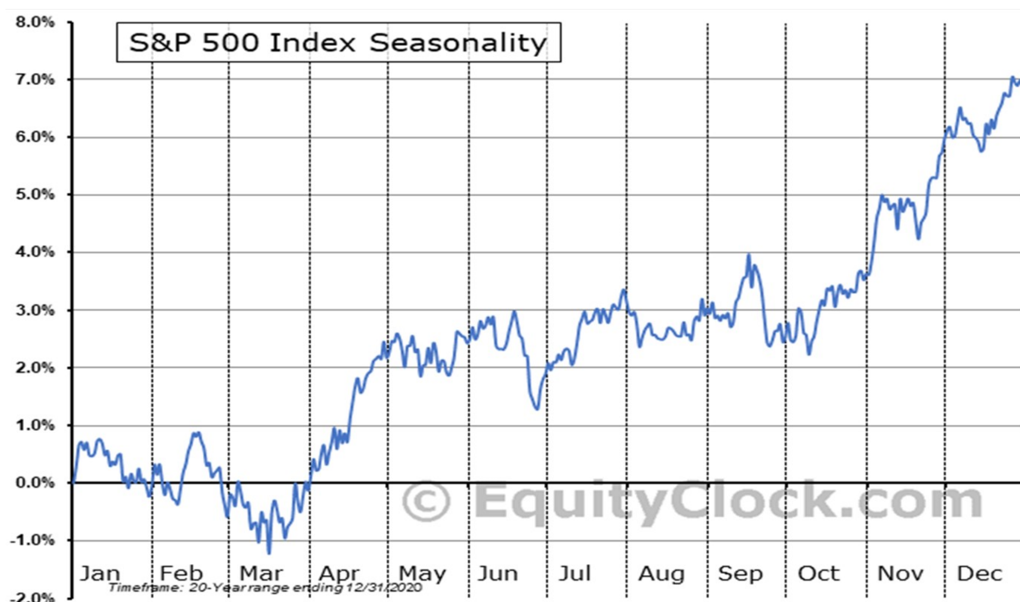
Our caution is also based on the behaviour of the S&P 500 in a US presidential election year, when the risk of a decline is more pronounced than in the previous three years.

This critical period is between mid-September and the end of October, just before election day.



Yet despite the risk of recession, despite geopolitical concerns, despite high levels of debt and global budget deficits, equity markets continue to rise. Central bank stimulus supports the bubble dream, says Michael Hartnett.

Another point of concern is statistical seasonality. April is the best month of the year; the MSCI World is down 6%. July is the third best month of the year; the MSCI World is down 8% (up to 5 August). August to mid-October is the worst period of the year; the MSCI World gained 10% in August and September. Mid-October to the end of November is the best period of the year; but if we continue with the same logic of "2024 = everything upside down", we would therefore be cautious about the coming weeks and would adopt a more defensive sector allocation.

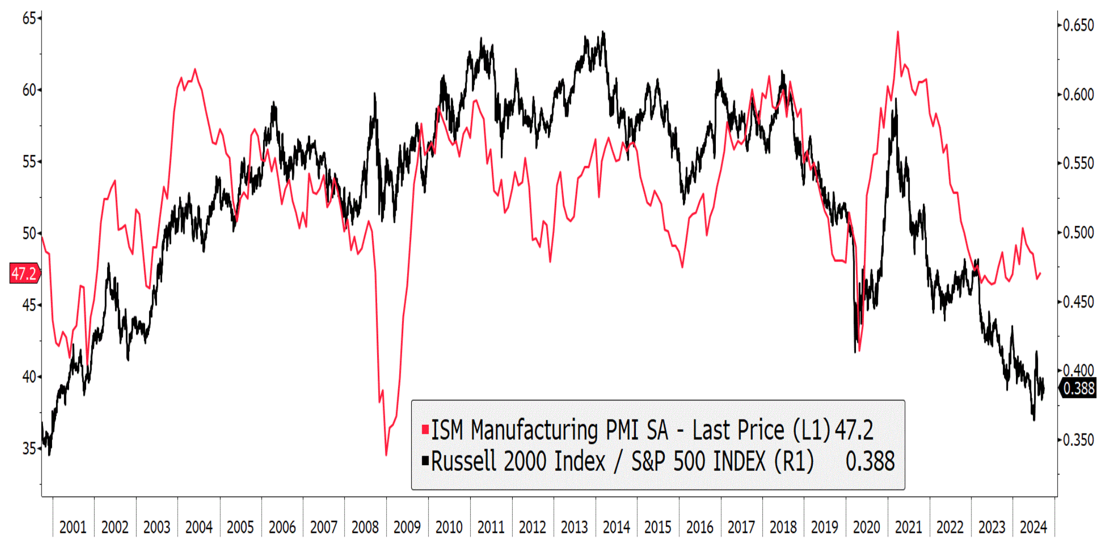


We lack the trigger that would prove history right, whether economic, geopolitical or otherwise.

The fall in interest rates could have allowed the small and mid-cap segment, in this case the Russell 2000 for the United States, to catch up with the significant lag in stock market performance. This has not been the case. Not

everything is perfect for this segment, such as global manufacturing PMIs below 50, signalling contraction, and protectionist measures of all kinds in a deglobalised world. The small- and mid-cap segment needs economic growth; it suffers more from trade restrictions than large multinationals. The gap has been significant over the past two years, but the environment since 2020 has been exceptionally uncertain.

Relative performance of the Russell 2000 vs. S&P 500 and the US Manufacturing PMI indicator.



In conclusion, on a historical basis, we believe a degree of caution is appropriate in the last three months of the year as we move forward in the economic cycle. If the Fed succeeds in its soft landing of the economy, it will be time to become more aggressive on equities again. It took 3 years between Greenspan's "irrational exuberance" in December 1996 and the market peak in 2000!

Alternative Investments

Focus on gold and bitcoin

After a sharp correction between May and July, industrial metals are recovering on optimism about a gentle slowdown, supported by central bank rate cuts and, more recently, Chinese stimulus measures.

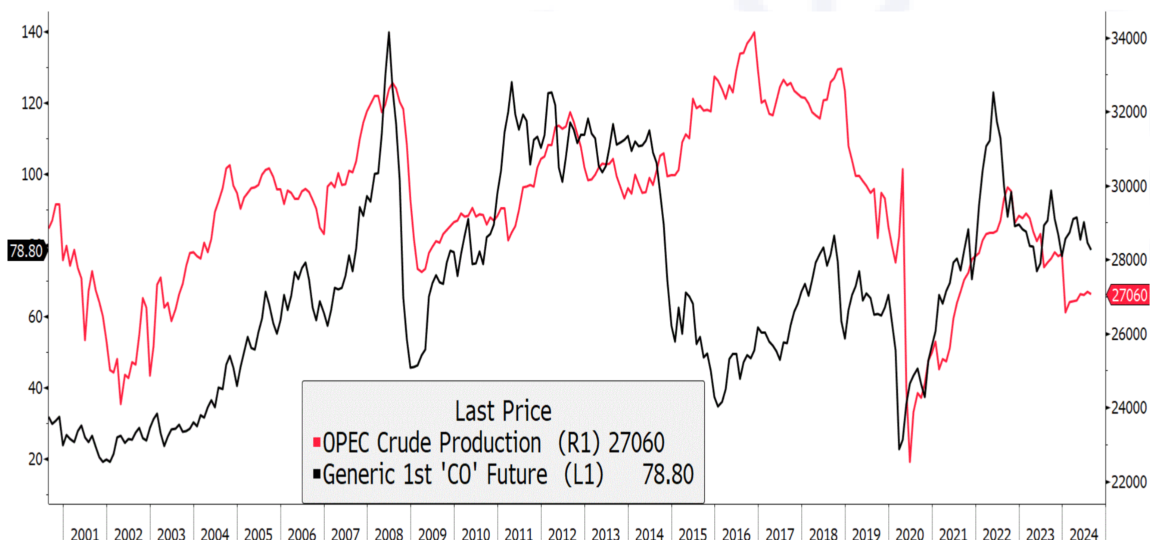
While we are tactically underweight industrial metals, structural demand will increase in the coming years thanks to the energy transition, electrification, data centres and AI. Australian miner BHP warns that this demand will put pressure on supply. Annual global demand for copper will rise from 30.4 million tonnes in 2021 to 52.5 million tonnes in 2050, an increase of 72%. Today, data centres account for less than 1% of total copper demand, but this will rise to 6-7% by 2050, according to BHP.

AI is transforming energy systems and demand for industrial metals. US banks and hedge funds are hiring teams of analysts specialising in the power generation sector. Data centres and AI are not copper-intensive businesses, but the electricity required to run them is.

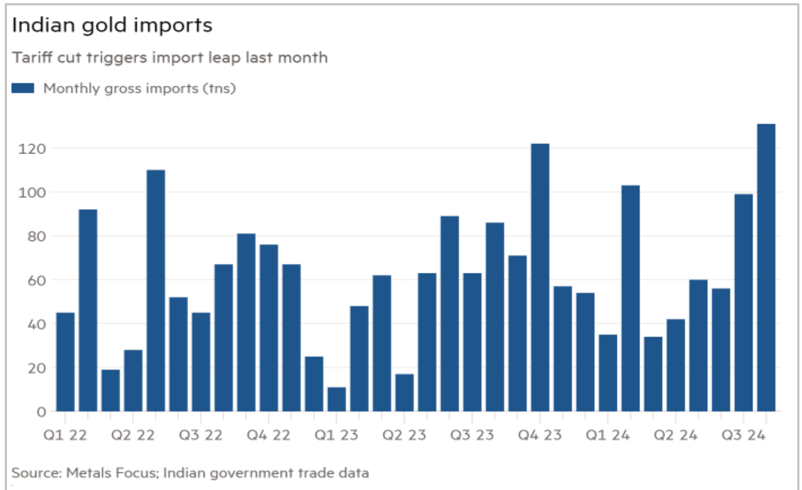
While BHP predicts a sharp rise in prices as early as 2026, in the short term weak global growth, particularly in China, BHP believes in a surplus copper market. For 2025, Goldman Sachs has downgraded the price of copper, at least as long as China's property sector remains in distress.

Oil prices remain depressed despite the risk of an all-out war between Israel and Iran, although we do not believe this will have a strong impact on oil prices as long as the oil monarchies and Iraq are not affected. Prices are correlated with global demand, which has been lower than estimated at the beginning of the year. Voluntary production cuts by OPEC+ have not had the desired effect.

OPEC production (red) and Brent price (black)



Saudi Arabia is ready to abandon its unofficial target of $100 a barrel and increase production, a signal that the kingdom is resigned to a period of lower prices. Saudi Arabia also sees the non-OPEC group producing more and gaining market share, particularly the United States, Canada, Brazil and Guyana.

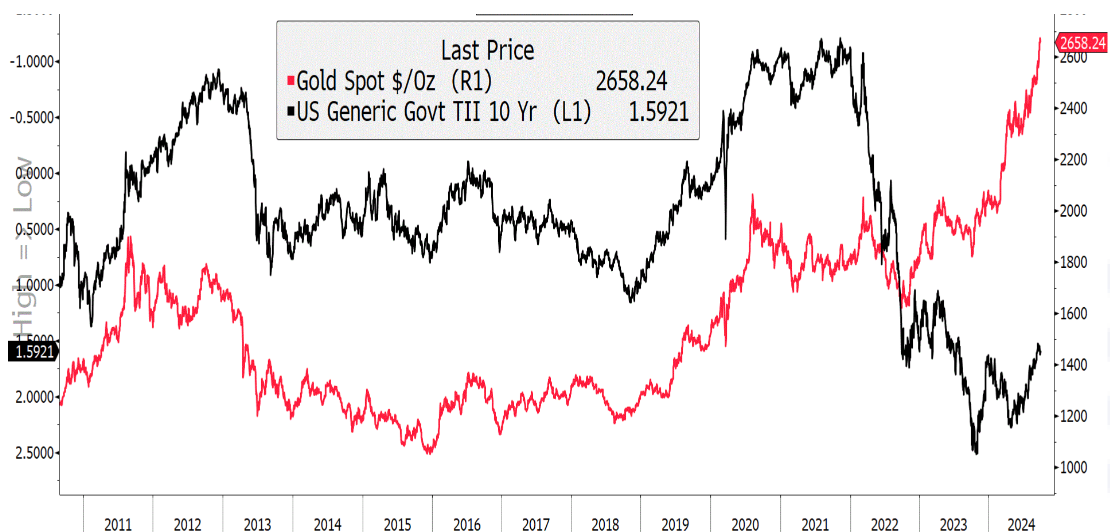


With a performance of almost 30% in 2024 (+12% in 2023), gold is one of the best performing commodities. Emerging market central banks have been less active since April, but private and institutional investors have taken over. Chinese households bought a lot of gold in 2024 due to the real estate crisis. But in August Indian households took over, thanks to a recent cut in gold import taxes, a strong economy and a good harvest. In August, Indian gold imports reached a record high in dollar terms at $10.1 billion and the 6th record in volume terms at 131 tonnes.

It should be noted that 47% of gold demand comes from jewellery and 23% from physical purchases by individuals/ institutions (excluding ETFs). Of the total annual demand, 20% comes from Chinese household demand and 17% from Indian households. In summary, 40% of global gold demand comes from China and India.

The accommodative monetary policies of central banks and the fall in US real interest rates have allowed gold to break through its technical resistance relatively easily, paving the way for $3,000.

Gold price and US real interest rates (inverted)



Gold's rise is also a signal of (very) high global debt and worrying budget deficits.

In the 1990s, gold, that "ancient relic", had sunk with the advent of the internet. But in the last 4 years, gold has risen with the Magnificent 7 and AI.
Does gold suggest that one way to reduce debt is through inflation?

Despite high volatility, bitcoin seems to be moving in its usual pattern of a post-halving, although there have only been 4.

The current economic and monetary environment is favourable for cryptocurrencies. Global liquidity is expected to increase in the 4th quarter. See chart below. 83% of the time, bitcoin moves with global liquidity.

Bitcoin is a decentralised asset, independent of central banks and governments. Favourable characteristics in a highly indebted world.

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