THE MONTHLY LETTER

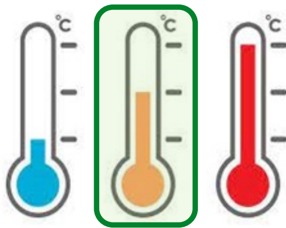
Tactical update

DECEMBER 2024

Gran Mercato

Global landscape

Inflation in Next 6m



Stance: bottoming-out

Trend: huge international dispersion

Economic growth in Next 6m

Stance: below potential

Trend: better dynamies from S225

Long-term macroeconomic regime. Irregular and volatile economic cycles

The weakness of the main structural factors (demographics, excessive debt and even productivity) will weigh on potential growth. The asymmetric risks of deflation or runaway inflation remain elevated. The uncertain pace of adoption of artificial intelligence adds to the uncertainty. The issues of deficit financing and debt reduction could disrupt long-term balances.

Cyclical outlook. A global and synchronized reflation cycle begins

US nominal growth will remain resilient post-election, courtesy of fiscal largesse. China is shifting towards growing accommodation. The two countries will lead the 2025 recovery. Europe and Japan are lagging. Unusual and large dispersion of global inflation cycles

Geopolitics. Silver lining on the horizon?

The bold change in the US administration is reshuffling the deck. The probability of fat-tail events (positive and negative) is increasing. The resolve and cohesion of the so-called axis of evil (China, Russia, Iran, North Korea) will be tested.

The abundance of global liquidity continues

Liquidity conditions are favorable, led by US financial engineering 3.0 and China.

Negative equity-bond correlation in force, for now

The expectation of sub -3% CPI over next quarters is to be tasted, depending essentially on the priorities and shape (implementation sequence of future US administration economic policy. A new German government could also mean more flexible, active reflation in the EU.

Highly volatile investors' sentiment and capital flows

Investors' cyclothymia is driving significant flows into risky assets. Animal spirits dominate, even more so following calm US elections.

Regime(s) change

The G3 is in middle of its Mercato period. Whether for coaches or their team leaders. The US will experience disruptions. The EU faces strong fragmentation pressures. Japan, traditionally stable and cohesive, will have to reinvent its policies to adapt to its exit from deflation. There is no doubt that the takeover of the levers of power by the Republicans in the US is the crucial development to be analyzed and carefully monitored. On the one hand, the prologue until 20 January could prove to be rich in surprises/changes. On the other hand, 1H25 will definitely see a lot of bold restructuring, policy decisions with high potential to reshape the US economy and the direction of international relations.

Japan is also on the brink of major change. Prime Minister Ishiba has won a parliamentary run-off vote to remain in office after his coalition lost its majority in last month's election. His days are numbered. Wage inflation is rising, pushing the BoJ into a delicate normalization process, and Trump's protectionism could have an impact (especially on steel). Speculators appear to have taken advantage of this window. The JPY's weakness in recent weeks is reminiscent of previous carry trade episodes ...

USDJPY: Watch for brutal / undesired direction changes

Germany, like France, has entered a political no-man's-land. German elections in early 2025 could result in a grand coalition. There is a growing chance of a break with the previous orthodoxy on economic policy. The removal of the debt-brake system - 'Schuldenbremse' - would open the door to more active reflation in the EU.

Trump / Republicans' victory is now well discounted by markets

Cards could also be reshuffled by political instability in Europe and Japan

When in doubt, double down!

Doing politics embeds bias. Decision-makers who want to please their voters - and get re-elected - naturally opt for profligacy.

The new US administration will ultimately prioritize growth at the expense of higher inflation, even if it means i) putting more pressure on the Fed ii) using financial engineering to cap yields.

The EU is in dire economic and political straits. It urgently needs i) a vigorous reflation plan, along the lines of the latest Draghi plan ii) a revival of its decision-making process. The acute crisis in the two big players - Germany and France - opens up the prospect of a significant change. Reflation will accelerate.

Japan's revival, which must be seen in the context of China's economic decline, means the end of extreme economic policies. The path to gradual normalisation is a delicate one.
The active generation of liquidity will continue in the next few quarters
Global reflation has just started

The inflation multi-trillion dollars' question

In China and the EU, cyclical disinflation will prevail in the medium term, regardless of the intensity of reflation. The risks lie on the other side, where too little growth could well favor serious deflationary tensions. The resumption of inflation in Japan is fundamentally/structurally good news. However, it is a source of short-term concern as i) the country's gradual tightening contrasts sharply with G2 + China (decoupling risks) ii) household frustration is rising and socio-political cohesion is evaporating. In the US, the risks of an average inflation rate of 3-4% from mid-2025 exist. However, the confluence of major countervailing forces resulting from the new administration's policies makes forecasting very difficult. The sequence and intensity of restructuring measures will play a crucial role, as will possible retaliation from China and the EU.
It is premature for the US to declare "mission accomplished" in fighting inflation
Cyclical developments in Japan (and China) will play a growingly important role in 2025
Expect above average Macro-volatility medium term

Investment takeaways

Rarely has the global geopolitical and macro landscape been so fluid, so hard to grasp. Still, in the short term, the stars continue to align for financial markets. Indeed, liquidity is abundant and reflation is accelerating. Moreover, we expect a negative correlation between equities and bonds to prevail in the coming months/quarters. However, this favorable landscape has fueled strong animal spirits, if not complacency. Therefore, one should not expect linear and calm developments of the markets, but rather a lot of U-turns and significant volatility.

As early as the middle of 1Q25, we should start to see more clarity. It will be time to reconsider - possibly - our current optimistic view.

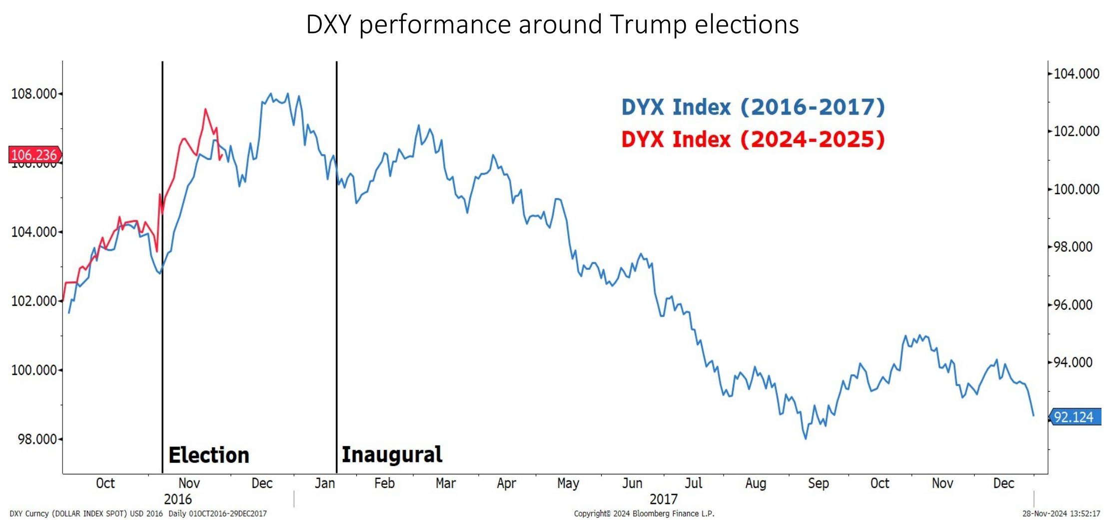
Currencies

Awaiting Trump's inauguration

Following the recent US presidential election, the USD index (DXY) has regained its upward momentum and reached a new annual high. Notably, the DXY's performance this year closely parallels its trajectory during the 2016 election, when Donald Trump also emerged victorious. The two patterns show a strikingly high correlation, with a coefficient of over 90%. This strong relationship provides valuable insight into the potential trajectory of the DXY.

In 2016, the DXY started to rise 3 months before the election and continued to rise after the election. However, it peaked about 6 weeks later, just before the inauguration, and began a prolonged downtrend that lasted about 18 months. If this historical pattern repeats, the DXY could peak before the end of this year, before reversing course in early 2025.

DXY performance around Trump elections

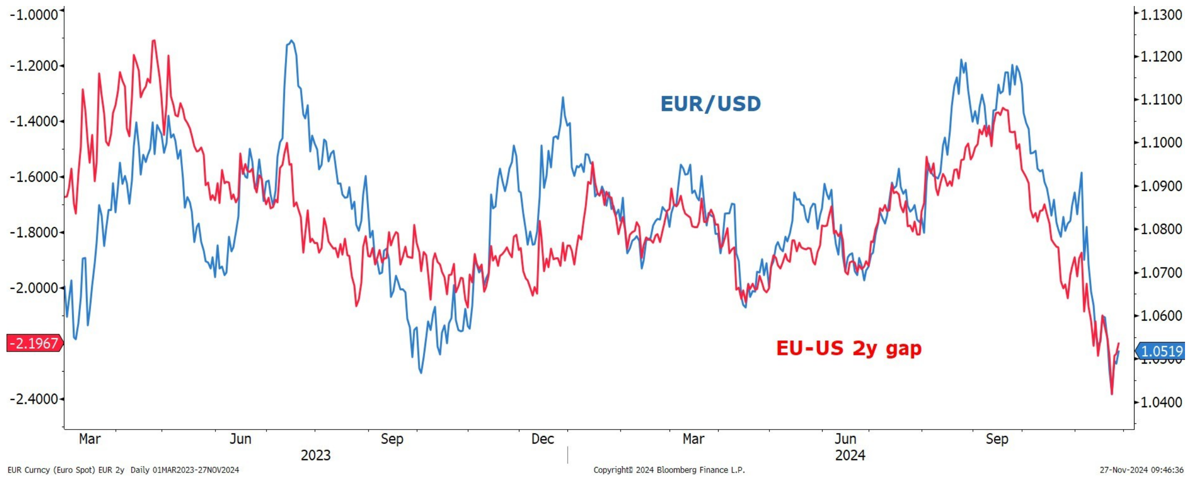


The USD gains have also outpaced changes in Fed expectations since the US election, suggesting that trade war fears are playing a bigger role. The trend looks a bit overdone. A lot of good news is already priced in.
We are still on track for a 25bps Fed cut in December and this, combined with positioning and seasonal USD weakness, should lead to USD weakness.

December central banks meetings in focus

The weak Eurozone PMIs hit short-term yields and sent EUR/USD to its lowest level since 2022. ECB policymakers said that monetary policy should not remain restrictive for too long, otherwise inflation risks falling below target. There is growing concern within the ECB that monetary policy could overshoot and have a negative impact on inflation. In the absence of fiscal stimulus in the eurozone, the only way to address the current malaise is for the ECB to cut rates faster than usual. A 50bp cut by the ECB in December is on the cards. The EUR/USD is following shorter-term interest rate differentials. The market is pricing in too few Fed rate cuts and too many ECB rate cuts. The EUR/USD should recover.

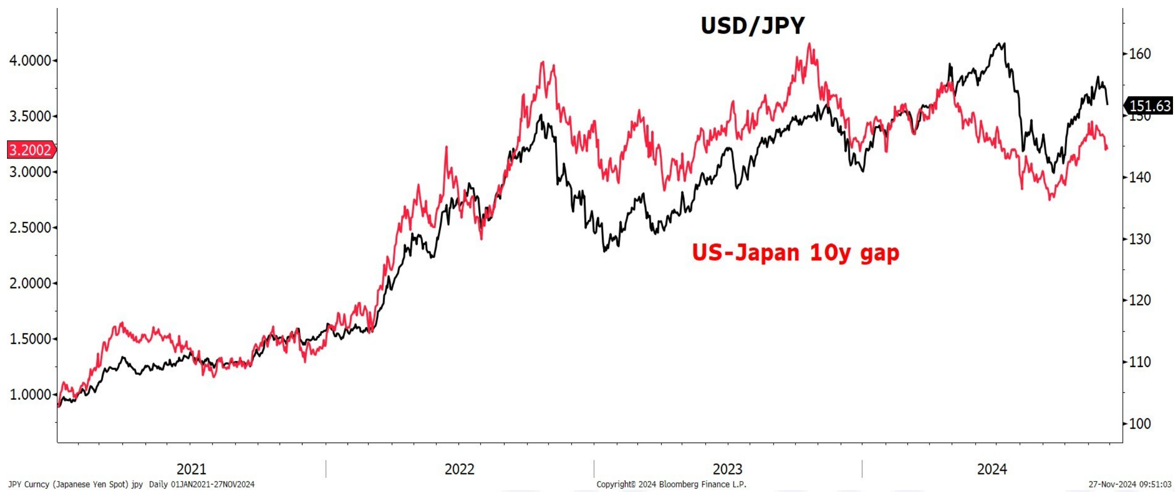
Most of the bad news is already discounted in



On the Japanese side, the shift in the fiscal-monetary policy mix is helping. The new coalition has agreed to the DPP's demands for an increase in the personal income tax threshold. This is a $250bn fiscal stimulus package. The fiscal stimulus supports the view that the BoJ will hike in December after all. We expect a 25bp hike.

The USD/JPY is already trading higher than the recent yield-currency correlation suggests. Above the 150, we are bullish on the JPY

Yields gap support a stronger JPY



The biggest takeaway is that the ECB will continue to ease while the BoJ will tighten policy

This mix should pressure the EUR/JPY lower

Bonds

Unusual easing cycle

Bond investors have become accustomed to higher interest rate volatility. Since the Fed's 50bps jumbo cut in September, US 2-year and 10-year yields have both risen by 70bps. This move is somewhat counter-intuitive given that yields tend to drift lower during a taper cycle and the steepening of the yield curve is driven by falling short rates, not rising long rates. Furthermore, the MOVE index has also reached its highest level since the beginning of the year.

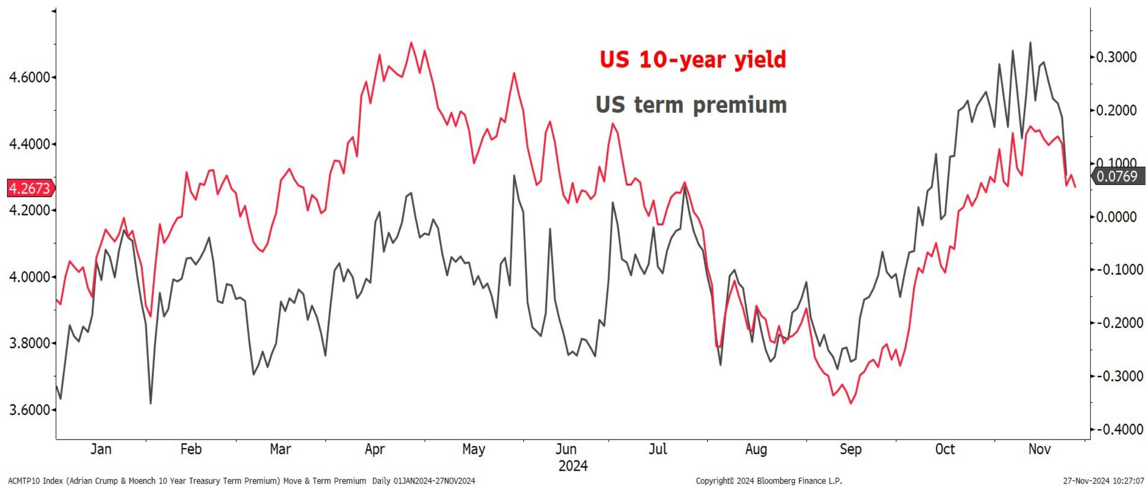
Two factors may explain this move. First, the Republican sweep. Long-end yields have risen on expectations of additional tariffs and higher deficits. Second, recession fears are easing. Recent data point to a higher probability of a soft or no landing. The appointment of Scott Bessent as Treasury Secretary reduces the risks. He has advised Trump to pursue a 3-3-3 policy. He wants to reduce the US deficit to 3% of GDP by stimulating 3% growth through deregulation and an additional 3 million barrels of oil per day.

Long-end yields sensitivity is half of the front-end

Yield Peak	Yield Trough	3M Change	10Y Change	Yld Crv Chg
1957	1958	-3.12	-1.04	0.33
1960	1960	-2.63	-0.69	0.26
1966	1967	-2.26	-0.07	0.03
1969	1971	-4.86	-2.36	0.49
1971	1972	-2.54	-0.59	0.23
1974	1976	-5.5	-1.31	0.24
1980	1980	-9.82	-3.59	0.37
1980	1982	-9.83	-1.33	0.14
1984	1986	-5.96	-5.57	0.93
1989	1992	-6.78	-3.21	0.47
1995	1996	-1.18	-1.9	1.61
1997	1998	-1.81	-1.28	0.71
2000	2003	-5.61	-2.52	0.45
2006	2008	-5.23	-2.3	0.44
2019	2020	-2.51	-1.88	0.75
2023	?	?	?	?
	Average	-4.64	-1.98	0.50

In large historical declines in short-term yields due to Fed rate cuts, the US 10-year Treasury yield has fallen by about half of short-term yields, although there is a lot of variation. Given that we expect the Fed to cut around 4 times over the next 12 months, you would expect the US 10-year Treasury yield to fall by 50 basis points. That would take us to 3.80%.

Lower term-premium should support a declining US long-end yield

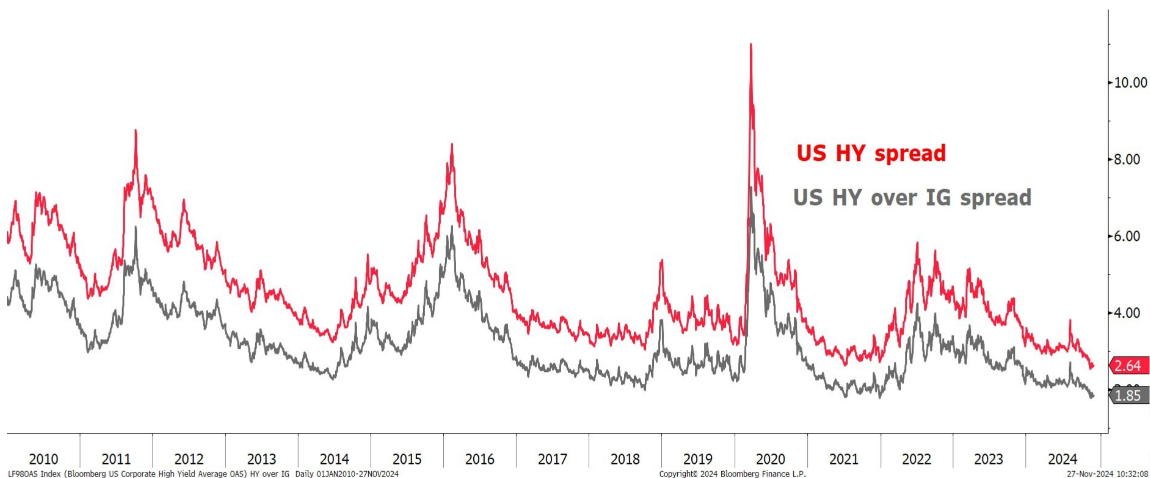


Investors should consider intermediate-term bonds to lock in attractive yields

Hot credit market

Any deterioration in the macroeconomic outlook is a good reason to sell credit. There are reasons to be concerned. US fiscal policy is on an unsustainable path, S&P 500 earnings misses are increasing and financing costs are rising. In addition, the German economy is moribund and China has yet to see a broad-based rebound in growth after a wave of stimulus.

Complacency warning in credit as spreads evaporate



Asset manager demand has pushed credit spreads to near all-time highs as the global economy remains strong. Corporate bond shorts have increased by 25% ($336bn) over the past year. The rise in shorts comes as a measure of complacency reaches its highest level since 2021, the amount of distressed debt falls to its lowest level this year and US growth continues to confound sceptics.

According to S&P, US bankruptcies could reach their highest level in more than a decade in 2024. There were 60 bankruptcy filings by public and some private companies in October. This follows a similar number of filings in the

previous 2 months. Since the beginning of 2020, there have only been 8 months when more than 60 bankruptcies were filed. October's bankruptcy filings bring the total for the first 10 months of 2024 to 570. If the pace of filings continues over the next 2 months, bankruptcies in 2024 will exceed the 638 bankruptcies filed in all of 2020, a new 14-year high.

Despite the warning signs, US HY spreads remain 30bps above their pre-GFC lows. And while European spreads still have some way to go, they are well below their historical average.
Hedging credit risk makes sense

Equities

The Santa Claus Rally is coming. A Saint-Nicholas Rally before ? Countries announcing pro-growth measures are outperforming

The term "Santa Claus Rally" has been found by Yale Hirsch, founder of the Stock Trader's Almanac. According to Hirsch, US equity markets tend to rally in the last 5 trading days of the year and the first two trading days of the new year. If it materializes in 2024/2025, which we believe it will, the S&P 500 will definitely break historical record, as it already is at all-time highs. But we could start with a St.-Nicholas rally, as St. Nicholas Day is on December 6. The positive arguments are the Trump trade with its pro-growth measures, the accommodative monetary policies and the appointment of Scott Bessent, to the key position of US Treasury Secretary, founder and CEO of the investment firm Key Square. Seasonality is also favorable for the last two months of the year and for the period from November to April.

After the perplexity of some nominations, that of Scott Bessent delights the financial markets. And this personality alone could be enough to reinforce not only the Santa Claus rally, but a rise over the entire month of December. Scott Bessent understands in depth the financial markets and the economy, and in particular the bond markets, skills that Donald Trump will need to achieve his objectives. Bessent favors a 3-pronged approach: GDP growth at 3%, a return of the budget deficit to 3% of GDP and the addition of oil production of 3 million barrels/day. He targets an inflation at 2%, the central objective of the Fed. He ardently defends a greater role of political power in the Fed's decision-making process. Scott Bessent warned that Donald Trump will not let inflation start again and that the S&P 500 will be the indicator of his success. We can therefore expect pro-stock market measures.

Some investors are worried about the valuation of indices that integrates a perfect situation, growth without inflation. Perhaps it will end up being perfect with deregulation, the reduction in the size of the federal government, tax cuts, the reduction of administrative hassles and Scott Bessent. We cannot rule out this possibility. In any case, the American stock market seems to smell it. Scott Bessent should play a counterbalancing role to Howard Lutnick, the nominee for trade, CEO of the Cantor Fitzgerald bank, an aggressive profile in trade matters with a strong desire to increase customs duties for all products entering the United States, and a strong detractor of China, while Scott Bessent is a supporter of free trade.

In the meantime, through his social network Truth Social, Donald Trump has already announced a series of increases in customs duties for products imported into the United States from Canada, Mexico and China. Nothing surprising so far.

Technically, the S&P 500 could end the year between 6,100 and 6,300. We have a target of 6,600 in 2025, supported by a 10% increase in profits in 2024 and 15% in 2025. Share buybacks are also a support for stocks, estimated at $1,100 billion in 2024 and $1,300 billion in 2025.

We underweight the eurozone. For the moment, Europe is the weak link in the trade and geopolitical wars that are animating the world. France is entangled in its 2025 budget with its incomprehension of a parliamentary regime and Germany will have legislative elections in February. The two heavyweights of Europe are mired in their problems, in addition to their divergent interests. Europe must put itself in a war economy - commercial, political and geopolitical - with recovery plans and have a cooperative approach.

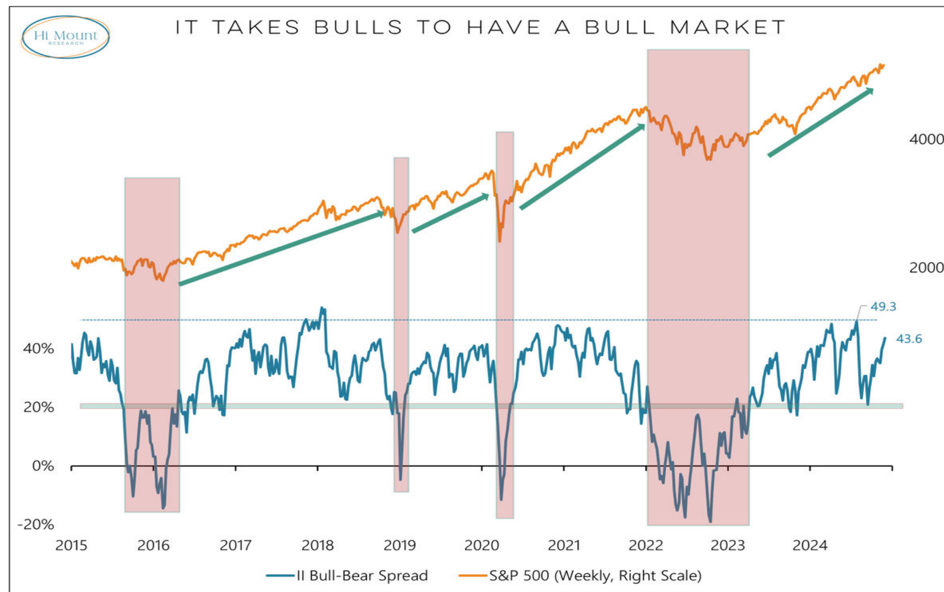
The last 3 months have been mixed for investors, because if the American stock market has been positive with +4% for the S&P 500 and the Nasdaq, whereas the other stock markets have all been negative: -3% for the Euro Stoxx 50, -6% for the SPI, -1% for the UK, -0.5% for the Nikkei and -1% for the MSCI Emerging. The Chinese indices are also positive thanks to monetary and fiscal measures announced in September and October. There is therefore a relationship between the performances of the indices and the desire to revive the economy. France is suffering from the presentation of a recessive 2025 budget.

In any case, for several years now, a sectoral approach has generated more performance than a country approach. We remain positioned on the Magnificent 7, industry, banks and electricity producers. In a world where power relations dominate, industrial metals seem attractive to us, but the market remains focused on Chinese demand, while demand from reindustrialization, the energy transition and defense is increasing. In the coming months, the Trump trade is to be favored in the United States: the Russell 2000, banks, fossil fuels, (semi) finished industrial metals, electricity producers, infrastructure, defense and cryptocurrencies.

In the short term, the very optimistic investor sentiment and the high positioning on equities could weaken our positive sentiment. Two additional risks are a more aggressive Trump than expected in the trade war and immigration.

A great bull sentiment on equities. A similar path occurred at the end of 2021,
that has been followed by a sharp correction in 2022, but ...

... the Bull Bear spread is not announcing an imminent correction



Trump's program on deregulation, reduction/elimination of administrative burdens and lower taxes is a boon for the small and medium-sized American companies. Since Donald Trump's election, the Russell 2000 has risen by 7%, compared to +4% for the S&P 500 and the Nasdaq. If we estimate a 10% increase in the S&P 500 in 2025, the Russell 2000 should rise by 25% to 3,050. Russell 2000 profits are expected to increase by 25% in 2024, 44% in 2025 and 25% in 2026. Given the high specific risk, this segment has to be invested through a passive ETF, the iShares Russell 2000 (IWM US).

Alternative investments

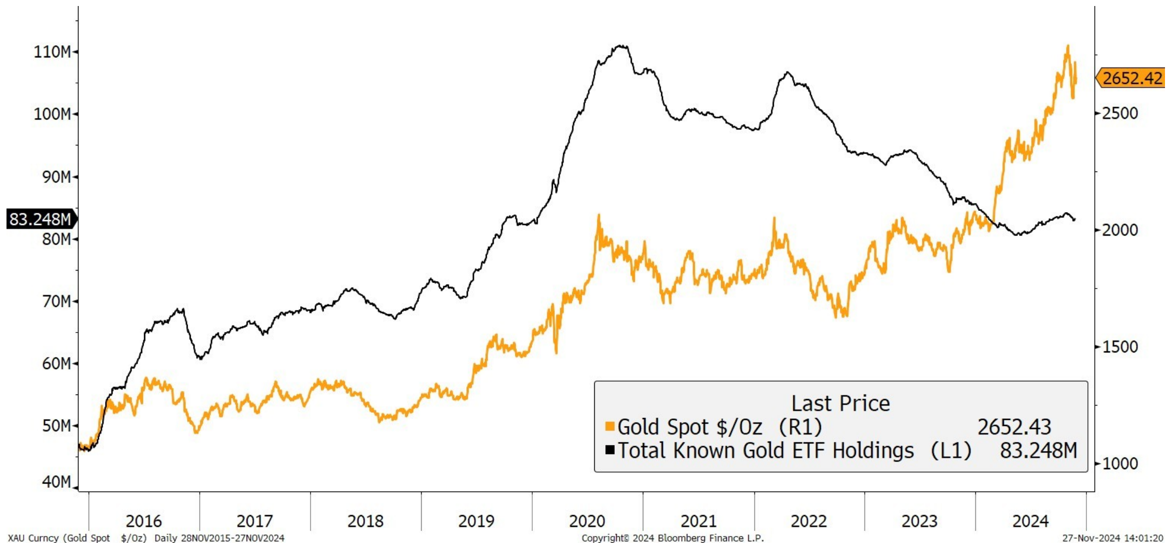
Bitcoin, the star of November. Oversupply in oil. Gold holds well. Industrial metals, still a Chinese story

Bitcoin rose 50%, from $66,000 to $100,000 with Donald Trump's victory. The new government will be pro-crypto. Donald Trump had sworn to "fire on Day 1" (the day of his inauguration on January 20) Gary Gensler, the boss of the American Securities and Exchange Commission (SEC), considered the enemy of the cryptocurrencies. This will not be necessary, because Gary Gensler has just resigned. Donald Trump will relax regulation on cryptocurrencies and wants to create a strategic national reserve invested in bitcoins. Donald Trump wants the United States to become the world leader in cryptocurrencies, as well as in mining. At the end of November, bitcoin normally corrected after a dizzying rise, but the potential for growth in the medium to long term is intact. Bitcoin is a very volatile asset, but not speculative. We are far from a speculative bubble: many investors are still negative on bitcoin and cryptocurrencies in general. This asset class is in an emerging phase, called the adoption curve, and is very gradually entering tactical allocations.

Based on past behavior before and after the halving, the growing acceptance of cryptos and the Stock-to-flow model, analysts estimate a price between $120,000 and $200,000 in 2025, such as Standard Chartered at $150,000 or Bernstein at $200,000.

Gold has been in an upward trend since early 2016. In November, gold consolidated after a great rise in 2024, justified by investors' fears of a return of inflation in the United States with Trump's programs and a slowdown in the Fed's monetary policy, and the strength of the dollar. A ceasefire in Lebanon also had a negative impact. We have also observed a switch from gold to bitcoin with Trump's victory. This trend should last a few weeks while waiting to know Donald Trump's economic, political and geopolitical agenda. In 2025, gold should start to rise again, with a target of around $3,000. Emerging central banks have slowed down their gold purchases since April, but they should

be back in 2025. Without exaggerations, institutional and individual investors are present. Technically, gold should evolve in a range of 2,550-2,780. The break of the 2,800 would be a strong message to go and test 3,000.



Oil prices remain depreciated due to relatively weak global demand, overproduction by non-OPEC countries and a limited conflict, so far, in the Middle East.

Donald Trump will facilitate the production of shale oil and gas. His new Treasury Secretary, Scott Bessent, has a target for an additional production of 3 million barrels/day. That is a lot. Current US production is 13.4 million b/d. With overproduction in Canada, Brazil and Guyana, where Exxon Mobil and Chevron have invested heavily, the excess supply will weigh on prices. Moreover, Donald Trump has warned that he wants very low energy prices.

The Iranian factor could change the situation, knowing that Donald Trump will seek to weaken Iran. Iran has been under international sanctions for more than 20 years, but has always managed to produce and export through hidden channels. In 2020, its production with 2.5 million b/d was at its lowest in 30 years. But today, it produces more than 4 million b/d. The main risk is a regionalization of the conflict that everyone wants to avoid, especially Saudi Arabia; the probability of such a risk therefore seems limited to us.

Technically, the price of Brent will fluctuate in a $70-$78 range. A geopolitical or climatic event would be needed for the price to break $80 per barrel. We favor American stocks that will benefit from a favorable domestic environment, in particular shale gas and the American export network.

If low oil prices come from an excess supply, the supply/demand imbalance comes rather from the demand side. The price of copper, the benchmark of the health of the global economy, is at the same level as at the beginning of the year. Analysts were counting on the energy transition, electrification, American reindustrialization, the data boom and defense to compensate the Chinese weakness in demand. For the moment, the market is focused on China and considers that the monetary and fiscal measures taken in September and October are not enough to

restart the machine. However, some Chinese macro figures are improving with PMI Manufacturing, industrial production and retail sales.

We are becoming more positive on industrial metals with the pro-growth measures of the United States and China - Europe must wake up - and a risk of concentration in production and refining on a few countries.

Interesting technical points to be back on industrial metals

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