SELVI
& CIE

THE MONTHLY LETTER

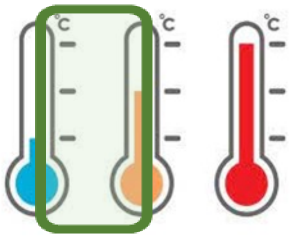
Tactical update

FEBRUARY 2024

Back to (new) business

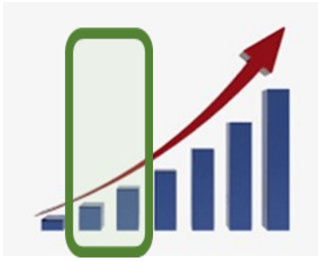
Global landscape

Inflation in Next 6m



Stance: Cyclical deceleration
Trend: Decelerating

Economic growth in Next 6m



Stance: Severe downturn
Trend: Steady

Long-term macroeconomic regime. Irregular and volatile economic cycles

Weak structural factors - demographics and productivity - are weighing on potential growth. Asymmetric risks of deflation or runaway inflation are increasing. The rapid mass adoption of artificial intelligence adds uncertainty. Unresolved issues of deficit financing and debt reduction could re-emerge and disrupt / dislocate markets.

Cyclical outlook. Atypical end of cycle in a new regime (post-Covid)

The current level of real interest rates (around 2% on the US 10-year) is a source of stress for public finances. It is unsustainable for the US Treasury, Italy, overleveraged/unprofitable players (HY/Tech) and those whose assets have fallen significantly (US CRE, Chinese institutions).

Geopolitics. Precarious truce in a chaotic landscape

Sources of conflict are multiplying. Iran's proxy wars are wreaking military and economic havoc.

Liquidity shift and volatile financial conditions

Ample Q423 liquidity framework will become more benign, if not adverse short-term. It may translate into less accommodative – more Fed friendly - financial conditions.

Unstable equity-bond correlation

Investment framework remains opaque. Hide and seek between Fed and investors will continue. The succession of favorable / corrective periods for risky assets will continue.

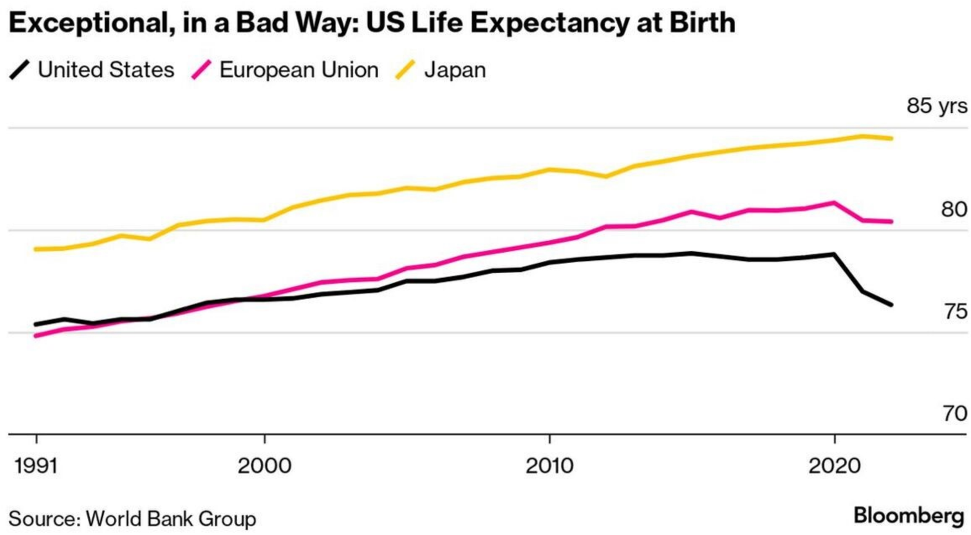
Highly volatile capital flows

Market sentiment improved dramatically featuring volatile capital flows. The ultimate destination of Money Market Funds could exacerbate risky asset markets / or not!

Anatomy of the *Aftershock Economy*

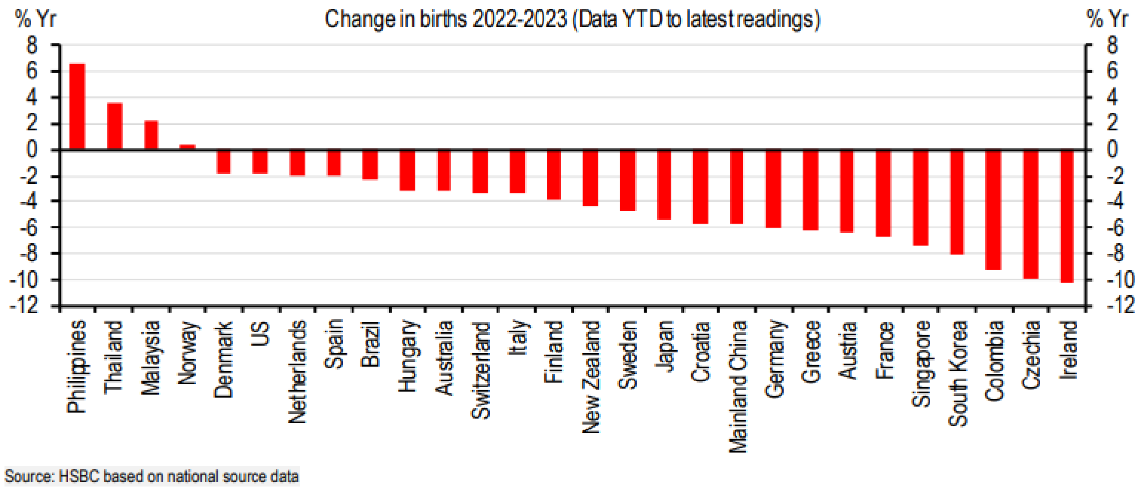
A broad deterioration of demographics

In principle, demographics change very slowly. As a result, it rarely attracts the attention of the markets. For example, the pre-Covid decline in US life expectancy, which seriously concerns specialists, is barely analyzed. Experts mainly attribute this nosedive to the widening of socio-economic inequalities. L. Summers goes so far as to remind us that ¨the economic decline of the Soviet Union was predicted by indicators such as declining life expectancy¨. In any case, it may be a harbinger of the end of the exceptional resilience of US growth.



Global fertility rates are falling as economic/geopolitical concerns, social change and a pandemic hangover push more people away from larger families or having children at all. The case of China, where the labor force is already in decline, is particularly striking. The worrying data for France, which used to have a high birth rate, explains the recent measures announced by President Macron: maternity leave and a plan to combat infertility, to "demographically rearm" the country. We should expect similar political initiatives, namely in EU, knowing that they will take a long time to produce results.

Global post-Covid birth is collapsing



If the current fertility rate decline of 3% continues, the world population could peak soon (2030), before starting to decline from 2040. This is in sharp contrast with former UN estimates, respectively 2100 and beyond! When it comes to aging's direct impact on inflation, the debate is controversial. However, an ageing population combined with a lower birth rate is likely to indirectly put more pressure on public finances, leaving governments with the choice of borrowing more and/or allowing inflation to deal with the problem. But this could also have climate change and energy transition benefits.

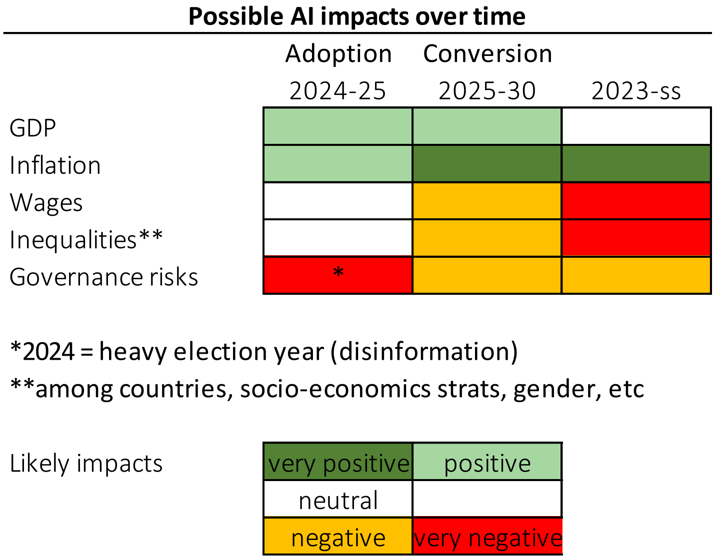
The demographic - secular - factor is the surprise guest, the unexpected source of volatility for the macroeconomic environment

Hopefully, the falling birthrate will prove to be temporary, as closely linked to exogenous shocks (pandemic, geopolitical). Otherwise, potential growth will decline.

AI - the un-domesticable white horse

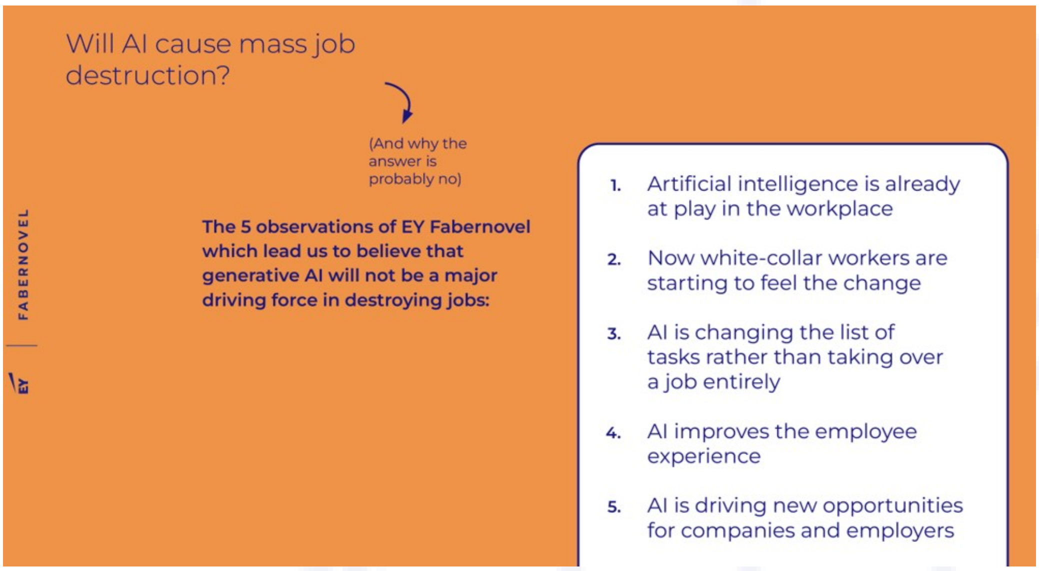
After the pandemic, productivity experienced larger fluctuations than usual. So it would take more time to understand the underlying new productivity trend, even without the arrival of AI. Needless to say, predicting this is simply impossible given the ultra-fast adoption rate of AI.

Towards an AI-pocalypse or an AI-revolution? That's the key macro question of the next decade. In short, the biggest positive impact is likely to be on (dis) inflation, while serious risks are likely to emerge from ST on policy and MT on wage pressures/inequalities.



Source: Heravest

The good news, contrary to popular belief, is that generative AI will result more in a change in tasks rather than mass job destruction, at least during the adoption period.



The - very - bad news is that breakthroughs in artificial intelligence are moving much faster than governance efforts, fueling diverse risks.

Two of three secular growth drivers are likely to deteriorate in the foreseeable future, while the third, productivity, will be particularly elusive / disruptive

US economy resiliency will not prevent a benign global 2024 slowdown / mild recession. No V-shape recovery is in the cards

Lower trend growth, high debt and macro volatility will impose decisive / imaginative policy responses. Otherwise, inflation will resurface and risk premiums demanded by the markets/bond vigilantes will come back with a vengeance

Investment takeaways

The very supportive liquidity environment of 2023 end is likely to take a pause as US financial engineering wanes (from Q224). It would take an end of QT to continue.

Geopolitics and politics remain highly unpredictable / adverse.

The positive equity to bonds correlation should continue to temporarily haunt markets, until policymakers set their plans / tolerance on the matter (H224).

Financial assets are set for further volatile/hectic re-pricing. Real assets (specific commodities) and currency hedges (precious metals and cryptos) will outperform.

We keep a relatively cautious attitude to investing i.e. recommend a *Moderate* risk taking / budget.

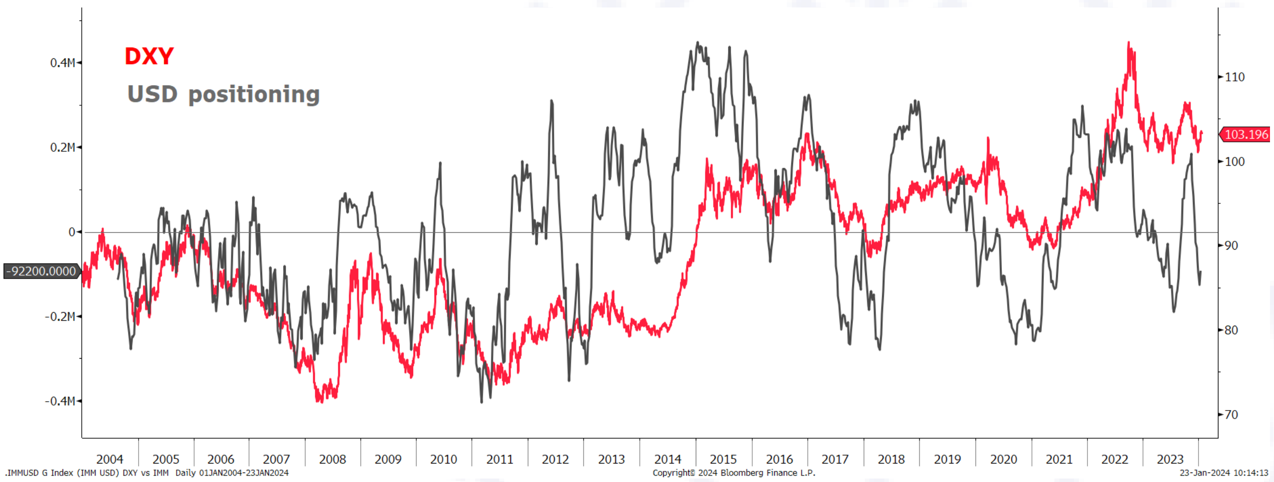
Currencies

Dollar up against everything

Investors have given up on betting that the Fed would cut rates in March. The cautiousness of policy makers and the plethora of positive data surprised have pushed the expected beginning of the easing cycle back to May. The USD is up against every currency this year. The US growth differential versus the rest of the world and the US 10-year yield are the key drivers. The consensus forecast for US GDP for 2024 has been on an upside trend since the middle of last year from 0.60% to 1.3%. The same pattern prevailed for the US 10-year yield which has been revised up from 3.10% to 3.80% over the same period. Furthermore, there is no doubt that other markets are marching to the bond piper's tune, to a degree seldom seen in the past. The US 10-year yield and the Dollar index, with projections from Bloomberg consensus forecasts, would imply the last year's relationship between the 2 continues to hold. The median year-end US 10-year yield forecast is 3.80%. The range of forecasts goes from 4.5% (RSM) down to 3% (TD). That implies a range of 100/105 for year-end DXY possibilities.

US 10-year yield remains the best USD driver

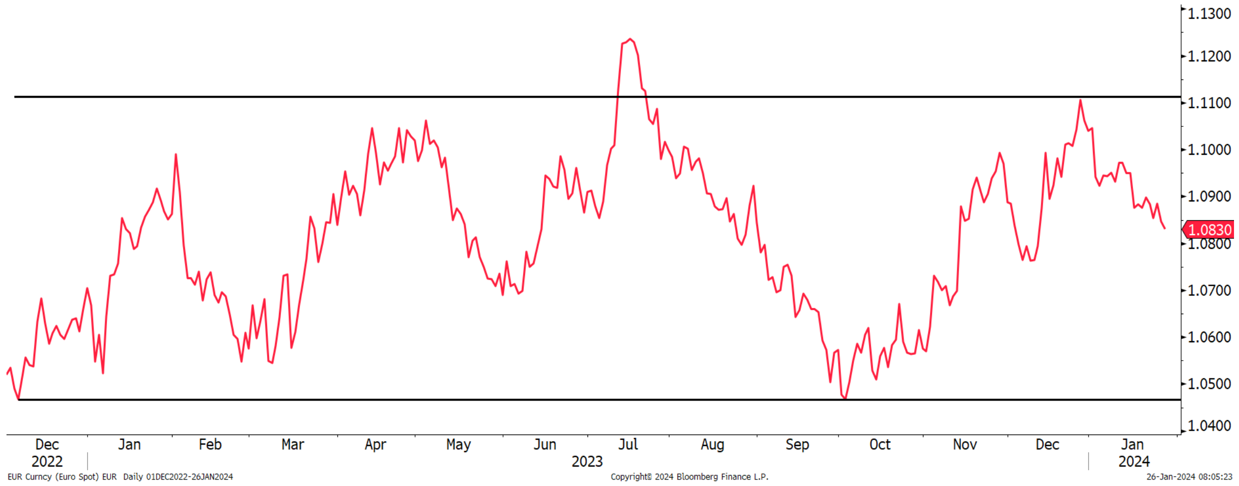
CFTC data show investors erring towards safety in a broad sense. Overall positioning is reflecting increasingly bearish speculative sentiment and positioning in the USD. The latest snapshot shows a light reduction in aggregate USD short positioning.



Economic underperformance should penalize the EUR

The ECB clumsily coordinated hawkish pushback had an eventually desired effect. Investors have scaled back their premature rate cut bets. EUR/USD downside risks have become most prevalent and the recent stickiness below 1.10 is telling. The challenge for EUR/USD bulls is that the rally to 1.11 in December from below 1.05 in early Q4 was US and Fed driven. The lack of a bullish domestic EUR drivers leaves the currency exposed.

EUR/USD in a tight range



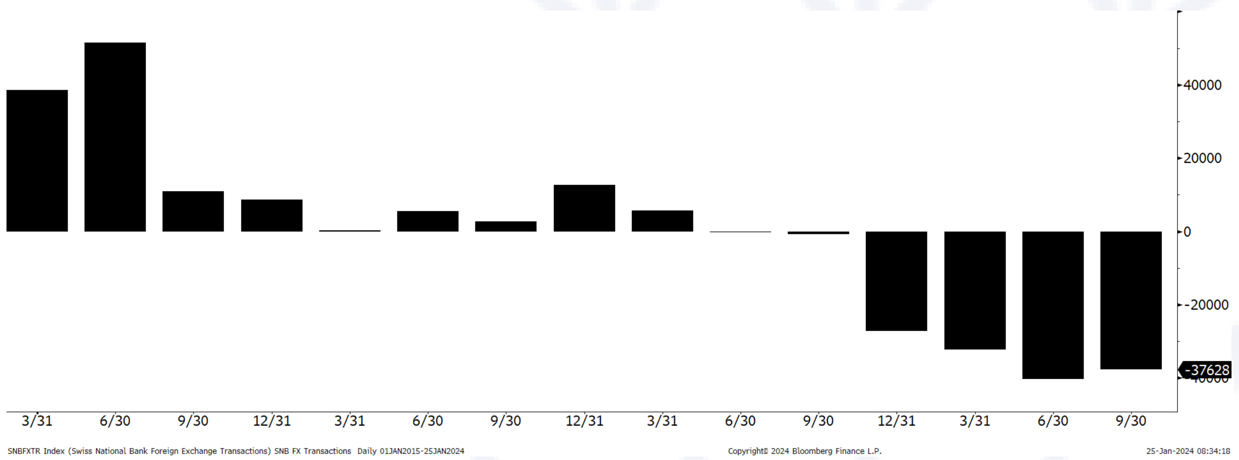
Euro-area rate expectations have become more dovish, but that has yet to be validated by ECB comments. Some policymakers have pushed back on the debate over easing. There are two risks. First, market participants may simply assume the underwhelming cyclical context and disinflation outlook will eventually trigger a policy response, larger than expected, and EUR negative. Second, surprise hawkishness from the ECB this year would be associated with weaker economic prospects and weigh on the EUR via the expected growth-differential channel.

A slight miss on leading indicators could pose a downside risk for the EUR

SNB wishes a weaker CHF

Do not ignore the SNB. The chairman's latest remarks about the currency validate the view that CHF strength may have been last year's story, but will not prevail in 2024.

SNB FX Transactions (CHF Mios)



The latest remarks from Jordan validate that Swiss economic cycle, the shift to a disinflationary outlook from heightened inflation risks, would presage a different approach to the CHF. Just 6 months ago, the SNB was hinting at selling foreign currencies and highlighting the virtues of an appreciating CHF in an inflationary world. That has changed. Swiss headline and core inflation have slowed below 2% -- to 1.7% and 1.5% year on year, respectively, in December. When recession concerns in a disinflationary environment dominate the policy outlook, a strong currency is no longer helping.

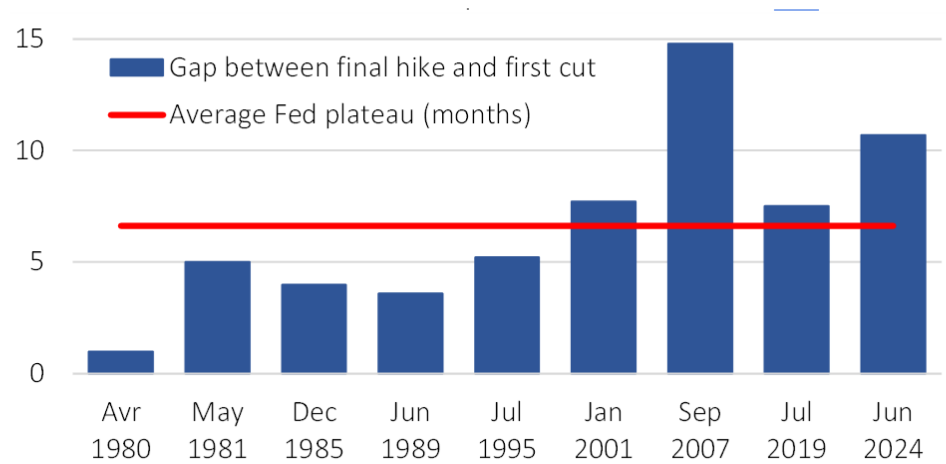
The mere fact that the SNB is acknowledging this may be seen as a first step toward actively managing the CHF lower

Bonds

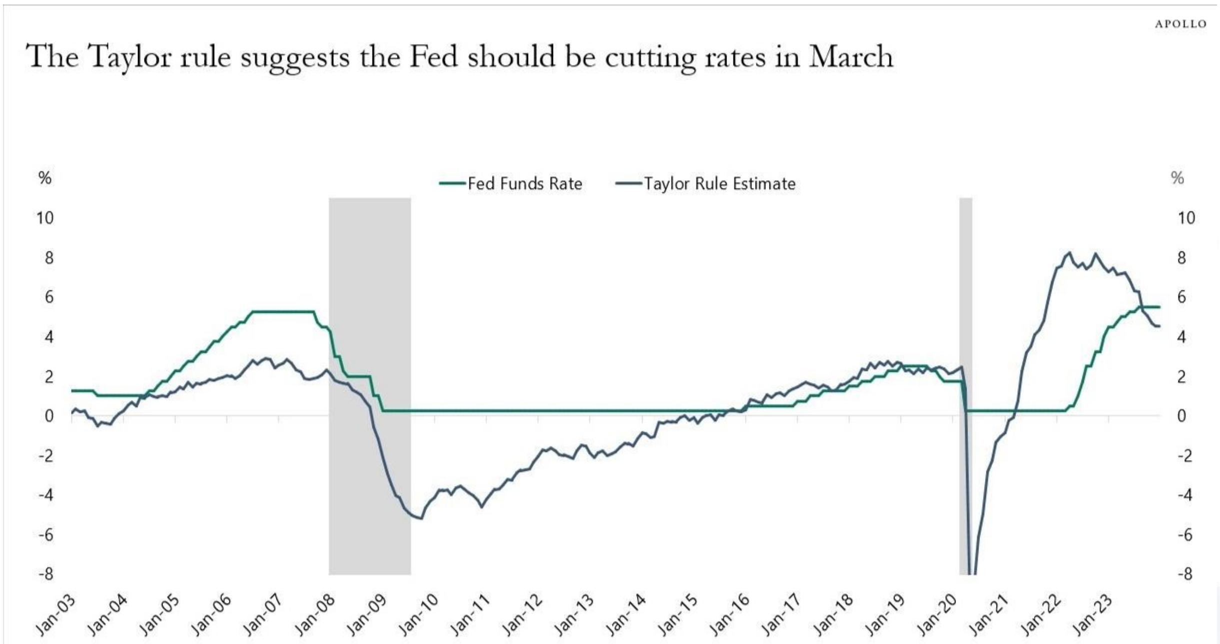
Rate-cut euphoria slams by central banks

Bonds bulls suffered their worst period since October. Resilient data and central-bank pushback hammered rate cuts expectations. The odds for a Fed cut in March tumbled to 50% from the 90% chance a couple of weeks ago. The UK acted as a stark demonstration. Gilts tumbled when CPI picked up for the first time in 10 months. Investors have been far too eager to base their bets on the previous cycles path when it cut 6 months after its final hike. Surprisingly, the speculative positioning did not adjust since October and remains extremely short.

Traders lean on history to bet a March rate cut



The Fed has used the Taylor rule for decades to assess where the rate should be. An argument for a March cut is the Fed model. With the sharp decline in inflation over the past 6 months, Fed Funds should not be 5.5% but 4.5%.



Market pricing shows that conviction of Fed March cuts is waning. Fed speakers have casted doubt on the timing and the magnitude of cuts. Bostic estimates the first cut in Q3, while Waller is calling for methodically and carefully ones. But with inflation falling fast and within striking distance its target, the Fed can quickly act. However, the magnitude of cuts (150bps) for this year are relatively unchanged. The Fed already acted. It confirmed the end of its BTFP on March 11th. Immediately, banks will be charged the rate paid on Fed reserve balances (5.40%) rather than the 1-year USD OIS +10bps (4.88%) to borrow money from the facility. This cancels the free lunch of banks.

A June rate cut and a mid-year change in QT is our scenario. An earlier start is a possibility if fundamentals deteriorate sooner. The US 10-year yield is likely to remain in the 3.75-4.25% range for Q1

March/April cut is premature for the ECB

President Lagarde sounded open to the likelihood that rates would come down at some stage in 2024. A summer cut is in play. The market's bets on rapid rate cuts could upend policymakers' efforts to curb inflation, by easing financial conditions too much.

Unless European economy collapses, the ECB will be reluctant to cut before summer. At that moment, German 10-year yield should come back below 2.0%

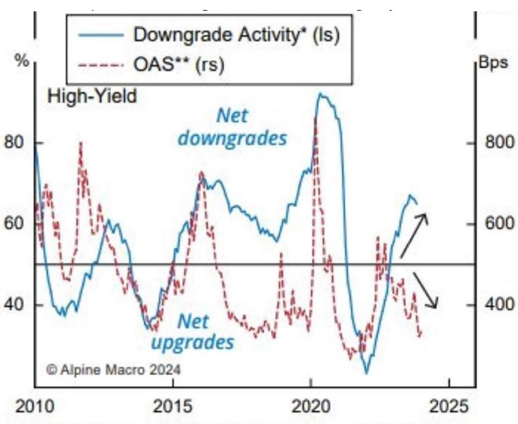
Japanese investors are facing a different dynamic

Poorly received auctions highlight the need for yield. Japanese returned to buying foreign debt in December. This is different from the typical pattern of Japanese offloading foreign debt at year-end. They have been net buyers of foreign debt in December in only 3 of the past 10 years. In 2023 they bought the most since 2020. This is a significant change.

(Too) strong appetite

IG companies tap USD debt market this year at the fastest pace. This is the busiest year opening for more than 3 decades. Borrowers are rushing to lock in lower interest costs, while investors are keen to buy new bonds before policymakers start cutting rates.

Spreads look tight relative to ratings dynamic



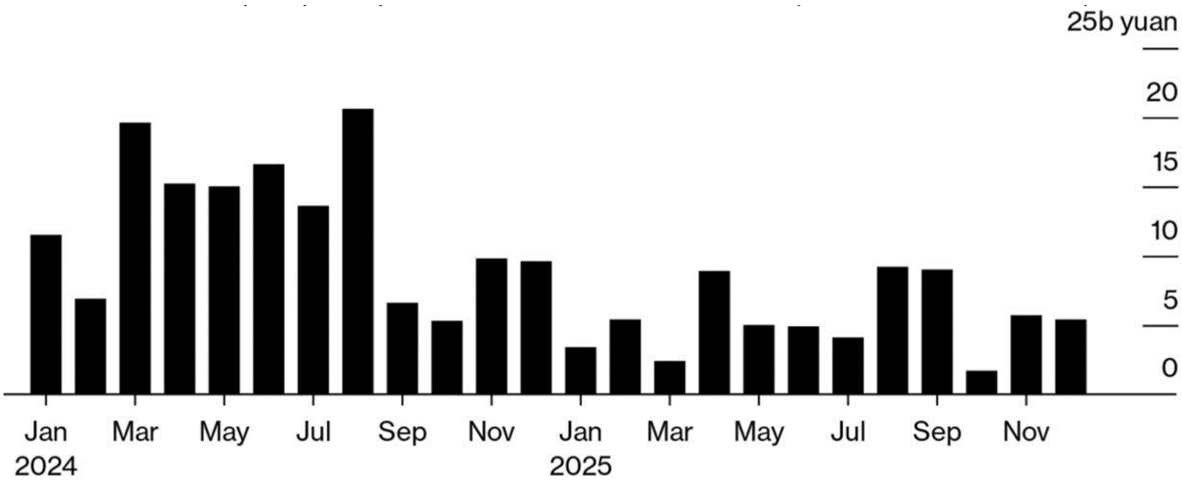
*Downgrades as % of total rating changes; source: S&P
**Source: Bloomberg Finance L.P.

Defaults seemed to stabilize in Q4, at least until November. According to Moody's, the European default rate dropped from 3.3% in September to 2.8% in November, and in the US from 5.4% to 5.3%. The results justified the H2 spread tightening. Spreads tend to look well past the peak or troughs in defaults and react well in advance.

However, December signal is different. Last year closed with default rates rising further to their highest levels since at least 2021. The US default rate hit 5.6% and in Europe jumped to 3.5%. According to the recent downgrade dynamic across the HY spectrum and with higher refunding conditions, default rates should keep rising for several months still.

If default rates continue to rise, credit spreads have yet to peak. The EM sovereign rating outlook is broadly balanced heading into 2024, according to Fitch which has 11 positive outlooks marginally outweighing 10 negative ones. This has a broadly neutral impact on sovereign ratings relative to 2023. This reflects a base case view of moderately weaker global growth and persistent strains on fiscal positions, balanced against lower inflation and reductions in most central bank policy rates. However, risks are skewed to the downside. Setbacks to global disinflation could lead to 'higher for longer' interest rates and financial market volatility. Failure to stabilize the Chinese property market could lead to a sharp slowdown in growth with adverse effects on trade partners and commodity exporters. No to mention material political risks.

Chinese property firms bond maturities (offshore market)

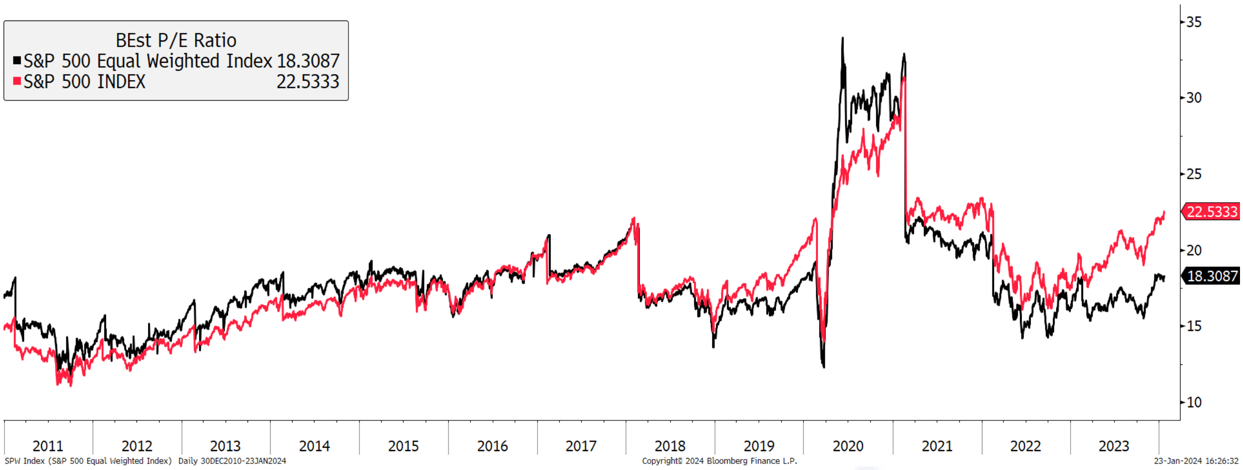


Equities

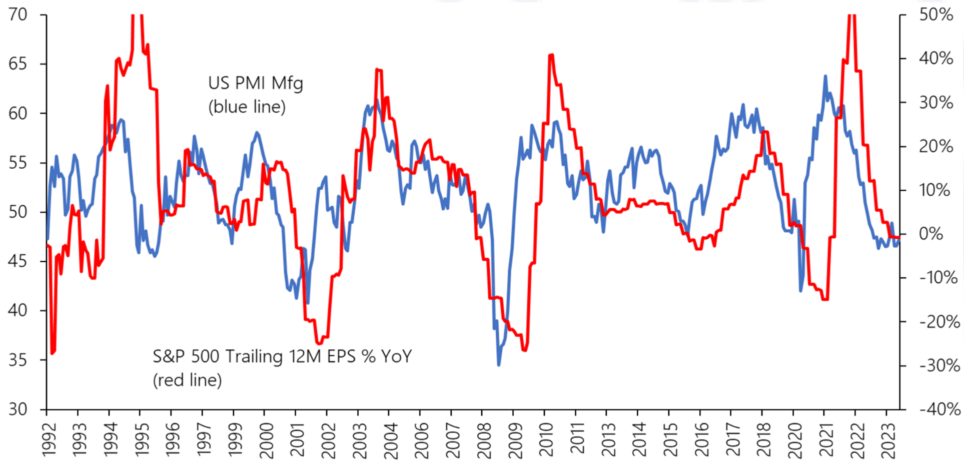
Irrationality, exuberance, complacency? Not that much

Certainly, the 35% increase in the S&P 500 since October 2022 (start of the bull market) is largely due to the strong rise of Big Techs, renamed the Magnificent 7, in 2023 with a performance of 107%, but the S&P 500 Equal Weighted index still rose 22%. Consumer discretionary and industrials performed decently. Investors therefore did not bet everything on the Magnificent 7. The PER of the indices increased in 2023, but they remain below the levels at the start of 2022. The PER of the S&P 500 is higher than its historical average, driven by the Magnificent 7, but that of the S&P 500 Equal Weighted (equal weighting of 0.2% for each title) is on its historical average. The PER of the Euro Stoxx shows a discount of 10% compared to its historical average. On the other hand, the normalization of inflation no longer allows us to hope for a strong increase in multiples. Corporate profits in the United States and Europe are expected to increase by 10% in both 2024 and 2025 after a short recessionary period at the end of 2022 and in the first half of 2023. The US recession, the most anticipated in history, is still not there and opinions are divided (50/50) on its coming or not. The recovery of American and European manufacturing indicators (PMI), after having stabilized at low levels, reassures the optimists about the state of the economies, despite the decline in services indicators.

PER S&P 500 and S&P 500 Equal Weighted



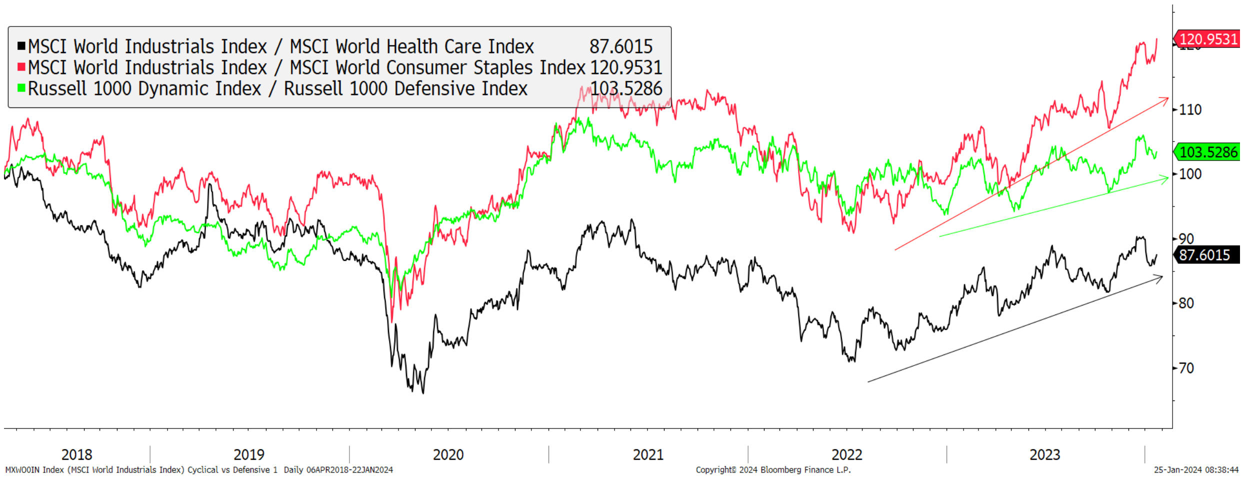
PMI US Manufacturing and BNPA 12M S&P 500



Investors are playing a winning formula, perhaps wrongly or with a little complacency: resilience of the economy and corporate profits, stabilization of inflation and reduction in central banks' rates in 2024. They are playing the perfection. Growing geopolitical tensions do not enter into this formula, nor the absence of an increase in oil prices which signals a risk on demand (recession) rather than a risk on supply. The technical aspects are all favorable for a positive performance of stocks in 2024, which we estimate at +10% for the MSCI World, but statistics are more mixed after a strong year in 2023.

After an attempt to catch up at the very beginning of the year, the defensive sectors remain in a trend of underperformance compared to the cyclical/industrial sector (Russell Dynamic/Russell Defensive) which benefits from a resilient economy and will benefit from the probable reversal of manufacturing indicators. Industrial stocks are to be favored in a global economy of war, that is to say the reindustrialization of Western countries, the energy transition and the increase in military spending. Thanks to the Magnificent 7 and technology in general, the Growth segment should outperform Value; the main arguments are Artificial Intelligence and the resumption of the semiconductor sales cycle.

Relative performance. Cyclical/Industrial vs Defensive



Amounts in USD money market funds in the United States

In 2023, money market funds were the “hottest” asset thanks to attractive returns, the amounts of which increased from $2,500 billion in 2018 to $6,000 billion today in the US. What will investors do when the Fed becomes more dovish, reducing returns on money market funds? Possibly we could see part of these funds converge towards risky assets, in particular towards stocks.

We do not see any reasons for a significant stock market correction, but January and February are unfavorable months in terms of statistical seasonality and the failures of the Santa Claus rally and The first 5 days of the year with negative performances argue rather for a consolidation. In a deglobalized and disruptive world, we can no longer take the emerging zone as a block. There are anti-Western countries (China, Iran) and countries that only take their own interests into account (India, Saudi Arabia). The Global South bloc and BRICS are very heterogeneous alliances. China appears to be a value trap. Beijing is considering a vast support plan ($278 billion) - window guidance - for its stock markets, while its economy is slowing and foreign capital flight is not weakening. But the disenchantment with Chinese stocks remains. India wants to be an alternative to China for Westerners, but its industrial ecosystem and its export structures (ports in particular) are not at the same level as those of China. Mexico remains a major partner for the United States in its onshoring/nearshoring strategy.

Commodities

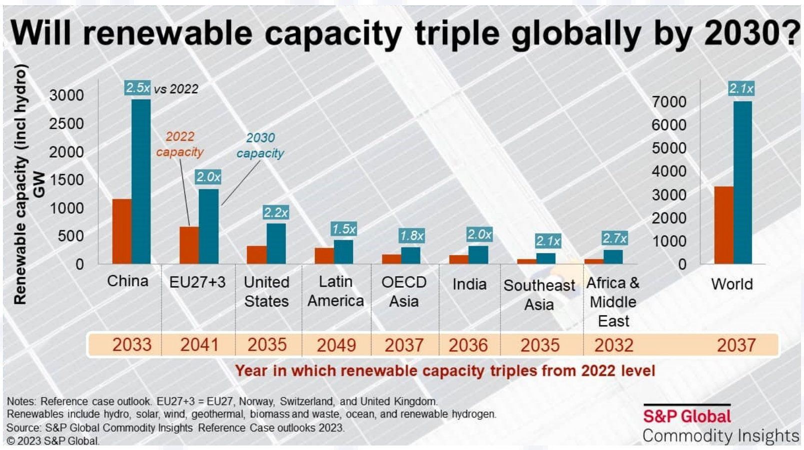
The overall economy is too weak to see a new bull cycle in commodities

Since mid-2022, the Bloomberg Commodity Index has fallen 30%. The global economy is soft, affected by all kinds of economic, geopolitical and climatic disruptions, particularly in China and Europe. Chinese real estate no longer supports global demand for industrial metals, a sector which accounted for 25% of global demand before the crisis.

Bloomberg Commodity Index

Copper has changed status. Experts consider that copper demand is no longer a true reflection of economic activity, both up and down. Demand for copper is supported at an unprecedented level, whatever the economic situation, by strong demand linked to the energy transition and mainly electrification. The Economist magazine points out that copper has just changed its status. Copper is no longer “Dr Copper”, a barometer of the health of economies. Despite the collapse of the Chinese real estate market, copper prices have held up relatively well. Annual demand for copper will double by 2035, a metal used in batteries, electricity networks, photovoltaic cells and transport. An electric car uses 80 kilos of copper compared to only 18 kilos for a combustion car. The increase in demand for copper will come above all, according to Wood Mackenzie, from the development of electric vehicles, which will represent 55% of demand. Demand from offshore wind will increase sevenfold by 2040.

However, in the short term, industrial metals, in particular lithium, are affected by a weakness in demand for electric cars observed at the end of 2023 in China, Europe and the United States.

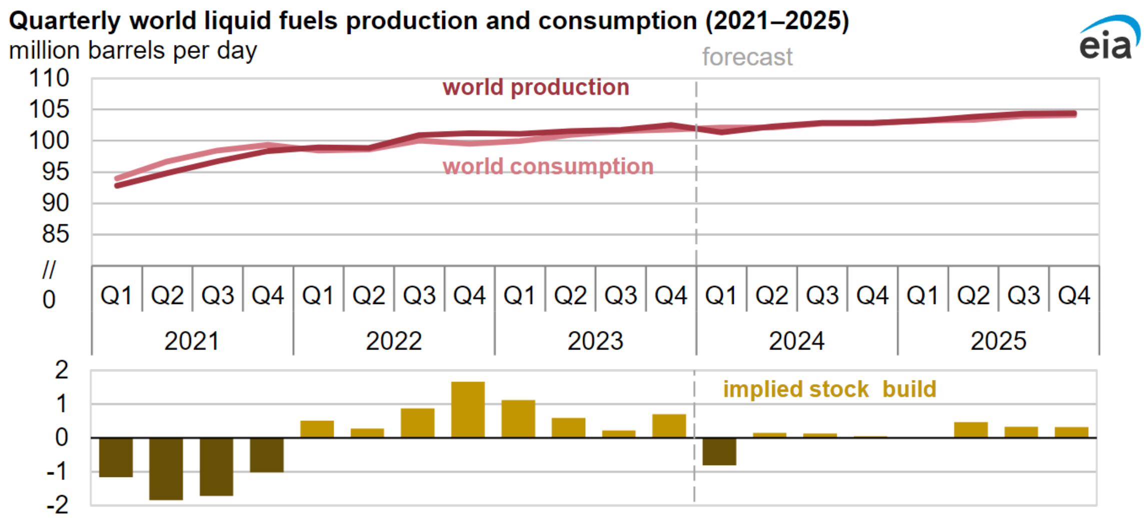


After the concept of a *Supercycle*, which no longer seems relevant today, HSBC bank describes a *Super squeeze* in raw materials, i.e.

prices supported by supply constraints, rather than an increase in demand, coming from geopolitics, climate and insufficient investment in new production capacities.
The energy transition will require a large quantity of industrial metals, copper, nickel, lithium, aluminum, cobalt, graphite. COP28 validated a plan that will triple renewable energy capacities by 2030.

Over the past 20 years, investments in critical metals used today for the energy transition have amounted to $45 billion per year, while $70 billion per year would be needed until 2030 to meet demand. Without new capacity, supply will be under severe pressure. Then, certainly, industrial metals will be back, offering great return for investors in the long term.

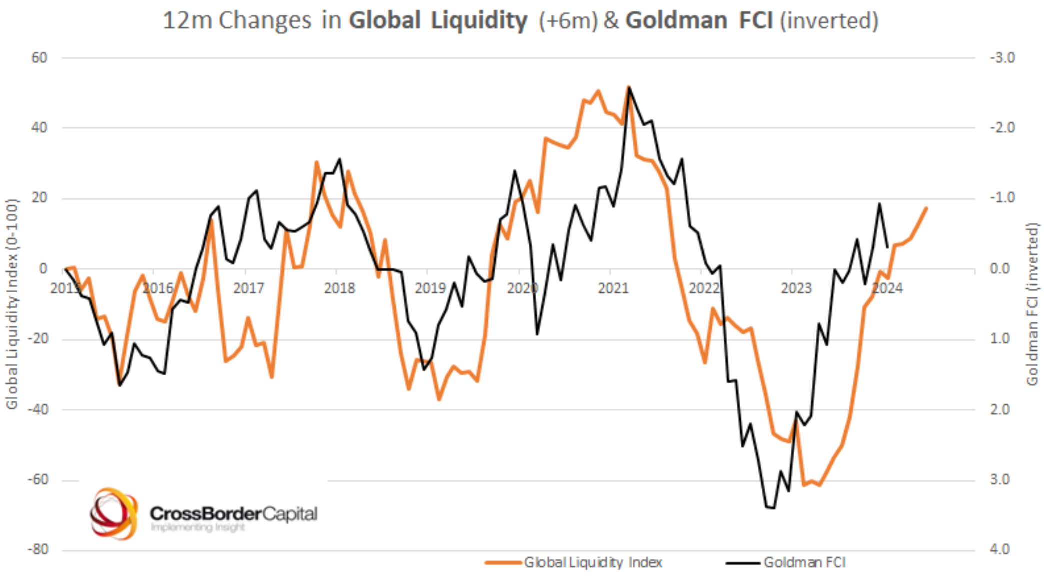
However, in the short term, for both oil and industrial metals, the market remains focused on weak demand and less concerned by structural supply issues in the medium to long term. Oil prices are not jumping despite an extremely dangerous geopolitical situation in the Middle East. The Gulf producer countries and Egypt remain little concerned by the Israel-Hamas (Iran) conflict. Supply from non-OPEC countries is increasing. The United States reaches production of more than 13 million barrels/day. Barring a major crisis, supply/demand will be balanced, resulting in stable prices. We are moving the energy sector from overweight to neutral, but the situation is extremely explosive.



Data source: U.S. Energy Information Administration, *Short-Term Energy Outlook*, January 2024

Precious metal

After the strong rally in Q423, fuelled by lower interest rates, a period of consolidation has begun. In the coming months, financial conditions are likely to stay accommodative on the back of the recent pick-up in global liquidity. This should prevent gold and crypto assets from crashing if the postponement of expectations for lower policy rates continues. Paradoxically, the summer and autumn could be more volatile in terms of liquidity as US financial engineering (RRF and BTFP), not to mention QT, comes to an end.



A breakout to new highs is not imminent for precious metals and crypto will remain in a post-ETF volatility phase in the short term.

Very supportive MT fundamentals remain in place for both assets