SELVI & CIE

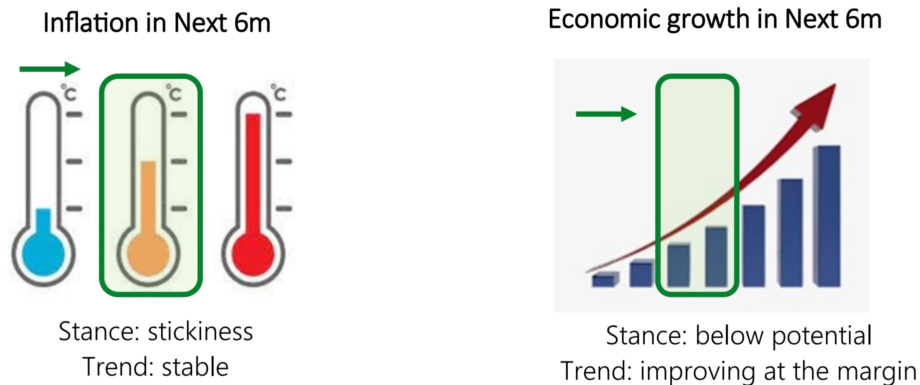
THE MONTHLY LETTER

Tactical update

JUNE 2024

A cumbersome taboo

Global landscape



Stance: stickiness
Trend: stable

Stance: below potential
Trend: improving at the margin

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 disrupt long-term equilibriums.

Cyclical outlook. Some light at the end of the tunnel, with wide dispersion

US growth and inflation will remain resilient with fiscal largesse ahead of the elections. China is reflating more broadly, even thinking about trying to stop property prices from falling. The downturns in Europe and Japan could end from H2 24.

Geopolitics. Still in a chaotic landscape

The proliferation of conflicts shows little sign of abating. The lack of positive developments in the Middle East and the Red Sea will continue to weigh on energy prices and global trade. The Ukraine conflict is unlikely to experience significant developments, at least before the November elections.

Shift in global liquidity and financial conditions

Liquidity framework will become more favorable from Q3. US financial engineering 3.0 will support risky assets and precious metals.

Unstable equity-bond correlation

Hide and seek between Fed and investors will continue. The succession of favorable / corrective periods for risky assets too. Next months should be more favorable than Q2, globally.

Highly volatile capital flows

Investors' cyclothymia is fueling significant capital in/out-flows into risky assets. The very large amount in Money Market Funds could exacerbate these trends, short-term.

Pass Muscade!

The famous 2% magic inflation level, which is the reference / target for most rich countries' central banks, is wrongly considered to result from thorough calculations of a long-term - theoretical - macroeconomic equilibrium. It didn't come from any academic study, but rather from an offhand comment during a television interview! In February 1990, New Zealand was the first country to mandate inflation targeting, with a ceiling of 2% and a floor of just 0%. Inflation was running at 7.6% at the time but had averaged over 10% between 1970 and 1990. The subsequent disinflation in New Zealand not only lent credibility to the process, but gradually spilled over among world central banks. The ECB set its own target after the monetary union (1999), while the Fed formally adopted inflation targeting in 2012. In recent decades, the relative orthodoxy of economic policy and the profound disinflationary forces, namely globalization, have entrenched this mode of operation for central banks.

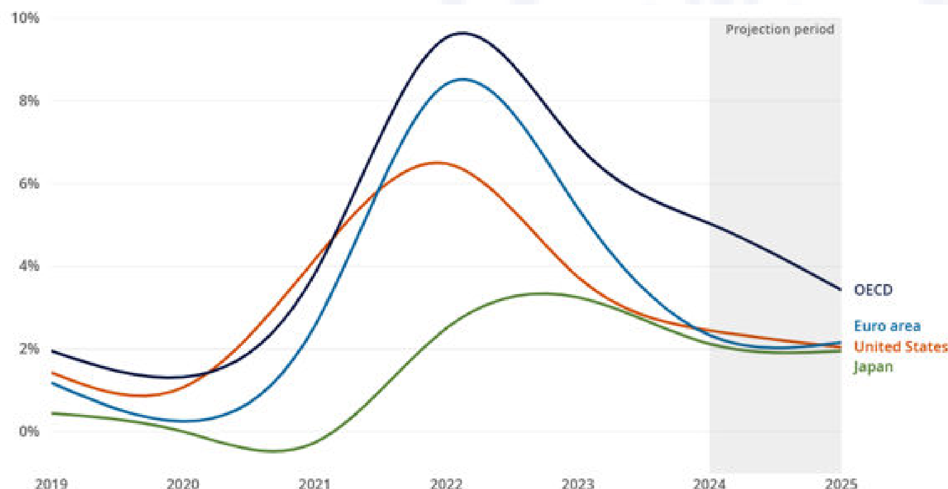
The ¨sillon¨ has become deep. Raising this 2% threshold would be seen as an abandonment of inflation containment, if not of central bank independence. This rule has become religiously enshrined in how several supranational organizations forecast macroeconomic trends. Therefore, once the pandemic shock is over, their expectation is for global inflation rates to converge towards… 2%. Including Japan.

Dates d'adoption des objectifs d'inflation

Country	Adoption date	Target rate (%)
New Zealand	1990	1 - 3
Canada	1991	2 (+/-1)
United Kingdom	1992	2 (+/-1)
Australia	1993	2 - 3
Poland	1998	2.5 (+/-1)
Brazil	1999	4.5 (+/-2)
Chile	1999	3 (+/-1)
Colombia	1999	2 - 4
South Africa	2000	3 - 6
Hungary	2001	3 (+/-1)
Mexico	2001	3 (+/-1)
Peru	2002	2 (+/-1)
Philippines	2002	4 (+/-1)
Indonesia	2005	5 (+/-1)
Romania	2005	3 (+/-1)
Uruguay	2007	3 - 7
Paraguay	2011	4.5
Dominican Republic	2012	3 - 5
United States	2012	2
India	2015	2 - 6
Jamaica	2017	4 - 6

Source : Inetrnational Monetary Fund

A wishful OECD call for an inflation rate of 2% in 2025

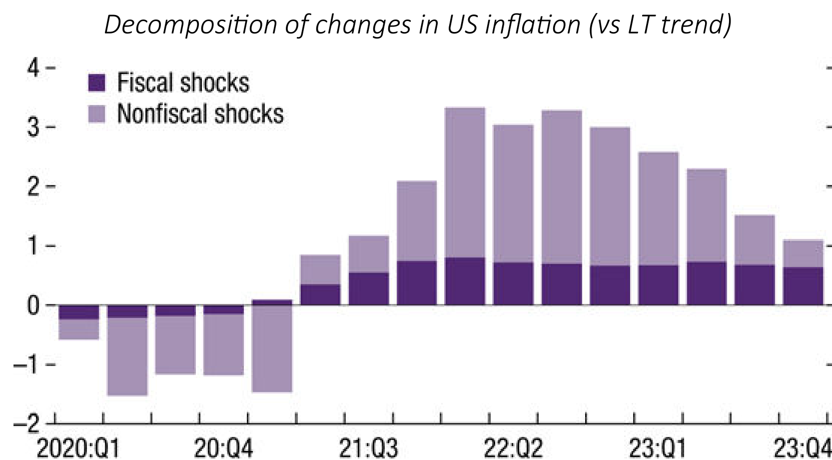


Further hide and seek between markets and policymakers

Admittedly, supranational forecasts have only a limited impact on markets. Still, they reflect the thinking of central bank economists/committees. This is precisely why the rich countries have (for far too long) regarded the sharp rise in inflation as temporary. Now they are doubling down in the expectation of a normalization of the economic cycle. Despite the huge debt burdens, the unprecedented deficits, the dire geopolitics, the green transition, the climate change, and so on!

Fortunately, lesser known (less politicized?) working papers by econometric experts offer more insight. According to the IMF, deviations of inflation figures from their long-term trend since the pandemics can be attributed to fiscal profligacy by about +0.8% (on average). In short, a continuing regime of US fiscal dominance would push inflation closer to 3% (2+0.8). As for the 2% inflation target, it will be soon enough for next administration/central banks to modify it, to adapt it, ex-post!

Decomposition of changes in US inflation (vs LT trend)



In an era of fiscal dominance / extreme policies inflation will remain higher than target and volatile
It would take a recession to allow for a cyclical normalization of inflation

Allocation takeaways

Post US elections, the issue / impasse related to fiscal dominance will resurface and potentially impact / weigh on the markets. But in the meantime/short term, a confluence of favorable factors will take over first. A cyclical slowdown in US, coupled with intense fiscal stimulus, will allow for an economic soft landing. Especially given the additional liquidity to be provided by a complacent Fed.
Some recovery in China will also help.

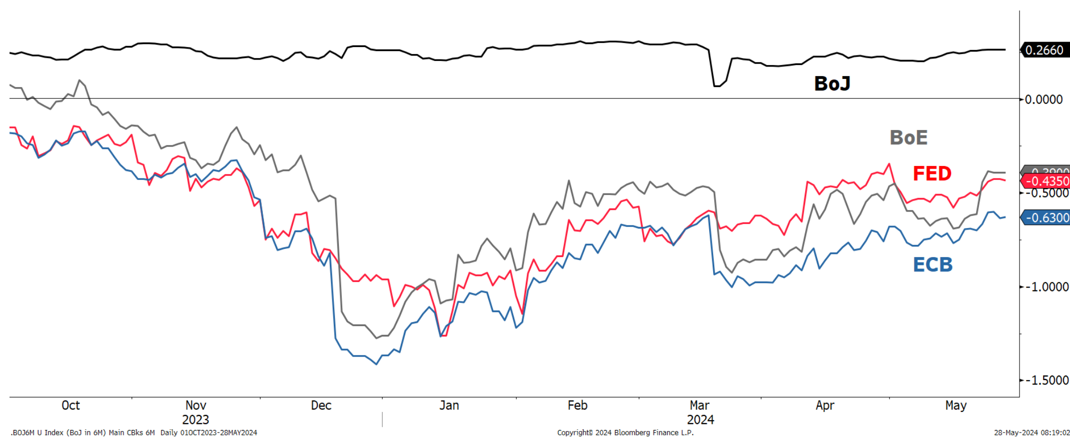
Given the prevailing positive correlation regime between equities and bonds, we recommend a neutral risk budget and a fully invested allocation in global portfolios.

Currencies

Trading range

The USD has been on the backfoot during May due to better risk sentiment reducing the need to hold safe havens. In addition, a softer April CPI print kept steady expectations for the Fed to cut rates this year. In May, the USD has been the worst performing DM currency, while risk sensitive currencies (NOK, NZD, SEK, and AUD) lead the way. But in terms of the Fed, expectations have not changed much during the month. The market is just fully pricing in one 25bps rate cut this year in November. Comments from Fed officials still suggest that a rate cut is likely this year, but many have indicated that the decline in inflation has been slower than expected and want to see more data to ensure that price pressures are sufficiently easing. So the USD remains sensitive to any surprises in price data.
Hence, we reiterate that we expect the USD to clearly weaken whenever the Fed cuts rates, or signals that it is close to doing so

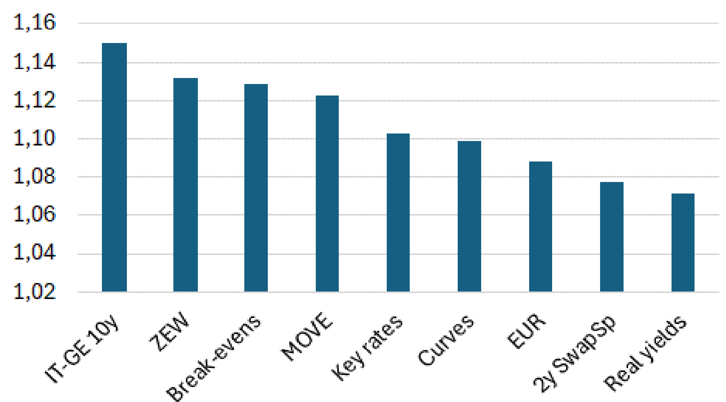
Market gradually removing central rank rate cuts within the next 6 months, ex-Japan



Cautious ECB cut should stay EUR supportive

The EUR has performed well against the safe havens over the past month but underperformed the risk/commodity currencies. US inflation helped pull EUR/USD higher, with 1.09 continuing to offer strong resistance. The EUR/USD has been in a broad 1.06-1.11 range since December 2022. Intuitively, a rate cut should be EUR negative. But the June easing is well flagged and priced in. It will not come as any surprise. What is more important is where rates are going next and how President Lagarde rhetoric is at the press conference. Effectively, the ECB is committed to a move in June.

Most of indicators are pointing for a higher EUR/USD



While most voters are agreeing on June, they are generally reluctant to commit to a path beyond. Wage gains, services inflation, Middle East tensions and US rate cuts delay are all risks. Hawkish Bundesbank President Nagel told

that a second cut may have to wait until September. Villeroy favors maximum optionality after June done deal rates cut. He noted that the ECB has significant room to loosen toward a neutral setting that should be between 2% and 2.5%. He called market expectations for where borrowing costs eventually settle — a terminal rate of about 2.8% in 5 years — not unreasonable. A June cut may be interpreted as a hawkish one and may not be euro negative if Lagarde adopts a data dependency approach.

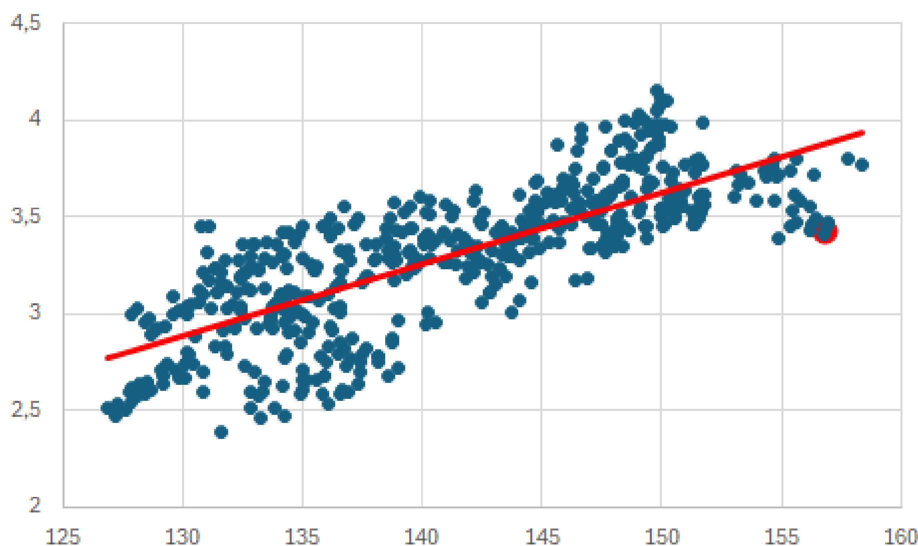
Yields spread points for a slightly weaker EUR. However, other relationships are pointing for a much higher EUR

While the JPY is cheap, recovery is not in the cards yet

Japan's Weighted Median Inflation Index, a BoJ inflation gauge indicator, increased 1.1% in April, a slowdown from 1.3% in March. The Corporate Service Price Index climbed to 2.8% in April, its fastest increase since 2015. The BoJ hiked rates in April and is likely to do so again but as the inflationary trend is unclear, it raises doubts about the timing of the next hike.

Not officially confirmed yet, MoF ordered intervention to contain yen weakness. Policymakers may simply have to wait for US rate cuts to pull USD/JPY lower. BoJ members had been verbally intervening for several months. The MoF/BoJ may have recently spent $60bn to support the yen. The last time it intervened, it spent $43bn in October 2022, after $20bn in September. Solo interventions rarely succeed.

JPY looks cheap according to yield gap



The short yen is still crowded. Japanese 10-year yield just reached a 12-year high, but just above 1%. The correlation between USD/JPY and the 10-year spread over the past 2 years remains high, pointing for a USD/JPY closer to 146.

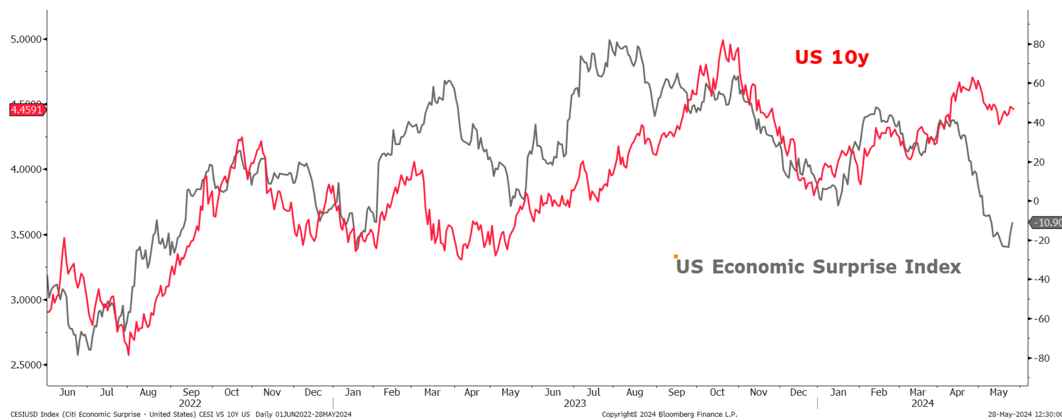
A lower USD/JPY remains linked to a US 10-year yield weakening or a dovish FOMC

A surprising BoJ hike could lift the JPY

Bonds

The ECB prepares to ease while the Fed is sticking to higher for longer. The policy path for both central banks is still far from certain. Global bonds price movements show a lack of conviction on the trajectory for policy or long-end rates. Despite a decline in inflation and job creation in the US, the hawkish tone of Fed members suggests that the Fed will need more time, at least 3 more months, to be sure that inflation will sustainably return to 2%. Expectations for rate cuts have been seriously dented and are expected to start later

Economic indicators surprised to the downside, but market only focus on inflation data



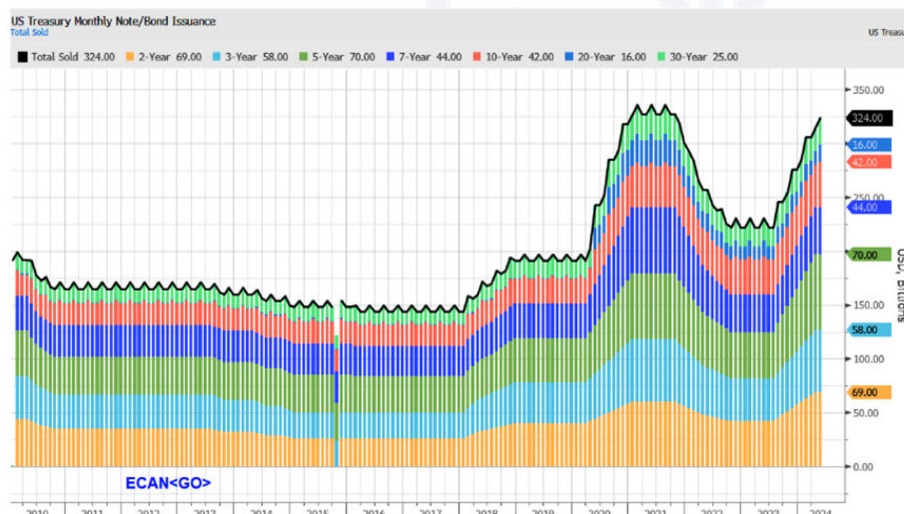
Although some FOMC officials are open to the possibility of higher rates, we envisage like Powell either an extended pause or rate cuts as the more likely scenarios. The June FOMC is likely to compound this cautious message that confidence is not there yet on inflation.

Towards a June consolidation

US Treasury demand under scrutiny

Demand for Treasury auctions has been weak with the bid to cover ratios falling short of expectations, reaching multi-month lows. The large issuance of new debt and the still running Fed QT have pushed yields higher. Auctions have become market movers and will have to be watched carefully for signs of falling demand. The next weeks will be key. Supply is expected to stabilize and the Fed will start to taper its QT.

US weekly supply is reaching 2021 peak

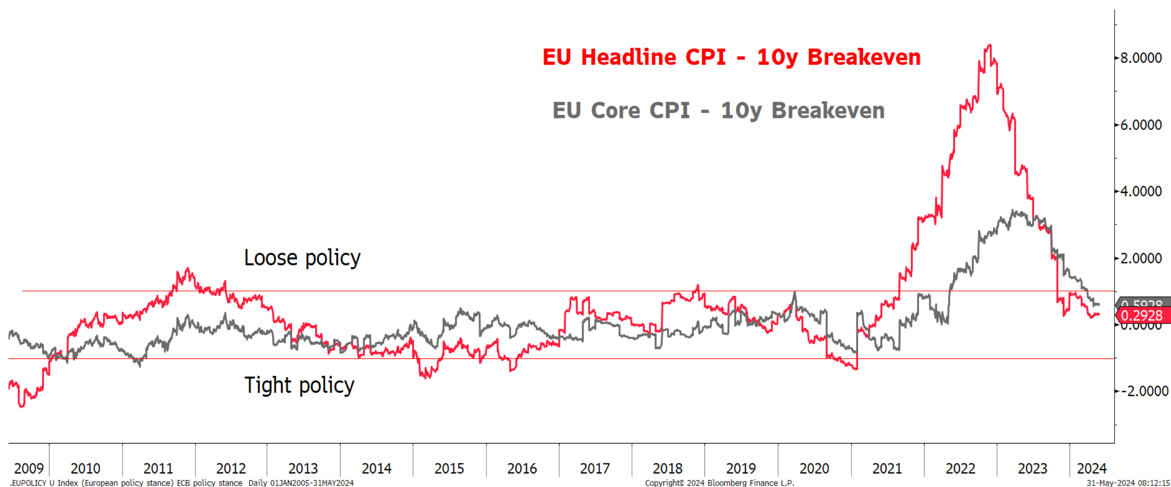


Markets have priced out rate cuts, but the ECB stays on track

Eurozone inflation rebounded in May thanks to higher services inflation. With the ECB on the eve of deciding on a historic rate cut, this adds to doubts about the future inflation path. While many forward-looking indicators remain benign, a hot labor market, supply chain disturbances, and a recovery of purchasing power will make for an interesting debate.

Services inflation remains elevated for now, but forward-looking indicators do gradually move in the right direction. Services inflation trend around 3.5% towards year-end, well above target. Wage growth surprised to the upside in Q1. The ECB was correct to dismiss this as resulting from German one-off payments as other countries see faster deceleration. Still, with unemployment remaining at a record low of 6.4%, the decline in wage growth over the rest of the year remains uncertain. Recent positive economic surprises could prompt the ECB to wait for the revision of economic projections in September. Even one of the most hawkish ECB members, Bundesbank President Nagel, considers September for the second rate cut. The usually centrist members, Governor Villeroy, is still leaving the door wide open to a possible cut in July too.

ECB can already easily ease its monetary policy



The market is just pricing in 60bps rate cuts this year and an ECB terminal rate which does not clearly drop below 3% until December 2025. This scenario is only consistent with inflation failing to move to the 2% area over the next 2 years.

The lack of direction in growth and inflation indicators creates volatility in bond markets

The uncertainty band is still significant. We expect an inaugural 25bps cut in June

Risk premium compression overdone

The bond market volatility measured (MOVE) has fallen to lowest level since February 2022. The US IG spread is at its narrowest level since September 2021. The US HY premium is back to its lowest level in 2.5 years indicating no worries about the economy. Signs of an overstretched credit market are resurfacing. A rising share of the US IG bond market is at risk of being slashed into HY. Rating agencies expectations of downgrades are exceeding upgrades for

the first time since 2021. The proportion of the lowest-quality IG bonds (BBB-) that rating agencies are more likely to downgrade stands at 5.7%. That is almost double the level at the start of the year. In contrast, the portion of bonds more likely to be upgraded stands at 5.3%, down from 7.9% in January.

While the share of bonds at risk of downgrade is still relatively small, the shift highlights the challenges facing corporate America. Last year, net rising stars totaled $119bn, highest level since 2010. This year rising stars stand at just $20bn. The entire BB-rated universe stands at $667bn. Large amounts of new bonds entering the HY market can cause changes in pricing, leading spreads to widen.

Historically, big downgrades are negative for spreads

Equities

Catch-up for latecomers?

We are in a bull market which is expected to extend beyond 2024 supported by the recovery in corporate profits and the prospects of rate cuts by central banks. We are in an industrial world with the reindustrialization of Western countries and investments in the energy transition and in defense. The United States benefits from this thanks to its huge protectionist investment plans, as does Japan thanks to an efficient industrial ecosystem. Japan and India benefit from the "China Plus One" strategy of Western countries, seeking to reduce their dependence on China, while wanting to remain in Asia, in an escalation of tensions between the United States and China.

In a disruptive world - the Trump presidency in 2016-2022, the pandemic, the wars in Ukraine and the Middle East, the expansion of the BRICS club, the emergence of the Global South, the confrontation of the West–China/Russia blocs - stock market performances are not where one would expect. For example, defensive sectors underperform in a risky environment. Certain segments are lagging behind in terms of performance and could outperform, or not: Chinese stocks, Swiss stocks, small and mid-caps, defensive sectors and energy transition.

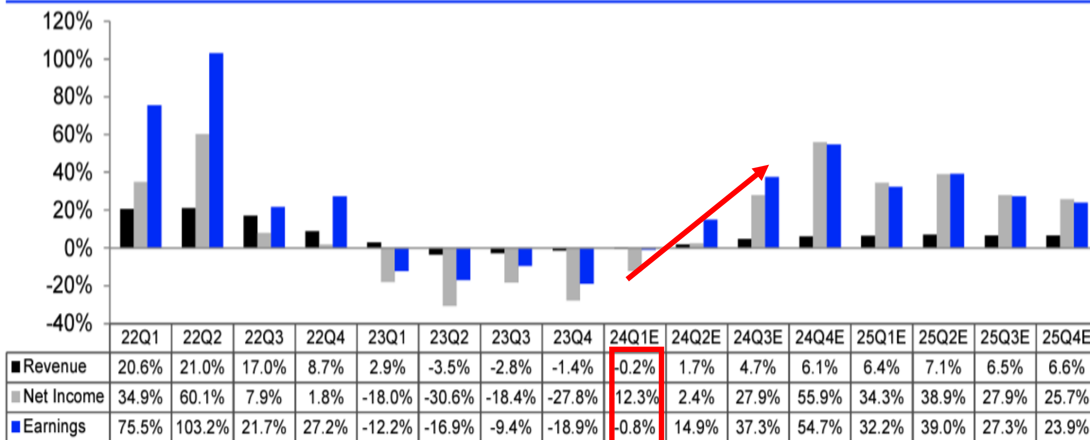
Chinese stocks. In a bear market since February 2021, the CSI 300 has plunged to a low of 47% (February 2024) and 38% today. Over the same period, Chinese stocks listed in Hong Kong lost 45% and those listed in New York 68%. The closure of the country for three years (2020-2022) due to the pandemic and the real estate crisis beginning at the end of 2019 weighed on the financial situation of households. In February, the Chinese government injected nearly $260 billion to support the stock market with limited success since it was mainly banks and brokers (on orders from the Party) which were buyers and recently $40 billion to support real estate by purchasing a part of the unsold assets, which is largely insufficient for the latter according to UBS, considering that it would need at least $300 billion. Chinese households do not want to take risks with stocks, because, according to different sources, real estate accounts for 50%-70% of their wealth. Real estate would have to be in an advanced recovery cycle for Chinese households to return to stocks. Individual investors play a major role on the Chinese stock market, as they represent around 60% of volumes, a strong contrast with the American stock market where individual investors only account for 20%. In a defensive approach, Chinese households are buying gold. At best, we could move Chinese stocks from underweight to neutral, because the authorities are still reacting, in homeopathic doses. But the risks remain high, not only economic, but also with Sino-American tensions, the potential return of Donald Trump, Taiwan and the return of the omnipotence of the Communist Party which is not a guarantee of performance and innovation. A risk premium is justified and the 15% discount compared to the valuation of the European stock market does not seem sufficient to us.

Swiss stocks. They have massively underperformed since October 2022, when one would expect defensive stocks to outperform in a chaotic environment. The Swiss stock market was penalized by the strength of the Swiss franc, the weaknesses of the German and Asian economies, Chinese in particular, and the underperformance of the defensive sectors, health and staples. In May, the stock market showed a better trend thanks to the fall in the Swiss franc. To confirm the return of Swiss equities, the franc will have to continue its decline with technical targets at 1.02, then

1.05-1.10. An economic improvement in Germany and in China would be favorable to the Swiss stock market. With a weaker franc, we move Swiss stocks from neutral to overweight.

Small and medium market capitalizations. We are in a disruptive world, more inflationary and with higher interest rates, an unfavorable environment, from a stock market point of view at least, for small and medium-sized companies. In the United States, the regional banking crisis in 2023 has made investors cautious in this segment. Caution also applies to the composition of the indices of small and medium-sized companies: 42% of Russell 2000 companies make losses, 33% for the CAC S&M Caps (150 stocks) and 18% for the DAX Mid Caps (60 stocks). Since the start of 2020, the Russell 2000 has increased by 24% compared to 64% for the S&P 500, the MSCI World S&M Caps by 30% compared to 47% for the MSCI World, the CAC S&M Caps by 9% compared to 35% for the CAC 40 and the DAX Mid Caps by –4% compared to 41% for the DAX. There is therefore a clear underperformance. It has been more than 600 trading days since the Russell 2000 has not broken an all-time high, which is the 3rd longest period after 2008-2009 and 2000-2003. In the long term, the Russell 2000 outperforms the S&P 500, but the PE ratio discount of 23% compared to the long-term average both in absolute terms and in relative to the Russell 1000 does not seem sufficient to us to see a catch-up in the short term. High interest rates favor mega caps. The good news for the Russell 2000 is the expected increase in profits from 2Q24. We maintain our preference for mega caps for the moment.

Russell 2000. Recovery of the earnings cycle



	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4	24Q1E	24Q2E	24Q3E	24Q4E	25Q1E	25Q2E	25Q3E	25Q4E
Revenue	20.6%	21.0%	17.0%	8.7%	2.9%	-3.5%	-2.8%	-1.4%	-0.2%	1.7%	4.7%	6.1%	6.4%	7.1%	6.5%	6.6%
Net Income	34.9%	60.1%	7.9%	1.8%	-18.0%	-30.6%	-18.4%	-27.8%	12.3%	2.4%	27.9%	55.9%	34.3%	38.9%	27.9%	25.7%
Earnings	75.5%	103.2%	21.7%	27.2%	-12.2%	-16.9%	-9.4%	-18.9%	-0.8%	14.9%	37.3%	54.7%	32.2%	39.0%	27.3%	23.9%

The energy transition. The green bloodbath since February 2021 with a decline in indices of 70%, mainly affecting small and medium-sized companies in solar, batteries and charging stations, which are often loss-making. But the green theme seems to have reached a bottom - everything has a price - and we are even seeing a recovery. The sector had suffered from cost inflation and disruptions in semiconductors and industrial metals coming from the pandemic and the Ukrainian war, rising interest rates and the crisis of US regional banks. The situation has normalized somewhat, but the recent rebound in stock prices is coming from where we least expected it: AI. According to UBS, AI will consume a lot of electricity which will come from renewable energies. The generation of electricity with green energies, solar and wind in the lead, is accelerating, while that produced with coal and gas is

declining. In 2023, global solar capacity increased by 23% and wind power by 10%. Global electricity production using low-carbon energies accounts for 40% of global production, while that with fossil fuels increased from 65% in 2000 to 58% today, with a target of 60% in 2030 according to the International Energy Agency. Positive momentum returns to the green theme.

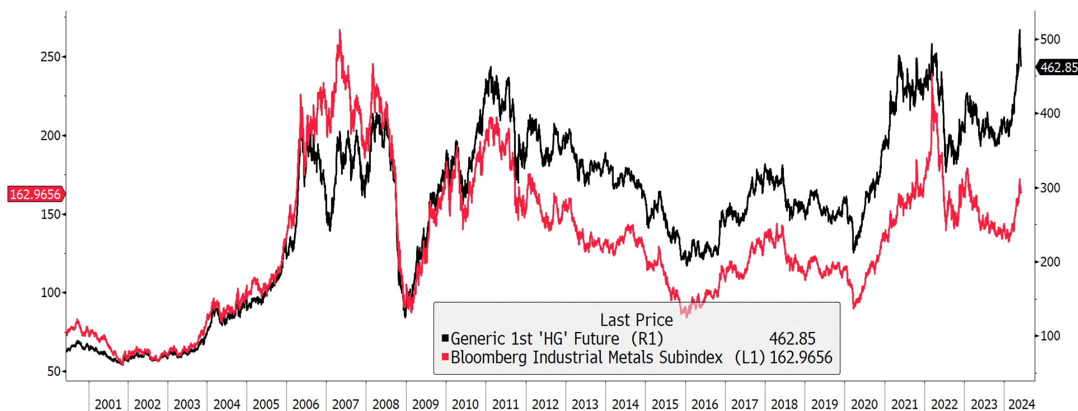
Defensive sectors. Continued underperformance. This trend is expected to continue in a resilient global economy supported by significant investment plans for reindustrialization, energy transition and defense. In a high interest rate environment, the Value segment (Industry, Energy, Materials and Finance) and Big Techs outperform the defensive sectors (healthcare, consumer staples).

Commodities

Raw material prices still trending upwards

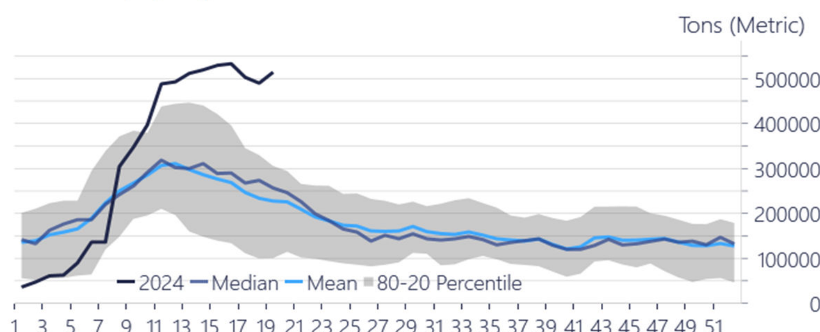
In 2024, the price of Brent rose by 9% and that of copper by 24%. The Bloomberg Commodity Index climbed more than 7%. Investors are buying industrial metals to play decarbonization, deglobalization, increased military spending, a hedge against inflation, geopolitical risks and underinvestment in new mining capacity.

Copper is emerging as the "new oil" as some like to say, with growing demand linked to AI, energy transition and defense. Electric vehicles consume 3 to 4 times more copper than vehicles with combustion engines. Some experts estimate a quadrupling of the price within 3-4 years in the face of a supply deficit. In April, BHP launched a $50 billion takeover bid on Anglo American, which just failed, and which is part of this positive long-term price trend view. However, at the end of 2007, BHP launched a takeover bid on Rio Tinto for $58 billion, still with the prospect of a lasting rise in industrial metal prices, a takeover bid which also failed. The period from late 2007 to early 2008 ended up being a peak in industrial metal prices, followed by a very strong correction. In mid-May, the price of copper reached an all-time high, pushing it into a very overbought technical zone in the short term; in recent days its price has fallen by 15%.

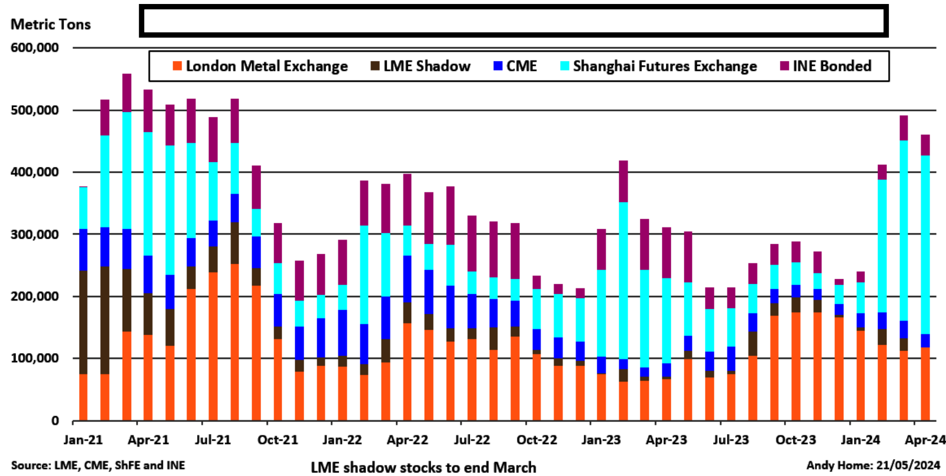


Over the first four months of the year, Chinese imports increased by 3.2% in dollars, supported by purchases of oil, gas, bauxite, aluminum, iron ore and copper from Russia. China is stocking up to help Russia and take advantage of discounted prices. Inventories in Shanghai have increased significantly. But this accumulation of raw materials questions analysts while the real estate sector isn't recovering and economic growth is sluggish. Could this be in anticipation of a devaluation of the yuan, an invasion of Taiwan followed by international sanctions or simply in consideration of having copper as a "currency reserve"?

Chinese copper stock levels (data since 2007)



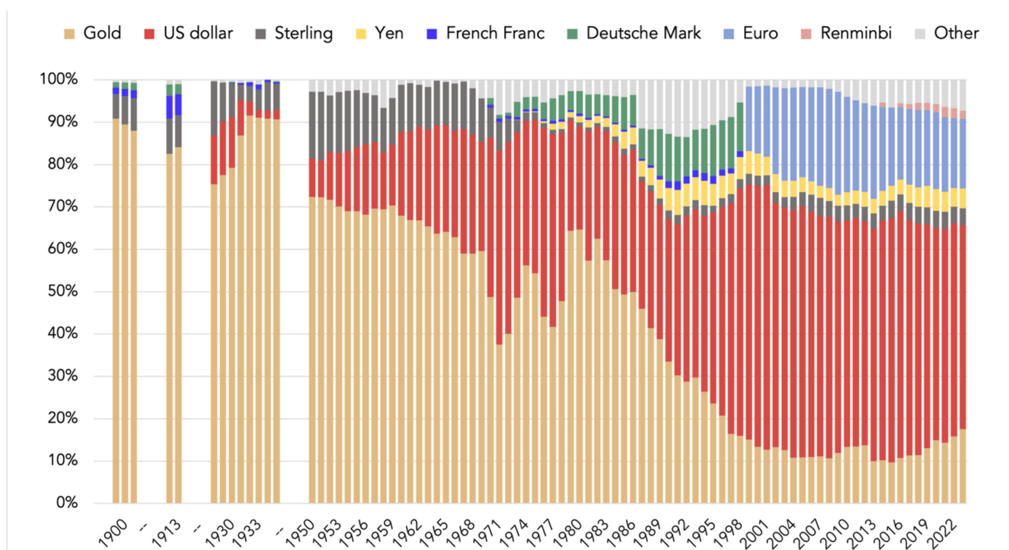
Global copper stocks at 3-year highs after china rebuild



In the short term, the situation is speculative with overbought copper, historically high long positions, covering of short positions and BHP's aborted takeover attempt on Anglo American. Recently, other base metals such as zinc, aluminum and lead have seen their prices increase since April. A correction will represent buying opportunities.

In a rather calm market, oil prices should remain stable. OPEC+ will extend its overall reduction of 5.86 million barrels/day, including 1.66 until the end of 2024 and 2.2 until the end of the 2nd quarter. Demand is good with the US entering the driving season. Stock prices of oil companies follow oil prices. Current prices satisfy all stakeholders, producers and consumers. The energy sector is a good hedge against geopolitical risks.

Global international reserves



Gold consolidates below $2,400. The buyers are emerging central banks and Chinese investors, while individual investors outside China continue to exit financial products invested in physical gold. For some countries, gold is protection against international sanctions. Gold remains a good hedge against geopolitical risks.

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