SELVI & CIE

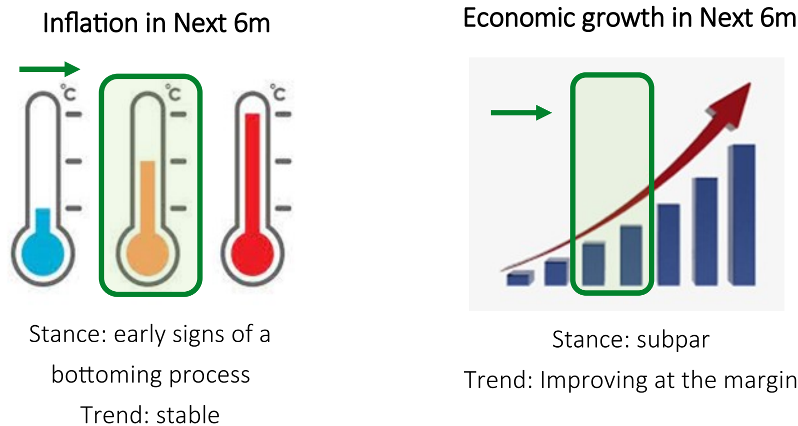
THE MONTHLY LETTER

Tactical update

MARCH 2024

So confusing

Global landscape



Stance: early signs of a bottoming process
Trend: stable

Stance: subpar
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. Wider dispersion in a new regime (post-Covid)

Further US growth and inflation resilience are likely short-term. Watch for tentative shifts in labor market. This is in sharp contrast with the collapse of Chinese nominal growth, where debt deflation and balance sheet recession are looming; classical means of reflation (liquidity-credit) will fail. Europe and Japan downturns may end from H224.

Geopolitics. Still in a chaotic landscape

Sources of conflict are multiplying. While the US are working hard on getting a cease-fire in Middle East, war with Iran's proxy is entrenching. A partition of Ukraine would take time to be negotiated and would neither remove misallocation of capital (weapons), nor restore diverted trade flows (re-onshoring).

Shift in global liquidity and financial conditions

Liquidity framework will become less benign from Q2 which prefigures 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 too.

Highly volatile capital flows

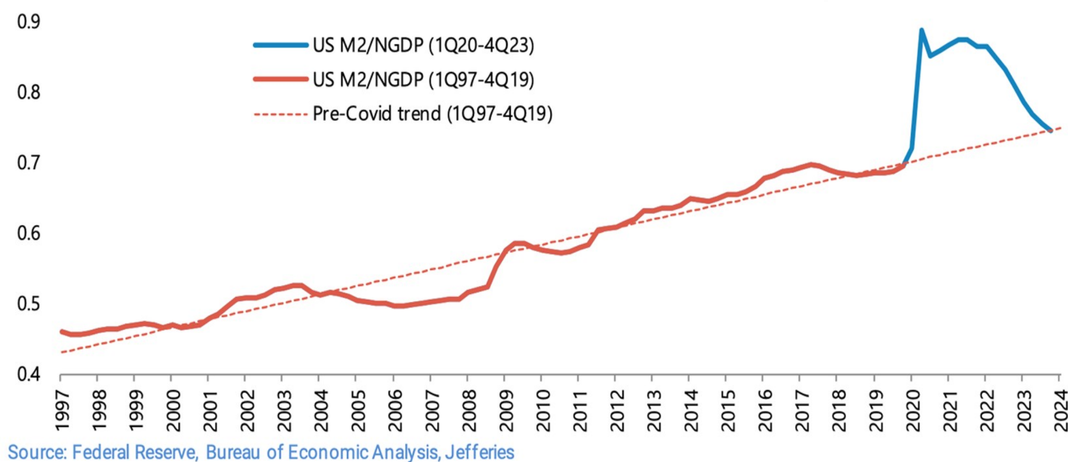
Market sentiment improved dramatically featuring favorable capital inflows into risky assets. The very large amount in Money Market Funds could exacerbate these trends, short-term.

Macro dispersion

The US quadrature

The end of business cycles is traditionally characterized by a high degree of instability, volatility, and unpredictability. In the wake of the pandemic and the ¨hallucinatory¨ stimulus provided by the major G7 countries, macro forecasting has become particularly difficult. We are not disappointed. Despite one of the most vigorous monetary tightening in modern history, the US economy is not only holding up, but also defying the Fed and the economists.

US monetary impulse: neutral... at last!?



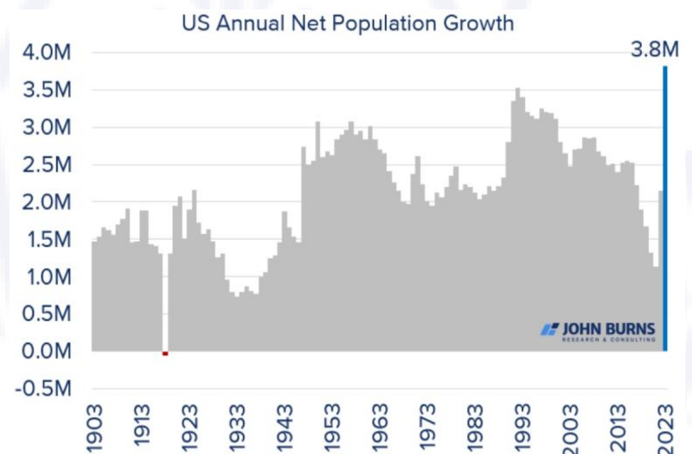
Source: Federal Reserve, Bureau of Economic Analysis, Jefferies

Ex-post, tentative explanations abound, especially with the blame on profligate governments. They legitimize the pursuit of it by naming the - absolute - urgency of the energy transition and the collapse of the World Order (in its Western version). And labor markets are undergoing structural changes with home working and immigration, which is again playing a significant and unexpected marginal role, especially in the US.

When it comes to inflation, de-globalization / relocation is going on, the national interest takes precedence, and so on and so forth. The situation in the Red Sea is likely to stop goods disinflation, if not reverse it partly over coming months.

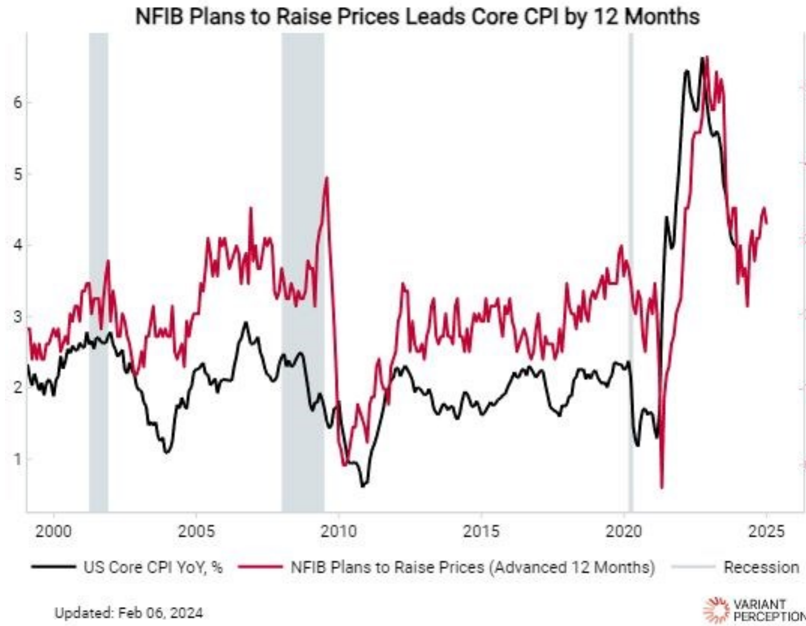
US: Structural ageing (93-20), but strong rebound in immigration (22-23)

Largest one-year population increase in US history



Sources: CBO, US Census, John Burns Research and Consulting, LLC (Data: Q23; Pub: Feb-24)

Early signs that corporate America is considering raising prices to protect margins

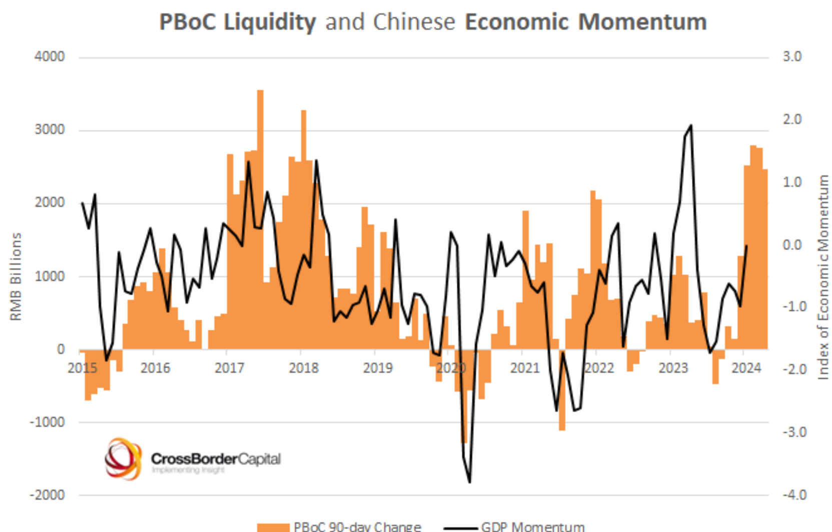


Nobody dares talk about the delayed effects of economic/monetary policy any more
Too resilient growth Q1/2 would result in higher inflation expectations

China reflates desperately

China's financial regulator set its sights on the property market, promising measures such as better support for cash -strapped developers and mortgage policies designed to offer more help to households. The priority for this year is to "accelerate the implementation of the urban real estate financing coordination ", whereby local governments would better cooperate with financial institutions to support real estate projects. Among classic measure is a cut of mortgage rates. And this will continue. But without a comprehensive plan to recapitalize the banks, possibly backed by QE, this will be in vain. Household confidence is being eroded as their main saving, property, deflates.

A cyclical rebound will occur from Q2/3
It will mitigate the real estate downturn, but not solve the issue at all



Watch for less supportive markets' conditions

The G2 central bankers did not like the market's premature expectations of lower policy rates. They are tightening their guidance to reverse overly accommodative financial conditions. USD liquidity will mechanically become less ample from T2, thanks to a) the end of the BTFP emergency program to bail out regional banks and b) the rapid drain on the Fed RRF ($0.57tn now vs $2.4tn from T322 to T223) due to the heavy issuance of T-bills by the Treasury. Similarly, the ECB, and gradually the BoJ, will be on the back foot. Investor complacency has resurfaced recently, jeopardizing the willingness of central bankers to calm animal spirits and consumption.

Investment takeaways

Too good economic news in the US is putting the Fed at odds. Geopolitics and politics remain highly unpredictable / adverse. Unstable equity to bonds correlation should continue to temporarily haunt markets, until inflation medium term trend and level become clearer.

We expect buoyant risky assets to experience volatile/hectic short-term developments. 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

Towards consolidation

The most striking story across asset classes this year has been the unexpectedly positive jump in US economic indicators. This follows a long streak of soft US data in late Q4, associated to a dovish Fed. Q4 GDP data paint a disperse picture: 3.3% annualized growth in the US, flat for the Eurozone, -0.4% in Japan and -1.2% for the UK. So the narrative has flipped.

The USD is together discounting good news and testing a key resistance

The EUR/USD bulls' best hope is for the US economy to lose some of its recent shine and the Europe to rebound strongly. Until that happens, the risk is that the USD remains firm. If growth is all that matters, the UK and Eurozone need to get on with sharp rate cuts. The Fed has no reason to hurry. And the BoJ still has every reason to get itself out of the current YCC and NIRP policies, but few reasons to do more. All point for a solid USD, but this scenario is well priced in.

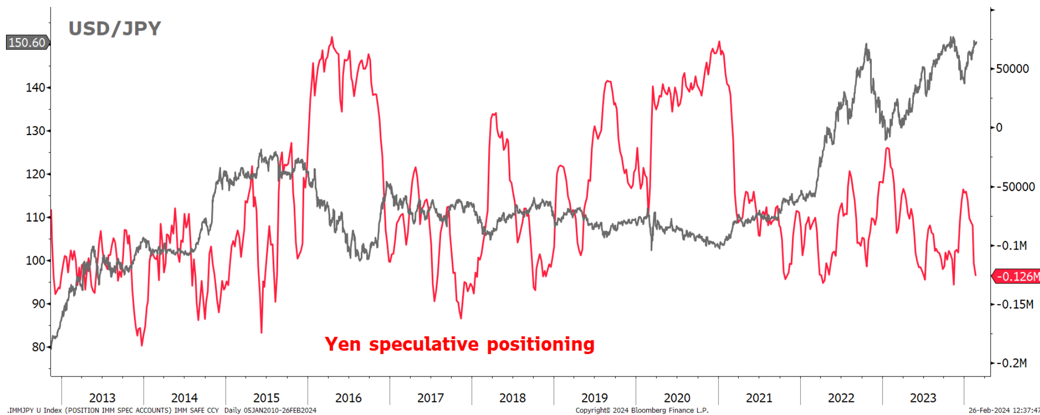
Risk sentiment remains the main EUR driver

The hawkish Fed tone is well discounted. The USD has few place to digest disappointing macro data
The EURUSD range between 1.05-1.10 area will stay over the coming months

BoJ procrastinating

According to speculative positioning, the FX market got long JPY in 2020 as rates were cut everywhere. Then rising US yields wore down the JPY bulls. A massive short position was built in 2021/2022. The USD/JPY high and largest JPY shorts came after the US yields peak. Short positions were reduced in December, and the JPY rallied as US yields dropped. The last few weeks have seen the opposite.

Market positioning highlights the lack of confidence in a BoJ bold decision



In February, the JPY fell once again on increased talk of the need for policy normalization. The chance of NIRP and YCC policies abandon in March has increased, but the first rate hike has been postponed to June. Amongst the reasons, we can find the latest inflation data which turned down again. Japanese services PPI came in 2.1% while it was expected at 2.4%. This is another strong hint that core CPI is not structurally above 2%.

To rebound the JPY needs a concrete signal from the BoJ

Not as bad as it should be

Years ago, China deliberately held a cheap currency to flood the world with exports. Those days are over. Chinese problem is to avoid a too weak CNY. In a worsening trade environment, it is more important to maintain purchasing power. That is why they cut mortgage rates, as it does not impact short-term yields. Chinese bond yields are well below US yields - it was not always this way - and it will continue to contribute to the CNY weakening. Only once the Fed cuts rates, the PBoC will be able to act more aggressively.

Stay away of the CNY as it remains fundamentally overvalued

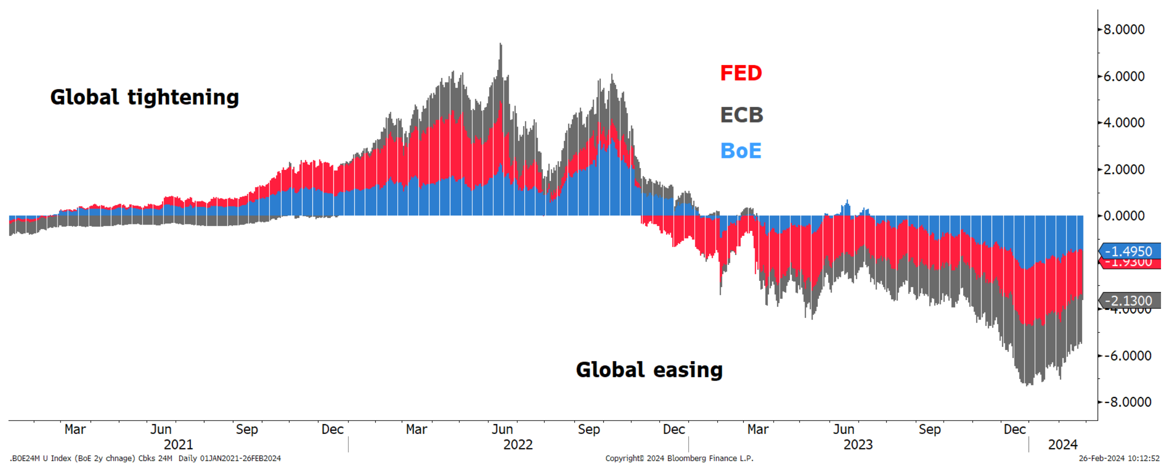
Yield gap points for a weaker yuan

Bonds

No rush to cut...

In the US, last raft of economic indicators rattled financial markets and added more puzzlement over the Fed next move. Inflation came in hotter than expected but consumer spending took a step back. This gave the impression that the encouraging disinflation trend has been stopped in its tracks. Goods prices are continuing to deflate for now, but service inflation remains stubbornly resilient. This validates the push back regarding an imminent rate cut.

G3 policy easing bets in 2 years pared back by 200bps

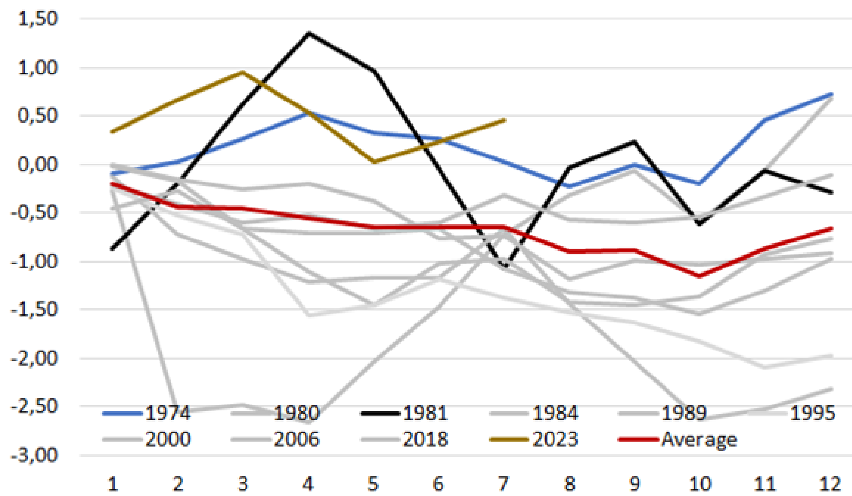


The Fed Reverse Repo Program (RRP) - a measure of excess reserves in the banking sector – is moving to zero. Once there are no longer abundant reserves in the banking sector, there could be less support for T-bills and bonds. Once RRP will reach zero in May or June, the QT will be stopped.

The use of the Fed Reverse Repo Program declines

The shift in the path of policy rates has been drastic. Upside economic surprises have pushed Fed Funds cuts pricing to 4 cuts down from 6/7 a few weeks ago. A rate cut in March is unlikely. The Fed is likely to gradually cut rates. Our central scenario assumes 125bps of rate cuts by year-end, with the first one in May/June. History can serve as a guide. Since 1971, over the next 10 months following the Fed Funds peak, the US 10-year yield tend to decline by 115bps. Even during inflationary cycles, it substantially declined in the 7 to 10 months period after the peak.

US 10-year yield change (months after Fed funds peak)



Even in a shallower path (75bps of cuts this year), in line with the Fed median dots and current markets expectations, we do not see much room for the US 2-year yield to rise meaningfully above 4.75%. Furthermore, we expect the US 10-year yield to stay in the 3.75-4.35% range in the near term.

Fed Funds repricing and neutral bond positioning suggest there is scope for yields to decline over the medium term. Buy global US Treasuries

Attractive long-end real yields

The January CPI came in hot. It was the first upside miss since May 2023. The bond sell-off was driven by higher long -end real yields with the 30-year yield back above 2.00%. The gap between core CPI and PCE is growing due to the higher weight of shelter in the CPI. With the Fed path influenced by core PCE, while TIPS are indexed to CPI, a persistent gap should be favorable for TIPS. We prefer long-dated TIPS as their yield is above the estimated longer-run neutral rate. The Treasury department kept the 30-year TIPS auction size unchanged at $9bn, the only coupon auction that has not increased since last year. So, yields are unlikely to rise significantly more.

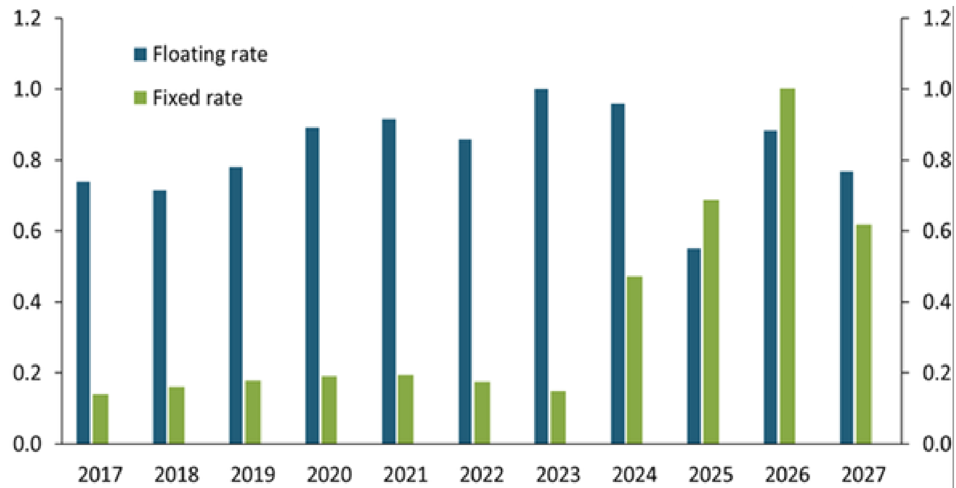
The real yield rise makes TIPS attractive

Keeping an eye on credit conditions

Credit conditions for IG, HY and EM have improved on the back of better economic and financing conditions, disinflation, positive growth surprises, and expected Fed funds cuts. The January senior loan officer opinion survey showed some progress in credit metrics. While lending standards remained tight, the severity lessened. Credit demand remained subdued but only 14.5% of US banks have tightened their terms of credit, the lowest in 7 quarters and a sharp drop from 33.9% in Q3. Lending standards should remain unchanged for corporate and residential loans but tighten further for CRE, credit card and auto loans.

Spread have significantly tightened since last November. More surprising, default rates have been rising despite some strong economic data. The US default rate has climbed to 6.0%. In Europe, it is much lower but rising quickly to 3.9%. While the main driver for credit (IG & HY) is high yield levels on average, some lower-rated bonds have even higher yields (CCC yielding between 13% and over 20%) which will challenge their refinancing. Not to mention than BB to B spread has not been that tight since 2018.

US corporate debt maturing in the next few years ($tn)



EM hard currency index yield has remained broadly unchanged this year c 7.0%. Rating activity among corporates was at a record level in Q4 23, with 24 upgrades and 31 downgrades according to Fitch. Most of the issuers are commodity-related companies and will be pressured by the downward trend in commodities. They have to rollover $95bn this year.

More companies will default in the coming months

Refinancing will stay elevated and challenging this year

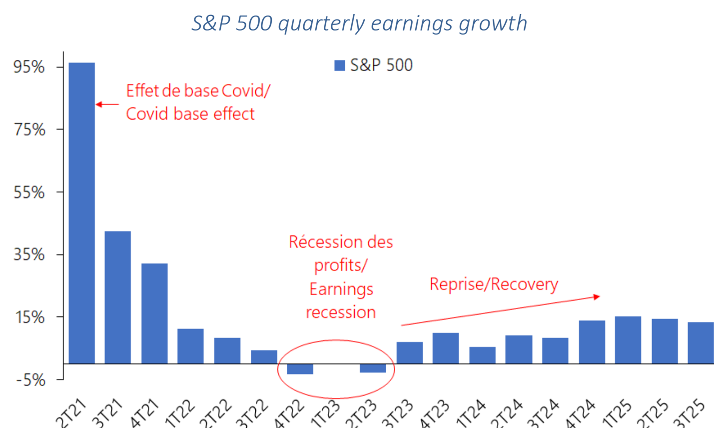
Equities

Bull market and resilience

AI is a tsunami, dragging down all the main world stock markets, raising fears of a repeat of previous bubbles ending in a "bloodbath", taking as examples the Internet Bubble of 2000, the Crash of 1929 or the California Gold Rush of 1849, The 49ers. It looks like it and the fears are not entirely unjustified. For the bulls, the arguments for this structurally bullish stock markets are the resilience of profits, right valuations and an economy of war, rather favorable to technology and industry. For Citigroup, a necessary condition for the formation of a bubble is cheap money, while interest rates are now at their highest since 2002-2007. In 2000, the Fed caused the crash of the dot-com bubble by increasing Fed Funds; in 2024, the Fed is supposed to lower them. So, the craze for AI and stocks in general should continue according to Citigroup.

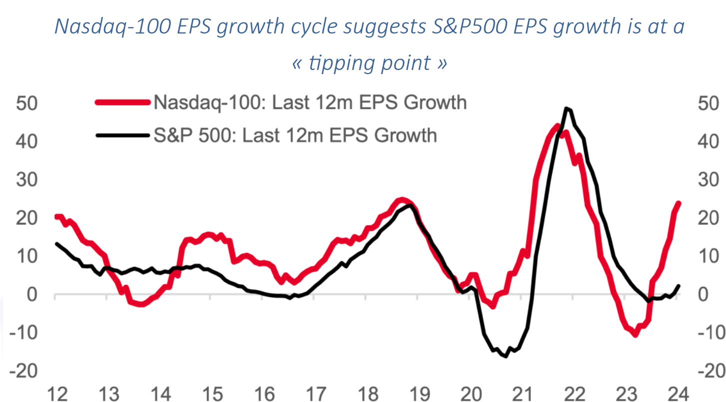
The long-awaited recession in the United States is still not here and even if Europe is one of the main victims of geopolitical disorder and its economic impacts, the Old Continent is not doing so badly. In an economy of war, Western companies are resilient thanks to passing on costs to customers, strict cost management and a change in business models, imposed by the pandemic, by shortening supply chains and by favoring onshoring/nearshoring to the detriment of offshoring (globalization).

S&P 500 quarterly earnings growth



After two major shocks, the pandemic of 2020-2021 and the Russian invasion of Ukraine in 2022, European societies face a new challenge with the war in the Middle East between Israel and Iran's allies, Hamas and Hezbollah, affecting maritime traffic in the Red Sea, which provides access to the Suez Canal.

Nasdaq-100 EPS growth cycle suggests S&P500 EPS growth is at a « tipping point »



The 4Q23 results of the S&P 500 confirm a resumption of the profit cycle, which had already started in 3Q23. The cycle for the Russell 2000 and Europe is expected to pick up from 2Q24. In 4Q23, the increase in EPS for the S&P 500 was +10%, higher than the +2% estimated at the beginning of January. Global profits are relatively well correlated with Korean exports which have been recovering since August 2023. Korean activity gives good signals about the global economy, South Korea being the 10th world economy and the 7th exporting country; it exports many cyclical products such as semiconductors, cars and chemicals. Margins are resilient and AI is expected to deliver productivity gains like never before.

Concerning 4T23 earnings, there is a strong positive contribution from Big Techs, but there is also a negative contribution from energy and health. Ex-Big Tech-Energy-Health, profits increased by 12.2%. Profits from the Discretionary, Finance and Industry sectors, which have significant weighting in the index, increased by 35.3%, 8.8% and 8.2% respectively (source LSEG/IBES). We maintain our preference for technology, communication services and industrial sectors in an economy of war (re-industrialization, energy transition and defense).

S&P 500 earnings growth	2Q23	3Q23	4Q23	1Q24
	-2.9%	**7.1%**	**10.0%**	**5.4%**
Ex Energy	3.5%	12.6%	13.7%	
Ex Pharma	1.9%	11.8%	14.5%	
Ex Big Techs	-6.9%	1.4%	1.7%	
Ex Energy + Pharma	10.7%	19.2%	19.4%	
Ex Energy + Big Techs	-4.0%	2.3%	1.3%	
Ex Energy + Pharma + Big Techs	5.7%	16.8%	12.2%	
	2022	**2023**	**2024**	**2025**
Source : LSEG	**4.8%**	**1.9%**	**9.5%**	**13.5%**

PE ratios of indices are in line with inflation levels. The stock markets are not cheap, but their PE ratios remain within historical norms. If we take the Magnificent 7, stock valuations are reasonable, even if we take Nvidia, thanks to their high profit growth prospects.

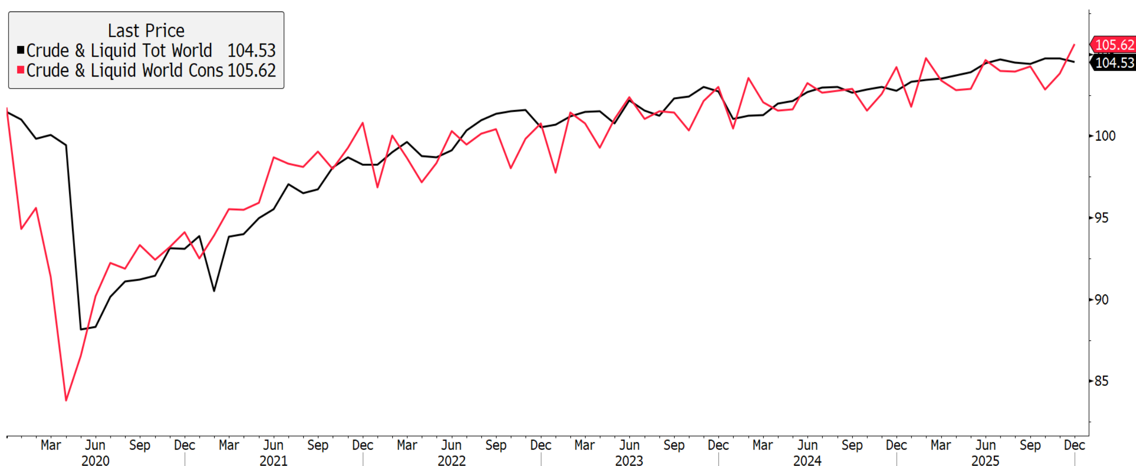
In Asia, we like Japan, India and South Korea. We have already argued extensively about Japan and India with reindustrialization and industrial alternatives to China. South Korea is well positioned with expected sales recovery of PCs, smartphones and semiconductors, AI and the defense industry. But more importantly, the Korean government, like Japan in 2023, is taking steps to reassess Korean stocks and boost shareholder value creation, particularly in governance. After years of reforms, the Nikkei returned to its historic peak of end 1989. The Korean government wants to emulate Japan, but more powerful, to reduce the Korean discount on stock prices. The Korean discount refers to the tendency of South Korean companies to have lower valuations than their global counterparts, due to factors such as low dividend payouts and the dominance of opaque conglomerates known as "chaebols" which have often had incestuous relationships with the government in the past. High inheritance taxes pressure the families who control companies to keep valuations low. Under the *Corporate Value-up Program*, the government will introduce an index of companies with high shareholder value, the Korea Value-Up Index, with tax incentives for companies that improve their market value and increase shareholder returns. Opaque and complex shareholder structures reduce the valuation of companies: Hyundai Motor owns 34% of KIA which owns 18% of Hyundai Mobis which owns 22% of Hyundai Motor. The boom in equity purchases by households during the pandemic prompted the government to give more power to minority shareholders. Nearly 50% of Korean listed companies trade below their net asset value. Hyundai stock is at a 70% discount to its enterprise value (EV). The price/EV discount is 10% for the S&P 500, 10% for the Nikkei and 25% for the Euro Stoxx (zone that we also like). China remains a value trap as long as we do not see major and real plans to support the economy.

Commodities

Oil demand increases in the age of energy transition

Oil is part of the equation in the energy transition. Despite the noise and the efforts of ESG investors and pressure groups, fossil fuels remain necessary for a smooth transition. Demand and supply are increasing, with more than 103 million barrels/day for both demand and supply. Forecasts for 2025 estimate 105 million bpd. Chinese demand growth is half of what prevailed before the pandemic. China will lose its position as the global engine of oil demand to India.

Oil demand (red) and supply (black).

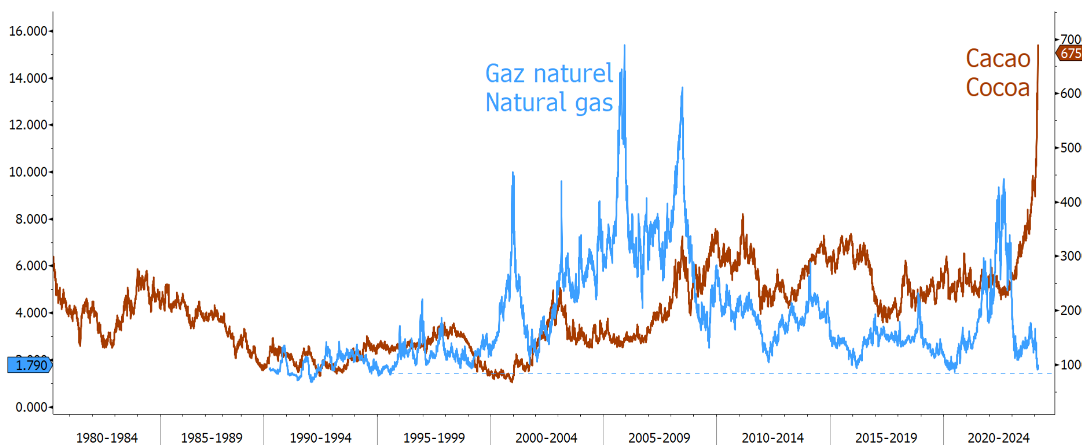


The price of Brent (graph below) seems to have found a point of equilibrium between $80 and $90 per barrel, a price that suits both producing and consuming countries. And as long as there is a good balance, there is no reason for oil prices to soar. However, oil stocks remain a good diversification for investors if the military situation were to get out of hand in the Middle East with impacts on production. The market does not believe it at the moment.

Brent price

As for industrial metals, prices are not rising despite demand coming from the energy transition, American spending on infrastructure and defense. China's fault. China consumed 40% of global industrial metal production before the pandemic. Its need is less important today with its economic and real estate crisis. The absence of a major economic recovery plan will not allow industrial metal prices to rise.

In terms of climate, the powerful El Niño has strongly affected cocoa prices with an increase of 60% in 2024 and 200% since October 2022. The hot winter in the US and Europe is affecting gas prices with a drop of 52% since mid-January 2024. The price of natural gas is at historic lows seen in 2020, in 2016 and in the 90s.

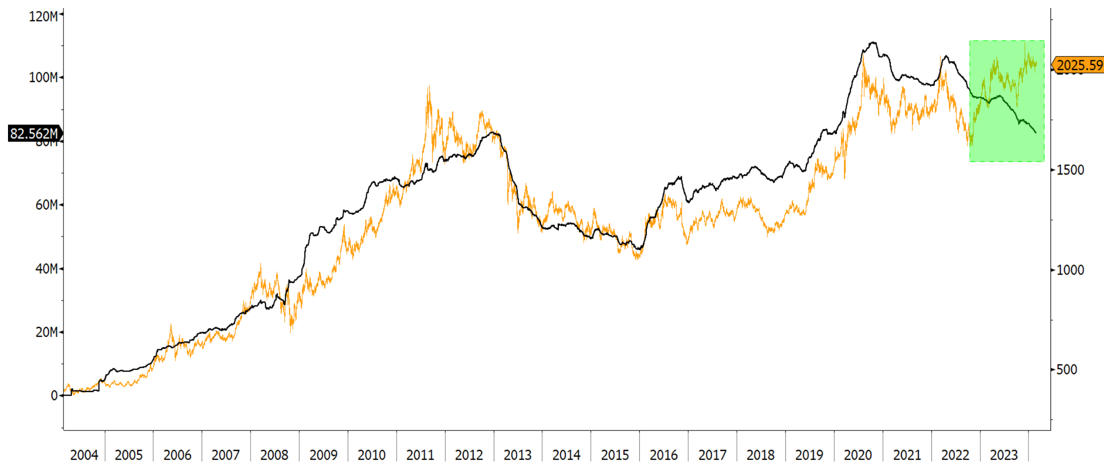


Overall, the Bloomberg Commodity Index is in a downward trend and we do not currently see a factor that could reverse the trend.

Bloomberg Commodity Index

Since October 2022, the price of gold should have fallen with the decline in holding of gold in financial products by private investors. It should also have fallen with the rise in real interest rates. This has not been the case and it is not usual.

Gold price (orange) and gold holding in ETFs (black)



The explanation is the support of gold by the purchases of emerging central banks and investors, who do not play gold through financial products, looking for a safe haven asset in a world that has become chaotic. The arrival of cryptocurrencies has complicated the historical correlations of gold.

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