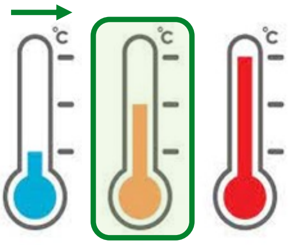
THE MONTHLY LETTER

Tactical update

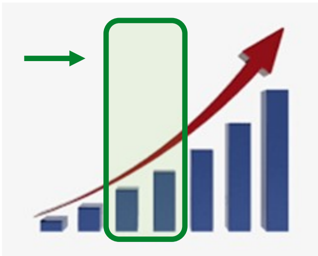
MAY 2024

Spring time green shoots

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. 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 has started to reflate more, but the classic means of reflation (liquidity-credit) will fail as debt deflation and balance sheet recession loom. The downturns in Europe and Japan could end from H224.

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. Following the latest US aid package, the Ukraine conflict is even less likely to be resolved, at least before the November elections.

Shift in global liquidity and financial conditions

Liquidity framework has become less favourable in Q2. Watch for the Fed's decision on QT and the Treasury's reaction/use of its TGA.

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

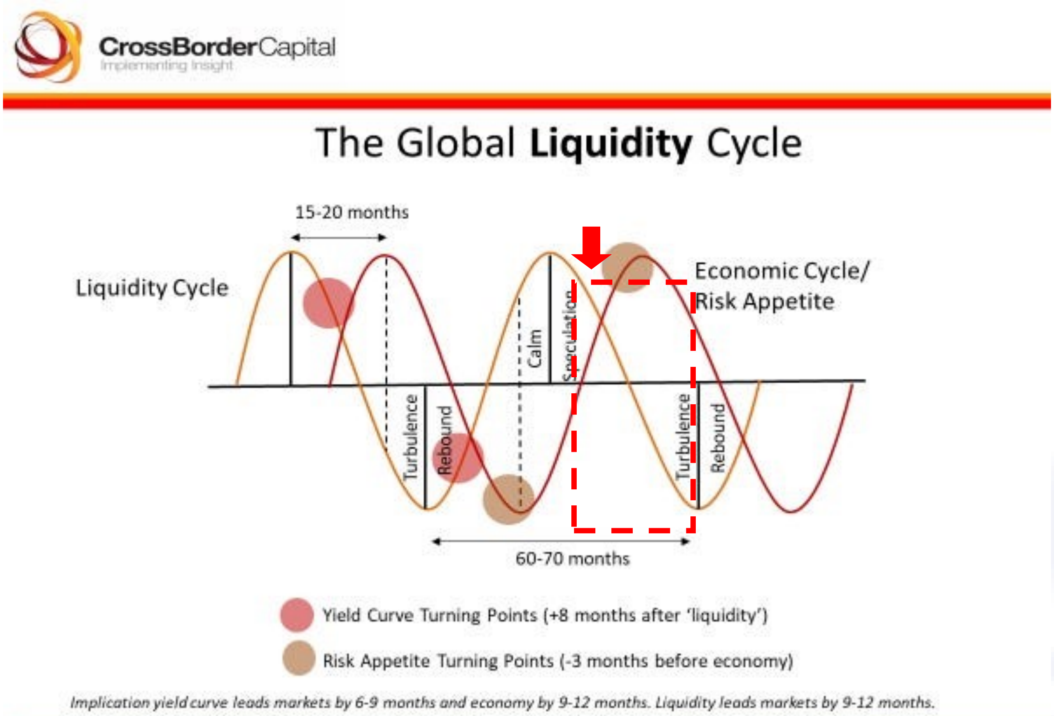
Investors' cyclothymia is fuelling significant capital in/out-flows into risky assets. The very large amount in Money Market Funds could exacerbate these trends, short-term.

Global manufacturing recovery

A canary in the coal mine?

In recent months there has been a whiff of a turning point. At various levels: geopolitical, economic, cyclical, etc. Links between major cycles have long been theorised schematically. While in many ways we have entered a new post-pandemic regime, it makes sense to try to capture the current status and next developments.

Long-term Cycles interconnections



Since the end of the first quarter, financial markets have turned brutally towards reflation on the back of resurgent PMIs (outside the EU). This makes sense as 1) global liquidity momentum peaked last autumn and 2) global policy rates plausibly peaked, globally, in S223 and have started to fall first in emerging markets, soon to be followed by the G7. The improvement in these soft data has been confirmed in recent months by the pick-up in global trade (led by Asia), reflecting rising demand for manufacturing and goods and putting pressure on global commodity prices.

Export growth (ex-Oil) Y/Y

Open question on the current dawn

Historically, the US business cycle tends to be ahead of those of other countries. By a few quarters. This is mainly due to the size of its economy and the dominance of the USD as the world's reserve and trading currency. Since pandemic, the US lags as well EU as emerging countries. This is even more evident when analysing inflation trends. What would happen to the global cycle if the US overheats in 2024 and enters recession in 2025?

Industrial sectors are capital intensive and therefore sensitive to changes in interest rates. They are also highly dependent on order flows. However, unlike in previous cycles, the global manufacturing recession observed in recent quarters has not affected services/consumption in the US. In any case, the cost of capital outlook has not deteriorated recently. More importantly, the huge public investments for climate and war efforts will remain very supportive. But can a small contributer to overall GDP (less than 15% in the OECD) turn the whole tide?

Global debt has reached quasi-unprecedented levels in the G20. This challenges the usual ¨mechanics¨ of economic policy. The higher the debt, the lower the response to stimulative policies. As a result, after decades of central bank monetary repression that fueled sub-par nominal growth, global policymakers opted for fiscal dominance (MMT), using the excuse of force majeure (pandemic). It remains to be seen what equilibrium can be achieved with capital markets and how international capital flows will evolve. In a multipolar world, this raises not only the question of ¨bond vigilantes¨ but also of international reactions to the weaponisation of the USD. A political turning point occurred recently when the US Congress hand President Joe Biden the legal authority to seize billions of dollars worth of Russian state assets to help Ukraine.

In recent months, China has been stockpiling natural resources like never before. In globalised markets, and because of its sheer size, this eventually spilled over into copper, aluminium, oil prices, etc. Ultimately, such decisions by a command economy may prove to be more political than economic, such as a) securing supply for the EV, solar and wind sectors, or b) preparing for devaluation in response to the outright fall of the JPY. Needless to say, a yuan devaluation - as in 2015 - would send shock waves through the markets.

Green shoots (manufacturing) are welcome

But a US ¨no landing¨ scenario could ultimately prove more toxic than favourable for the inflation cycle and markets

Investment takeaways

The Fed is caught between a rock and a hard place. The Treasury may add fuel to the fire, contingent to how it uses its large war chest (TGA) in the short term.

The positive correlation between equities and bonds is likely to haunt markets until the inflation outlook becomes clearer.

We expect risky assets to be volatile/hectic in the short term. Real assets (specific commodities) and currency hedges (precious metals and cryptos) will outperform.

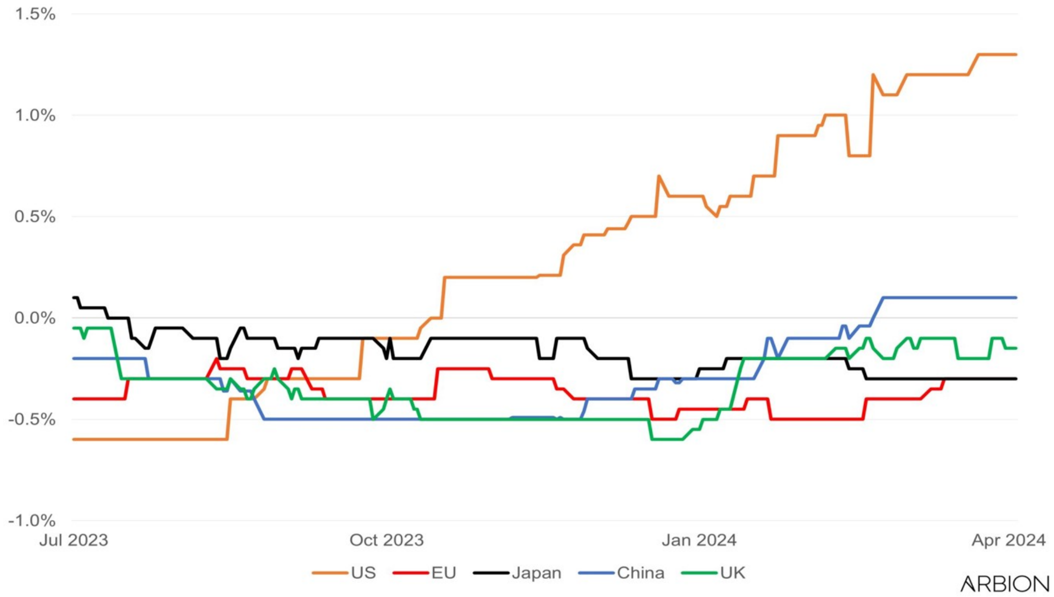
We maintain a relatively cautious investment stance, i.e. we recommend a moderate risk appetite/budget.

Currencies

6, 5, 4, 3, 2, 1…

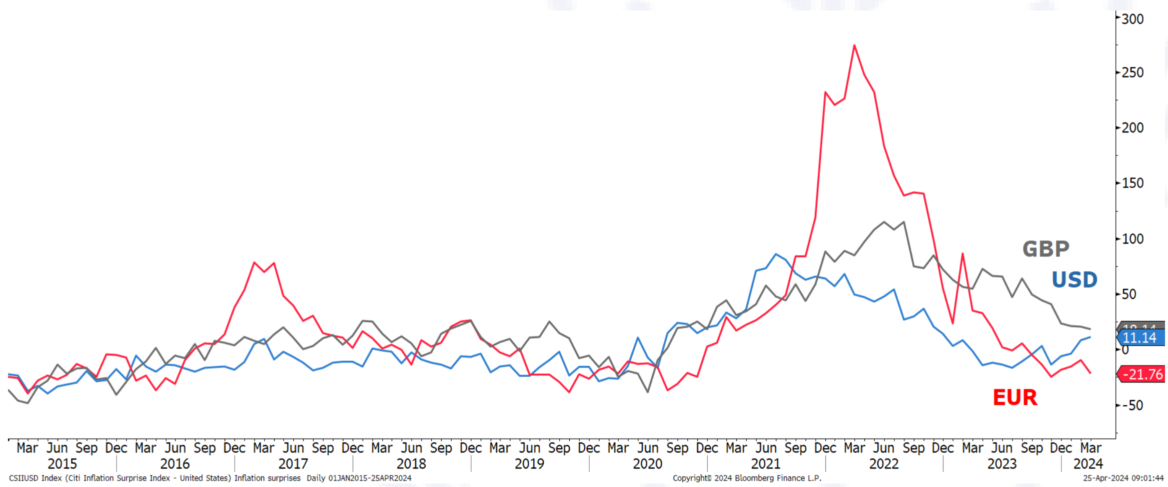
The FX market was a sea of calm since autumn 2022, but a series of recent stronger-than-expected US economic releases has changed the picture. The recent upside surprises completely changed the outlook for Fed policy. It is now become a steady countdown, and not one that is going to be followed by a spectacular liftoff. Financial markets had at one point been expecting 6 quarter-point rate cuts for the Fed in 2024. Now even 2 cuts are seen as no certainty. FX markets are more sensitive to monetary policy and short-term interest rate movements than usual.

6-month rolling revisions to GDP consensus growth forecasts for 2024



But it is also a function of the outperformance of the US economy. In April 2023, G-10 GDP forecasts for 2024 were clustered around 1.3%. Now, the average has fallen to 0.9% while the US is accelerating and the rest falling or at best stagnating.

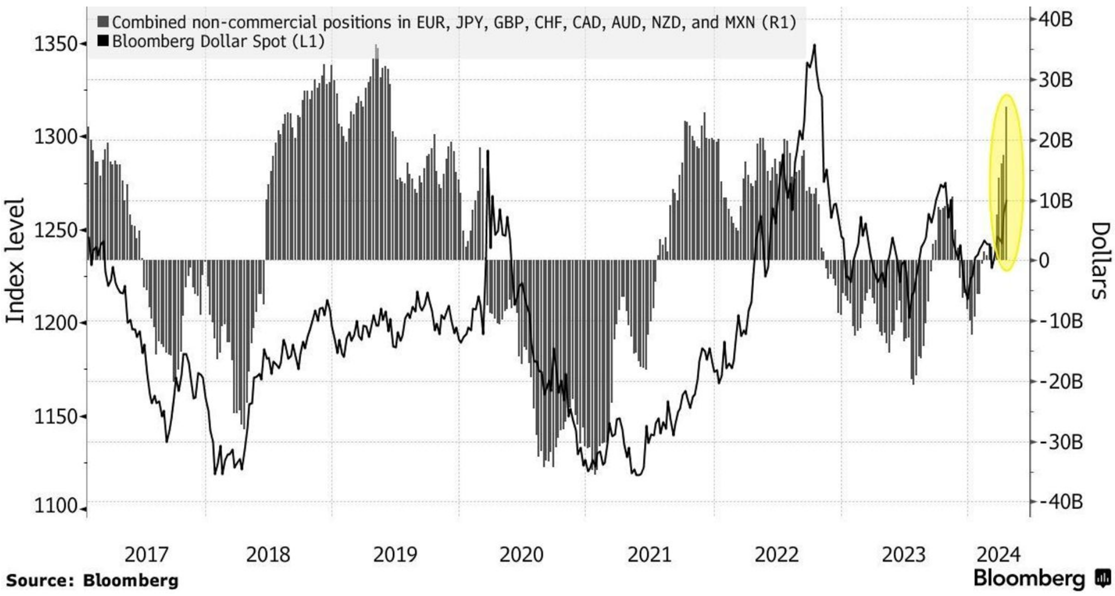
US inflation surprises index rebound contrary to the rest of the world



USD strength has been supported by retreat of rate cuts expectations following US CPI surprise. Even more when others surprised to the downside (EUR & UK). The divergence in rate outlook should keep the USD in a bid tone, especially as Fed speakers are turning more hawkish, while BoE or ECB peers are already penciling the next rates cuts.

European headline inflation fell to 2.4%, down from 2.6% in February, while core fell to 2.9% from 3.1%, the lowest reading since before the war in Ukraine. March inflation data surprised to the downside. Disinflation remains on track, with inflation still expected to be broadly back at 2% later in the year.

USD speculative positioning is already elevated



However, market participants have already reloaded sizable USD exposures. While the recent move was quite contained against the EUR, it was more sizable against the JPY and the GBP. It would take a more strongly outperforming economy, for stronger

The USD has strengthened further as US yields have risen amid a paring-back of rate cut expectations. Such support may continue but we still believe that eventual rate cuts will be USD-negative

CHF replacing JPY as the best funding currency

JPY has long been considered the go-to funding currency for carry trades, but recent developments may be shifting the tide. Offshore investors are currently short JPY, but the CHF has emerged as a potential contender. The BoJ has terminated its NIRP while the SNB has cut its policy rate, reducing the relative return of carry against JPY compared to CHF. The recent rise in USD/JPY volatility has also increased the relative attractiveness of CHF as a funding currency.

CHF should stay under pressure

Monetary policy gravitation pulls on the CNY

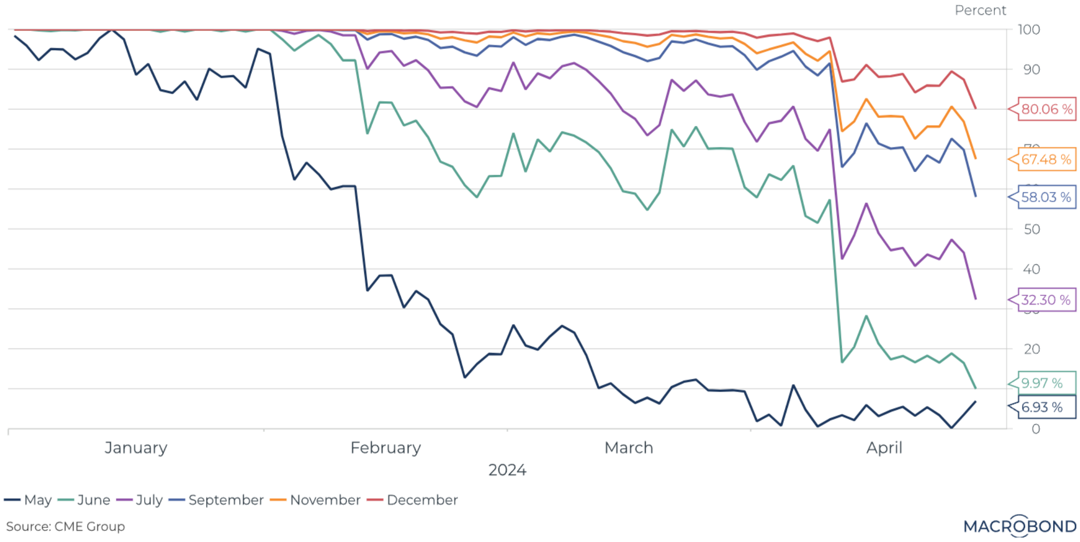
When push comes to shove, the PBOC will decide to let the yuan weaken to secure its targets of controlling the cost of money and capital flows. More stimulus is needed to put the economy at a sustained growth path. The recent monetary policy developments with the reduction of the Reserve Requirement Ratio for large banks, also point for a much weaker yuan. So, the only development able to derail further appreciation of USD/CNY in this context would be on the US side: weaker inflation and the renewed pricing in of cuts from the Fed for 2024 or 2025.

Rate differential still points to 7.40

Bonds

Real GDP growth came to 1.6% in Q1, well below expectations of 2.5% and significantly below the Atlanta Fed GDPNow estimate of 2.7%. The details show a strong consumer and sticky inflation. The market is pricing in just one rate cut in Q4. A significant reversal from the 6/7 cuts that were priced in January. At next FOMC meeting, the market will be looking for clues of further hawkishness from Powell at the press conference and for changes to the statement that might acknowledge sticky inflation. A slowdown in growth and a decisive shift in the disinflationary trend are throwing a wrench in the Fed easing bias.

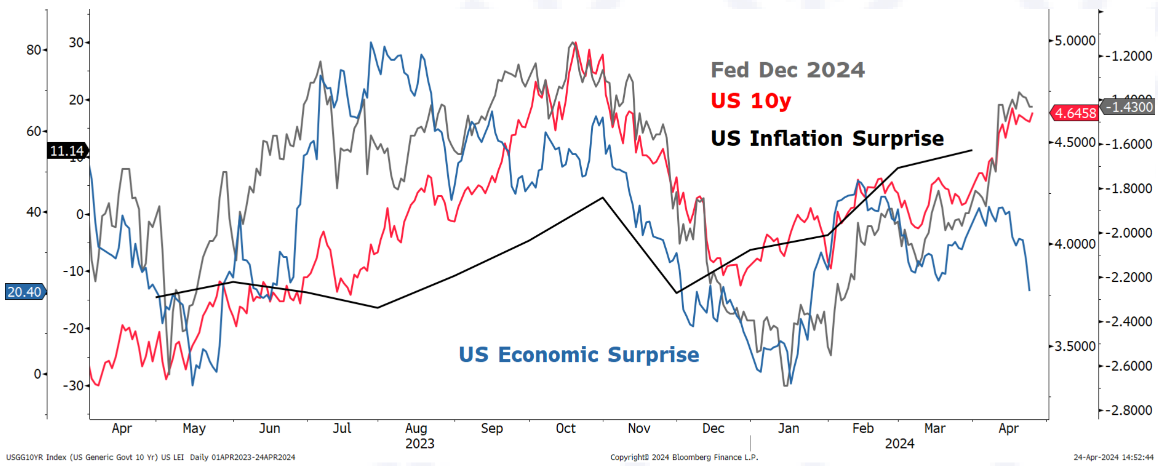
Diminishing expectations for Fed rate cuts



The Fed might announce a slower pace of Treasury run-offs (QT) starting in June. We expect Treasury yields to stay within the recent range as we wait for more data. Despite the continued upward pressure on yields, our bias remains toward lower yields as 'higher for longer' and tightening financial conditions are likely to take a toll on the consumer. At its Quarterly Refunding Announcement, the Treasury will be closely monitored too.

A higher inflation outlook uncertainty is one of the factors justifying higher term premium

Market focus turns from growth to inflation… again



Divergent

The repricing up of the ECB terminal rate marks a definite end of the rate cut exuberance that got underway in late 2023. Terminal rate expectations are now close to 2.70%, back to their early November levels.

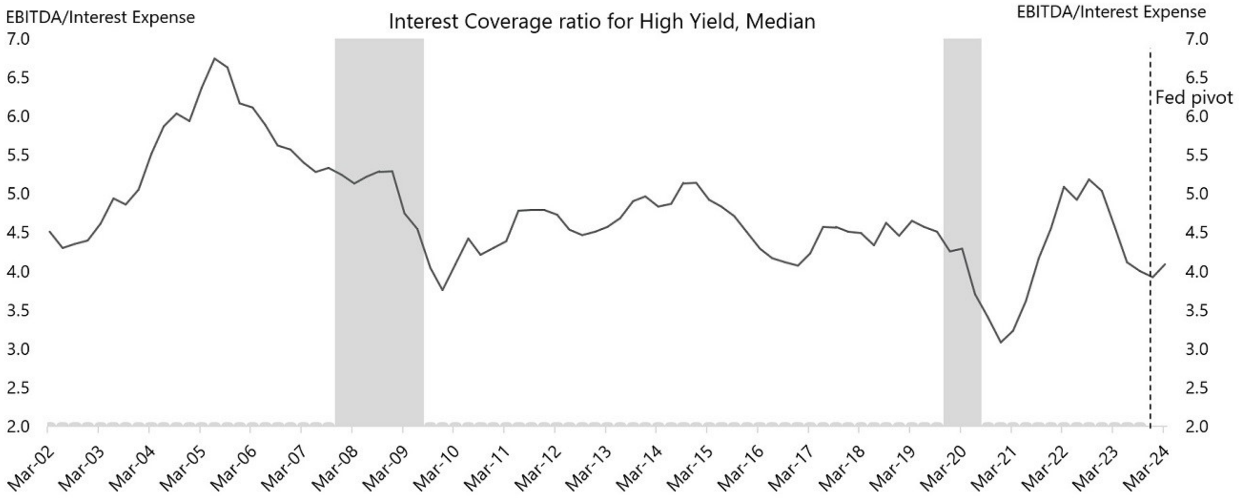
In April, the ECB echoed the constructive outlook on inflation, as most measures of underlying inflation are easing, wage growth is gradually moderating, and firms are absorbing part of the rise in labor costs. In its statement, it explicitly mentioned rate cuts for the first time. Given the ECB communication on the inflation outlook, financing conditions and its view on underlying inflation, it should start its rate cut cycle in June. While the ECB is not pre-committing to a particular rate path. Upside risks to inflation skew the outlook towards fewer rather than more ECB rate cuts.

The long-term trend has turned towards higher yields. But deviations from this long-term trend are driven by monetary policy expectations for the next 2 years.
At this juncture, April and May inflation prints will be crucial in determining whether the recent strength in core was more technical than a trend

Navigating the asymmetry in credit

It seems IG spreads are tighter than a drum, sitting below 90bps and at levels only surpassed in 3 periods over the past 2 decades. The current state for credit presents a rather uninviting prospect for multi-asset investors, where the room for potential gains appears minuscule due to the limited scope for further tightening. Conversely, the specter of more significant losses looms large should these spreads begin to widen.

High Yield interest coverage ratio has stabilized thanks to last year Fed pivot



Amongst the reasons why the spreads have tightened we can site strong earnings and the last year Fed pivot. They have both helped interest coverage ratios to rebound for both IG and HY credit and so spreads to tighten. A main point is now that the higher for longer rhetoric has resurfaced and is discounted in the market. Why high yield spreads remain so resilient?

Furthermore, recoveries for bond holders are near record lows when issuers default at just over 20% according to Bloomberg calculations. As bankruptcies are happening later than usual, it results in reduced recoveries. This is a reason to believe that the longer-term recovery rate may remain below the commonly admitted 40% level.

Euro IG Spreads are still offering a tad more room for potential spread narrowing

High Yield and EM spreads are even tighter relative to history

Equities

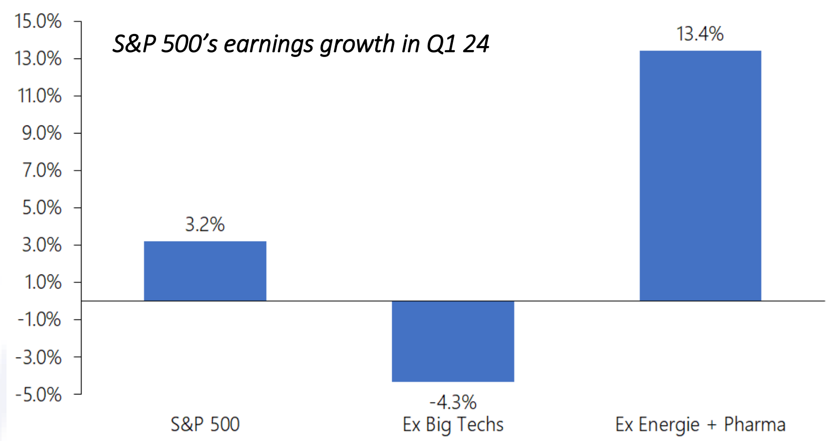
Don't panic, the bull market is solid

The stock markets are consolidating after a strong 1st quarter, the overall index increasing by 9%, and a powerful 5-month rally (from November 2023 to March 2024) without a correction greater than 2%, supported until the end of March by expectations of cuts in Fed Funds by the Fed, the progression of earnings for the S&P 500 companies, AI and the industrial sector. From December 2023 to the end of March 2024, indices rose, while the momentum indicators were in an overbought area and very overbought situation for some industrial and technological stocks, an abnormally long period.

The month of April, known to be statistically the most favorable month of a year, is (finally) consolidating. For the moment, no correction, defined as a decline of 10% or more. We're not there. The triggering factors for this consolidation were the questioning of a rate cut by the Fed in 2024 following inflation figures higher than expected (inflation is still decelerating elsewhere), the direct military conflict between Israel and Iran and investor fatigue after overplaying the AI. At the end of April, the publication of a US GDP lower than expected and a PCE Deflator (the inflation indicator monitored by the Fed) higher than expected brought back the fear of stagflation, but we will not draw hasty conclusion over one month and the stock markets ultimately did not overreact to this unfavorable data.

Today, stock indices are in a more favorable technical situation with momentum indicators close to oversold areas and the establishment of supports on moving averages. Investor sentiment indicators have returned to the neutral/ fear zone. In short, a more favorable time to buy stocks than a month ago.

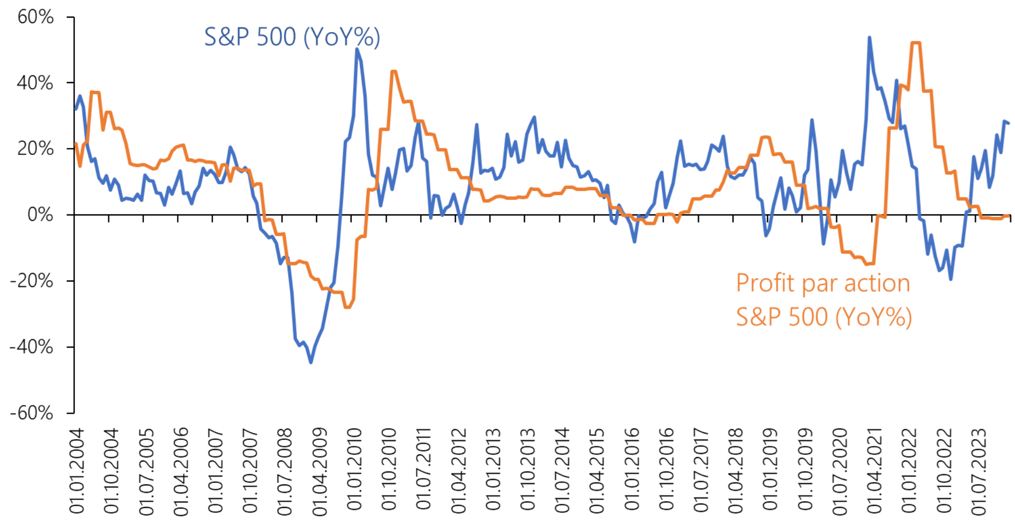
Disinflation through the positive base effect with the decline in energy prices behind us, the rise in stock market indices will be driven by the resumption of the profit cycle rather than the rise in PE ratios. On a historical basis, inflation levels justify current PE ratios. Profits of S&P 500 companies are expected to increase by 3.2% in 1Q24. 5 of the Magnificent 7, Nvidia, Microsoft, Amazon, Alphabet, Meta, will have a strongly positive contribution in 1Q24 and in 2024. In 1Q24, without Technology/Communication, S&P 500 profits would be down by more than 4%. But the Energy and Pharma sectors have a strongest negative contribution. See graph below. The Technology/Communication sectors will maintain their positive contribution throughout the year, while the negative contribution of the Energy/Pharma sectors will gradually reduce, which will give the S&P 500 profit growth of +3.2% in 1Q24, +15.5% in 2Q24, +9% in 3Q24 and +14.7% in 4Q24 according to Lipper Alpha; the expected increase in profits is +9.7% in 2024 and +13.5% in 2025.



The recovery of the S&P 500 profit cycle began in the 3rd quarter of 2023. On the other hand, the recovery cycle for the Russell 2000 and the Stoxx 600 will start in 2Q24 according to Lipper Alpha, with respectively an increase in profits in 2024 of 27% and 5% and in 2025 30% and 15%.

We can therefore expect indices to continue to perform well thanks to earnings. We value the S&P 500 at 5,600 in 2024 with two working hypotheses: US inflation at 3.5% and an increase in profits of 10% per year over the next two years, it is true, supported by budget deficits for an economy of war (reindustrialization, energy transition and defense).

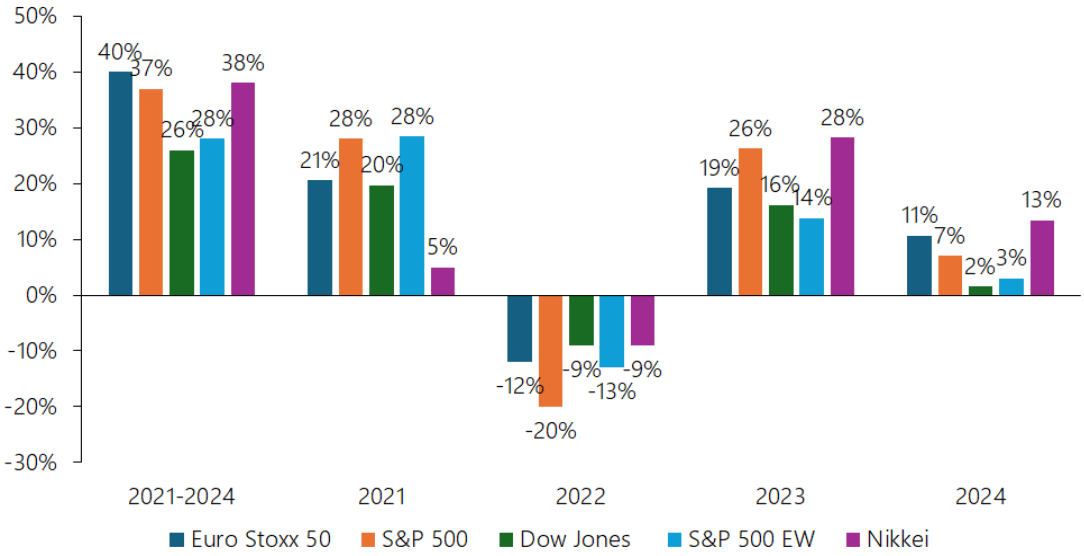
S&P 500 has already anticipated a recovery in profits and its positive trend will continue (beginning of the cycle)



April's consolidation allows us to return to sectors and stocks that were heavily overbought at the beginning of April, such as some technology, industrial and defense companies. Europe will significantly increase its defense spending by 2030 with an overall envelope that will increase from €350 billion to €500-550 billion. The Swedish agency SIPRI announced an increase of 6.8% to $2,443 billion in military spending in 2023. The French president's proposal for a large European defense loan will, in our opinion, result in the entry of defense sector in ESG criteria which has disadvantaged Europe. In this complicated relationship between Europe and ESG, TotalEnergies is considering a primary listing on Wall Street, the two main arguments being the predominance of North American shareholders and ESG constraints.

For several years, decoupled from macroeconomic fundamentals, European stock markets have challenged investors. The Euro Stoxx has outperformed American indices. Long awaited, the severe global recession is not here and the soft landing dominates. European economic growth is weak, but the pivot of central banks suggests an improvement in the economy. Cheap, European indices offer significant potential for catching up with the valuation of US indices. For Morgan Stanley, the current situation resembles that of 1995 when the Fed pivoted and Europe experienced a period of equity revaluation. In 2Q24, European stocks will enter a profit recovery cycle. Moreover, this analysis could also apply to the Russell 2000, whose profit cycle is expected to pick up from 2Q24, and to all small and medium-sized companies, but we find that their discount is not important enough and we prefer to stay on megacaps.

Outperformance of Europe and Japan ex-IT



In Asia, the cheap Chinese stocks argument doesn't work, because they have always been cheap. The big Chinese economic recovery plan is not there. Households are turning away from domestic stocks, not wanting to combine financial suffering with their real estate investments. They buy gold massively. We maintain that without visible change, Chinese stocks remain a value trap. Chinese stocks are risky due to geopolitics (possible invasion of Taiwan) and face attractive stock markets like Japan, South Korea and India.

Japanese stocks are outperforming thanks to the sharp depreciation of the yen, favoring exports in a reindustrializing world. Tourism also benefits. An interest rate hike by the BoJ will benefit the financial sector. South Korea is interesting thanks to the reforms put in place, like in Japan, and its strong market share in semiconductor production. Japan and South Korea offer an efficient industrial ecosystem in the deglobalization process. India wants to profile itself as an alternative to China for Western countries in supply chains. India is also a country to play the growth of domestic consumption, supported by strong demographics and economic stability.

Commodities

Before talking about a Commodities Supercycle, a rally is in place

Everything is rising: oil, copper, gold and agricultural goods, for geopolitical, economic and climatic reasons.

Bloomberg Commodity Index

In its latest report, the World Bank writes that the decline in commodity prices of the last two years is behind us and that they will no longer be a major deflationary force. The World Bank cites the causes, geopolitics, energy transition and climate change, and is concerned about interest rate levels and the possibility that the Fed won't cut Fed Funds.

Oil. Geopolitical tensions in the Middle East have brought Brent prices back towards $90 per barrel, after falling from $125 in mid-2023 to $70 in mid-2023, while OPEC+ maintains its production cuts. Demand linked to overall growth is increasing. In 2022 and 2023, the increase was 2 million barrels/day, and forecasts are +1.5 million barrels in 2024 and 2025. There are also disturbances in the Red Sea (Houthi attacks) giving access to the Suez Canal. We like the energy sector. Oil companies are a good hedge against geopolitical risks.

Gold. The strong demand for physical gold comes from emerging central banks, the OTC market and Chinese households (caution regarding domestic stocks and real estate). Individual and institutional investors, invested in financial products, have been exiting financial products for three and a half years and the relationship between gold prices and real interest rates has not worked for more than two years. We therefore have a medium-long term structural demand and no longer a speculative demand. This is a historic change. Western sanctions against Russia, after the invasion of Ukraine, growing tensions between the United States and China, the emergence of the Global South and the strengthening of BRICS are accelerating the de-dollarization process, favoring gold. Donald Trump's announcement, if he were to be elected, to replace Jerome Powell and put the Fed under his supervision could result in chaos and favor gold. After Antony Blinken's visit to Beijing, the United States is reportedly preparing sanctions against Chinese banks that are helping Russia in its war in Ukraine and excluding them from the international dollar system, which could accelerate the de-dollarization process and benefit to gold. The technical breakout of major resistance at $2,075 opened price prospects well beyond $2,500 in the long term.

Industrial metals. Prices are recovering with increasing demand from reindustrialization, electric vehicles, electrification, infrastructure and military spending. The price of copper is no longer far from the 2021-2022-historic highs. BHP's acquisition offer for Anglo American for $39 billion is part of this positive view on demand and prices. The Australian group promised to revise its offer upwards after the rejection by Anglo American. Despite everything, this offer is not necessarily the start of an Industrial Metals Supercycle: in November 2007 (peak of industrial metals prices), BHP launched a giant $150 billion takeover bid on Rio Tinto, which was postponed, and from March 2008 to February 2009, the industrial metals index fell by 64%!