THE MONTHLY LETTER

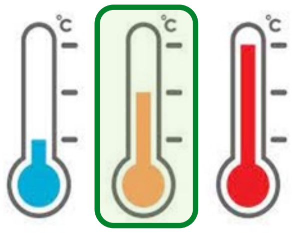
Tactical update

SEPTEMBER 2024

The dogs are barking, the caravan is on the move

Global landscape

Inflation in Next 6m



Stance: cyclical disinflation
Trend: stabilization process underway

Economic growth in Next 6m

Stance: below potential
Trend: stable

Long-term macroeconomic regime. Irregular and volatile economic cycles

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

Cyclical outlook. Global reflation begins as central banks turn accommodative

US nominal growth will remain resilient thanks to pre-election fiscal largesse. China is starting to pursue an unorthodox monetary policy (YCC) but is unable to stop deflationary forces (bursting of the property bubble). A sustained recovery in Europe and Japan is not expected before the end of 2024.

Geopolitics. A chaotic / recessionary landscape

Conflicts show little sign of abating. The spread of fighting in the Middle East is putting further pressure on shipping and weighing on prices. The Ukraine conflict is unlikely to experience significant developments, at least before the November elections.

Early signs of a favorable shift in global liquidity

Liquidity conditions are starting to become more favorable, led by US financial engineering 3.0 and China.

Negative equity-bond correlation tentatively restored

Cyclical disinflation finally emerged in the US. The odds of sub-3% CPI over next quarters have now become dominant. The mid-summer JPY carry trade unwind shock confirmed the mechanical shift of correlation into negative territory, for now. Still, sustainability of this virtuous outcome will depend on many factors, namely the shape of future US administration and Congress.

Highly volatile capital flows

Investors' cyclothymia is driving significant flows into and out of risky assets. This trend has been exacerbated by the unwinding of the Japanese carry trade and Volmageddon 2.0 shocks. Despite the BoJ's recent cautious capitulation, the irreversible normalization of the Japanese cycle and monetary policy will continue to haunt markets MT.

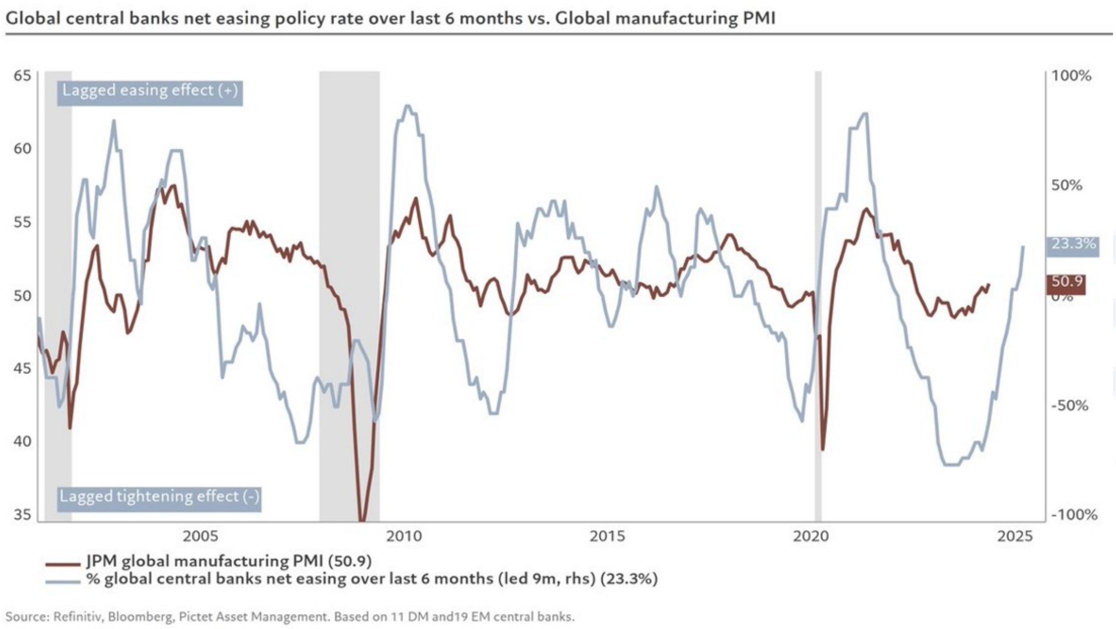
Global View

Stars aligned, short term

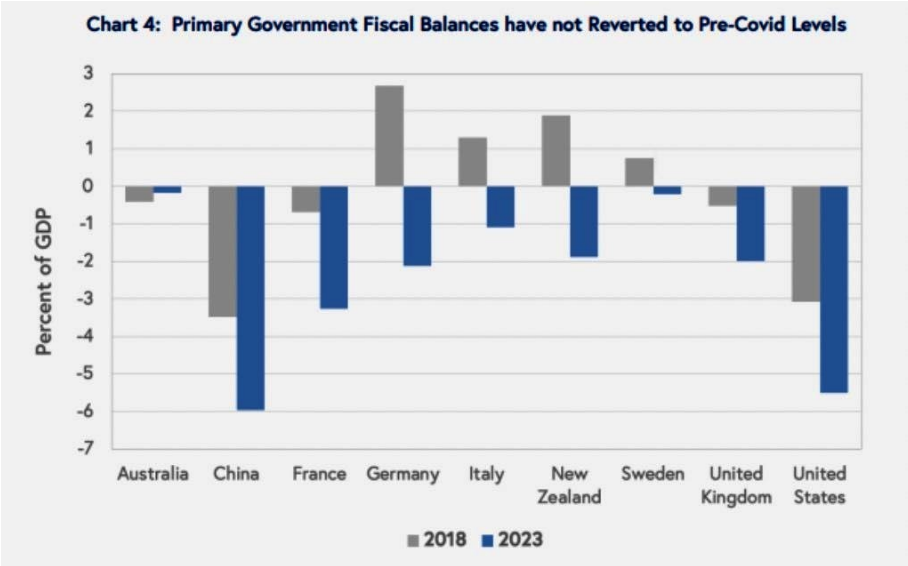
The coming months will see a confluence of positive factors. The end of overheating in the US economy, coupled with sub-par growth in China, will result in a cyclical accentuation of global disinflation. The gradual shift of central banks to an accommodative mode and the US authorities' willingness to stimulate ahead of the elections will allow for a more ample production of liquidity.

The current soft patch will be prevented from turning into an outright/corrosive recession by the prevailing regime of fiscal dominance.

Regime of fiscal dominance becomes entrenched



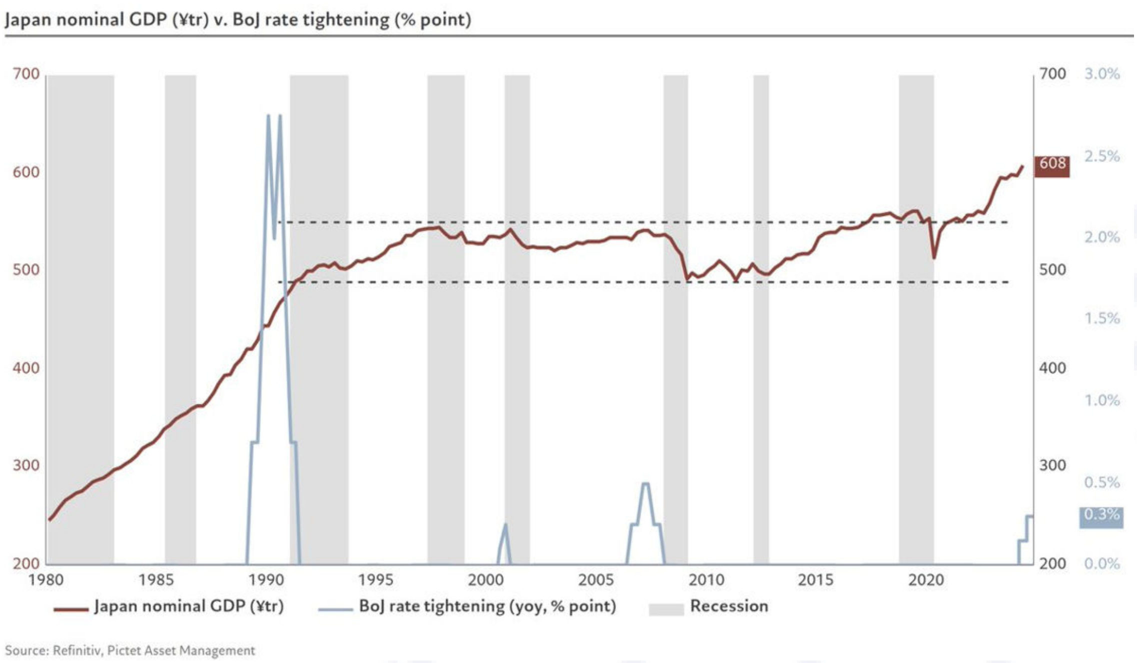
A global reflation cycle has begun



The overdue process of normalization puts Japan on a tightrope

Japan's economy had been in quasi-stagnation for several decades. The entrenched deflationary regime was expected to continue, given the unattractive prospects of the country's long-term drivers, namely population and productivity growth. But against all odds, the pandemic shock finally put an end to deflation. Finally, beyond the temporary rise in goods prices caused by disrupted supply chains, domestic sentiment began to change dramatically. Several months of runaway services inflation, coupled with buoyant wages, have finally seeped deep into the private sector psyche. According to the BoJ, inflation expectations are stabilizing at around 2.4% after peaking at 2.8% in 1Q23, still well up on 0.7% in 1Q321!

A new regime for the Japanese economy



The exit from deflation has mechanically led to nominal growth becoming established above 3%. According to the latest forecasts from the supranationals, this trend is sustainable thanks to resilient consumption, a tight labor market and solid wage growth. Despite the - very gradual - shift towards higher policy rates and the exit from the yield curve control, monetary policy remains extremely accommodative. Indeed, Japanese real policy rates are still deeply negative (minus 2%) and the BoJ is still printing money to buy government bonds (contributing to the JPY carry trade!).

Future nominal growth expected to set above 3%						
	2024	2024	2024	2025	2025	2025
	Growth	*Inflation*	***Nominal growth***	*Growth*	*Inflation*	***Nominal growth***
OECD	0.5	2.6	3.1	1.1	2.0	3.1
IMF	0.9	2.3	3.2	1.0	2.3	3.3

BoJ ultra-accommodative stance is reminiscent of Fed inaction vs. inflation late 2021 early 2022
Japan's economic and monetary cycles are starting to re-converge with those of the major countries

China is sinking without any effective reaction

The official data confirm the lack of momentum, but do not provide any insight. In recent months, buoyant exports have masked the extent of the domestic consumption slump. This appears to be fading. More worryingly, the pollution data from the big cities and the dismal M1 statistics (turning worryingly negative) confirm the growing odds of a recession.

The authorities have started to implement the YCC by putting a floor under falling long-term yields. The idea is to counteract the deflationary sentiment of households fleeing property and equities for the safety of gold and government bonds. Coincidentally, the US is shifting to a more accommodative stance and the JPY is on the rise. This is a relief for the yuan and Beijing authorities. The upcoming - possibly large - liquidity injections will not solve the balance sheet recession of the Chinese private sector. At best, it may temporarily restore some risk appetite for speculators. Bolder measures are needed.

Investment takeaways

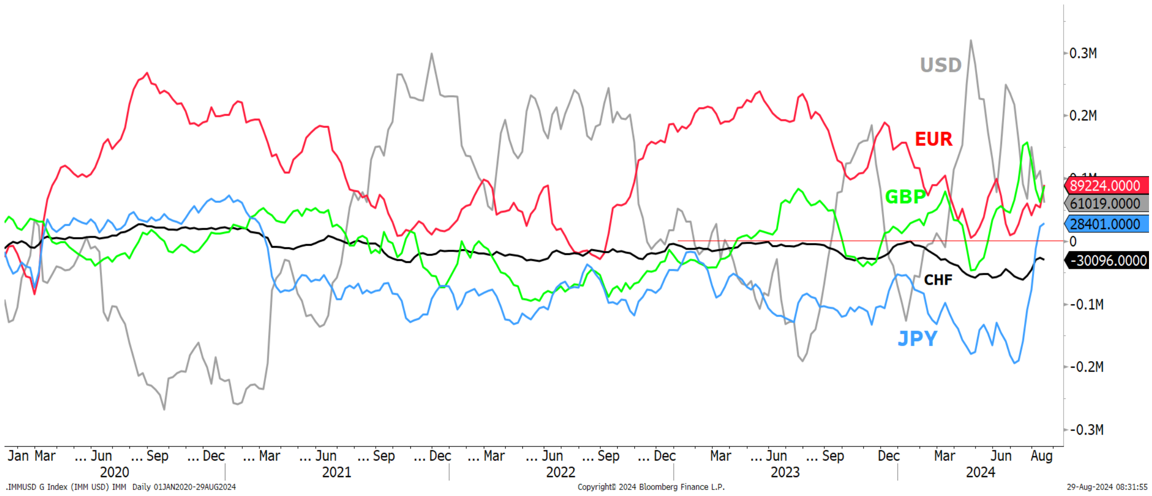
Tectonic shifts are taking place in Asia. A window of opportunity is opening short term for China to implement unorthodox monetary policy. Ample global liquidity, coupled with US electoral stimulus, would benefit and favor a ¨risk-on¨ bias in risky assets towards the end of 2024. Medium-term, the normalization of Japanese economic policy is inexorable. It is likely to happen in months, not years. It will again provoke significant/destabilizing capital flows.

Currencies

A pause after a shaky summer

The USD has weakened over the past month as the US economy has slowed and the Fed's rhetoric has turned dovish. The market is pricing in 100bps of easing by the end of the year. This means that it is positioned for a soft landing, coupled with no further inflation hikes. And while Powell's explicit guidance on rate cuts is significant, investors had fully priced in easing long before and the negative USD reaction to the speech looked a bit overdone. We are not calling for a big USD rally. Falling US interest rates have made the greenback much cheaper to short, and the general USD weakness is entirely consistent with the Fed's easing outlook. However, the risks from a technical (including positioning) perspective and rate differentials are undoubtedly more balanced, and in the very near term slightly upside-tilted for the USD.

USD positioning not yet short

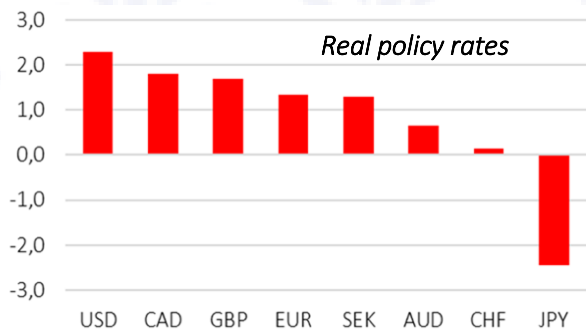


Even after the recent decline, the USD index is still within the broad 100-106 range that has been in place for over a year and a half. Instead, levels around 101 have been used as a buy signal. This time will be different. We have argued that the beginning of the easing cycle would be a catalyst for USD weakness. The USD has benefited strongly from rate hikes and the reverse should be true.

- USD consolidation is welcome. The Fed may need to be even more dovish for the USD to easily extend its recent decline.

A more hawkish ECB means a cheerful EUR

The EUR may not be able to maintain the pace of last month's frantic rally. The currency is likely to remain elevated thanks to more resilient euro rates than in the US. The EUR gained around 3.3% in August, its best performance in over a year and a half. The Fed Chairman signaled that he does not seek/welcome further cooling in the labor market - opening the door to significant policy easing. The ECB indicated that it may not be in



quite the same mood. Its chief economist warned that the policy rate must remain in restrictive territory for as long as necessary to guide the disinflation process towards a timely return to target.

The market is discounting 65bps of policy easing by the end of the year. The ECB's real policy rate is not as high as the Fed's. The Fed's real rate is close to 250bps, while the ECB's is a meagre 150bps, based on core CPI.

- We do not see the conditions for a significant unwinding of the recent EUR/USD rally.
- The ECB's hawkish stance is likely to offset the yield gap and support the EUR.

Rising against the USD, but struggling against others

The CNY has strengthened over the past month, reaching its highest level against the USD this year. It is trading close to 7.1. The move has mainly been driven by a weaker USD, with the Yuan underperforming most of its DM and Asian peers. Once the Fed starts cutting rates, lower US yields and the USD should drag USD/CNY lower, even if the Yuan continues to struggle against other currencies.

USD/CNY remains driven by US yields

Policymakers have continued to warn of the potential financial risks of excessive bond buying. The Chinese 10Y yield has risen slightly over the month, with the US-China 10Y spread falling to 1.6%, the lowest since February. However, the Chinese 10Y yield also remains low at 2.2% and is a concern for the authorities.

Admittedly, a stronger CNY/USD - due to a weaker USD - will not help exports, but a lower USD may ease pressure on policymakers to allow the PBoC to cut rates to support the economy without worrying too much about the impact on the currency.

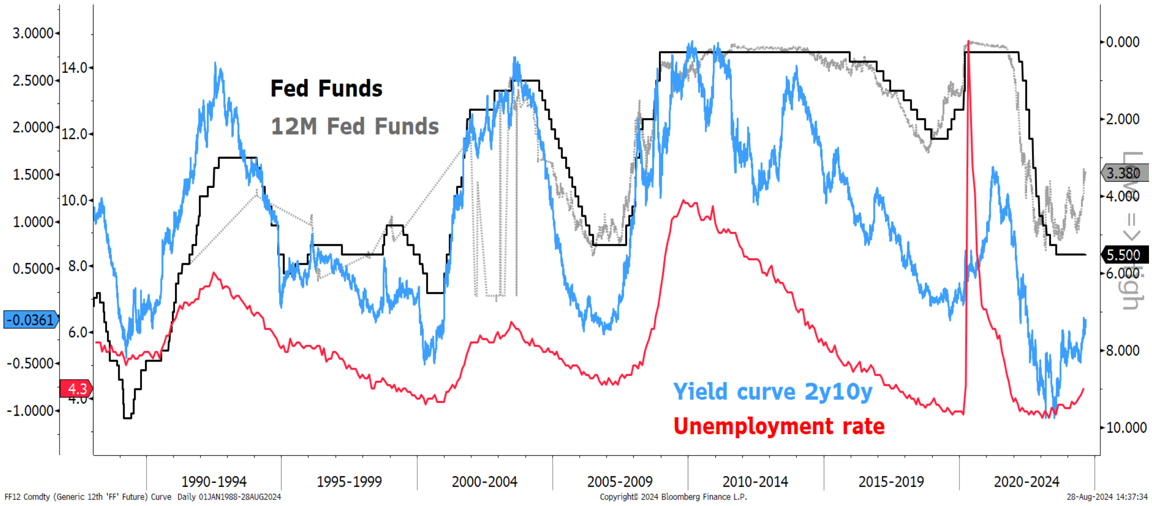
Bonds

Summer shift

The summer saw a surprisingly dovish reassessment of central bank expectations and a collapse in inflation expectations. The bond market quickly shifted its concerns from inflation to the growth/jobs outlook.

The minutes of the Fed's July meeting and Powell's speech at Jackson Hole confirmed what was already priced into the market: the Fed will almost certainly cut in September. Several members noted that recent progress on inflation and the rise in the unemployment rate had provided a plausible case for a 25bp cut in the Fed Funds rate. The debate in the market has shifted to the pace of cuts and the terminal rate.

Fed Funds futures are already discounting a sharp slowdown



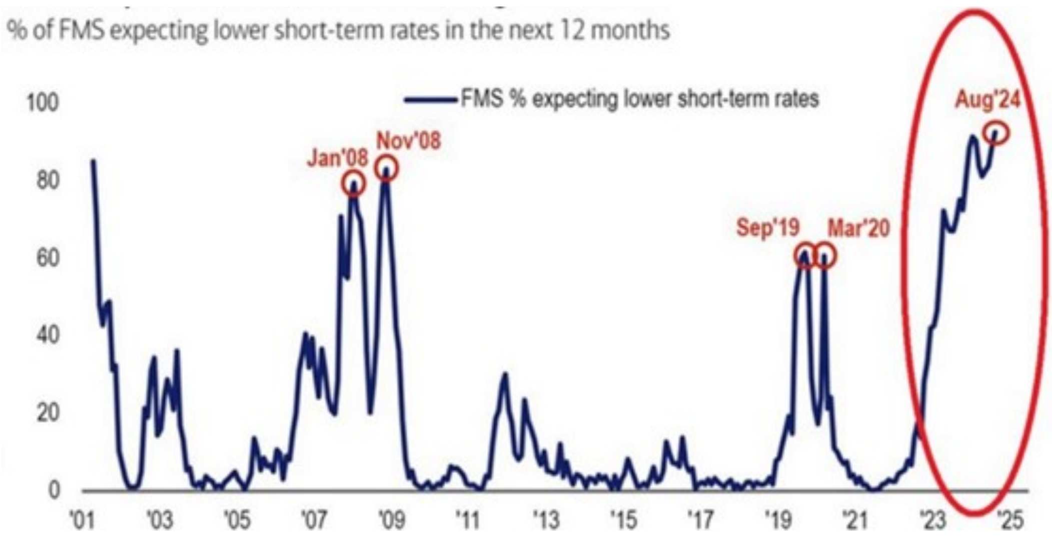
The market is pricing in a relatively fast pace of easing, with 125bps of cuts by January. Historically, Fed Funds futures pricing in at least 100bps of cuts over the next 6 months has been a strong recession indicator. We have a more gradual pace of easing than is currently priced in, as we do not see an imminent recession.
Markets seem to be pricing in too many cuts for the next 6 months. US data in early September will be key

Investors already positioned for lower yields

Bond traders are taking on record amounts of risk. The number of leveraged positions in Treasury futures has risen to an all-time high, a record 23 million 10-year futures equivalent. Asset managers increased their net long position by 120K 10-year futures equivalent, according to the CFTC.

According to a Bank of America survey, 47% of fund managers expect the global economy to slow next year. And 76% still expect a soft landing, the highest proportion in at least a year. Even more unanimous is the expectation and positioning for lower interest rates (93% of the 189 global asset managers surveyed expect lower interest rates within the next 12 months).
Being overweight bonds is consensual. This is the largest share ever recorded, even above 2008 levels

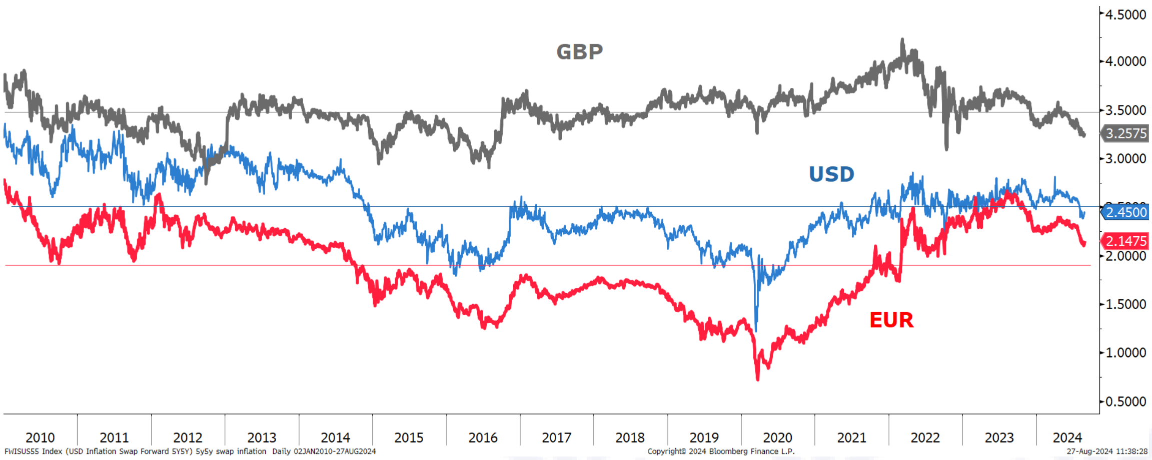
Expectations for lower rates are the highest on record



Inflation expectations have fallen too much

Inflation concerns have eased. Investors are focusing on global recession risks. European growth data has been on the weaker side and the disinflationary trend appears intact. Eurozone wage growth slowed sharply in Q2, strengthening the case for a second ECB rate cut in September.

Forward inflation swap 5y5y have all declined



Long-term inflation expectations have reached their lowest level in almost 2 years. Eurozone 5-year forward inflation swap, an assessment of price growth over the second half of the next decade, has fallen below 2.1% for the first time since October 2022. Meanwhile, the UK equivalent inflation swap has fallen to 3.2%, close to its lowest level since 2016. US inflation expectations have also fallen to 2.4%. Investors have been encouraged by the Fed's increased confidence that inflation is moving towards its 2% target. The fall in inflation expectations has also tracked the fall in global commodity prices, led by oil and gas and major metals.

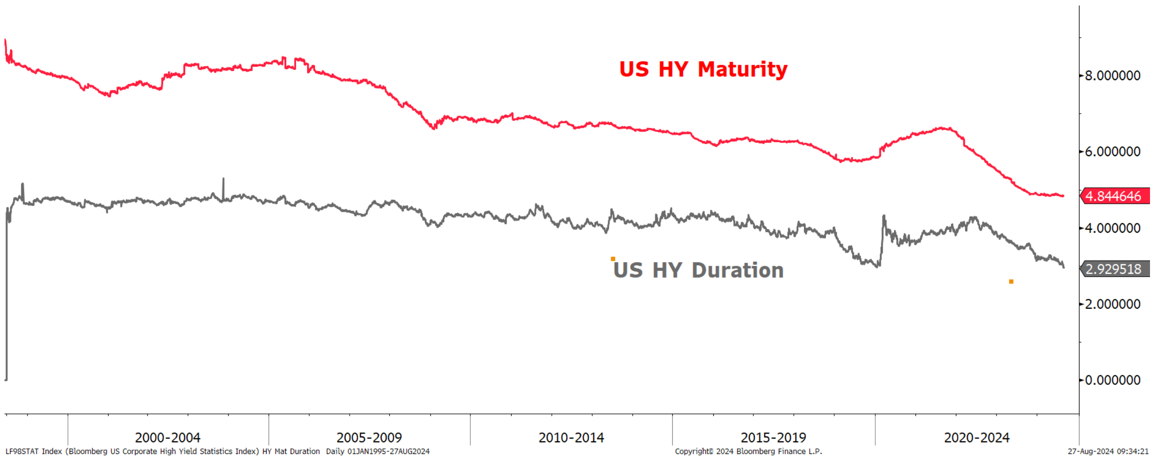
Fears of stagflation are receding in favour of a demand-led slowdown. We favor US TIPS. Although inflation expectations have fallen, they are likely to remain volatile.

Bankruptcies hit the highest level in 14 years

US bankruptcy filings reached 346 in the year to June, the highest level in 14 years. There were 75 bankruptcies in June alone, the most in over 4.5 years. The number of companies in Chapter 11 has risen to 2462, the highest in 13 years. A Chapter 11 filing is a court-supervised reorganization that allows a company to stay in business and restructure its finances and operations. It is the pre-bankruptcy stage. The Fed's Senior Loan Officer Opinion Survey of July 2024 reported that credit conditions for C&I loans were tighter than average in Q22024, but easier than a year earlier. A good sign.

Funding costs are falling. Lower yields and the imminent start of the easing cycle have marked the beginning of the transition to lower funding costs for sub-IG borrowers. New funding costs have fallen to their lowest level since early 2022, with the exception of CCC-rated borrowers.

Corporate HY duration has collapsed



One source of stress is that the duration of HY debt has fallen to a record low, suggesting a more muted impact on prices as the Fed eases. Most of the market will roll over the next few years. A risk of indigestion for investors.

US HY spreads almost back to pre-scare levels

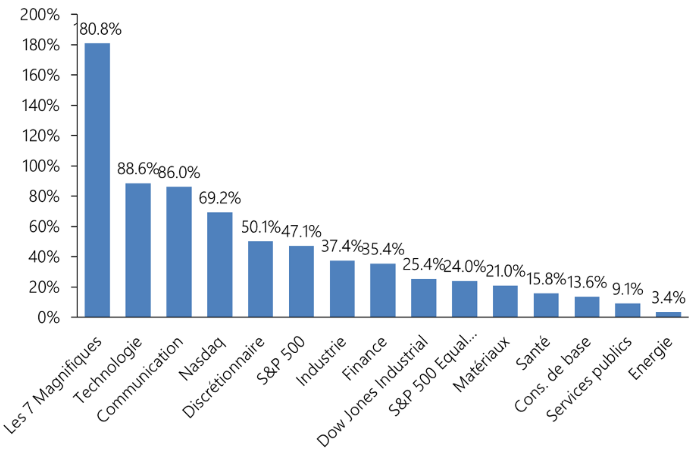
Spreads do not discount an economic slowdown

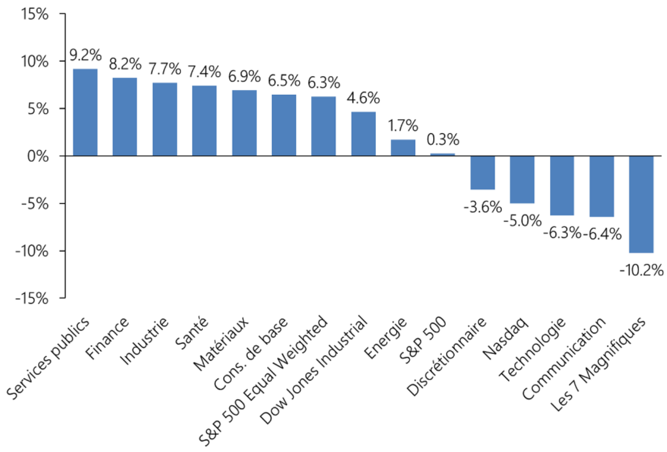
Equities

The steepening of the curve has modified the sector allocation

The wind seems to have turned on July 10th, 2024. The Magnificent 7 are no longer the engine of the S&P 500; global indices can rise without them. The Value/Defensive sectors have taken over, led by utilities, healthcare, consumer staples and finance.

Performances since the beginning of 2023 and since July 10th, 2024. Since July 10th, 2024, the Magnificent 7 index has fallen by 11%, but global indices have increased thanks to the return of Value/Defensive sectors.





The reasons for this sector rotation are:

- Stock market fatigue on Big Techs with the realization that profits will not increase indefinitely, already because of a base effect.
- A steepening of the yield curve, often heralding a recession when the slope becomes positive.

The steepening of the yield curve is changing the positioning of investors. Here are the impacts:

- Valuations. Long rates can rise, which can negatively affect stocks with high PE ratios. We can easily distinguish the Growth segment (the Magnificent 7, technology and communications). They can also deteriorate the outlook for earnings growth.
- Sector rotation. We have often observed a new sector positioning in favor of finance and defensive sectors. So from Technology/AI to Value/defensive. Banks and insurance generally outperform global indices when the yield curve steepens.
- Dividends. High dividend yields are preferred in the face of economic uncertainty and more volatility. This is not the segment we would buy first, because we do not see a recession in the short term.
- Volatility. It increases when there is a steepening.
- Diversification. In a more volatile environment, diversification is a good strategy.
- Recession. Historically, a positive steepening has often translated into a recession 4-6 months later.

For the moment, investors, the vast majority of whom do not believe in a recession, are taking into account this steepening of the yield curve, not by reducing stocks, but by changing their sector allocation. It is not necessarily negative: it can provide buying opportunities in sectors and stocks that had been neglected in the past, as we have seen since July 10. We therefore have a bull market with broad participation. The fundamental factors remain: disinflation, resilience of the economy, growth in corporate profits, synchronization of accommodative monetary policies and recovery of the liquidity cycle.

We think we are in a bull steepening, a steepening caused by a drop in short-term rates, which is rather positive for risky assets. The Fed should cut rates in September, because inflation is coming back below 3% rather than in reaction to a risk of recession. Then, September should be a good month in terms of returns.

What about small and mid-cap stocks? Since the beginning of July, this segment has outperformed large stocks thanks to the recovery of the Russell 2000 profits cycle and a return of global liquidity. However, it should be noted that this segment underperforms before and during the first part of a recession. On the other hand, it outperformed in the second half and 12 months after the end of a recession.

Electricity producers have benefited from this shift in sector allocation. Since July 10, the Utilities index has jumped 10%, while the S&P 500 and MSCI World have gained 0.3% and 1.3%, respectively; the Magnificent Seven Index has declined 10%. Historically, Utilities has a positive performance record and outperformed broad indices 3-6 months before a recession. But the market is building a specific story around U.S. electricity producers, boring as it usually is, related to the significant increase in energy demand from electric vehicles, AI, data centers, cloud, blockchain, and cryptocurrency mining. The technology requires a lot of energy for these activities and by 2026, energy needs are expected to double. It is estimated that they will account for 15% of global electricity consumption by 2030. In the United States, the regulator allows independent producers a high profitability (high profits) on new investments, unlike regulated historical players. The East American regional organization for electricity transmission, the PJM Interconnection, reports a shortage of production in its network, pushing prices up. For the United States, the entire electricity theme is interesting given the obsolescence of the network with the need for renovation (electrical equipment, cables). Electricity producers with natural gas are also attractive, because the production of green energy is not sufficient to meet needs.

In the emerging zone, we still favor India, while the index for the Southeast Asian region (Indonesia, Malaysia, Singapore, Thailand, Vietnam, Philippines, Cambodia, Laos) has broken resistance. All these countries benefit from the *China Plus One* strategy of Western companies.

For the moment, China remains a Value trap due to the absence of a real recovery plan, the real estate crisis and weak domestic consumption. Chinese households prefer to buy gold and foreign companies and investors are cautious about investing in China. Chinese indices show no desire to catch up, quite the contrary. In 2024, the global indices are negative: -3% for the CSI300, -16% for Shenzhen and -13% for the Golden Dragon China (Chinese companies listed in the US). Domestic investors are waiting for a strong fiscal support from the government.

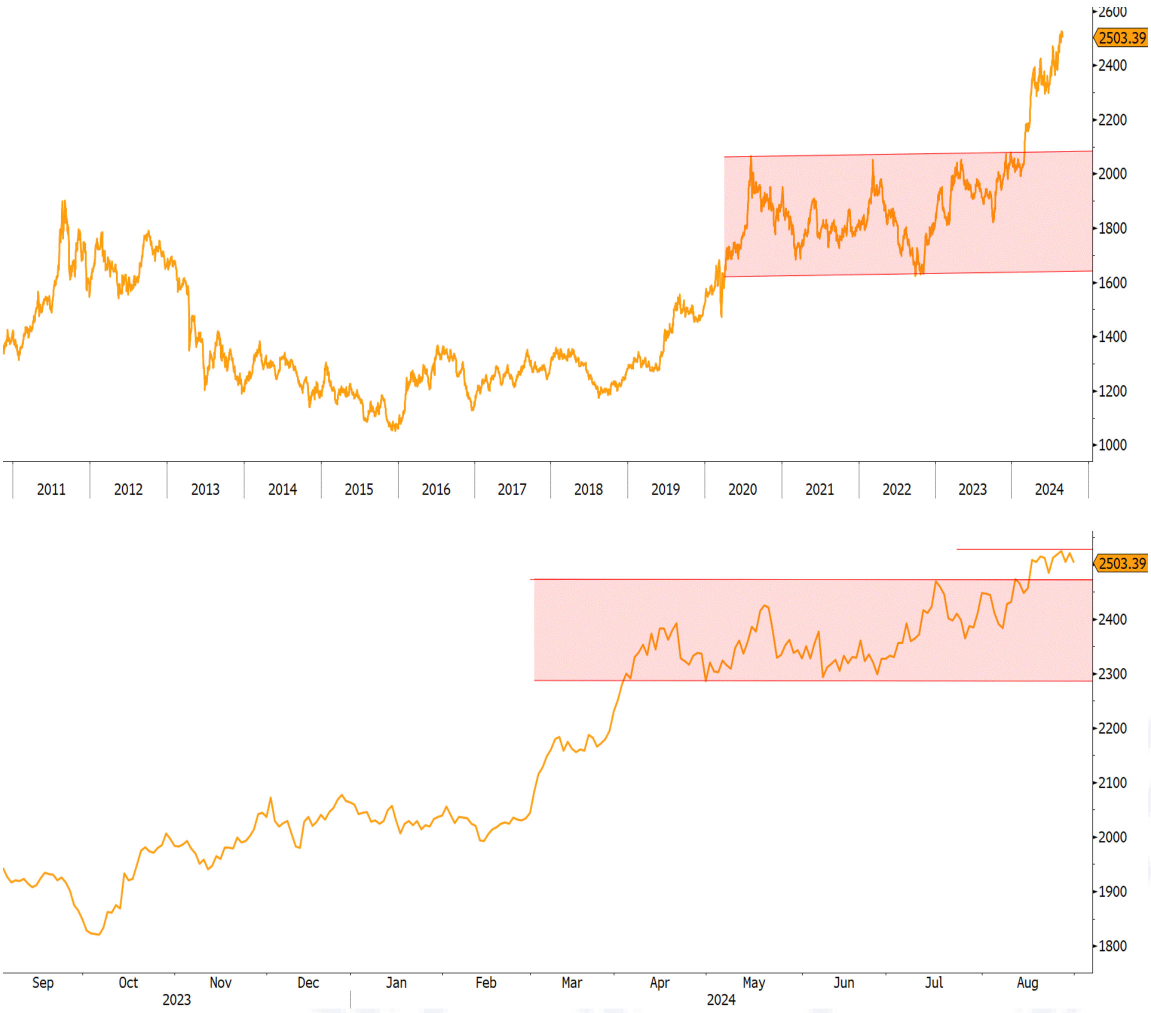
Alternative Investments

September is an unfavorable month for gold and oil

Since 2013, the gold price has only risen once in September, it was in 2016. September is not just about gold, it is also true for stocks and oil.

For gold, the explanation could be purchases before and during the summer against potential risks, offering peace during holidays and resales in September. September is traditionally a favorable month for the dollar, penalizing gold. The price of gold has benefited from purchases by emerging central banks until April 2024, then the return of individual and institutional investors, but not enough for the price to clearly pass the $2,500 mark. The decline in the Fed Funds in September is a support. Technically, the trend is bullish. In the short term, the consolidation of September could be confirmed due to relatively high non-commercial long future positions.

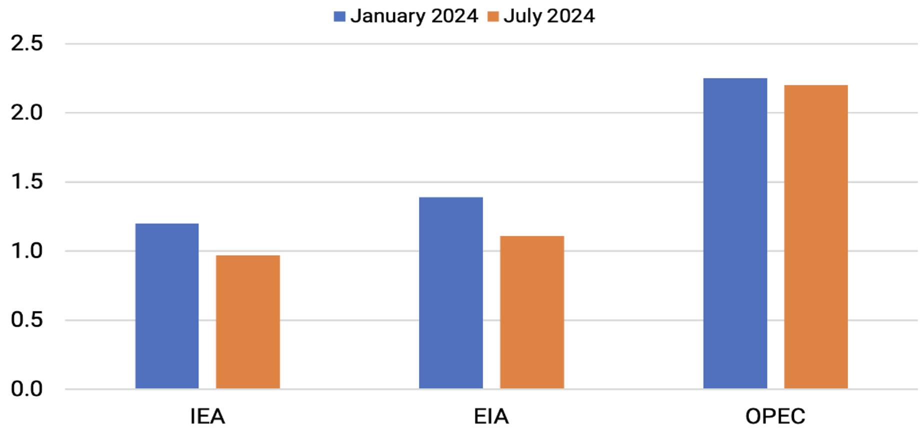
Gold price. Gold consolidation in September (?) between $2’530 et 2’480 in technical bullish trend



Not much to say about oil. Despite a sensitive geographical situation, oil prices have not been affected by the conflict in the Middle East. Given the massive presence of the American army in the region, the market does not believe in an extension of the conflict. Before winter, tanks in the northern hemisphere are full. Global economic growth is weak, resulting in downward revisions to demand growth forecasts.

OPEC has planned to gradually increase its production starting in October. Prices have not reacted to the announcement by the authorities in eastern Libya of the closure of all oil fields and terminals as well as the cessation of exports until further notice, due to a major political crisis with the rival government in Tripoli, recognized by the UN.

Oil. Demand growth projections. IEA : International Energy Agency. EIA : US government



Bitcoin is struggling to break out of its wide $70,000-$52,000 band. Two visions are clashing. One that thinks that bitcoin will start to rise again in September, following the classic historical pattern of behavior before and after a halving (the 4th took place on April 14, 2024). And the other saying that this classic pattern has probably disappeared with the integration of cryptocurrencies into asset allocations by individual and institutional investors thanks to the creation of Bitcoin and Ethereum ETFs. Bitcoin will now behave like a classic risky asset. September will probably bring us an answer. In the meantime, bitcoin whales (big buyers) continue to massively accumulate bitcoins, while individual investors are nervous and sell.

Bitcoin price