

Review & Outlook

July 2024

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-The Economy, Financial
Markets and Central Banks
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The Economy, Financial Markets and Central Banks

As the second quarter draws to a close, we summarize below some of the characteristics of this period and reflect on the outlook going forward.

Overall, economic activity remained resilient during the period. We estimate that the global economy grew at a 2.7% pace, broadly 0.5 points above potential. Towards the end of the quarter, US data started to point towards more modest growth. This is apparent from light retail sales, weaker housing indicators and some below par labor market data. This weakness had been anticipated and can be seen as part of the post pandemic normalization. But as investors, we recognize that the limit between a healthy normalization and excessive slowdown is always difficult to determine in real time.



MSCI World Index, from 01.01.2024 to 01.07.2024
Source: MarketMap FIS

The economic picture outside of the US is less favorable. China is still plagued by a multi-year adjustment, and its industrial and domestic indicators remain weak. The Euro area spent much of the period with growth below potential and is only now attempting a rebound. How far this rebound can go is an open question given the political uncertainties affecting the region.

The delay in central bank easing (due to more sticky inflation than expected) led to higher bond yields. This had a negative effect on many risk assets. Only AI related equities (benefitting from the investment boom in generative artificial intelligence) managed to escape this negative trend. Given the weight of these companies in the indices, this was sufficient to push the overall indexes upwards but should not mask the issues plaguing the overall market.



The higher bond yields penalized fixed income investors. At the benchmark level, they broadly

had the effect of wiping out (through losses on the principal) the 6 months accumulated coupon. We see these losses are temporary and will be recovered once the Federal Reserve can start its easing process.

Even after the release of very disappointing inflation data at the beginning of the quarter, the US central bank went at pains to communicate that it didn't seriously consider additional rate hikes. It signaled its intention to deal with sticky inflation by prolonging the current interest rate regime, which is seen as highly restrictive.

Unfortunately, the same cannot be said of the European Central Bank. The Frankfurt institution fell victim to its own forward guidance. Having virtually guaranteed a rate cut for June, it felt obliged to deliver one at the same meeting at which it announced an upwards revision to its inflation forecast. This is not a great way for a central bank to enhance its credibility. From our point of view, it means that the uncertainty associated with Euro area rate forecasts must be increased.

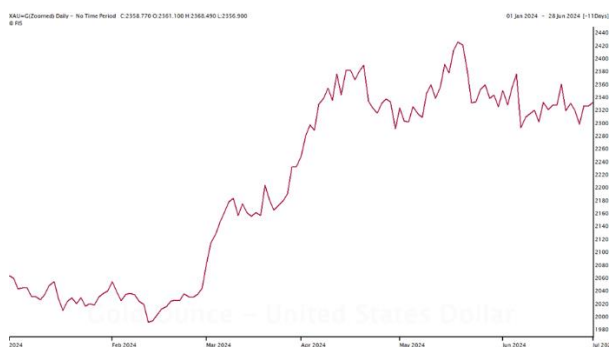
The quarter also showed that the US restrictive policy is "biting" in the areas where monetary policy is traditionally effective. We saw, for example, a series of defaults in the real estate sector which affected some highly rated securities. We also noted, towards the end of the quarter, some weakness in labor market indicators and in housing statistics.

Overall, stocks advanced during the quarter. This advance was however much narrower than in Q1; all the gains originated from the technology sector. Consequently, the rally was limited to the US market: the S&P 500 was up 3.9%, but non-US stocks fell 0.5%. We see this equity rally as aligned with fundamentals. Overall, the earnings season showed solid results. EPS rose by 6% year on year compared with initial

expectation of 3% growth. Capital expenditure estimates have also increased significantly as corporates accelerate their AI investments, benefitting companies exposed to data center and related investments.

On the currencies side, most non-US currencies fell versus the USD. The JPY continued its rapid depreciation without causing any disruption in Japanese financial assets. In general, we ascribe the USD's strength to the persistence of high US yields.

Despite large intra quarter swings, industrial metals such as copper ended the quarter with solid gains. Gold also rallied by 4%, despite the underlying strength in the USD. Energy prices were stable.



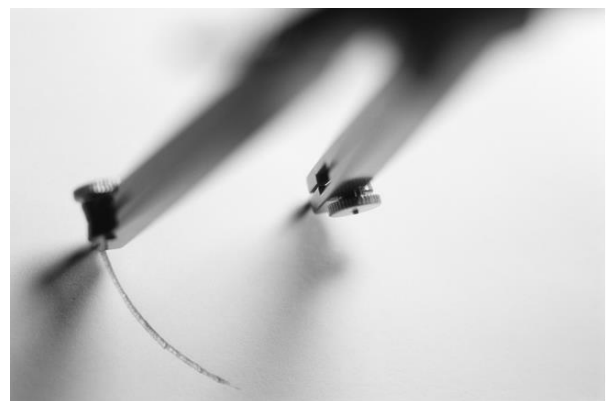
Gold Spot Prices in USD, from 01.01.2024 to 28.06.2024
Source: MarketMap FIS

Investment Outlook

To sketch out an investment outlook for the rest of 2024 and beyond, we are required to answer the following questions.

- How likely is US a recession in the next 12 months?
- Will the Generative AI boom prove sustainable?

- Are central banks going to be able to deliver on their planned monetary easing?
- Will geopolitical risks derail the economy/financial markets?
- What will be the effect of the US election outcome on the markets/economy?



The question of the probability of a recession is tied to a cyclical assessment. Most of the data points we are observing (stability of default rates, low risk of recession, economic growth close to potential) lead to consider that we are currently mid-cycle. This would be consistent with the phase of low volatility in financial assets. We recognize that this cycle has been blurred by Covid and has yet to fully normalize. In this context, the current restrictive monetary policy characterized the end of a cycle. Forecasting recessions is notoriously tricky, so we would limit our statement to saying that a recession in the next 12 months is not more likely than at any other average period (which broadly means 15% probability).

The boom in artificial intelligence related investments is no longer a sector specific question. The companies involved in the capital expenditures chain have demonstrated earnings growth well ahead of the market over the past

two quarters. The path to monetization of this technology is the subject of intense debate among investors. Some doubt that the massive investments made in this field will prove profitable and expect at the very least a slowdown in the future. Others observe that we see more and more examples of the technology being monetized and expect further uses to emerge from the current "arms race" among developers of models and applications. We are in the second camp and would compare the current investment phase to the initial stages of the development of the cloud related technologies. Based on this view, we are not concerned by overall valuations levels for market cap weighted indices. We also note that the same indices in their equally weighted form are not expensive in historical terms. This leads us to favor well diversified portfolios on the equity side.

Central banks have had to maintain restrictive monetary policies for longer than generally expected. Conditions are now falling in place for some measure of relaxation, thanks to the decline in US inflation indicators for the past 2 months, combined with softer growth. There is little doubt that the Federal Reserve is not interested in inflicting unnecessary pain to the interest rate sensitive part of the economy. We see measured easing in the US this year (in the range of 0.50 - 0.75 basis points for Fed Funds) to be followed by more in 2025. If this occurs without a recession (our highest probability scenario) this will lead to curve steepening and will be supportive to overall risk assets. It would also contribute to the elusive and long-awaited broadening of the US equity rally.

As always, we will be attentive to geopolitical and political risks. At the time of writing, it appears that the risks linked to the French snap elections will be contained. Looking at the US electoral process, we are concerned by the

overall risk posed by a punitive tariffs policy of a potential Trump administration and are striving to minimize exposure to exposed companies or sectors. This is one of the reasons we maintain an underweight in emerging market assets.

Going forward, we think investors should maintain their full allocation to equities (in a diversified manner), own some credit for income, high quality bonds for capital gains as monetary easing approaches and be exposed to alternative assets for diversification.

Daniel Jakobovits
Head of Investments



“Luck shouldn’t
be part of your
portfolio.”

HYPOSWISS
A D V I S O R S

Expect the expected

Mission Statement

- Hyposwiss Advisors' mission is to offer personalized wealth management services and financial advice to high-net-worth individuals and families, with the overriding objective of capital preservation and asset growth, performance oriented.

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