

Review & Outlook

October 2024

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The Economy, Financial Markets and Central Banks

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

During the period, the market focused on US labor market data, the evolution of global inflation, the initiation of the Federal Reserve monetary policy easing cycle and the large Chinese monetary/fiscal policy initiative.

In the US, labor market data published during the summer months printed on the weak side. Non-farm payrolls registered a gain of 142k for August (118k for private payrolls) and the unemployment rate ticked up to 4.2%. At that point, including the revisions to prior months, payroll growth had fallen to 116k on a 3-month moving average basis, which the market took as an indication of the loss in momentum in the US labor markets. However, the September data showed a sharp turnaround. US non-farm payrolls grew by 254k in September, prior months were revised higher, and the unemployment rate fell back to 4.05%. Moreover, this strong release was corroborated by higher frequency labor market data.



MSCI World Index, from 02.01.2024 to 01.10.2024
Source: MarketMap FIS

On the inflation side, the string of favorable US inflation reports continued. September core CPI indicated a year-on-year inflation rate of 3.3% for the headline figure. Fed Chair Powell had already highlighted progress on inflation and risks to the labor market in his early summer congressional testimony. For us, the key sentence in this testimony was: "Reducing policy restraint too late or too little could unduly weaken economic activity and employment".



The economic picture outside the US remains less favorable. China is plagued by a multi-year deleveraging process compounded by weak consumer and corporate confidence. The woes of Europe are illustrated by the recent German government downgrade to its 2024 GDP growth (to a 0.2% contraction). Most of the blame can be attributed to "structural problems" and will affect growth in the foreseeable future.

As to inflation, the favorable picture extends to Europe, where annual inflation is settling at 1.8% in September, according to the flash estimate. We acknowledge that the ex-food and

energy figure is less favorable (at +2.7% year-on-year). However, services inflation remains the main driver of the core rate, and ECB speakers have so far chosen to downplay it and accentuate the trend convergence versus the ECB target.

On September 18, the U.S. Federal Open Market Committee shifted policy and cut interest rates by 0.50 points, the largest reduction since 2007. This was a bold decision, as most observers were expecting only a 25 basis points move. The magnitude of the move reflects the Fed's response to the rising unemployment rate, and a return to their dual mandate (price stability and maximum employment) from a previous exclusive focus on inflation. The FOMC's updated projections indicate a desire to normalize rates quickly, with expectations for the fed funds rate to drop to 3.5% by the end of 2025.

This was certainly the most important, but by no means the only September central bank move. The European Central Bank delivered a 25 basis points cut on September 12, as widely expected. The policy language was cautious and focused on a data dependent meeting by meeting approach. In the projections, the horizon for the return to a 2% headline inflation is left unchanged, expected to occur during Q4 2025.

The Swiss National Bank eased timidly by 25 basis points on September 26. It could have done more considering a strong CHF and inflation projections converging towards an annual rate of 0.6% for the end of the forecast horizon. The modest size of the move was tempered by the adoption of an explicit easing bias and indications of an openness to foreign exchange market interventions.

The Bank of Japan passed the opportunity to continue its tightening process, and its

communication shifted to a more dovish direction. As the BOJ assessment on inflation and economic activity has not changed, we ascribe this dovish tone to the episode of high volatility in the JPY and Japanese equities of early August. Understandably, the monetary authorities are adopting a more cautious approach to the tightening process.

On September 24, the PBOC (China's Central Bank) announced a large and combined set of policy measures aimed at containing the deterioration in economic activity. These measures included a cut in the policy rate, a cut in the reserve requirements, and guidance on further policy easing measures.

A few days later, China added a fiscal component to this monetary easing. The details at this stage are sparse but the announcement is to be taken seriously as it emanates from the Politburo and is complemented, according to reports, by a capital injection into its largest banks.

The September barrage of monetary easing led to buoyant fixed income markets. 2-year yields in the US collapsed from 4.75% to 3.60% during the quarter and 10-year real rates declined from 2.00% to 1.60%. This performance was replicated elsewhere, e.g. 10-year Bund yields moved down from 2.60% to 2.10%.

As to spread markets, there have been no signs of any credit cycle taking hold during the tightening phase. Default rates remained low and stable in most categories. As global monetary easing gets under way, the risk of this credit cycle taking hold are further diminishing. Consequently, credit spreads ended the quarter at their lows.

Overall, stocks added to their H1 gains during the quarter. This advance can be explained by a

healthy profile of earnings growth and the anticipation and realization of monetary easing. Encouragingly, this time the advance was broad based. In the US equity market, leadership rotated out of tech stocks in Q3, as utilities were the top performing sector in the S&P 500, followed by industrials. The extent of the broadening of stock market leadership can be seen in the relative performance of the equal weight S&P 500 (+9.56%) versus the traditional market cap weighted index (+5.35%).



Oil prices ended the quarter lower at 72/barrel, pressured by a potential resolution to the production halt in Libya and the prospect of increasing OPEC+ supplies, as the group looks to scale back its voluntary production cuts. Some of this decline has since been unwound by middle east tensions.

In a major change of trend, the US currency lost around 5% on its trade weighted index during Q3. The repricing of US rates was certainly the driving factor behind this decline. The magnitude of the move has been accentuated

against the JPY (extreme positioning) and the CHF (safe heaven flows). After a strong first half (+13%) Gold rallied over Q3 by an additional 13%, as cyclical factors (Fed easing and USD weakness) added their weight to existing structural forces (central bank diversification and physical buying in emerging markets).



Gold Spot Prices in USD, from 02.01.2024 to 01.10.2024
Source: MarketMap FIS

Investment Outlook

To sketch out an investment outlook going into 2025, we are required to make a few distinctions:

- US versus the rest of the world,
- Economic fundamentals versus geopolitical risks.

The concept of "US exceptionalism" is being often discussed. It refers to the past 10–15 years during which the US economy has been able to:

- Outgrow the rest of the developed world in real terms.
- Achieve better productivity than the rest of the world.
- Sustain higher real rates than the rest of the developed world.
- Deliver corporate profit growth at a much faster pace than the rest of the world.

This has led to a sustained outperformance of US assets, and to a strong USD. This regime held through the various economic cycles that developed over the period.

It seems that in the medium term the key forces that have shaped this outcome are still in force, and perhaps even accelerating.

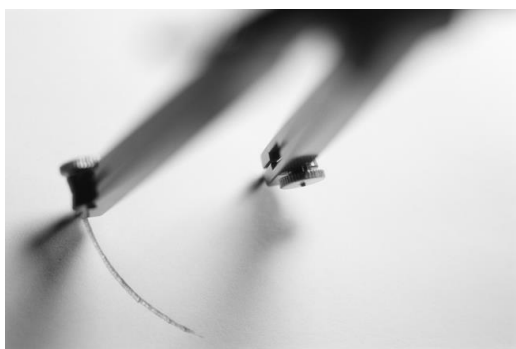
In general, developed markets appear on track to return to target inflation levels in 2025, driven by normalizing consumer demand. The Fed, like other DM central banks, is expected to realign monetary policy to this new cyclical reality.

If we look at US economic data in isolation, we are almost forced to conclude that, by luck or talent, the Fed is close to achieve a rare soft landing – moderating growth and inflation without recession.

This implies the following for our portfolios.

- We stay invested with a full allocation to diversified US fixed income assets. Forward rates have already discounted much of the expected easing. Consequently, we see no opportunity at present levels to add to this asset class overall. As far as credit spreads are concerned, we note that the market is reflecting a contracting risk premium, leading us to hold off from additional allocation to this segment. Emerging markets are a candidate for selective additions.
- We stay invested with a full allocation to equities (US and global, no China). This allocation reflects the top-down forces leading to a US soft landing and the bottom-up impressive margins performance of US corporates.
- Some of the possible outcomes of the US November elections are a source of

concern. We would expect markets to react negatively to the blanket imposition of tariffs on tradeable goods, to a large fiscal stimulus package or to increased regulations. On that basis, and not wanting to preempt the elections outcome, we have added downside hedges to our US equity position. We also chose to stay absent from Chinese equities despite the large scope of the monetary/fiscal package.



- As a rule, we have found it has been unhelpful to introduce geopolitical considerations into our investment process. We are following with concern the evolution of the middle east conflict and think our hedges could prove helpful also in this regard. The transmission mechanism to financial markets would operate through energy prices. Our analysis leads us to conclude that at this stage the overcapacity on the supply side means that any spike in oil prices would be short lived. We also expect our gold allocation to act to a certain extent as a geopolitical hedge.

Daniel Jakobovits
Head of Investments

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

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Mission Statement

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