FINANCIAL MARKETS DEEP DIVE

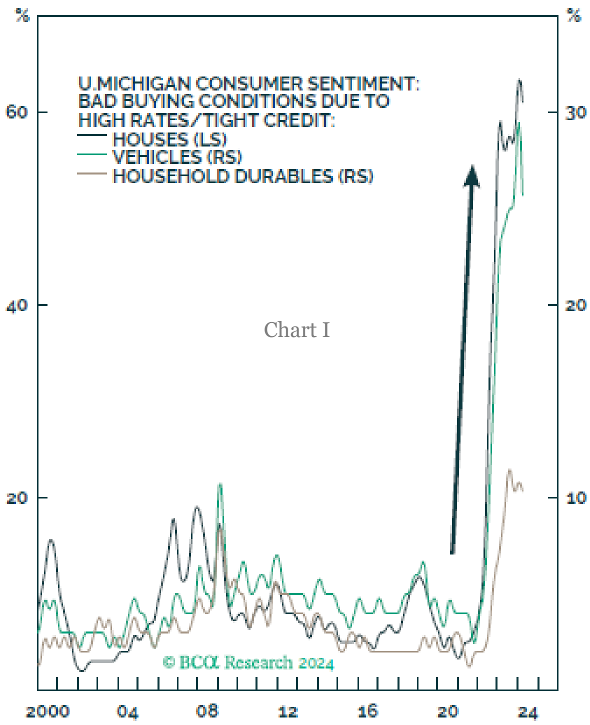
2024/October

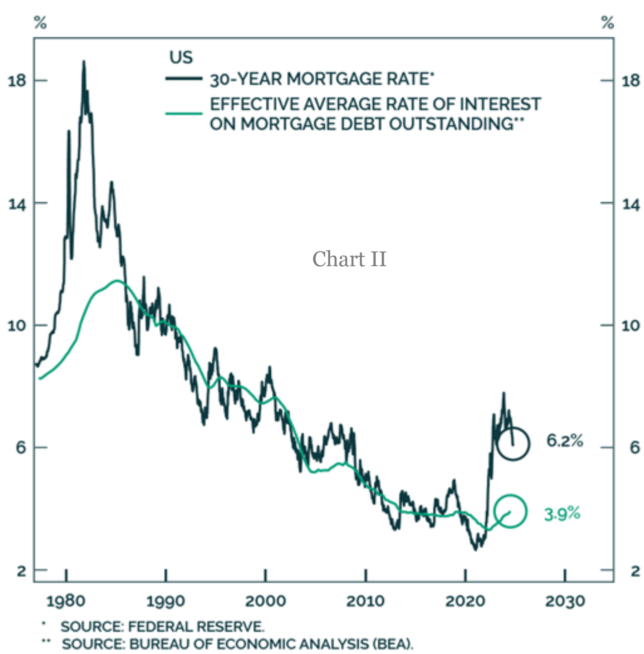
“The Fool in the Shower” – Milton Friedman, Nobel Laureate

ECONOMY: RECESSION PROBABILITIES RECEDING, BUT NOT ZERO

Imagine yourself taking a shower. The water is too cold thus, you turn on the hot water. After a few seconds (and a few shivers), the water is still cold. Irritated and chilled to the bone, you boost the hot water even more. Suddenly, and with little warning, the water is too hot, and you have burned yourself.

This metaphor was used by Milton Friedman in describing the delicate maneuvers central banks must perform when dealing with a mutating economy. Today’s environment is a perfect example. As we wrote in our latest monthly market commentary, the US economy is characterized by an indisputable resilience, driven by a healthy consumer base. Households leverage stands at very low levels and, despite the erosion of the pandemic-related fiscal stimuli, the recent increase in wages alongside falling inflation has ramped up consumers’ disposable income. All this feeds into the expectations that the US GDP will grow at above 2% annualized in 2024. Yet, at its latest meeting, in sharp contrast with the trend of domestic consumption, the Federal Reserve (FED) has decided to cut its reference rate by a whopping 50 basis points. What has prompted the FED to overlook the numerous and optimistic economic data reported?





As we have often observed, the current economic environment is complex and at times confusing. While consumption is holding up well, it is also true that both the lower-tier and middle-tier household are starting to bleed (Chart I). Firstly, while inflation is lower today compared to last year, goods are on average 20% more expensive compared to five years ago, while wages have by no means increased by the same amount. Secondly, the effective average mortgage rate is still low (3.9%), but new mortgages are issued at a rate above 6%, which is making purchasing a home for first-time buyers unaffordable (Chart II). Thirdly, interest rates on auto loans and credit card balances have skyrocketed, fueling a rise in the delinquency rates which now stand at the highest level since the great financial crisis. Luckly enough (?), this is clearly a bifurcated economy, where the top-tier income earners make up much of the domestic consumption. Thanks to very strong financial markets, this bracket of the population has been able to increase its wealth meaningfully, notwithstanding the steep rise in interest rates. The downside risk is that their marginal propensity to spend is low (i.e. increasing their disposable income will not drive consumption much higher) therefore little support should be expected from this segment of the consumer.

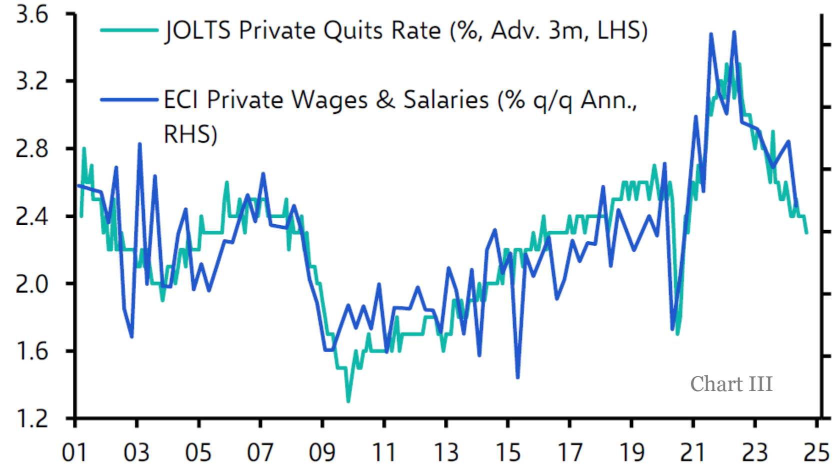


Chart III

The labor market may represent another warning signal the FED may have decided to tackle. The latter is clearly weakening from the peaks reached in '23 (Chart III). Admittedly, perception is at play here. One could argue that this is a simple normalization of what once was an overheated job market. The counterargument to this would be that, as history shows, once the labor market starts to weaken, it continues to do so until the economy falls into recession. Moreover, the number of people working multiple jobs hit a new record in September, with temporary workers rising at the expense of full-time employment. Is this a sign of something breaking at the margin? Evidently, the FED has decided to focus on this latter evidence.

What we would like to flag as a meaningful risk in the pursuit of avoiding becoming the fool in the shower is the fact that inflation, while under control, is still above the FED's target, and has recently shown little improvement; the common component of inflation, which measures true inflationary pressures, is still slightly above 3%. Certainly, within the walls of the Eccles Building in Washington, this fact did not go unnoticed.

In summary, we believe the probability of achieving a soft-landing has increased, but we still estimate the chances of entering a recession some time in 2025 as being non-zero. Interest rates have been high for some time, and the ability of the FED to lower them meaningfully is constrained by relatively strong consumption and an inflation rate that resembles a runner at the starting blocks, awaiting the gunshot. Indeed, the risk that this shower will turn out unpleasant for the FED is rising.

Elsewhere in the world, the situation isn't less complicated. In Europe, the economy has stagnated and is flirting with a recession (Chart IV), although the services sector is holding up well and the unemployment rate remains low. For once, Germany does not stand out for its ability to tow the rest of the region. Rather the opposite.

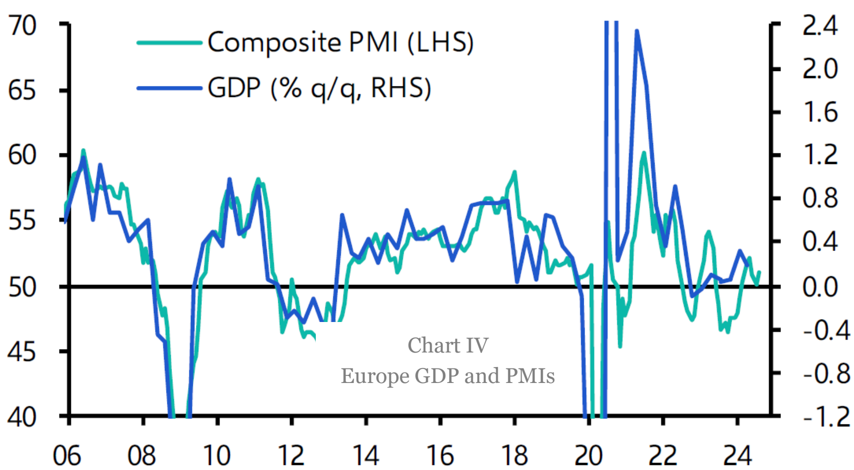


Chart IV
Europe GDP and PMIs

Inflation is falling, prompting the ECB to cut interest rates for the first time since 2016. Yet, as China continues to struggle with a shaky economy, and as the US may enter a mild recession by the end of 1Q'25, it is highly likely the European economy will follow suit.

Further east, the Chinese economy rebounded during the first months of the year, supported primarily by the services sector and less so by domestic consumption. Chinese authorities may have acknowledged they are experiencing Keynes' Paradox of Thrift, a situation in which people tend to save more money, thereby leading to a fall in aggregate demand of the economy as a whole. The recent monetary and fiscal stimuli will help the economy, but in a balance sheet recession more may be needed to sustain escape velocity.

FIXED INCOME: YIELD CURVES NORMALIZING

It is widely accepted in the financial industry that bond investors are smarter than equity investors; they tend to better predict the trends in the economic cycle and thus they correctly adjust their stance accordingly. This is a myth. Bond investors adjust their expectations according to new information, the same way as any other investor does. Otherwise, how do you explain the huge yield curve volatility we have witnessed since the FED started raising rates?

Another proof that bond investors face the same challenges as anybody else does, is to be found in the dichotomy between the yield curve inversion and its subsequent normalization, and the credit spreads of junk bonds. History shows that when the treasury yield curve inverts (i.e. long-term bonds yield less than short-term bonds) a recession materializes within the following couple of years. When the yield curve normalizes (from a state of inversion), the recession is upon us. Both phenomena have happened since 2022 hence, we should all brace for the worst. Yet, if you look at high yield credit spreads (the difference between the yield of junk bonds and that of US Treasuries), they stand close to all-time lows, hinting that there are no recessionary risks on the horizon (Chart V). This is, apparently, in sharp contrast with the rising number of corporate defaults. Admittedly, the beginning of the rate cutting cycle could bring some relief to the more distressed segment of the economy, alleviating the pain highly indebted companies are currently experiencing. But it all depends on the pace of the rate cuts and, as we discussed earlier, it is yet to be seen whether the FED will be able to press on the accelerator without risking overheating the economy.

The labor market may represent another warning signal the FED may have decided to tackle.

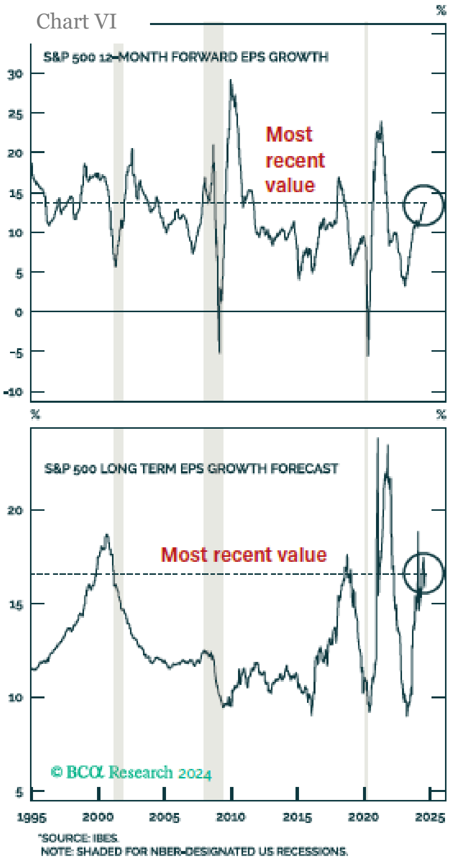
Thus, in this highly uncertain environment, and with valuations that are all but attractive, we continue to prefer sticking to the safest portion of the fixed income market. Investment grade companies offer strong balance sheets and a decent absolute yield. Admittedly, they are not cheap compared to historical averages, but the risk of negative surprises is rather limited. An exception we would like to make concerns subordinated bank debt. While this investment is classified as one of the riskiest in the fixed income space, and it does carry heightened volatility during times of stress, banks currently offer strong capital bases, coupled with valuations that are still attractive, and long-term returns that can satisfy even the most discerning tastes.

In terms of duration, the recent jump in long-term government yields, from the lows of 3.60% reached on the 17th of September to 4.12% (10th of October) represents a good opportunity for those that missed out on the government bond rally, to jump on the bandwagon and increase portfolio duration while locking-in a 4% annual return for the longer-term.

EQUITY: A *BOBO*-DRIVEN MARKET?

Dr. Hussmann, a very bright investor whose research we often read, once wrote: “I think we can all agree on two propositions. First, if enough speculators believe that stock market gains are driven by a tap-dancing squirrel monkey named Bobo, and Bobo starts tap-dancing, well, the stock market is going up, at least in the short run. Neither truth nor logic have anything to do with it. Second, because stocks are ultimately a claim on future cash flows, that must be delivered over time, higher starting valuations still mean lower long-term returns, which is why no speculative episode in history has ever ended well. Both of these propositions can be true at the same time.”

Chart VI



You may or may not see the resemblance of the current state of the equity market with Dr. Hussmann's short note, but this is less important, because it is highly subjective. On the contrary, what is utterly objective is the fact that, if you purchase equities today, at current valuations, your expected returns over the long term will be dismal.

The current equity rally may continue. Bubbles don't burst because of high valuations. Valuations simply amplify the magnitude of the fall. There is a lot of optimism among CEOs and analysts; the former expect to avoid a recession, while the latter see earnings growing above 10% for 2025 (Chart VI), backed by lower wages, rising pricing power, and falling interest rates (?). Moreover, the last earning season saw an improvement in the breadth of companies reporting positive results as mega-caps companies have given way to the rest of the market. A similar story is true sector-wise, with just materials and real estate posting negative earnings growth. Yet, underneath the surface, management communication regarding the health of US consumers is not euphoric; as we have outlined earlier, this is a bifurcated economy, which translates to lower-tier-focused companies such as Dollar General or Target hinting at increased suffering, while higher-tier companies such as American Express or Uber posting solid results. Consistent with our view that the probability of an economic recession taking place over the next quarters is non-zero, we continue to believe the fair value of the S&P 500 to be much lower (25% - 35%) than current levels, while mildly overvalued in the absence of recession.

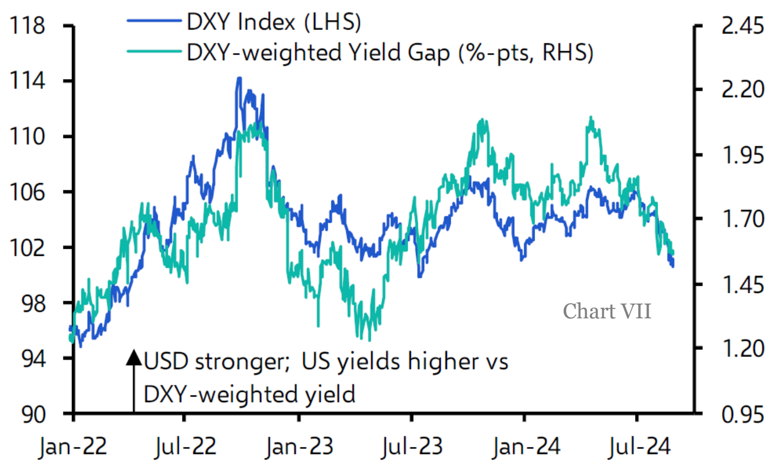
In Europe, companies are expected to enjoy a broadening improvement in earnings growth, backed by cost-cutting measures, lower wages, and lower energy costs. Services-led countries such as Italy and Spain helped compensate more capital-intensive regions, such as Germany and France, which are suffering due to endogenous problematics. Towards the end of the year, a slowing economy and tougher *comparables* will make further improvements difficult to achieve. However, both in absolute and relative terms, valuations of the European equity market are balanced, offering more downside protection vis-à-vis the US market.

Regarding China, which has recently hit the headlines given its highly volatile stock returns, we would like to refer to a comment written for the benefit of our colleagues early last week. Until a few weeks ago, when the monetary stimuli were announced, we weren't that thrilled, for the reasons outlined earlier in this note. To jumpstart the economy, a fiscal stimulus was needed, which now seems to be coming, from what we read in the Politburo minutes. That said, without further information, the incredible return of the CSI 300 Index (+32% in six trading days, followed by -9% in three) has already priced in a potential new beginning for the Chinese economy, as well as the possible disappointment from failing to live up to investors' expectations. While the Chinese equity market remains extremely cheap, and the recent news flow is certainly promising, more clarity is needed before taking a long-term investment view.

CURRENCIES AND COMMODITIES: A RESILIENT SWISS FRANC

During the recent quarter, commodity returns have shown a remarkable correlation (+8% since the lows of early August). Despite central banks having diminished their purchases amid very high prices, the expectations of falling real interest rates, increased apprehension regarding the multiple war fronts, and mounting concerns about the fiscal imbalances of major governments continue to support the yellow metal. Partially, an argument that can be applied to the energy market as well, where crude prices have rebounded meaningfully (+14% from the lows in early September) since the escalation between Israel and Iran. Oil will continue to act as a hedge against this shaky geopolitical environment. Similarly, also industrial metals have been on the rise, following the recent announcements in China. Yet, they may face some headwinds as the global economy slows down, with metals linked to the electric vehicle market pressured as the latter suffers from overcapacity and falling demand.

The quarter saw a meaningful depreciation of the USD, as short-term yield gaps moved further against the greenback (Chart VII). Only the latest economic data (a strong jobs report and higher than expected inflation) helped the dollar recoup some of the initial losses. Long-term, we continue to believe fundamentals will kick-in, and the greenback is set to depreciate significantly.



Outside of the United States, the Japanese Yen remains heavily undervalued, even after the recent rebound. The Bank of Japan is expected to continue raising rates, in a countertrend vis-à-vis other major central banks. On the other hand, if the US manages a soft-landing, the EUR appreciation has probably run its course, as the FED will not cut as much as investors currently price in. In Switzerland, the Swiss National Bank (SNB) just cut interest rates by 25bps and announced that further cuts may be necessary. However, the solid finances of the Swiss government, a strong economy, and the safe-haven role of the Swiss Franc will make it hard for the currency to depreciate heavily, unless the SNB intervenes with massive operations in the FX market.[1]

[1] Document sources: Capital Economics, BCA, 3Fourteen Research, Creditsight, Empirical, Vontobel, Factset, Refinitiv IBES, Hussman Strategic Advisors, Yardeni, Bloomberg.

OUR STANCE

Liquidity: Underweight ▼	**Bonds**: Overweight ▲	**Equities**: Underweight ▼	**Alternatives**: Underweight ▼	**Commodities**: Overweight ▲

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