September 2024

# MONTHLY HOUSE VIEWS

## THE FED SIGNALS POLICY EASING

### Macro

Citi's global economic surprise index fell steadily from April to mid-August, hitting its lowest level since October 2021, before staging a rally in the last few days of the month. However, the dip into negative territory has still not had any impact on 2024 GDP growth forecasts – indeed, economists revised estimates higher in July to 3.1%, their most optimistic forecast so far. Economic data remain mixed. Much of the bad news is in industry, especially in advanced economies where S&P Global's Purchasing Manager Index (PMI) for manufacturing has not crept above 50 points, the dividing line between expansion and contraction, since September 2022. On the other hand, their equivalent survey for services has strengthened steadily since dipping just below 50 last October. And in Asia, China's growth momentum remains flat at a low level, pulled back by the recession in property – sales contracted -15.4% in July.

### Central Banks

With no major central bank meetings scheduled for August, attention turned to statements from policymakers and in particular to the speech given by Jerome Powell, the chairman of the US Federal Reserve (Fed), at the Jackson Hole symposium in late August. In it, he expressed confidence that inflation was heading back to target and signalled a shift in focus towards the job market, stating that "the downside risks to employment have increased" and that so "the time had come" for rate cuts. By month-end, traders expected at least a -25bp rate cut at the September 18 policy meeting, if not -50bp. This would bring the Fed in line with the European Central Bank, Bank of England and Bank of Canada, which have all cut rates at least once this year. The exception to this dovish rule is the Bank of Japan, which is still expected to continue hiking rates.

### Markets

August continued a solid run of gains for the MSCI World index of global equities which advanced 2.5%, its ninth increase in the last ten months to reach a new all-time high at month-end. However, the record high came after a sharp -6.4% sell-off over the first three trading days of the month. The subsequent rally was broad-based with ten out of the eleven sectors posting positive returns, leaving only energy down for the month. Moreover, there was little difference between factors – Value gained 2.6%, closely followed by Growth which rose 2.4%. Hopes of impending rate cuts helped move bond markets higher with Bloomberg's Global Aggregate bond index up 2.4%, its fourth consecutive monthly advance, but did little to help the dollar index which fell -2.3%.

### Bottom Line

Our recommended equity allocations remain unchanged at modestly Overweight. Our suggestion in July to lock in some profits on US tech and internet platform stocks and to reinvest in small and mid-cap equities has helped rebalance portfolios away from the highly-valued Growth factor and towards undervalued segments which have lagged the broad market. Our geographic preferences remain unchanged, with the US preferred to Europe and Europe to Asia. Our allocation to US duration (i.e., sensitivity to changes in rates) remains at Neutral, while credit spreads (the difference in yield between corporate and sovereign bonds) tightened further – we suggest bond investors should remain selective.

Summary House Views

# OUR ASSET ALLOCATION

The tables below present the latest conclusions of our Global Investment Committee.

| Equities | Equity performance has pushed allocations into slightly Overweight territory. We continue to recommend investors strike a balance between Value and Growth. We prefer the US to Europe, and Europe to Asia. | + |
|---|---|---|
| United States | We have adjusted our US allocation to achieve a better balance between Growth and Value. Quality and Growth stocks have dominated this year's market performance, but their valuations are getting stretched. | + |
| Eurozone | The bear story for Eurozone equity markets is well-known. However, the markets are still cheap, still under-owned and still in an uptrend. | = |
| UK | Recent macro data in the UK has shown some improvement, and the equity market has begun to catch up with its neighbours. | = |
| Switzerland | The Swiss market is dominated by high-quality, defensive stocks, which should help cushion any downside, while inflationary pressures remain well below those suffered by its neighbours. | = |
| Japan | Recent strength in the yen against the US dollar could encourage investors to reassess the outlook for Japanese stocks which could in turn interrupt their bull run for now. | = |
| Emerging (EM) | The Chinese authorities have taken some measures to shore up domestic equity markets and Chinese stocks look cheap in light of expected earnings growth. | = |

| Fixed Income | Lower inflation readings, interest rate cuts and some worries about economic growth have helped bonds rally into positive territory for the year to date. However, we continue to prefer equities. | − |
|---|---|---|
| Sovereigns | As bonds have rallied, the yield curve has begun to normalise, shrinking the difference between 2 and 10-year yields. However, any sign that inflation might prove sticky could push 10y yields higher again. | − |
| Duration | We have now rebuilt a Neutral allocation in duration which has both reduced our Underweight compared to the market and provided a hedge against macro weakness and Fed easing. | = |
| Inflation-linked | Inflation-protected securities tend to have very high duration, making then extremely sensitive to small shifts in inflation expectations. | = |
| Investment Grade | Elevated policy rates and inverted yield curve have created some buying opportunities in short-dated high-quality corporate bonds. We remain Underweight nonetheless. | − |
| High Yield | Credit spreads have tightened to unattractive levels, especially if growth weakens. Investors should remain very selective given the potential for a deterioration in credit quality. | − |
| Emerging debt (in € and $) | In recent months, we have warned that political risk in Latin America required careful monitoring. The reaction to June's presidential elections in Mexico underlined this point. | = |

↗ Upgrade ↘ Downgrade + Overweight = Neutral − Underweight

| Commodities | Although the long-awaited recovery in China will eventually boost demand for raw materials, worries about a slowdown in advanced economies in H2 lead us to keep allocations to commodities at Neutral. | = |
|---|---|---|
| Energy | With OPEC+ cutting output and oil majors reluctant to invest in new production capacity, crude oil supply is constrained. However, fears of economic slowdown in the west have kept prices rangebound. | = |
| Industrial metals | The key driver for industrial metal prices will be Chinese demand once the economy finally picks up. We also continue to highlight the attractions of transition metals like copper. | = |
| Precious metals | Central bank demand for gold remains strong and bullion continues to provide useful diversification benefits in terms of portfolio construction. | + |

| Currencies | The dollar index has reached the low end of the wide trading range where it has been stuck since late 2022. After tumbling -2.3% in August, the index is only 0.4% higher than at the start of 2024. | | |
|---|---|---|---|
| EUR/USD | With the European Central Bank (ECB) and the Federal Reserve (Fed) both set to cut rates, the euro looks set to exit its pennant technical formation to the upside. | ↗ | + |
| GBP/USD | The UK's growth outlook has begun to improve despite its structural weaknesses, and the strong majority won by Labour means the country faces little political uncertainty over the next few years. | ↗ | + |
| EUR/GBP | Both currencies face numerous challenges, and the advantage conferred by the Eurozone's better budget discipline is offset by sterling's higher rates. | | = |
| USD/JPY | Global investors began to unwind some of their "yen carry trades" (constructed by borrowing in yen to invest in higher-yielding assets in foreign currencies), which could mean further upside for the yen. | ↘ | − |
| EUR/CHF | After weakening sharply from January to late May, the Swiss Franc commenced a rally which has taken it back to January's levels, despite the likelihood of further SNB rate cuts. | | = |
| Emerging | EM currencies have tracked generally sideways against the US dollar in recent months and could begin to build a base for recovery from their recent all-time lows. | ↗ | = |

↗ Upgrade ↘ Downgrade + Overweight = Neutral − Underweight

Economic Outlook

# IS EUROPE'S PESSIMISM JUSTIFIED?

With armed conflict on its borders, energy supply difficulties, grid-locked domestic politics and extremely sluggish economic activity, it is easy to be negative about Europe. Is this pessimism justified? And what is the outlook for the region's financial markets?

Much of the weakness in the Eurozone economy is concentrated in the industrial sector and in manufacturing in particular. One of the best gauges of confidence among manufacturers is S&P Global's purchasing manager index (PMI) survey, which has been stuck in contraction territory for over two years and shows little sign of recovery.

Worryingly, it is the region's largest economies which are dragging Eurozone manufacturing confidence lower. In Germany, the IFO Institute's current assessment of business confidence hit its lowest level in August since the 2008-2009 Great Recession and 2020's pandemic-driven slump. And in France, the INSEE manufacturing sentiment index has been declining steadily since January 2022.

Luckily, services businesses see a very different environment. August's services PMI survey recovered from July's dip, no doubt helped by a big boost from the summer Olympics in France, and has been solidly in expansion territory for seven straight months. Activity in the services sector has been supported by a robust job market – the unemployment rate in the Eurozone fell to its lowest level on record in July. Moreover, consumer confidence has recovered steadily in recent months to its highest level since February 2022, just before Russia invaded Ukraine and sentiment plummeted, while the consumer savings index sits close to its highest level since early 2010.

The final revision of the Eurozone's Q2 GDP showed quarter-on-quarter (QoQ) growth revised down from 0.3% to 0.2%, continuing the sluggish series commencing in Q4 2022. The region's cumulative growth over the past seven quarters has only been 0.6%. Moreover, Q2's growth was pulled lower by household consumption which fell -0.1% QoQ. Investment was also a drag – gross fixed capital formation reduced Eurozone growth over the quarter by -0.55 percentage points (pp).

Given this backdrop, the publication of Mario Draghi's Future of European Competitiveness report was very timely. In it, Draghi painted a bleak picture of the European Union's prospects. He highlighted the wide gap in GDP which has opened between the EU and the US, stressing that real disposable income per capita has grown twice as fast in the US since 2000. He went on to note that the foundations on which Europe built its prosperity are being shaken – world trade growth will slow under the weight of deglobalisation; the region has lost its prime supplier of cheap energy, Russia; the EU has largely missed the boat on digital innovation and its attendant productivity gains; while the post-cold war peace dividend has evaporated and geopolitical tensions are on the rise. He wrote, "never in the past has the scale of our countries appeared so small and inadequate relative to the size of the challenges".

Of course, the report also contained a raft of policy proposals to address these challenges. Draghi proposed to raise EU investment by between €750bn and €800bn per year to finance the necessary reforms. Such an amount would be equivalent to between 4.4% and 4.7%% of EU GDP, the highest level in more than 50 years and dwarfing the 1-2% of GDP invested via the Marshall Plan between 1948 and 1952. It would take the investment share of GDP from 22% to 27%, the highest level since the post-war years.

Not surprisingly, Draghi's plan will meet stiff political opposition from key member states. Many countries face severe political fragmentation – for example, the new French government led by Michel Barnier is not backed by a solid parliamentary majority while Otto Schulz's hold on power looks weakened by the far right's first victory in a German state election in the post-war era. And the initial reactions to Draghi's report were hardly encouraging. Germany's finance minister took to Twitter to state that "joint EU borrowing will not solve structural problems", a sentiment echoed by his Dutch counterpart who opined that "more money is not always the solution".

The myriad problems faced by the EU have long been clear to voters and investors – the Draghi report only serves quantify some aspects of the challenges in a rigorous analytical framework. Its great merit lies in his willingness to envisage unpalatable solutions. Obviously, many proposals will prove unimplementable in the near term. But we should not forget that the €750bn worth of Next Generation EU bonds, which were introduced in July 2020 to finance member states' recovery from the COVID-19 pandemic, would have been unthinkable only six months before. Moreover, the external geopolitical pressures which the EU faces (ranging from the war in Ukraine to energy security to trade tensions with China) all argue for greater integration and cooperation, not less.

### Bottom Line

For many investors in equities, Europe has been a structural underweight for many years. It is not surprising that European equities trade at such a massive discount to the US – the trailing earnings multiple stands at 14.4x versus 24.0x in the US according to MSCI indices. However, although a valuation discount is clearly appropriate, we would caution against being too negative on Europe – according to Bloomberg, analysts have revised their earnings forecasts for the next twelve months up to 7.3% for the EUROSTOXX index, less than the 14.0% expected for the S&P 500 index but respectable growth nonetheless.

# EQUITIES

The MSCI World index of global equities ended last month at a new all-time high, after recovering from a -8.2% drawdown between mid-July and early August. The rally was broad-based across factors – Quality and High Dividend Yield led the way with jumps of around 3.5% while Value, Growth and Momentum were all close behind with gains of around 2.5% over the month. For the second straight month, the very largest global companies lagged the broader market – the Magnificent Seven index of the biggest US tech and internet platform companies shed -0.5% in August. However, smaller companies also underperformed – the MSCI World Small Cap index gained only 0.4% last month. At the regional level, Europe outperformed the US again (3.7% versus 2.3% on the MSCI indices) while emerging markets lagged with a 1.4% monthly return (all data in dollar terms).

US . Participation in the rally in US equities broadened in August after an initial dip, with the proportion of stocks trading above their 50-day moving average (DMA) hitting 82% at month end, the highest level since end March. In terms of factors, there was little to choose between MSCI's indices – Quality led the way with 3.5%, followed by Momentum and Value which returned 2.8% and 2.7% respectively with Growth bringing up the rear with 1.9%. Despite the weakness in the Magnificent Seven, technology managed a 1.3% gain. Indeed, out of the eleven sectors, only consumer discretionary and energy fell on the month, down -0.7% and -2.3% respectively. Interestingly, the S&P500 index and its equal-weighted version both returned 2.3% in August, suggesting a broad-based rally. However, the rally did not extend to small caps – the S&P Small Cap 600 index fell -1.6% last month.

The rally in stocks since last October has pushed S&P 500 valuations up from 19.1x trailing earnings to 24.2x. At these levels, hopes are high that analysts' optimism will prove well-founded – currently, they expect S&P500 index earnings to grow by 13.8% over the next twelve months according to Bloomberg, which would be the best performance since the 9.9% jump in earnings in Q1 2022. Already, Q2 earnings came in 5.1% above expectations, taking year-on-year earnings growth to 11.6% on revenue growth of 5.3%. This has kept the trailing valuation premium over European stocks at 9.5 percentage points on MSCI data, well above end October's 7.9 points. This premium cannot fully be explained by the market-dominant valuations of the Magnificent Seven stocks – the valuation premium of US tech stocks over their European peers is one of the lowest among sectors at 14.4%, well below consumer discretionary and financial stocks, which are 100.0% and 74.6% more expensive respectively. The same holds true for factor indices – according to MSCI, US Growth stocks trade at a 41.9% premium to Europe and US Value 78.1% higher. We continue to call for a blend of Growth and Value stocks in portfolios.

Europe . Investors have long been bearish on European equities. It has to be said that the geopolitical backdrop remains worrisome – the war in Ukraine continues to drag on while Israel's war with Hamas has spilled over to the broader region. Moreover, Houthi attacks on cargo ships in the Red Sea continue to disrupt supply chains, adding to inflationary pressures on the key Asia-Europe freight route. In addition, investors continue to shy away from European equity funds – according to EPFR, redemptions since the start of this year now total -$32.9bn. Moreover, Citi's Economic Surprise Index remains close to its twelve-month lows. Nonetheless, equity analysts are becoming more optimistic – according to Bloomberg, they now expect 6.2% growth in 2024 MSCI Europe earnings over the next twelve months. Finally, European equity markets continue to perform satisfactorily – over the past two years, the STOXX 600 index has provided a net total return of 33.4% versus 32.9% for the S&P 500 in euros.

In valuation terms, European equities continue to look cheap compared to history and to other markets, notably the US. As highlighted above, the MSCI Europe index trades at 14.9x trailing earnings versus 24.4x for its US counterpart. Moreover, European stocks are expected to pay investors a handsome 3.4% dividend yield in 2024, more than twice the forecast 1.3% yield on the MSCI US index.

Emerging Markets . The main emerging regions performed in line with each other last month – Latin America led the way with a 1.8% advance followed by Eastern Europe and Asia, up 1.6% and 1.5% respectively. In LatAm, Argentina led the way with a 11.7% surge followed by Brazil which jumped 6.5% - the region's performance was dragged lower by Mexico which dropped -7.6% on the back of a -5.6% fall in the peso against the US dollar. Across Asia, performance was mixed. Indonesia stood out with a 10.8% jump while South Korea eased -1.1% lower. Finally, regional heavyweight China underperformed the region as a whole – the CSI300 index fell -1.8% in August, its third decline in the last four months (all data in dollar terms).

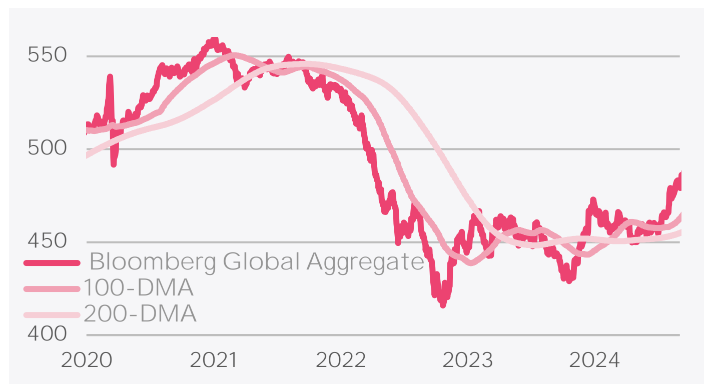
Factors . Value stocks outperformed Growth for the second straight month according to MSCI's factor indices. As is to be expected, earnings forecasts for Value are modest – the consensus expects only 8.3% growth over the next twelve months versus 22.0% for Growth. But this is reflected in valuations – global Value stocks trade at 15.5x trailing earnings versus 32.9x for Growth.

### Bottom Line

Our Investment Committee has decided to keep equity allocations unchanged for now, at a modestly Overweight allocation to stock markets. Our geographic preferences remain unchanged, with the US preferred to Europe and Europe to Asia. The discrepancy between Value and Growth has become extreme and we reaffirm our suggestion to take some profits in megacap tech stocks and to add to holdings in small and mid-caps.

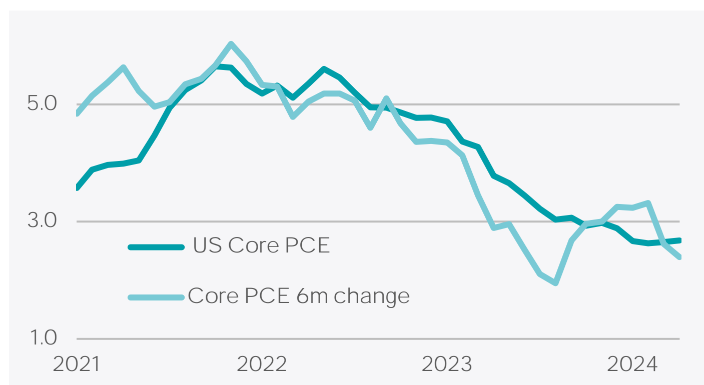
# FIXED INCOME

Bloomberg's Global Aggregate bond index rose 2.4% in August, its fourth consecutive monthly advance, ending the month up (+1.9%) for the year so far for the first time this year. As illustrated on the chart below, the index has commenced a pattern of higher highs and higher lows since its -25.7% swoon between January 2021 and October 2022.



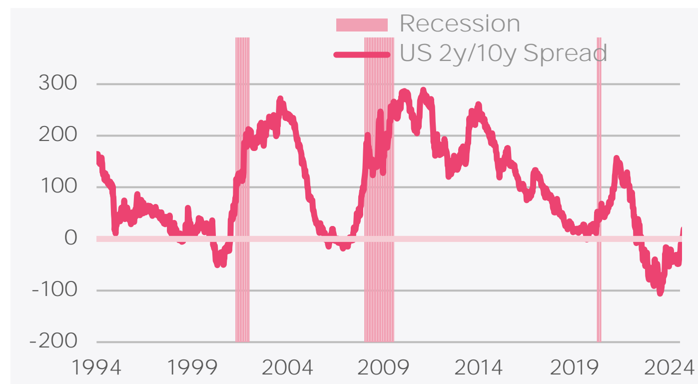

*Source: Bloomberg*

US . Economic indicators are deteriorating but are not yet at alarming levels. More importantly perhaps for the bond market, inflation figures continue to come down, most notably the 3m and 6m annualised data.



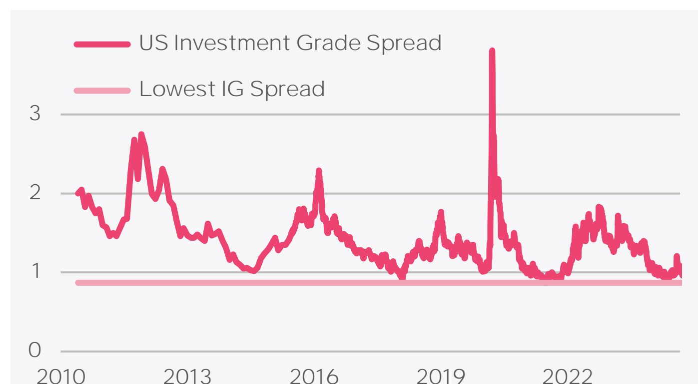

This has bolstered central banks' determination to cut rates. The Federal Reserve (Fed) has clearly indicated its determination to ease policy at its mid-September meeting, while the European Central Bank (ECB), Bank of England and Swiss National Bank are likely to cut further before year-end.

Two-year (2y) Treasury yields – which are very sensitive to rate cut expectations – have fallen much faster than 10y yields. This has caused the yield curve – the difference between short-dated and longer-maturity yields – to begin to normalise. As a general rule, 10y yields tend to be higher than 2y rates as investors demand additional compensation for the uncertainty regarding future inflation trends. However, after remaining inverted since July 2022, the US 10y2y curve has narrowed to only -2bp, well above the troughs at over -100bp it reached on 2 instances in 2023. As illustrated on the chart below, the return to a positively sloping yield curve after previous inversions has tended to prefigure economic downturns. Economists and bond traders will pay particular attention to macro data on coming months,




*Source: Bloomberg*

Credit . Despite economic indicators having rolled over and the yield curve having normalised after its lengthy inversion, which often points to a recession, we also see positive signs for corporate bonds (credit) as a whole. While there are some borrowers who are clearly unable to withstand higher rates, the credit market has deleveraged in aggregate. This trend has been helped by the strong nominal growth since the pandemic which enabled many companies to reduce debt and/or push back maturities. The ample liquidity in the financial system also helps, as witnessed by the very high amounts of cash on households' balance sheets.




*Source: Bloomberg*

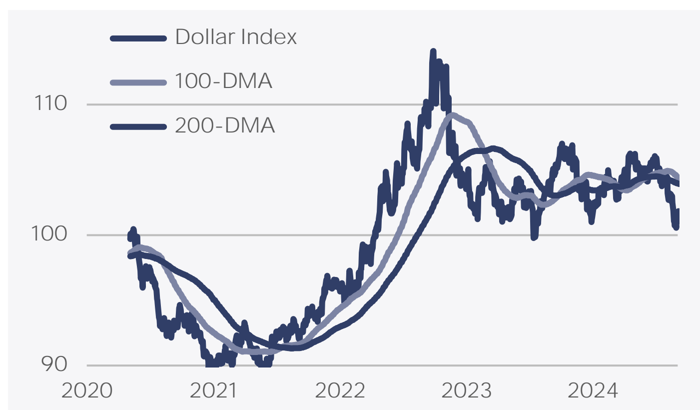
**Bottom Line**

Although we remain defensive overall in our fixed income allocations, with a clear focus on high quality credit, we maintain a Neutral allocation in duration given the possibility of some economic weakness in coming months.

# CURRENCIES

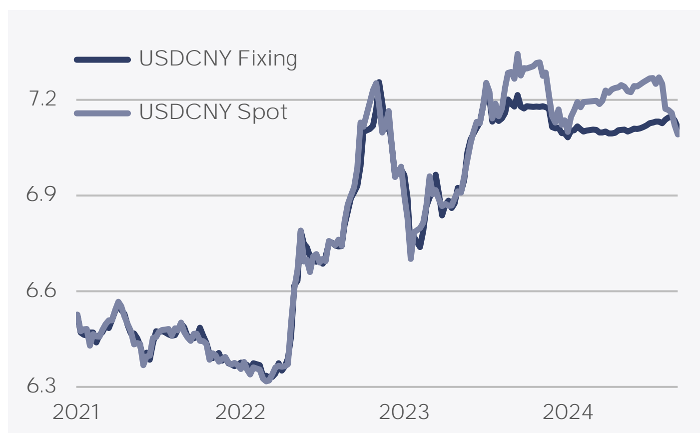
Since late 2022, the dollar index has been stuck in wide trading range. After tumbling -2.3% in August, the index is only 0.4% higher than at the start of 2024.

USD . The dollar did not perform well over the summer months. The Fed chair Jerome Powell confirmed market hopes that rate cuts are imminent when he spoke at the Jackson Hole symposium in late August, which will narrow the interest rate differential between the Eurozone and the USA. The impending shift in the cost of carry appears to be the main driver behind recent dollar weakness.




*Source: Bloomberg*

CNY . The renminbi also strengthened significantly in August, gaining 1.9% against the dollar. Such moves in CNY often have an impact on other currency crosses given the China's importance in international trade flows. Although we did not expect this sudden rally, we have often warned in the past that divergences from China's mid-point fixing rate can correct rapidly, which is what happened over the summer.




*Source: Bloomberg*

# COMMODITIES

Global spot commodity prices fell -2.7% in July, their third decline in the last four months, pulled lower by sharp weakness in energy prices.

Energy . Brent's recovery from May's sharp -7.1% tumble proved short-lived, and prices fell another -2.4% in July, taking year-to-date performance to only 2.3%. Brent is still stuck in the broad trading range between $75 and $90 per barrel (/b) which has been in place since January but weak macro data from China and rising US unemployment mean that risks are to the downside. This helps explain why the OPEC+ cartel announced in early September that they would delay the modest output increases they decided in early June in order to stem further downside in crude prices. Even after the increases kick in, potential supply equivalent to between 3.2% and 5.7% of global demand will remain offline until end-2025.

In its August report, the International Energy Agency (IEA) forecast that strong output growth from non-OPEC producers this year will help compensate for these OPEC+ curbs, pushing world crude production up 0.73mb/d to a new all-time high at 102.9mb/d. On the demand side, the IEA kept its 2024 forecast for global oil demand growth largely unchanged at 0.97mb/d, leaving this year's total estimated demand at 102.8mb/d. With supply and demand close to equilibrium and both at all-time highs, we would expect OPEC+ to continue to adjust output so as to keep crude oil prices within their trading band for the rest of the year.

Gold . Gold prices rose 2.3% in August, after hitting a new all-time high at $2'525 per ounce just before month-end, taking year-to-date performance to 21.3%. Central banks, notably in emerging markets, have emerged as a significant source of demand as they seek to diversify their foreign exchange reserves away from G7 currencies. This year's buying up to end-July has totalled 220 tonnes (t), led by Turkey, India and Poland which have each bought more than 30t so far this year.

At long last, retail and institutional investors have begun to participate in the bull market, as witnessed by flows in gold exchange-traded funds (ETFs). The last four months have seen uninterrupted inflows to gold ETFs totalling 101.9t, which has reduced total outflows over the past twelve months to -158.1t. However, the strong rally in gold prices means that assets under management in gold ETFs ended August at an all-time high of $257.3bn, up 20% year-to-date. Also of note was a bounce in buying from India – with China, one of the two main gold markets – in the wake of a -9.0% cut in gold import duties, which lowered prices thereby boosting demand.

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