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WEEKLY ANALYSIS

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POSITIVE TREND FOR US EQUITIES

Slower GDP growth in Q1. A soft landing is emerging. Decline in leading indicators. Employment is finally deteriorating. Consumption expected to fall. Inflation will slip below 5%. The Fed will pause. Weakening of the dollar. Opportunities in the capital markets. Positive outlook for equities.

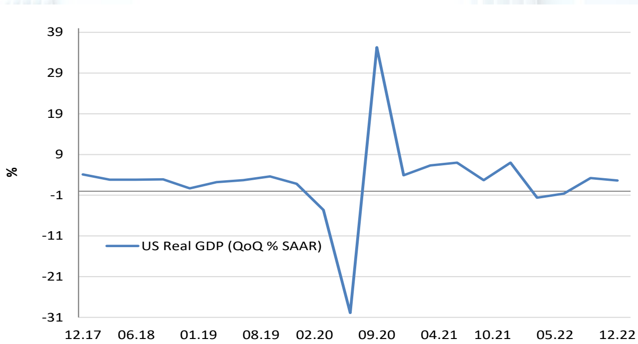
Key points

- A solid year-end will give way to a soft landing
- Q1 2023 will still be positive
- Temporary decline in US momentum
- Decline in leading indicators
- Employment statistics are finally deteriorating
- The Fed should take a break
- Inflation will be below Fed funds in June
- Yield curves adjust downward
- Further decline in the dollar forecast
- Outlook for equities remains positive

A solid year-end will give way to a soft landing

The US economy ended the year 2022 with solid GDP growth of nearly +2.6% annualized, above economists' expectations, although slightly down from the momentum of the third quarter. The personal consumption was a major contributor to this positive development with growth of +2.1%, but in fact it remained on a similar trend to that of previous quarters. However, this increase certainly masks some difficulties for consumers to maintain their spending levels, while wages did not grow at the same pace as inflation. A loss of momentum is being temporarily held back by the use of excess household savings built up during the pandemic period. This situation is expected to deteriorate in the coming months and weigh on the growth outlook. It should also be noted that inventory building accounted for almost half of the increase in GDP, which from our point of view is not a very positive sign for the coming quarters, as it rather suggests weaker demand than expected by companies. The latter should certainly reduce their production in the coming months in order to adjust to it, as we are already seeing in the unchanged industrial production figures for January and February. Meanwhile, the Federal Reserve has continued to raise its key interest rates to counter inflation, causing a sharp rise in financing costs and a deterioration in credit conditions, including in the real estate and industrial sectors. The reactions have been quite rapid, particularly in the technology sector, which has proceeded with fairly massive layoffs, which are now beginning to show up in the figures for new applications for unemployment benefits, and with reductions in investment. The central bank's priority is still to fight inflation, despite the positive developments underway, but if inflation is already in a clear deceleration phase, it also seems that the tightening of credit conditions is already affecting the growth prospects of the main segments of the economy and very clearly those of household consumption, the main component of US GDP. We believe that a soft landing is already taking place and that the slowdown will be noticeable as of the first quarter of 2023, with growth reduced to around +1%.

Quarterly GDP growth - United States



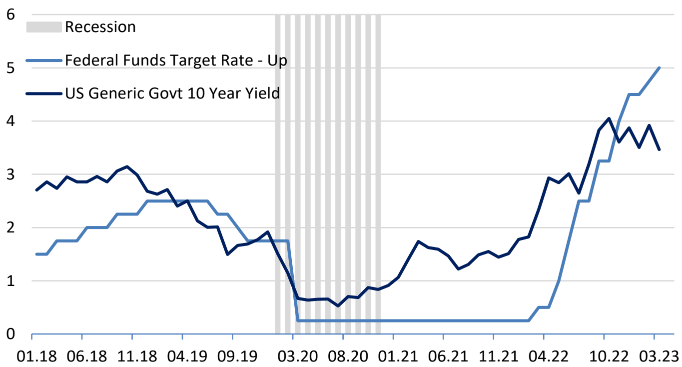
Sources: Bloomberg, BBGI Group SA

Q1 2023 will still be positive

US GDP growth should therefore be close to +1% in Q1, which will certainly prove to be the last before a more marked downturn in the economy, which will materialize over the next two quarters (+0.2% and then -0.5%), before a probable recovery at the end of the year.

US households have resisted the rise in rates and inflation by using their savings, but they will not be able to continue this strategy for long, although it is estimated that the decline in household savings could theoretically continue for some time before it is halted by the current 1.4 trillion in reserves that can still be deployed.

US recessions, Long rates and Fed funds



Sources: Bloomberg, BBGI Group SA

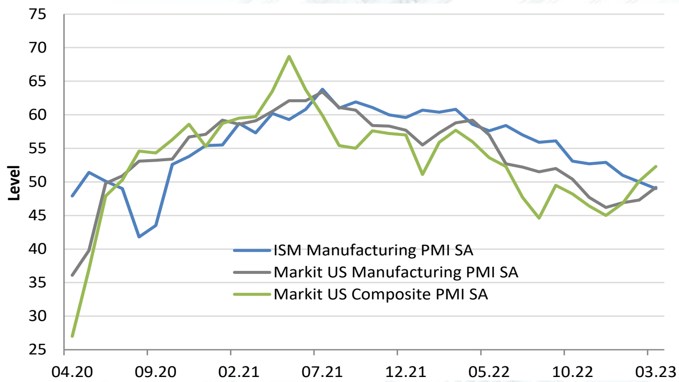
Temporary decline in US momentum

The no landing scenario for the US economy, which had surprisingly taken hold during the quarter on a temporary rebound in inflation and job creation, will not withstand the banking crisis and its possible implications for the evolution of credit. The Fed's monetary policy is adjusting by injecting more than 500 billion in liquidity and considering the end of its monetary tightening cycle in March 2022. In the face of rising rates, the US consumer had largely dipped into his savings by 2022 and has maintained his spending since then thanks to the increased use of credit. We doubt that they will be able to cope for long with the rise in financing conditions before they are forced to adjust their consumption. The decline in purchasing power is now a fact and is beginning to bite on confidence and retail sales. On the investment side, companies seem much less willing to make new equipment purchases in the face of growing economic uncertainty. A clear economic slowdown seems increasingly likely in the coming months. However, positive developments on the inflation front should help to lower interest rates and mitigate the recessionary effects of the banking crisis. However, the economic downturn should remain moderate, and our outlook for the first half of the year is +0% to +0.5% and +0.5% to +1% for the whole of 2023.

Decline in leading indicators

The rebound in the PMI indices continues with the manufacturing segment recovering in March (49.2) from its December lows (46.2), but it is still very uncertain, while the services index, down slightly from 53.8 to 52.6 over the month, remains well above the growth threshold. The composite index slipped slightly over the month, but also remained in the positive zone with a level down from 53.3 to 52.3. In March, the ISM indicators also fell sharply from 47.7 to 46.3 for the manufacturing sector and from 55.1 to 51.2 for services. The new orders component fell a sharp 10 points, from 62.6 to 52.2, indicating a likely slowdown in the coming months.

PMI-ISM indicators

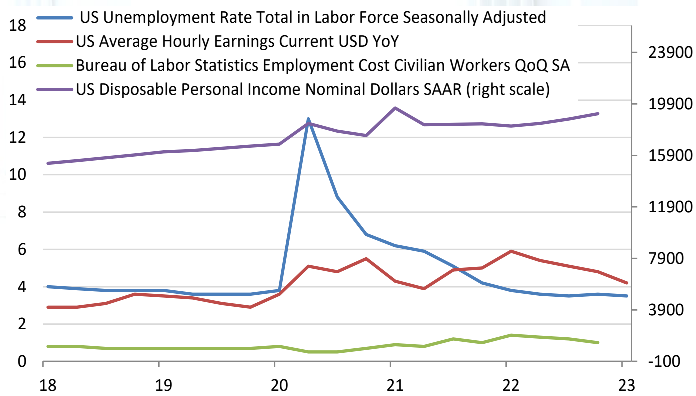


Sources: Bloomberg, BBGI Group SA

Employment statistics are finally deteriorating

Unemployment claims have been rising steadily since the end of January almost every week and now average 240,000 new claims, significantly higher than the September 2022 low of 180,000. This reflects the layoff announcements made at the beginning of the year, which are only now gradually coming on stream. This confirms that the labor market is weakening with the decline in economic activity. Job openings have also contracted significantly below 10 million after peaking in March 2022 at 12 million. These developments should satisfy the Federal Reserve, which was recently concerned about the risks that a tight labor market could pose to wage and inflation trends. We believe that US companies will continue their efforts to adjust their costs through the employment variable in order to protect their profit margins and results during an economic slowdown.

Unemployment rate, Income, Labor costs, Wages



Sources: Bloomberg, BBGI Group SA

Inevitable slowdown in consumption

Household confidence remains hesitant, perhaps improving on the back of declining inflation as measured by the Conference Board, but declining according to the University of Michigan survey driven by declining real household income. The labor market will not be of much help in our view to support further improvement in sentiment, which will more likely depend on lower financing costs, interest rates and credit. Rising interest rates ended up pushing credit growth down to 15.3 bn in February, significantly less than the 19.5 bn increase in January. In this difficult environment, consumers often had no choice but to dip into their savings and increase their debt levels by using their credit cards more than usual. The increase in credit card rates above 20% is now slowing down consumers' desire to maintain their consumption through the use of credit cards. As a result, consumption is only up +0.2% in February, while real personal consumption is down -0.1%.

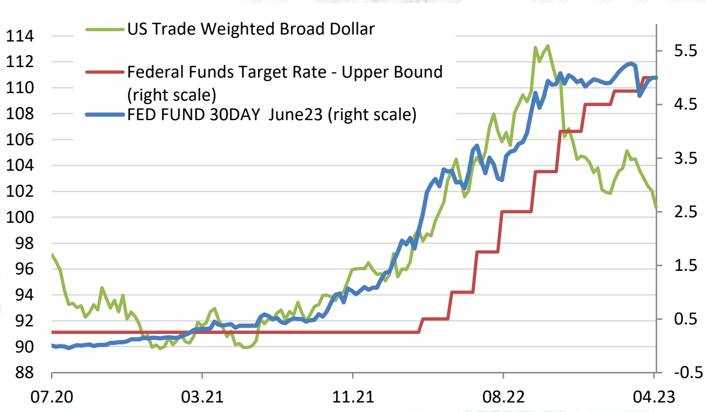
The Fed should take a break

The publication of a rebound in inflation in the United States in January to +0.5%, followed by an extraordinary figure of job creation of 517k, well above expectations of 189k, had together set off the fire. The central bank was quick to confirm that if the economy continued to be very strong, it would not hesitate to raise its key rates longer and higher. An abrupt change in the scenario appeared, causing a 100 bp adjustment in Fed funds rates for December 2023 to 5.6% in particular, which was accompanied by a similar movement in short-term yields. All yield curves adjusted upwards, without considering that this scenario was unlikely to materialize. The US economy was far less resilient than the lagging data on the job market or rents suggested. While the economic slowdown seemed increasingly clear in many other economic statistics, general sentiment remained affected by negative expectations of a monetary policy that was ultimately more permanently restrictive than previously expected.

The banking crisis at the beginning of March brutally reinforced the prevailing uncertainty and caused a wave of panic for a few days, raising fears that a new systemic situation similar to the one in 2008 could seriously threaten the sustainability of the international financial system. It only took a few days of panic to push the Fed and the US government to adopt a resolute stance in which they reaffirmed the soundness of the banking system while completely reversing the policies they had previously stated. The Federal Reserve reassured investors and savers by providing all the liquidity necessary to avoid any systemic risk of contagion from the SVB bankruptcy, making the Fed's balance sheet jump by 500 billion, or about 6%, in a few days and thus putting an end to its QT strategy. This latest episode of inflating systemic risks is still far from having developed all its effects in the medium term, but in the short term the result is clear: key rate expectations have massively readjusted to this new environment.

Fed funds rates for December have fallen by 150 bps, with June Fed funds now below the current 5% policy rate, implying an expectation that the Fed will cut rates in the coming months already. This is now a new paradigm for monetary policy, which is perceived to have already reached its zenith and is close to an easing phase in the US. The Fed is now expected to refrain from raising rates before easing further, perhaps at the end of the year, if the economic slowdown proves to be more severe and deeper than expected.

Fed funds, Key rates and USD Trade Eeighted



Sources: Bloomberg, BBGI Group SA

Inflation will be below Fed funds in June

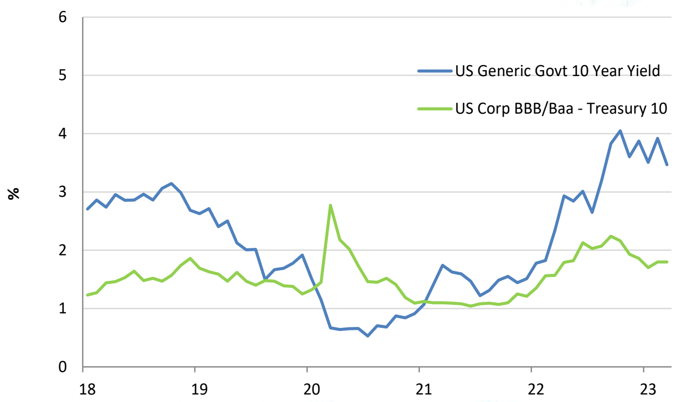
Reported inflation for March in the US fell from +0.45% in February to just +0.1% for the month, which implies a drop from +6% for the annual CPI in February to +5% in March. Inflation is falling significantly and is returning to an increasingly satisfactory monthly pace. The price index excluding food and energy is not yet showing the same momentum, but it remains at +0.4% on a pace of about +4.8% annual. Among the elements that are still resilient, we find almost exclusively the rents component, which is holding back the general downward trend somewhat. However, it should be noted once again that this component is totally lagging, as it measures the overall level of all rents. It seems very likely to us that it will follow the already visible downward trend in prices observed in the new rents sub-segment. The expected gradual decrease in inflation to an acceptable level is therefore, in our opinion, still fully underway. Moreover, the evolution of producer price indices is already down by -0.1% (excluding food and energy). Inflation therefore seems to be following the expected trend and should soon fall back below the June Fed funds level (5%) and even below the September level (4.8%).

Yield curves adjust downward

Bond yields in the United States have adjusted extremely quickly to the change in the situation regarding the Federal Reserve's upcoming monetary policy. The bank failures of the last few weeks have directly and indirectly affected financing conditions and the psychology of savers. While the government and the central bank have reacted quickly enough to control the situation and avoid any immediate systemic type slippage, all the effects of this banking crisis are not yet really visible and may take time to materialize. The central bank would be well advised to consider the risks that it may still represent on access to financing and on the indirect tightening of monetary conditions and therefore on the risks of a cyclical shock. We believe that this situation is conducive to the end of the QT and the rate hike cycle and that this will have a significant impact on the upcoming evolution of the US yield curves. A decrease in inflation (CPI) below +5%/year already in the second quarter seems very likely and conducive to a lowering of US Treasury rates below the current level of 4.7% (12 months), 4% (2 years), 3.6% (5 years) in the short term.

The slowdown in the economy and inflation will be the main factors in the change in perception of the shape and levels of the yield curves. Although they were largely inverted only a few weeks ago, we should soon see a general lowering of rates on the "short" side, contributing to an overall flattening of the yield curves. The outlook for dollar-denominated bond markets therefore seems favorable and sufficiently attractive to support a diversified exposure favoring investment-grade corporate bonds offering both an attractive yield and the prospect of capital appreciation.

US Treasury Yields and BBB Bonds (Spread)



Sources: Bloomberg, BBGI Group SA

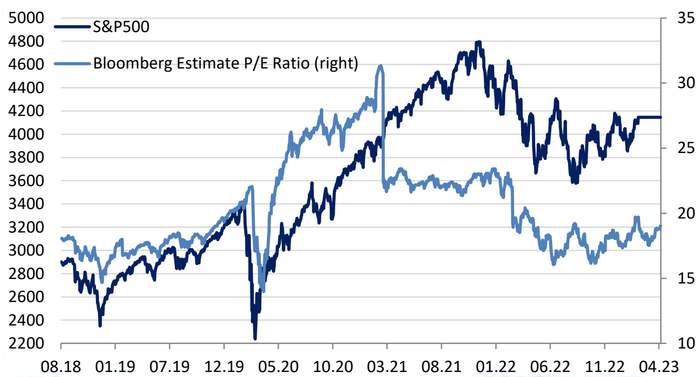
Further decline in the dollar forecast

The dollar was the big winner of the wave of interest rate hikes observed in 2022 and of the tightening of US monetary policy that began before most other central banks. The Fed's key rate hikes created a yield spread widening dynamic favorable to the US currency (+19.3%) until the fall of 2022. Since then, a loss of momentum in this dynamic has become apparent with the reduction of Fed rate hikes from 0.5% to 0.25% while other central banks maintained their 0.5% hikes. The contraction of the differential partly explains an already significant correction of the dollar trade weighted index (-11.5%) which should continue in the second quarter of 2023. US inflation will quickly fall back below +5%, causing dollar interest rates to fall. Interest in US assets will certainly remain sufficient to curb a weakening trend in the dollar, which should gradually lose momentum. However, the decision of some Gulf countries to accept oil and gas sales in yuan is a new long-term threat to the evolution of dollar demand that must be taken into consideration.

Outlook for equities remains positive

The quarter was volatile in the equity markets due to fickle economic scenarios and drastic changes in the outlook for Fed funds and interest rates. But with the return of a soft landing scenario and the probable end of the rate hike cycle, the macroeconomic environment at the beginning of the second quarter confirms our positive outlook for US stocks. They should indeed benefit from a certain normalization of the yield curves and a drop in financing costs, which will accompany the announced decline in inflation that is taking shape. The rebound in equity indices in recent weeks has erased the March correction linked to unfounded expectations of an overly strong US economy and further tightening of monetary policy. Growth stocks (+11.04%) have significantly outperformed substance stocks (+5.77%) in line with our expectations based on a normalization of interest rates that is more favorable to technology stocks in particular, which have been favored since the beginning of the year in our investment policy. We believe that the expected earnings growth for the S&P500 of close to zero for the next twelve months is particularly conservative and therefore maintain a positive view of the next evolution of equities while maintaining an overweight on growth stocks.

S&P500 & PE ratio



Sources: Bloomberg, BBGI Group SA

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