WEEKLY ANALYSIS

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FLATTENING OF THE USD YIELD CURVE

Moderate economic slowdown. CPI at 3% in sight. Labour market eases. End of monetary tightening cycle. Sharpest drop in short-term rates. Dollar declines. Broader participation of equities in the upside.

Points clés

- US economic momentum remains solid
- Moderate slowdown in Q2 (+1.2%)
- Leading indicators point to a slowdown
- Significant easing in the job market
- The Federal Reserve should give itself time
- Inflation declines, though some components adjust only slowly
- Volatility persists on yield curves
- Dollar likely to weaken in 2nd half
- Positive surprises for company profits

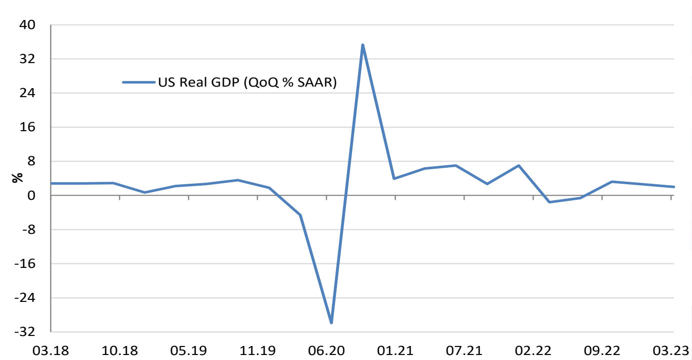
US economic momentum remains solid

The revised GDP figures for Q1 2023 underline the still relatively solid economic momentum in the United States. Revised GDP growth is +2% annualized, following a more favorable revision of exports and private consumption. Household consumption finally recorded a +4.2% increase, its strongest rise in twenty-four months, thanks to positive adjustments in the services segment, supported by a still solid labor market, despite weaker wage trends. Export growth of +7.8% also contributed significantly to the quarter's result. Conversely, the decline in government spending weighed on the performance of the US economy for the second consecutive quarter. The real estate sector continued to struggle, posting its eighth quarterly decline, while capital goods investment contracted for the second consecutive quarter. The start of the year has thus proved more robust than expected by the consensus, which was still counting on GDP growth of just +1.3% instead of the +2% forecast. As in the previous quarter, the US economy continues to surprise observers, and may yet deliver further surprises in the months ahead.

The risks of recession, so often evoked in recent months in response to the central bank's severe tightening of monetary conditions over the last year or so, have yet to materialize. The spectre of a hard landing also clearly seems to be fading, and growth forecasts are now tending to push back the probability of negative economic growth to the third or even fourth quarter of 2023. Recent statistics published in May and June have been rather better than expected, supporting expectations of a further positive development in US gross domestic product in the second quarter.

The relatively favourable situation of US households also comes as a surprise in the context of tighter credit conditions and more difficult access to credit. It will undoubtedly contribute to further growth in household spending, although this will probably be significantly weaker in Q2. In particular, it is underpinned by a wealth effect that is undoubtedly more positive than many observers imagined. US household wealth grew by $3 trillion in Q1, or +2.1% over the period, to reach a global valuation of $148 trillion, according to estimates published by the Federal Reserve. Second-quarter performance will also depend on continued positive trends in exports, investment and government spending.

Quarterly GDP growth - United States

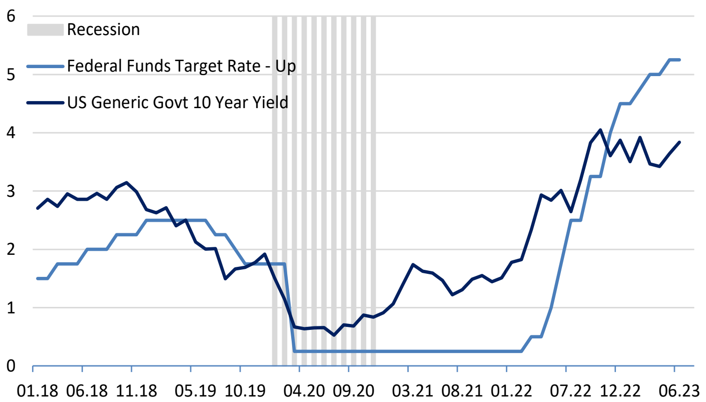


Sources: Bloomberg, BBGI Group SA

Moderate slowdown in Q2 (+1.2%)

The US economy is proving far more resilient than forecasters feared, and could therefore still end Q2 on a positive note, ahead of expectations. Inflation is receding ever more sharply, and this is certainly helping to boost consumer confidence, as consumers are now much less worried about their purchasing power. All the more so as the wage increases they have agreed to have already reduced the impact of rising prices on their ability to consume. They are also reassured by the resilience of the job market and the absence of the much-hoped-for downgrading by the Federal Reserve. Unemployment remains relatively stable and historically low at 3.6%. American households resisted the rise in interest rates and inflation by using their savings to maintain their purchasing power and consumption. The rising cost of credit will undoubtedly put a brake on this trend, although it is estimated that the decline in household savings could theoretically continue for some time before it comes to a halt, thanks to the 1.4 trillion in reserves that can still be deployed.

US recessions, Long rates and Fed funds



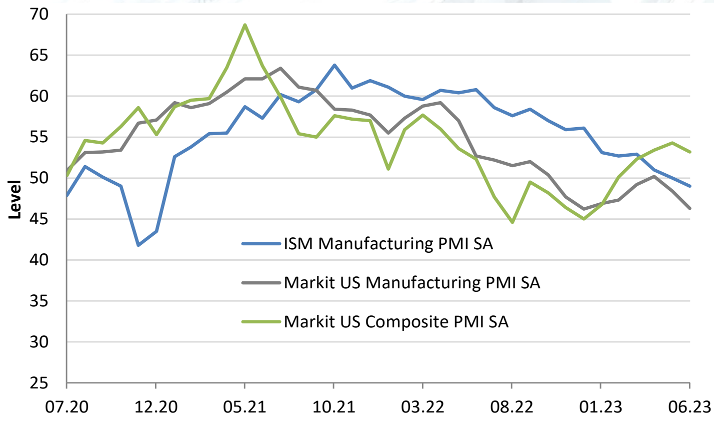
Sources: Bloomberg, BBGI Group SA

Faced with the risks posed by the short-lived banking crisis at the end of the Q1, monetary authorities reacted swiftly by reinjecting over 500 billion in liquidity. However, this liquidity has been completely withdrawn in recent months, causing volatility on interest-rate markets and a rise in financing costs. Consumer confidence nevertheless improved from 102.3 to 109.7 in June, according to the Conference Board. Overall, the economic surprises were rather favorable during Q2, leading us to modify our cautious growth estimates for the period ending in June to +1.2% and +2% at the top. According to this estimate, the 1st half of the year therefore showed satisfactory growth in a particularly uncertain and tense environment. Our outlook for 2023 remains logically positive, close to +1%, as the risks of recession diminish.

Leading indicators point to a slowdown

PMI indices contracted in June, returning to their lowest level of 2022 in the manufacturing segment (46.3). April's rebound above the 50 growth threshold was short-lived. On the contrary, the services index continued to perform well in June (54.4), supporting the overall indicator down to 53.0, which also remains in positive territory. The ISM manufacturing indicator also fell, confirming this trend, while the ISM services index (53.9) strengthened above the growth threshold. The new orders component rebounded from 52.9 to 55.5, suggesting a better situation for the months ahead.

PMI-ISM indicators

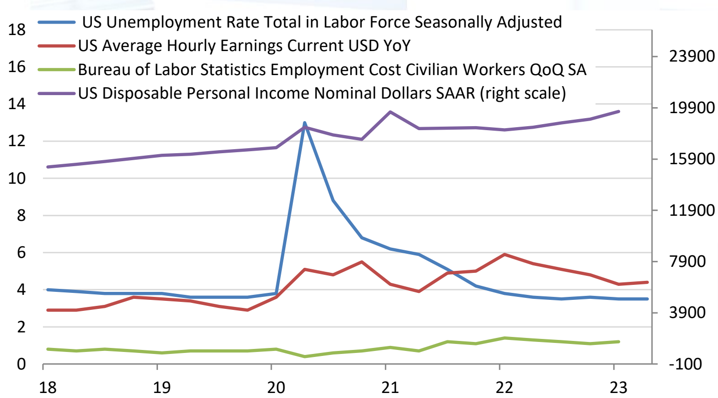


Sources: Bloomberg, BBGI Group SA

Significant easing in the job market

Jobless claims have continued to rise steadily since the end of January, almost every week, and now stand at 248,000 new claims, significantly higher than the 180,000 low of September 2022. Non-farm job creation is now down from 339,000 in May to just 209,000 in June, the lowest since December 2020. Private sector employment also contracted from 283,000 in May to 149,000 in June. This confirms that the labor market is weakening as economic activity declines. JOLTS job vacancies also fell from 10.1 to 9.8 million, after peaking at 12 million in March 2022. Annual growth in average hourly earnings has been falling steadily since March 2022 (+6%) to just +4.4% in June 2023, which is still higher than year-on-year inflation (CPI), which fell to +4% in June. Despite a still historically low unemployment rate, these developments should satisfy the Federal Reserve, which was still 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 via the employment variable, in order to protect their profit margins and earnings during an economic slowdown. On the other hand, the decline in inflation is also likely to dampen claims for wage increases, and put a further brake on average hourly wage levels.

Unemployment rate, Income, Labor costs, Wages



Sources: Bloomberg, BBGI Group SA

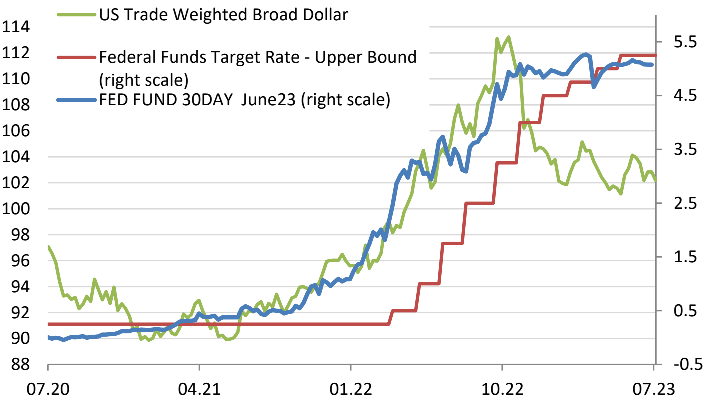
The Federal Reserve should give itself time

As a result, the labor market has been showing some signs of improvement over the past few months, and seems at last to be responding to monetary policy without collapsing, which should reassure the US central bank. Even if employment remains relatively buoyant, a reduction in tensions and the risk of wage increases being passed on to price indices are positive factors for the Federal Reserve. On the price front, CPI inflation has already fallen to just under 4% at the end of May, down sharply on the previous figure for April (+4.9%), and could even slip to 3% for the end of June in the next few days. The monthly CPI inflation rate (+0.2%) is clearly improving, as are producer prices, which are now negative for May (-0.3%). In our view, the Federal Reserve can already consider that overall price trends are moving in the right direction, even if inflation excluding food and energy is still up +5.3% year-on-year in May. The central bank president announced a pause in the rate hike process after the last FOMC meeting on June 14, pending confirmation of recent trends. We believe that, despite the continuing likelihood of a 0.25% rate hike on July 26, it is more likely that the status quo will be maintained if June's annualized inflation actually slips to 3%, and if inflation excluding food and energy continues to fall to 5% below the 5.25% key rate.

For the past three months, the central bank has once again been reducing the size of its balance sheet. After a massive injection of 500 billion in liquidity needed to allay concerns linked to the outbreak of the banking crisis in March, which had increased the size of its balance sheet to 8.7 trillion, it has since withdrawn almost 500 billion, bringing it down to 8.3 trillion at the beginning of July. Since then, it has withdrawn almost 500 billion, bringing it down to 8.3 trillion in early July. While it raised interest rates in April, May and June, it also tightened monetary policy a little further, withdrawing liquidity from the financial system. In this once again more restrictive environment, we expect the Bank to maintain its stance in July. After betting too early on a reversal of monetary policy and cuts in key rates at the start of the summer, due to the perceived high risk of recession, investors now seem to have completely ruled out this eventuality. The yield curve is increasingly inverted, while the risks of a slowdown are now smaller. Our forecast for key interest rates envisages an initial phase of status quo until the fourth quarter of 2023, followed by a further period of rate cuts leading to a flattening of the yield curve.

Fed funds rates for December have also rebounded significantly from their post-banking crisis levels of 4% to 5.4%. They are thus once again higher than current key rates (5.25%), and no longer take into consideration any possible easing of monetary conditions over the next six months. This is yet another major paradigm shift for monetary policy, which in our view fails to take into account the real opportunities for lowering inflation to levels close to the central bank's target and, above all, well below that of Fed funds. It seems to us, therefore, that an annual inflation rate already down to just 3% at the end of the 1st half of the year, while the GDP deflator has already fallen to 3.9%, would be a good argument for holding back the FOMC from further hikes.

Fed funds, Key rates and USD Trade Eeighted



Sources: Bloomberg, BBGI Group SA

Inflation declines, though some components adjust only slowly

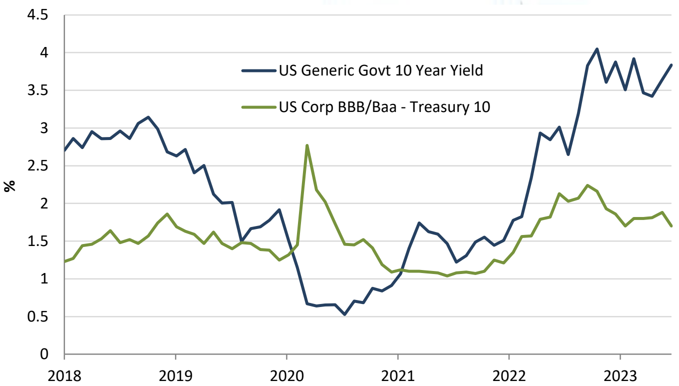
The inflation figures published for May in the United States confirm the new regime that has been in place for the past twelve months. Since then, it has been fluctuating between +0.5% and 0% per month, well below the +1.2% recorded in June 2022. It has averaged just +0.25% for the past four months. Inflation is receding significantly and 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 an annual pace of around +4.8%. Among the elements that are still holding up, 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 highly likely to follow the already visible downward trend in prices observed in the new rents sub-segment. We therefore believe that the expected gradual reduction in inflation to an acceptable level is still fully underway. Moreover, producer price indexes are already down by -0.1% (excluding food and energy). Inflation would therefore appear to be following the expected trend and continuing to decline without any massive new restrictive measures from the Fed. All the more so since, in our view, the causal relationship between unemployment levels, growth, key rates and inflation is not so clear-cut, particularly when we consider that price trends have been more a phenomenon of supply bottlenecks in the wake of the pandemic, than of excess demand.

Volatility persists on yield curves

Over the past nine months, volatility has remained high on the fixed-income markets, which have experienced fluctuations marked by short cycles of rising and falling yields on most maturities. Ten-year Treasury yields underwent five phases of 70 bp rises and falls, ranging from 3.3% to 4.25%, the last of which exceeded 4% again at the beginning of July. On the shorter two-year maturities, the latest cycle pushed rates to 5%, too close to Fed funds in our view and too high according to our estimates of medium-term inflation trends. Remember that the University of Michigan's 1-year inflation expectations are only 3%, and that the breakeven of two-year Treasury bonds has fallen from 3.4% in March to 2.05% today. Yields on the short end of the government curve clearly seem too high to us.

Influenced by the Fed's monetary policy statements announcing two more potential rate hikes should this become necessary. We have already mentioned our expectations for future growth, inflation and key interest rates, and believe that Treasury yields are currently too high on the short end, resulting in a steep slope that is unsuitable for the situation. A flattening of the yield curve through a sharper correction of the short end now seems the most likely scenario. We expect rates on short maturities to fall as soon as signs of inflation closer to 2.5% to 3% become more evident. This rate cut will be more pronounced on 2- to 5-year maturities, which could slide by 150 to 200 bps, and by 70 to 100 bps on 10-year Treasury maturities. The outlook for dollar-denominated bond markets therefore seems favorable to us, and sufficiently attractive to support a diversified exposure favoring investment-grade corporate bonds offering both attractive yields and prospects of capital appreciation.

US Treasury Yields and BBB Bonds (Spread)



Sources: Bloomberg, BBGI Group SA

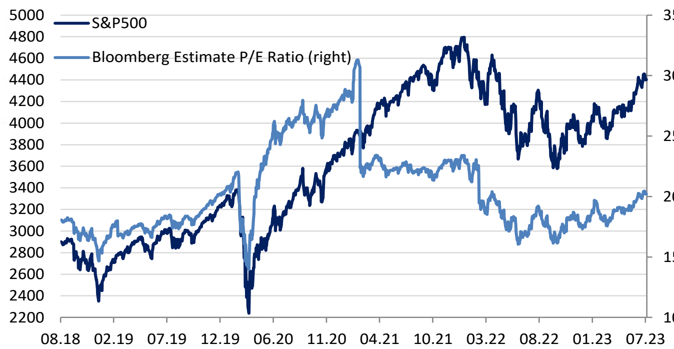
Dollar likely to weaken in 2nd half

Over the past three months, interest-rate dynamics have been stronger in the United States than in Europe. With a jump of 150 bps, two-year dollar rates rose more strongly than euro rates (110 bps). The dollar had initially been the big winner from the Fed's change in monetary policy, before weakening at the end of 2022. The stabilization of the dollar at lower levels over the past six months, against the backdrop of a probable deterioration in yield differentials, is not very reassuring for the US currency as we look to the end of the year. The expected decline in dollar yields will add further pressure on the greenback, which could well weaken again against the euro in particular. Interest in U.S. assets will certainly remain sufficient to curb the dollar's downward trend, which should gradually lose momentum.

Positive surprises for company profits

Over the past few months, equity markets have shown excellent resilience, despite the tighter interest-rate environment in May and June and the Fed's recent standstill. The S&P500 index has continued to climb, gaining 10% since the start of the year. Our expectations of a bullish recovery in the equity markets, underpinned by renewed interest in the main technology stocks, have come true, with the Nasdaq now up +25% by 2023. Growth stocks are back in vogue, driven by the wave of enthusiasm provoked by technological developments and the prospects for Artificial Intelligence (AI). The concentration of investor interest on a limited number of large stocks may be a cause for concern, but we expect participation to increase in the coming weeks. The rise in indexes should no longer be concentrated on a limited number of stocks, but should gradually broaden to support a further rise in equity markets. Our Q2 growth scenario reinforces the feeling that earnings expectations for 2023 are still too pessimistic and will hold some positive surprises. The expected near-zero earnings growth for the S&P500 over the next twelve months is particularly conservative, so we are maintaining a positive view on the outlook for equities, while remaining overweight growth stocks.

S&P500 & PE ratio



Sources: Bloomberg, BBGI Group SA

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