WEEKLY ANALYSIS

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END OF SUMMER CONSOLIDATION IN US MARKETS ?

Economic slowdown rather than recession. Inflation falls in services. Long-lasting FED pause. Downward adjustments to yield curves. Weak dollar. Positive outlook for bonds and equities.

Key points

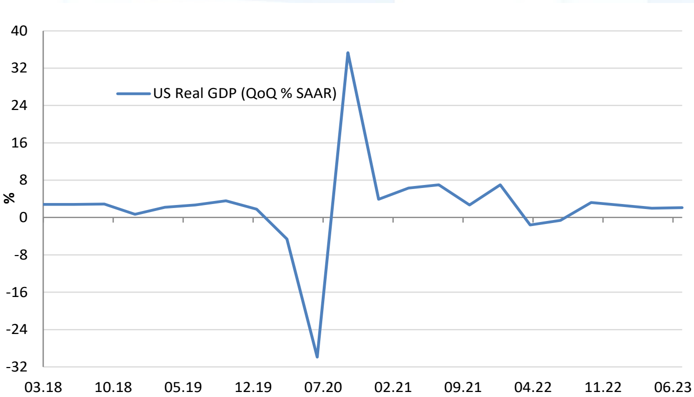
- Economic growth may be slowing more than it seems
- Slowdown looms for year-end
- Leading indicators suggest a soft landing
- Job market still highly uncertain
- The Federal Reserve will mark a lasting pause
- Inflation now also falling in services
- Excessive tension on yield curves
- The dollar temporarily benefits from rising rates
- Positive outlook for equity markets

Economic growth may be slowing more than it seems

The 2nd quarter GDP figure, revised from +2.4% to +2.1%, nevertheless suggested a resilience in US economic activity that surprised many observers, who had been predicting a recession in 2023 for several quarters. Real annualized growth in Q2 was therefore similar to Q1. Personal consumption slipped sharply in Q2, rising by just +0.8% after a strong Q1 (+4.2%), which was its biggest increase in the last twenty-four months. The GDP revision was affected by weaker investment, while consumption was revised slightly upwards. A still robust, albeit easing, labor market is supporting personal consumption spending, and should continue to drive positive GDP growth in Q3. Companies are moderating their enthusiasm for hiring new staff, allowing the market to ease somewhat. Job creation figures are weakening, but jobless claims are not rising massively. On the corporate side, the reduction in inventories should be a positive factor in assessing the outlook for industrial production over the coming months. It should also be noted that the +3.9% rise in investment in capital goods is regaining some strength after the -0.4% decline of the previous quarter. The -10.6% fall in exports was considerably stronger than the -7% contraction in imports. As for government spending, growth slowed from +5% to +3.3%. As in the previous quarter, the US economy continues to surprise observers in a positive way, 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 strong tightening of monetary conditions over the past eighteen months, have yet to materialize. The spectre of a hard landing also seems clearly to be fading, and growth forecasts are now tending to push back the risk of negative economic growth further into 2024.

Consensus now seems to be forecasting Q3 GDP growth of +1.8%, before activity eases to +0.4% at the end of the year. Q3 GDP growth could prove even stronger, however, and exceed consensus expectations if the Atlanta Fed's GDPNow indicator, currently at +4.8%, proves correct. But this summer strength could also be short-lived, as measures other than GDP are already pointing to a slowdown in activity at the end of the summer.

Quarterly GDP growth - United States

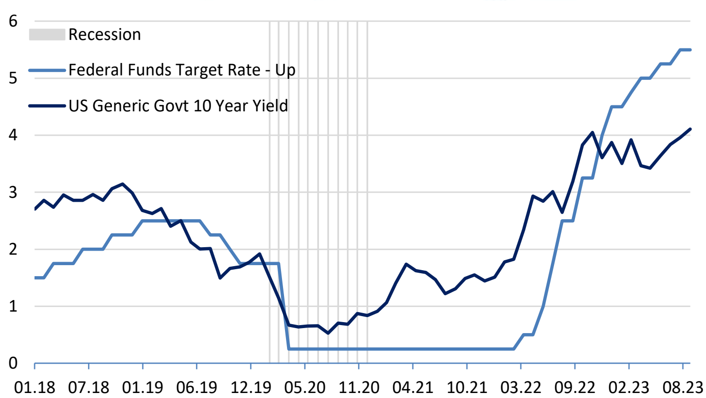


Sources: Bloomberg, BBGI Group SA

Slowdown looms for year-end

Q3 will certainly still be strong, but this surge in GDP growth could quickly falter towards the end of the year. The current resilience of consumption can be attributed to the use of what remains of the surplus savings accumulated during the pandemic, while rising interest rates are increasingly squeezing the borrowing capacity of households and businesses. Consumer credit has collapsed, and the banking sector is clearly confirming this trend, putting the brakes on household and business demand. The real estate sector is also being hit hard by rising financing costs, while retailers are also facing growing uncertainty over sales for the festive season. Inflation is receding ever more sharply and is certainly making a positive contribution to household sentiment, but the trend in financing costs is having an even more negative impact on consumer confidence, which is worsening. The very gradual weakening of the job market, together with a slight rise in the unemployment rate, should contribute to a slowdown in consumption. US households initially resisted the rise in interest rates and inflation by resorting to savings to maintain their purchasing power and consumption, but rising credit costs are likely to put a brake on this trend.

US recessions, Long rates and Fed funds



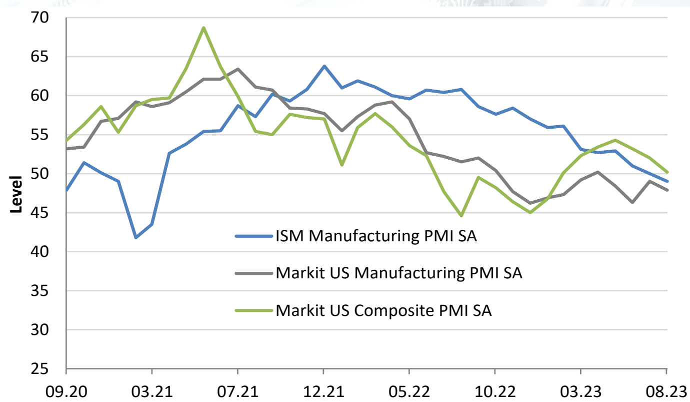
Sources: Bloomberg, BBGI Group SA

Monetary policy has also become more restrictive, with the Fed's balance sheet shrinking by almost 10% as it raises interest rates until the end of the quarter. At the end of the year, this should weigh more heavily on growth, confirming a soft landing scenario that is probably becoming increasingly perceptible. Our outlook for 2023 remains positive, approaching +2% with a rather weak final quarter.

Leading indicators suggest a soft landing

PMI indices have recently stabilized at levels close to the growth threshold. The preliminary PMI index for the manufacturing segment (48.9) recovered slightly in September (+1), but remains below the growth threshold of 50. While the manufacturing segment stabilized, the services index declined more sharply from 50.5 to 50.2, weakening even more than expected. The services sector, which has long been highly resilient, and more important in assessing the overall economic trend, is now also beginning to feel the effects of restrictive monetary policy. The composite indicator is therefore on balance at 50.1, hesitating to point more clearly towards the announced slowdown. Uncertainty therefore intensifies at the end of Q3, with leading indicators increasingly inclined to point towards an « orderly » slowdown in activity. The consumer confidence index declined again in September, as did the national activity indicators measured by various Fed (Chicago Fed, Dallas Fed, Philadelphia Fed), and the Richmond Fed's business conditions index.

PMI-ISM indicators

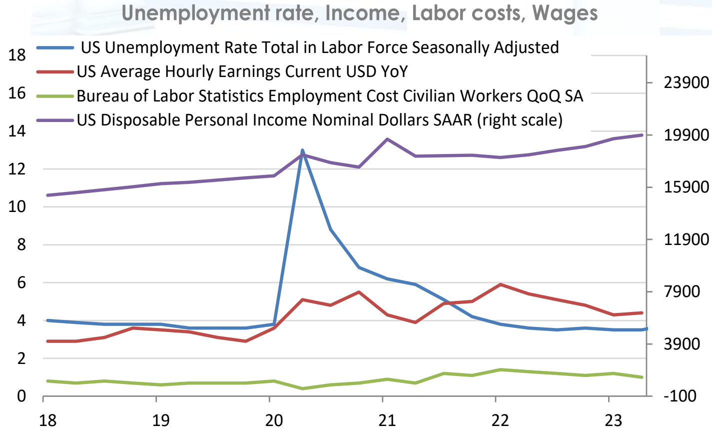


Sources: Bloomberg, BBGI Group SA

Job market still highly uncertain

Claims for unemployment benefits had been rising steadily since the end of January, almost every week, and stood at almost 265,000 new claims, before falling sharply in recent weeks, plunging to just 201,000 claims at the end of September, its lowest level since January. Continuing claims have been falling in parallel since April, from 1,863,000 to 1,662,000. The job market is still far from collapsing, and while job creation is weaker, redundancies are not soaring despite the downturn in economic activity. JOLTS job vacancies continue to decline, and have now fallen below the 9 million mark, dropping to 8.8 million after peaking at 12 million in March 2022. Annual growth in average hourly earnings has fallen steadily since March 2022 (+6%) to just +4.3% in August 2023, which is still higher than year-on-year inflation (CPI), which has dropped to +3.6%. With a slight rebound in the unemployment rate from 3.5% to 3.8%, these developments are still sufficiently uncertain to justify a certain wait-and-see attitude on the part of the Federal Reserve, which only recently expressed concern about the risks that a tight labor market could pose to wage and inflation trends.

Unemployment rate, Income, Labor costs, Wages



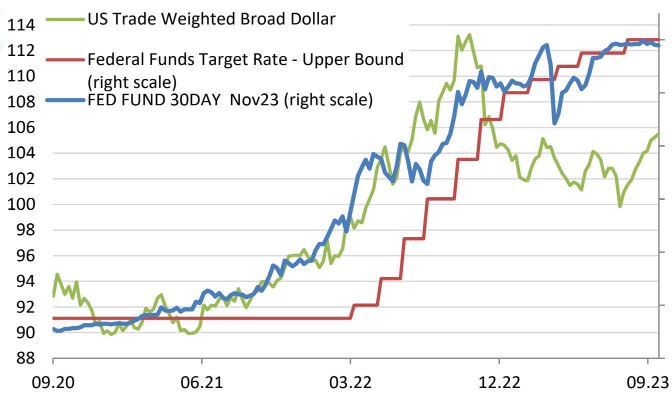
Sources: Bloomberg, BBGI Group SA

The Federal Reserve will mark a lasting pause

The labor market has seen some better developments in recent months, and finally seems 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. In terms of price trends, CPI inflation had already fallen to just 3.7% by the end of August, while the index excluding food and energy was down to +4.3%. Monthly CPI inflation (+0.2%) is clearly improving, as is producer price inflation. In our view, the Federal Reserve can already consider that the general trend in prices is moving in the right direction, even if the Fed Chairman's last public speech, announcing a pause in monetary policy, was accompanied by warnings.

The Fed decided not to touch its key rates on September 20, and so, in our opinion, begins a long phase of stability which will soon appear as the end of one of the most rapid and severe monetary tightening cycles in its recent history. Between what the Fed Chairman can't say, what he would really like to say, what he thought he should say, what he actually said, what the financial markets heard, what they thought the Chairman meant, what they probably thought they understood and what they deduced in terms of the outlook for interest rates, the last few days have undoubtedly been particularly confusing for many. The bond market finally did not react much while the equity markets recorded a negative performance over the week in disorder and confusion. The Fed hinted that rates would have to stay high for longer to keep inflation under control, which was initially seen as a negative factor, but we believe it is actually secretly pleased to have implemented a soft landing that is accompanied by a decline in inflation on all fronts, including in the lagging services segment. In parallel with its rate hike policy, the Federal Reserve has also been reducing the size of its balance sheet for several months by selling Treasury bonds, at the risk of pushing up long-term rates through its sales. While the Treasury increased its debt issuance, the Fed did not hesitate to increase the supply of bonds, thereby reinforcing its restrictive monetary policy. Against this backdrop, and with indicators pointing increasingly to weak economic activity, we strongly doubt that the Fed has any real intention of further rate hikes. The next few months should therefore see a stabilization of key rates and a probable softening of yield curves. 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 March 2024 have also largely rebounded from their post-banking crisis levels of 4% to 5.45%. They are thus slightly below the current 5.5% upper limit for key rates, 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 does not take into account the potential need for a normalization of the Fed's strategy in Q2 2024, when the slowdown scenario will have materialized more clearly and the inflation level will have stabilized close to 3%.

Fed funds, Key rates and USD Trade Eeighted



Sources: Bloomberg, BBGI Group SA

Inflation now also falling in services

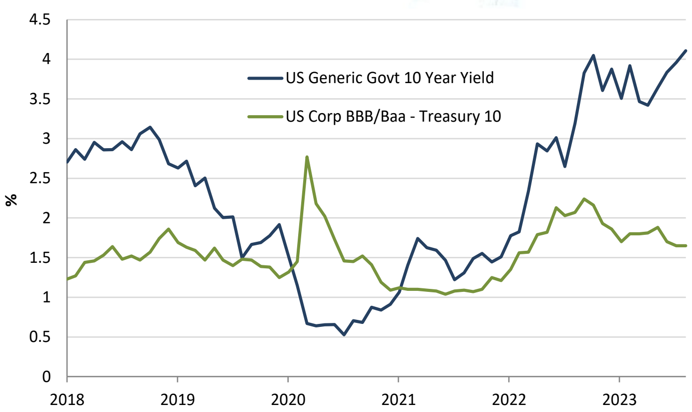
The inflation figures published for August in the United States confirm the new regime that has been in place for the past twelve months. Since then, it has been fluctuating between +0.6% and 0% per month, well below the +1.2% recorded in June 2022. It had averaged just +0.25% for several months prior to the August rebound driven by energy prices. Inflation is easing off significantly, returning to an increasingly satisfactory monthly pace. The price index excluding food and energy joined this trend with a reduced increase of +0.3% over the month in August. Among the elements that are still holding up, we find almost exclusively the « rents » component, which is holding back the general downtrend somewhat, but we can also see that services have been making a reduced contribution for some months now. We therefore believe that the expected gradual reduction in inflation to an « acceptable » level is still a valid trend. Furthermore, producer price indexes (excluding food and energy) have been stabilizing for the past year, averaging +0.2%/month. Inflation therefore seems to be following the expected trend and continuing to decline, without the need for massive new restrictive measures by the Fed. All the more so since, in our view, the causal relationship between unemployment, growth, key rates and inflation is not so clear-cut, particularly when we consider that price trends were more a phenomenon of supply bottlenecks after the pandemic, than of excess demand.

Excessive tension on yield curves

Despite the already significant decline in US inflation, yield curves that should have been falling have instead shifted upwards in recent months. Ten-year Treasury yields have now reached their highest level of the year, in a context clearly marked by the growing likelihood of an economic slowdown. Recent rate movements have therefore been less sensitive to inflation and growth prospects than to other factors. The reduction in the Federal Reserve's balance sheet, coupled with the large and concentrated financing needs of the US Treasury in recent months, have increased the supply of bonds, but the bond market was also still largely influenced by the Fed's monetary policy statements suggesting that rates would have to stay high for a long time to keep inflation under control.

As we have already discussed our expectations for future growth, inflation and key interest rates, we believe that Treasury yields are currently too high, not only on the short end but also on the long end of the yield curve. We now expect yields to fall across the entire yield curve. 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

The dollar temporarily benefits from rising rates

In the end, interest-rate dynamics proved stronger in the USA than in most other regions. The trade weighted dollar index took advantage of the rise in dollar yields to rise by +7% since its low point on July 15, returning to its mid-November 2022 level. The dollar had initially been the big winner from the Fed's change of monetary policy, before subsequently weakening. The recent rebound is likely to be short-lived, however, as monetary policy gradually normalizes and dollar yield curves adjust downwards.

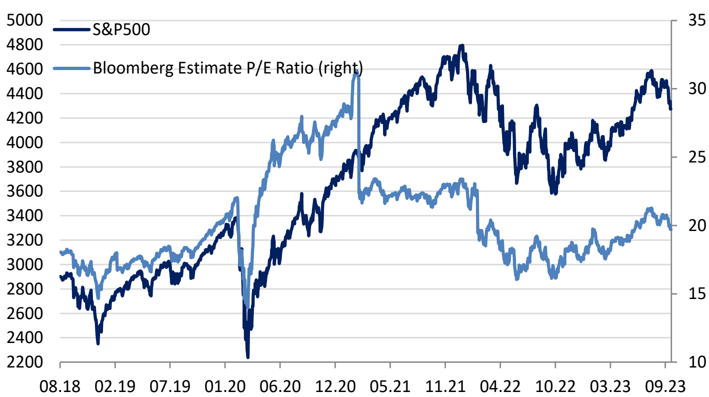
The expected decline in dollar yields should trigger further weakness in the greenback. Interest in U.S. assets will certainly remain sufficient to curb a fall in the dollar, which should instead materialize as an erosion of the dollar.

Positive outlook for equity markets

Interest rate tensions have not been without effect on equity markets in recent months. After showing excellent resilience in the more tense environment of May, June and July, the latest phase of rate hikes, which took ten-year yields from 4% to 4.5%, was harder to digest. The S&P500 finally succumbed to this negative environment, recording a consolidation of -7%, inversely proportional to the rise in the dollar. The summer consolidation on equity markets was no more marked on technology stocks, with the Nasdaq index sliding -8% over the same period.

While the rising dollar is a negative factor for the valuation of dollar-denominated profits of US export companies, it is not the primary factor behind the short-term correction in equity markets. Indeed, interest-rate tensions were the main determinant of the downturn. Our scenario for economic growth and interest rates should once again support interest in US stocks. The consolidation of the equity markets seems to us to be temporary and close to an end. We take a positive view of the future trend in equity indices, maintaining an overweight in growth stocks.

S&P500 & PE ratio



Sources: Bloomberg, BBGI Group SA

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