Investment Strategy

October 2023

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The third quarter was strongly marked by the surprising rise in US interest rates, which clearly disrupted the summer stock market climate. After a few weeks of limited increases in July and August, it was in fact during September that the acceleration in long rates was extremely rapid, triggering a rapid rise in uncertainty. In fact, this surprise rise seemed quite irrational in view of the real economic situation, which was in the throes of a downturn. The rise of almost 70 bps in ten-year yields to 4.7% seemed totally disconnected from the economy, whose many signs of slowdown should have lowered investors' yield requirements. The current economic slowdown and a calmer inflation regime were therefore no match for the triple influence of the US Treasury's high financing needs, the Fed's balance sheet reduction strategy and its worrying hawkish comments. Since the agreement to raise the U.S. Treasury's debt ceiling in July, the Treasury has rapidly increased its issuance, increasing the supply of government bonds on the market by several hundred billion dollars in just a few months. At the same time, the Federal Reserve was also drastically reducing the size of its balance sheet by selling Treasury bonds and de facto reducing the money supply in circulation. This influx of supply during the summer was digested by the markets only at the cost of a rate hike unjustified by economic fundamentals. Still too focused on controlling inflation, despite better-than-expected downward trends in CPI and PPI indices, monetary authorities were still suggesting potential further rate hikes, which never ceased to worry financial markets. Despite numerous signs pointing to an increasingly perceptible slowdown in growth, including in the job market, this triple influence pushed up long-term rates to the point of creating increasingly difficult conditions for financing consumption and investment in the months ahead. Indeed, the rise in nominal rates as inflation has contracted has pushed real rates to levels that may already be unsustainable, thereby drastically increasing the risk of a fall in demand and economic growth. With its dual action on short and long rates, the Fed seems to us to be implementing a monetary policy that will probably appear too restrictive in a few months' time. Even if it is deliberately seeking to influence the entire yield curve through its actions, it has probably not yet gauged the extent of the brake it is imposing on the economy. The Fed's monetary policy thus seems excessive to us, and US growth may ultimately fail to withstand these new pressures. Recent developments may indeed call into question the soft landing scenario and revive recession risks for 2024. The US central bank was wrong to judge inflation as transitory, before recognizing the need to adjust its monetary policy a little too late in 2022, with the consequences we are now aware of. We fear that it is still not sufficiently capable of measuring the risks of its restrictive policy, which could once again prevent it from achieving the soft landing for the economy that seemed possible. The end of the quarter was thus marked by the irrationality of the US capital market, which was hit by rate hikes on all maturities, unjustified by known and expected economic parameters. The third quarter should have been favorably influenced by an orderly economic slowdown in the USA and by less negative growth than expected in Europe, as well as by very encouraging signs of inflation and reduced risk of key rate hikes. Tensions on US interest rates caused capital markets in most regions to fall together during the quarter, with only the Swiss market managing to end the quarter without a loss (+0.06%), while all major markets fell by an average of around -3.59%. Unsurprisingly, such rate hikes could not go unnoticed by other financial assets, with equity markets also suffering significant sell-offs at the end of the period, pushing most indices down. The Swiss market (-3.32%) followed the same trend as the MSCI world index (-3.46%). Most regional markets recorded similar declines, with the exception of the FTSEE index, which rose slightly. Securitized real estate markets did not escape this trend either. Rising financing costs had the greatest impact on the US market, which contracted by -7.19%, twice as much as Asia (-4.3%). The European market reacted positively to falling inflation and the ECB's relatively measured monetary policy, finally recording a significant rebound of +7.02%, the best result among national indices. Swiss real estate funds also benefited from stable interest rates and historically low fees, rebounding slightly by +0.43%. In commodities, energy prices performed exceptionally well, surging +28.79% over the quarter. This rise was not underpinned by a recovery in Chinese demand, but by more effective control of supply, mainly orchestrated by OPEC and Saudi Arabia in particular. The +15.98% rise in the global commodities index is therefore welcome news for all diversified investment strategies which, as in 2022, benefited from the decorrelation of this asset class, while traditional bond and equity markets posted negative performances over the period. The final quarter is likely to be marked by further evidence of economic slowdown, including a weakening labour market and persistently positive inflation trends. Against this backdrop, fears of further rate hikes should diminish, encouraging a downward adjustment in dollar yield curves. This favorable environment for financial assets and commodities could, however, be negative for the greenback.

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Partner & CEO
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BIG PICTURE

Main Convictions

- Dangerous flattening of the US yield curve
- The Federal Reserve will miss its target
- Faster and more intense downward rate adjustments
- Positive outlook for financial markets

Dangerous flattening of the US yield curve

The US yield curve has recently undergone a very significant flattening, which we consider particularly inappropriate for current economic conditions, and which once again threatens the soft landing scenario that had previously been very likely to materialize. At the end of the previous quarter, the yield spread between short (2-year) and long (10-year) U.S. Treasury maturities had reached -110 bps, reflecting a curve inversion essentially triggered by the Fed's egregious rate hike and the decline in long rates driven by successes on the inflation front. The fall in inflation to around 3% for the CPI and -3% for the PPI (NSA) in June allowed inflation expectations for 2024 and beyond to be lowered below 3%. Against this backdrop, the two-year Treasury yield stabilized at just under 5%, significantly lower than the key rate level of 5.5%, while ten-year rates ended the quarter at around 3.7%. This logical inversion at the end of the rate hike cycle and in anticipation of a future economic slowdown was suddenly corrected in an unexpected and historically rare fashion. Normally, the flattening of the yield curve occurs through monetary policy easing when inflation normalizes and the economic slowdown or recession materializes. In recent months, however, the spread has contracted as long rates have risen, while short maturities have remained unchanged. Two-year rates were still at 5% at the end of September, reflecting positive inflation expectations for 2024 and 2025, as well as the probable end of the rate hike cycle following the pause announced by the Fed in September. On longer maturities, and in particular ten-year rates, a surprise 100 bp rise pushed yields to 4.8% at the time of writing. The spread has thus narrowed from -110 bps to just -30 bps in three months, as the economic outlook and risks of accelerating inflation weakened.

This situation is quite exceptional and worrying, as it suddenly and very significantly tightens credit and financing conditions for all economic players and agents, including the US Treasury, in a way that is drastic and worrisome for the growth prospects of the US economy. As far as households are concerned, the rise in the cost of 30-year mortgage financing from 7.1% to 7.9% during the quarter further reduced access to real estate and increased mortgage debt servicing at a time when consumption was also weakened by the rising cost of credit. At a time when the US economy was showing increasing signs of weakening, this flattening of the yield curve seems to us to be a particularly negative indicator for the outlook at the end of the year and for the first half of 2024. The soft landing scenario we have been describing since the beginning of the year as the main economic scenario for the US in 2023 is still very much in place, and should prove accurate for the 4th consecutive quarter. However, we now see a higher probability of a more severe slowdown in early 2024 if current conditions remain unchanged on the US yield curves.

The Federal Reserve will miss its target

The U.S. central bank is now in danger of missing its objective of a soft landing for the U.S. economy, thanks to a monetary policy that is ultimately too aggressive and deliberately pursued on two fronts at the same time. While it may not have the intention of provoking a recession in 2024 during the presidential election period, it is in any case now creating all the conditions for such a scenario to eventually materialize. Indeed, the Fed's monetary policy is generally assessed by investors primarily through announced decisions to raise key rates and the prospects of future hikes. Historically, this was the Fed's main steering factor, but since the introduction of quantitative easing and the explosion in the size of the central bank's balance sheet, it can intervene effectively across the yield curve and influence financing conditions more broadly across all maturities. Between June 2022 and September 2023, the Fed raised its key rates eleven times, from 0.25% to 5.5%, in one of the fastest tightening cycles in recent history. These decisions have not escaped the attention of any investor, but the reduction in the size of the Fed's balance sheet that took place during this period has received far less media coverage. The Fed's quantitative tightening reduced the size of its balance sheet by $1,000 billion, or almost 12%. Between April and September 2023, the Fed sold around $700 billion in US Treasury bonds on the capital markets, while the US Treasury issued an additional $1.4 trillion in debt over the last three months, thanks to the raising of the debt ceiling by elected politicians in July. The combination of these developments was certainly the main cause of the very sharp rise in yields on all the longer maturities of the yield curves. The pause announced by Chairman J. Powell would be good news if it were not accompanied once again by the same warnings from monetary authorities that rates would remain higher for longer to ensure that inflation returned to its stated 2% target.

Is the Fed aware that it is putting the brakes on economic activity by pushing up the entire yield curve with its quantitative tightening?

No doubt it is not yet measuring the very significant risks of a potentially brutal impact on the economy, since it does not seem to have scaled back its securities sales program in recent months, despite the sharp rise in financing costs for all economic agents at the end of the quarter.

For too long, the Federal Reserve had totally underestimated the inflation trend in 2021, regularly declaring it to be transitory, before belatedly coming around to the evidence at the end of the first quarter of 2022. Since March 2022, it has finally been fighting inflation so hard that it has been unwilling to take into account the already significant progress made in consumer and producer price indices.

Having lagged far behind in its fight against inflation, the Fed is perhaps still too slow to consider the growing likelihood of an economic slowdown linked to the rising cost of financing. While it could undoubtedly achieve the soft landing objective by steering its quantitative tightening policy more carefully and at least temporarily halting its bond sales, for the time being it is the cause of the generalized rise in the cost of credit. We believe that, without an immediate halt to the latter, which would allow yield curves to ease, recession risks are set to increase significantly in early 2024.

Faster and more intense downward rate adjustments

We see two possible scenarios for the next few months: a reaction from the Fed in the first case, and no reaction in the other, as economic conditions gradually worsen without a very clear improvement in inflation. In the former case, the Federal Reserve would be on the verge of accepting the idea that an economic slowdown is underway, and that it could rapidly worsen if financing costs remain as tight as they are today. It would then perhaps already consider the visible improvements in the labor market sufficient to agree to make its quantitative tightening policy more flexible, by implementing a pause similar to that decided for its key rates in the coming months. An easing of the yield curves could then take place, particularly if the Treasury's financing requirements also normalize in the final quarter. If yield curves were to ease, the soft landing scenario could once again become the main scenario for early 2024. Conversely, if the Fed were to wait for further evidence of the loss of economic momentum and maintain its policy of double action on rates, the risks of recession would rapidly increase and probably materialize in the first half of 2024. The Fed's assessment of the situation and risks will be decisive over the coming months, and could precipitate a change in the financial markets' perception of the likelihood of a recession.

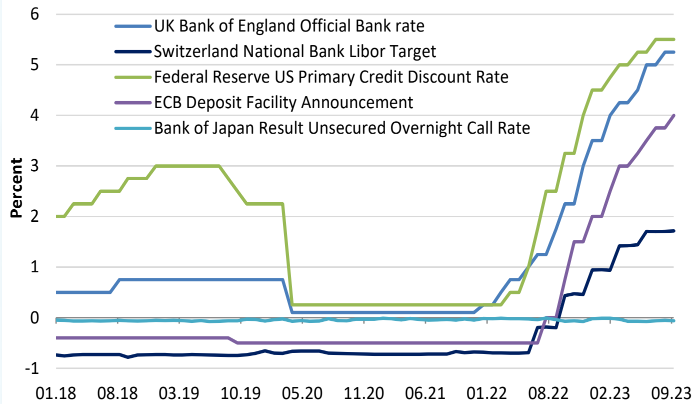
We believe that the US central bank will unfortunately remain overly concerned by the slower normalization of monthly inflation data than in previous months, which should not lead it to change its current policy. In this case, at the end of the year, it will most certainly continue with its current policy, characterized by resolute and regular quantitative tightening, and high and stable key rates, but accompanied by unchanged comments and warnings about the possibility of raising its key rates further in the future, if necessary. The future course of the yield curves therefore still seems closely linked to the intensity of QT and the Fed's decision to reduce its amplitude. But now, with both nominal and real rates rising sharply, it seems to us that the US economy is likely to show increasing signs of slowing. Against this backdrop, we believe that a growing body of statistics pointing to an economic slowdown will materialize in Q4, allowing yields to ease without any Fed intervention in the coming months. As a result, the short end of the yield curves will not be strongly affected for the time being, with most of the adjustment taking place on longer maturities. Further inversion of the yield curves could soon be observed, until the -110 bp level reached in June 2023 is reached again.

If the central bank nevertheless maintains its policy during the autumn, as we expect, the risks of a sharper-than-expected slowdown now seem more significant and will be taken into account by the markets. The current main economic scenario favoring a soft landing could therefore quickly be called into question in favor of a possible new recession scenario, which would then be largely due to the overly restrictive monetary policy pursued by the Federal Reserve during the second half of 2023. We believe that the Fed will then have to change its policy and lower its key rates more quickly than is currently envisaged and anticipated by the financial markets. The easing of key rates expected at the end of 2024 will, in our view, take place well before the end of the first half of the year, and should be accompanied by a pause in QT.

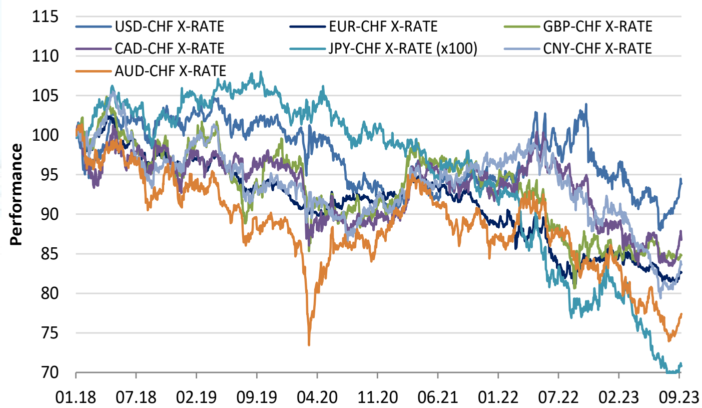
Positive outlook for financial markets

After the rate shock of the 3rd quarter, which triggered significant corrections in most financial assets, the 4th quarter should instead be characterized by an initial stabilization, followed by a downward adjustment of yield curves in the USA. This trend is unlikely to be followed by the same developments in Europe and other developed countries, where inflation levels are still somewhat high, but overall the interest rate and monetary policy environment should ease with the expected economic slowdown and reduced fears of further key rate hikes. Such an environment will be particularly favorable to the USD capital markets, and to long maturities in particular. Securitized real estate will also benefit from the easing of interest rate pressures in most regions. This should also be the case in equity markets. This improvement in the investment climate, which is favourable to all asset classes, should take hold and develop positive effects over the course of the quarter, unless signs of recession become more pronounced and lead to fears of a fall in corporate profits in 2024, which would call into question the factors supporting the equity market.

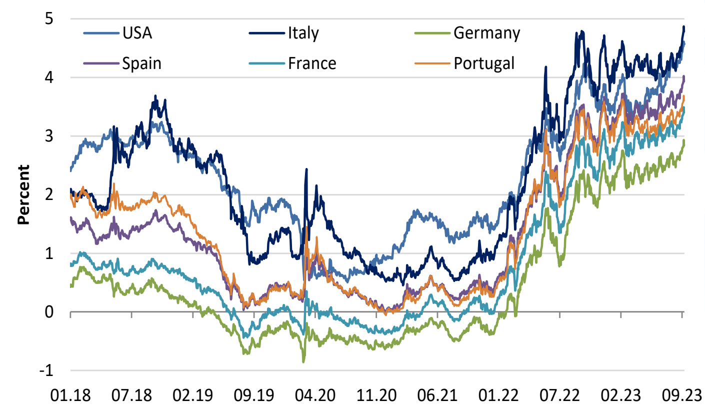
Policy Rates (EUR, CHF, GBP, USD, JPY)



7 Main Currencies against CHF (base 100)



10-year Government Rates



Graph sources: Bloomberg/BBGI Group

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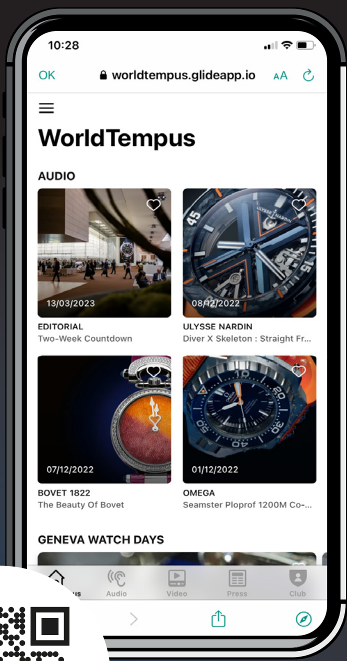

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