WEEKLY ANALYSIS

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THE FED SHOULD LOWER ITS RATES IN MARCH 2024

Economic slowdown rather than recession. Inflation will reach the +2% target in Q2 2024. The Fed will have to cut rates. Continued readjustment of yield curves. The dollar under pressure. Positive outlook for equities.

Key points

- Significant slowdown after an exceptional 3rd quarter
- Declining momentum raises fears of recession
- Leading indicators do not point to recession
- Relative resilience of the job market
- The Federal Reserve will have to cut rates
- Inflation to reach +2% target in Q2 2024
- Major readjustment of yield curves
- Dollar suffers as expectations adjust
- Positive outlook for equity markets

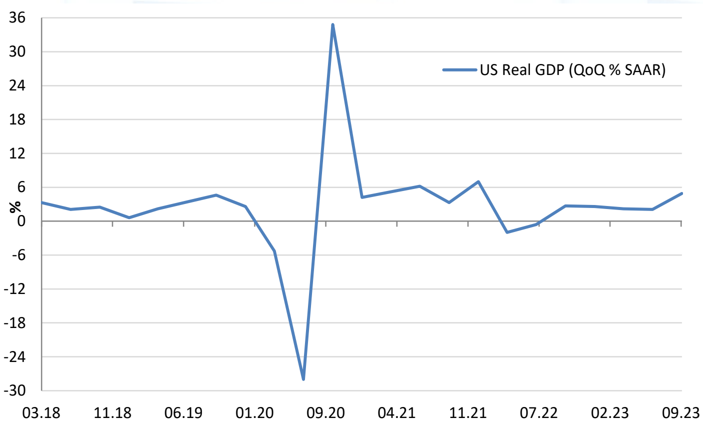
Slowdown likely after an exceptional Q3

Despite a final revision of Q3 GDP indicating slightly weaker growth than initially published (+5.2%), growth of +4.9% remains one of the most remarkable in recent years. The slowdown that had been expected for many months has still not materialized, despite an exceptionally intense monetary tightening cycle and a general acceleration in the rise in interest rates and financing costs for all economic agents. The resilience of the US economy has been remarkable so far. Personal consumption, which had slipped sharply in Q2, rising by just +0.8%, has now recovered strongly. The +3.1% increase is indeed very surprising given the specific context of the quarter, marked by a sharp rebound in interest rates. Growth in household spending seems to have been stronger in the durable (+6.7%) and non-durable (+3.9%) goods segments than in services (+2.2%). There was also a marked increase in private capital expenditure (+10%). The contribution of public spending was also very significant, with an increase of +5.8% higher than in previous quarters. Personal consumption expenditure was unaffected by the easing of tensions in the labor market, and instead benefited from the steady decline in inflation. As in previous quarters, the U.S. economy continues to surprise observers, and may yet deliver further surprises in the months ahead.

However, growth forecasts for the final quarter are now significantly weaker, although this does not mean that negative growth is on the cards. The Atlanta Fed's GDPnow indicator still suggests a positive development of +2.7%, slightly higher than that of the New York Fed, which seems less optimistic (+2.2%). In both cases, the US economy is still judged to be particularly resilient as the year draws to a close by these various models. The risk of recession has thus diminished since June, when it peaked at 65%. They are now estimated at 50% for the next twelve months, against a backdrop of persistently restrictive monetary conditions.

For our part, we believe that rising interest rates are finally having a clearer impact on the economy, and on household consumption in particular. As a result, 4th-quarter GDP is likely to be significantly less robust, with growth probably below +1%. For 2023 as a whole, GDP growth should be +2.4%, but the slowdown is on the horizon and should finally materialize during the winter.

Quarterly GDP growth — United States



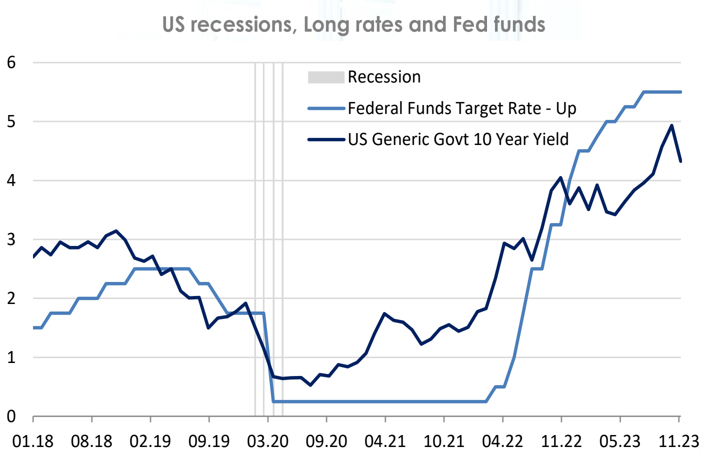
Sources: Bloomberg, BBGI Group SA

Declining momentum raises fears of recession

Q4 should therefore be much less resilient, with real annualized growth below +1%. The downturn expected at the end of 2023 and beginning of 2024 should be caused primarily by an adjustment in consumption and a reduction in public spending. But consumer confidence will perhaps be more sensitive to the particularly favourable trend in inflation and the reversal of the trend in interest rates than to the evolution of some less favourable parameters in other segments. The fall in interest rates may have a greater than expected impact on household credit, which had contracted sharply in recent months. The decline in overall credit (net foreign exchange) in October from 12.25 bn to just 5.13 bn may turn out to be only temporary.

However, as the level of average rates (22%) charged on credit cards has not been lowered, despite the fall in capital market rates, we believe that this factor will continue to weigh on households' ability to sustain their consumption by continuing to use their credit cards to the same extent. Consumer credit has thus collapsed, and the banking sector is clearly confirming this trend, curbing household demand.

The real estate sector has also been hit hard by rising financing costs, while retailers are also facing growing uncertainty over their sales trends. 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 will no doubt put a brake on this trend.

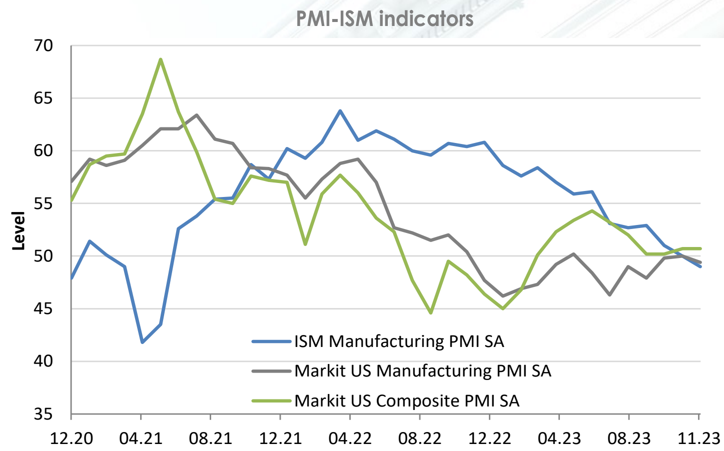


Sources: Bloomberg, BBGI Group SA

Leading indicators do not point to recession

PMI indices continue to stabilize above the growth threshold for the services PMI and the global PMI. The preliminary PMI for the manufacturing segment (48.2) remains highly uncertain and slipped again in December. The services index, meanwhile, stabilized somewhat after a worrying decline over the summer, and ended the year in a more optimistic zone. The composite indicator is therefore in balance at 50.1.

Uncertainty remains for the start of 2024, with leading indicators not yet ready to confirm the risks of recession. The consumer confidence index seems more optimistic, with a rebound in December.



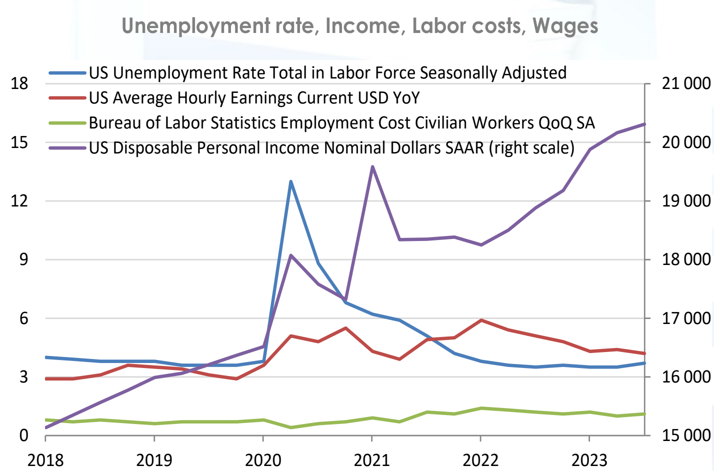
Sources: Bloomberg, BBGI Group SA

Relative resilience of the job market

Unemployment claims had been rising steadily since the end of January, virtually every week, and stood at almost 265,000 new claims, before dropping significantly again during the summer. The volatility of last quarter's statistics does not fundamentally change the picture: claims are still close to their lows for the year, at just 205,000 in December.

While redundancies are not soaring despite the current slowdown, JOLTS job vacancies continue to decline, dropping to 8.7 million after peaking in March 2022 at 12 million. Job growth is stabilizing at around 100 thousand creations per month after peaking at 450k in June. Overall, however, claims for unemployment benefits have resumed their upward trend, reaching a high for the year of almost 1,865,000. Annual growth in average hourly earnings has also been falling steadily since March 2022 (+6%) to just +4.0% in November 2023, which is still higher than CPI inflation over the year (+3.1%).

These developments are still sufficiently uncertain not to alter the perception of the Federal Reserve, which was still recently concerned about the risks that a tight labor market could pose to wage and inflation trends. It is therefore likely to adopt a wait-and-see attitude until there are clearer signs of reduced tension in this market.



Sources: Bloomberg, BBGI Group SA

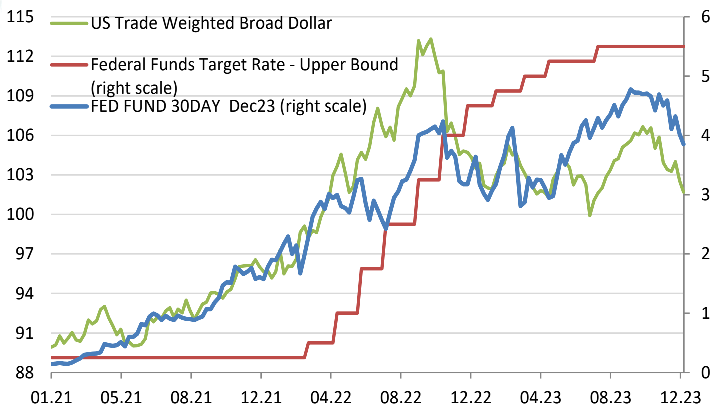
The Federal Reserve will have to cut rates

The fall in job vacancies and job creation, the rise in the number of unemployment benefits and the slowdown in wage growth are already positive indicators, but insufficient, in our view, to reassure the Federal Reserve that tensions in the job market have eased sufficiently to support a rapid change in monetary policy. However, it is undeniable that the risk of a further rise in wages being passed on to price indices is diminishing, which should be a positive factor for the Federal Reserve, which can already be satisfied with the current trend in price trends. Inflation (CPI) is once again on the decline, posting a reduced increase of +3.1% year-on-year. The monthly inflation regime for CPI improved markedly in 2023, as did that for producer prices. In our view, the Federal Reserve can already consider that the general trend in prices is moving in the right direction, even if in his last speech on December 13, the Fed Chairman remained cautious about a potential change in monetary policy, always stressing that the institution remained totally focused on the objective of bringing inflation down to 2%.

The Fed has logically decided to leave rates unchanged for the 3rd time in a row, which is probably already a sign of the end of the cycle. While FOMC members seem ready to consider a reversal of the cycle, we should not expect them to act too quickly. According to their comments, recent indicators do point to a slowdown in economic activity and a decline in inflation, which the Fed believes remains too high. But they also point out that the tightening of financial conditions on credit will weigh on the economy, employment and inflation. At this latest meeting, however, the Fed seems to us to have given a clearer signal of the end of the cycle, particularly in the comments made by Chairman Powell, who seemed to find it difficult to rejoice at having won the battle against inflation without plunging the economy into recession, and to refute the growing likelihood of a further rate cut. All FOMC members now seem more convinced that policy has been sufficiently restrictive and that no further rate hikes are on the cards. It is also interesting to note that J. Powell mentioned that the first rate cut will come before inflation reaches the 2% target. As a result, it is possible that the latter could occur as early as the end of March, when the six-month annualized PCE supercore inflation rate reaches +2.2%.

Our forecast for the evolution of key rates envisaged an initial phase of status quo that could last until the fourth quarter of 2023, before being followed by a new period of rate cuts leading to a flattening of the yield curve. This pause forecast has now been confirmed by the Fed, and we now consider the probability of a first rate cut as early as the beginning of Q2 2024 to be increasingly credible, given the current economic context and the FOMC's evolving assessment of the situation. Fed funds rates for March 2024 already suggest a dip to 5.21% from the current level of 5.33%. For June, the Fed funds rate is even significantly lower, at 4.64%, suggesting a sharp rate cut from the current 5.25% to 5.5%.The market's current expectations do not seem excessive to us, and are in fact in line with our own estimate of a change in monetary policy regarding key rates that will take place within a time horizon of three to four months. For the end of 2024, the FOMC is forecasting a reduction in Fed funds to 4.3%, slightly higher than our own estimate of 4%. The year 2024 will begin in a totally different monetary policy climate, with expectations of a rate cut of around 125bp. The easing is therefore expected, and all that remains is for it to be confirmed by economic statistics supporting this new policy.

Fed funds, Key rates and USD (Trade-weighted)



Sources: Bloomberg, BBGI Group SA

Inflation to reach +2% target in Q2 2024

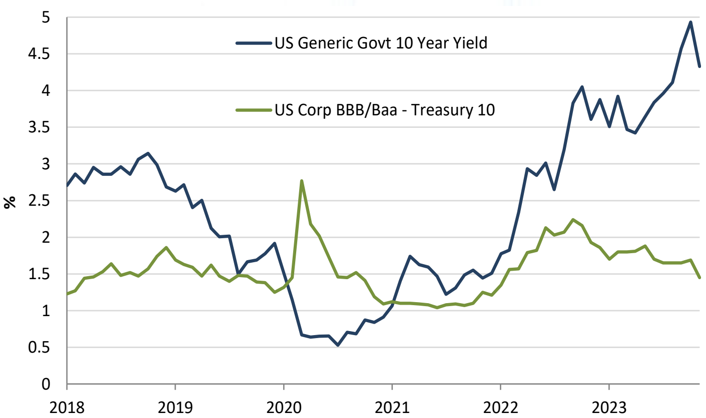
The inflation figures published for November in the United States confirm the new regime that has been in place for the past fifteen months. The CPI of +0.1% follows a stagnation in prices (0%) in October, allowing the year-on-year measure to slip to +3.1%. Inflation is easing significantly, returning to an increasingly satisfactory monthly pace. The price index excluding food and energy has joined this trend, with a reduced rise of +0.3% for a still slightly high annual increase of +4%. Among the elements that are still holding up well, 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. The expected gradual reduction in inflation to an « acceptable » level is therefore, in our view, an increasingly clear trend. More importantly for the Federal Reserve, its main indicator, the general PCE index, slipped by -0.1% in November, lowering its year-on-year level to +2.7%, while the core PCE index fell from +3.5% to +3.1%. Meanwhile, producer price indexes (excluding food and energy) have been stabilizing over the past year, averaging +0.2%/month and rising by only +2% year-on-year.

Inflation therefore seems to be following the expected trend and continuing to decline, without the need for further restrictive measures by the Fed. Especially since, in our view, the causal relationship between unemployment levels, growth, policy rates and inflation is not so clear-cut, particularly when we consider that the price trend was more a phenomenon of supply bottlenecks after the pandemic, rather than excess demand, which the Fed seems increasingly ready to accept. We believe that inflation will no longer be a penalizing factor in 2024, and that the +2% target will be reached in Q2 more quickly than the Federal Reserve expects.

Major readjustment of yield curves

The rate-curve readjustment we were predicting began in November and accelerated in December, with growing evidence that Fed policy was now close to a cycle reversal. A few months ago, our expectations for growth and inflation were already pointing to a forthcoming change in monetary policy. In our view, Treasury yields were clearly too high not only on the short end, but also on the long end of the yield curve, calling for a major downward adjustment when signs of a Fed policy reversal became clearer. This is now clearly the case, and the fall of over 110 bps in ten-year Treasury yields is the main witness to this. The outlook for dollar-denominated bond markets seemed to us to be very favorable to support a diversified exposure favoring investment-grade corporate bonds offering both attractive yields and prospects of capital appreciation. As we enter 2024, the increasing likelihood of inflation returning to +2% and of key interest rates being cut as early as Q2 have probably not yet developed all their potential positive effects on dollar yield curves. We are therefore maintaining our positive view of future interest rates and the outlook for US bond markets.

US Treasury Yields and BBB Bonds (Spread)



Sources: Bloomberg, BBGI Group SA

Dollar suffers as expectations adjust

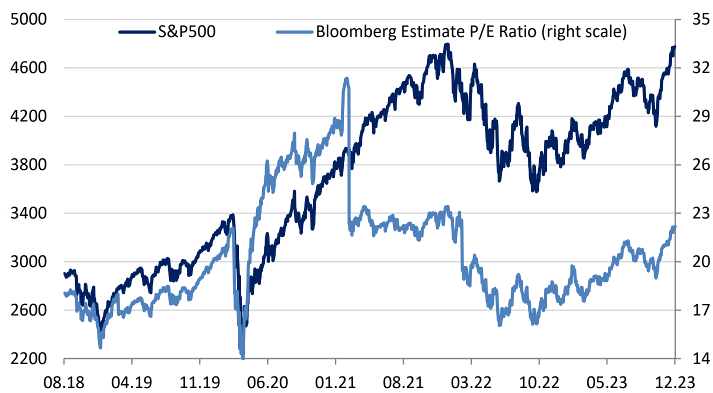
The change in outlook that took place during the last quarter, taking into account the end of the US monetary tightening cycle, was clearly not a positive factor for the dollar. The trade weighted dollar index logically felt the impact of this new rate outlook, falling -6% during the quarter after rising +5% in Q3. At the start of Q4, we announced that this rebound would be short-lived, given the likely gradual normalization of monetary policy and the downward adjustment of dollar yield curves. The expected decline in dollar yields which thus materialized triggered the predicted weakness of the greenback. Interest in U.S. assets and the adjustments that are bound to occur in other countries recording significant declines in inflation will help to limit the dollar's decline, anticipating a likely recovery in 2024.

Positive outlook for equity markets

Interest-rate tensions in Q3 had taken their toll on the positive momentum of the first six months. 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 in equity markets was no more marked in technology stocks, with the Nasdaq index sliding -8% over the same period. At the start of Q4, our scenario for economic growth and interest-rate trends underpinned interest in US stocks, which should benefit from a positive change in the investment climate, driven mainly by a new positive outlook for monetary policy.

In our view, the consolidation of the equity markets was temporary and nearing its end. We therefore took a positive view of the future trend in equity indices, maintaining an overweight position in growth stocks. As 2023 draws to a close, the S&P500's rise of around +10% over the quarter has proved in line with our expectations. We believe that the upside potential of US equities remains very significant for early 2024, given the reversal in monetary policy, and confirm our bullish outlook. The concentration of performance on a limited number of stocks should give way to a broadening of index participation.

S&P500 & PE ratio



Sources: Bloomberg, BBGI Group SA

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