WEEKLY ANALYSIS

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POSITIVE ENVIRONMENT FOR USD ASSETS

Resilient economic momentum. Encouraging leading indicators. Recession risks averted. Inflation close to Fed target. 1st rate cut in May. Positive environment for USD assets. Beware of high PEs. USD winner.

Key points

- US economy maintains good momentum at start of 2024
- No recession, but a gradual slowdown
- Steady improvement in leading indicators
- Declining tension in the labor market
- 0.25% cut in key rates in May?
- Inflation nears Fed target
- Favorable environment for USD bonds
- The dollar remains a winning currency
- Beware of generous stock market valuations

US economy maintains good momentum at start of 2024

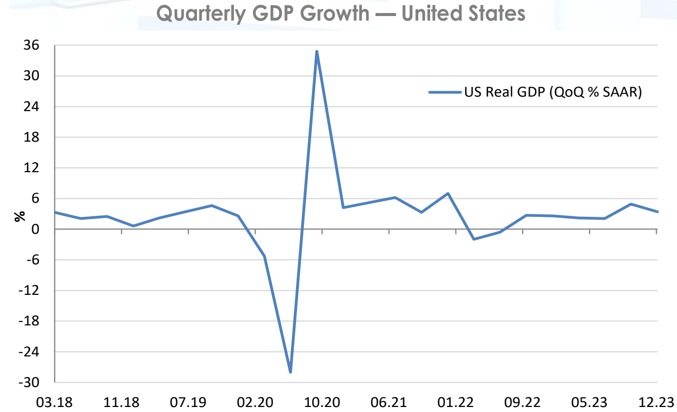
GDP growth in Q3 had already been exceptional (+4.9%), and was the best since December 2021. The figures published for the final quarter of 2023 are still particularly satisfactory, and show that the US economy is still very buoyant. With GDP growth of +3.2%, the US economy has shown surprising resilience to the tightening of monetary conditions implemented by the Federal Reserve to combat inflation since March 2022. The central bank's objective was indeed to bring inflation down to a target of +2%/year, at the risk of having to curb economic momentum or even provoke a recession. Two years on, we can see that inflation is indeed on a significant downward trend, but that this result was not achieved at the expense of a collapse in economic activity. So, despite an exceptionally intense monetary tightening cycle and a general acceleration in rising interest rates and financing costs for all economic agents, GDP is more than resilient. The resilience of the US economy is indeed remarkable, and belies the prognosis of forecasters who expected a recession in 2023 and then pushed back their forecasts for early 2024.

In the end, GDP will have grown by +2.5% over 2023, against all expectations, while the prospects for an easing of monetary conditions are increasingly encouraging and further reduce the risks of an economic contraction in the coming quarters.

Against the backdrop of the start of 2024, and just a few weeks ahead of the first key rate cut expected in June, the economy is showing no signs of weakening. Personal consumption remained robust in Q4, rising by +3%, virtually unchanged from the previous quarter. Growth in household spending thus suggests a relatively low sensitivity to price and interest rate trends, and remains an important contributor to GDP. Government spending (+4.2%) also supported GDP, while residential (+2.9%) and non-residential (+2.4%) investment also contributed.

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 start of the year are now a little weaker, but still very satisfactory given the monetary policy context. The Atlanta Fed's GDPnow indicator still suggests a positive development of +2%, slightly higher than that of the New York Fed (+1.9%). For our part, we believe that the rate cut expected in May and the general improvement in household and investor sentiment will also contribute to maintaining growth in the region of +2% over the first two quarters of 2024.

Quarterly GDP Growth — United States



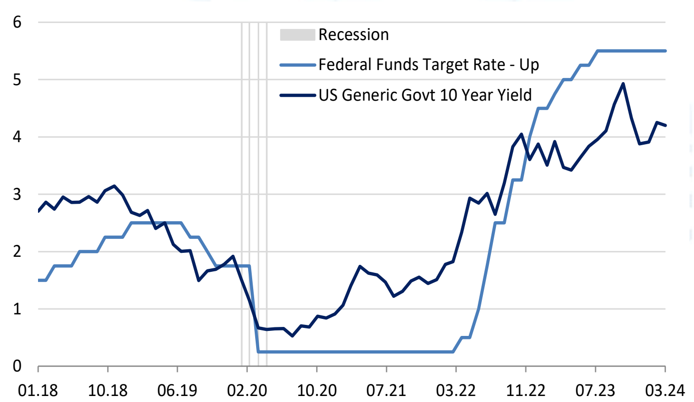
Sources: Bloomberg, BBGI Group SA

No recession, but a gradual slowdown

The start of 2024 therefore seems once again to be thwarting predictions of a US recession. Our outlook also confirms an estimate of growth in both Q1 and Q2, despite a monetary policy that has proved particularly restrictive, despite a status quo on rates committed in August 2023. The persistence of high key interest rates (5.5%) over the past eight months has so far had only a limited impact on growth. Nor does the 16% contraction in the Fed's balance sheet over the past twenty-four months appear to have had a dramatic effect on the US economy. The adjustment anticipated by economists on household consumption and investment spending has not really taken place to date, and in the context of expected further rate cuts, we rather feel that risks have diminished in recent months. As far as consumer confidence is concerned, the fall in inflation and the prospect of monetary easing in the 2nd quarter should also lead to an improvement in their perception of risk. In an environment characterized by high household indebtedness, the collapse in lending in December was surprisingly followed by a strong rebound in January. American households initially resisted the rise in interest rates and inflation by resorting to savings to maintain their purchasing power and consumption, before resorting more extensively to credit, which still seems to be largely the case today.

At the start of this year, they still appear to be in a position to cope with persistently high interest rates and financing costs, but the prospects for further reductions are now very good. In the current context, the risk of recession has diminished considerably, and our central scenario favours a gradual slowdown in the 2nd half of the year. The cut in key rates and the expected adjustments in yield curves will also help to limit these risks in the 2nd half of the year. The Federal Reserve can therefore be satisfied that it has succeeded in reducing inflation while maintaining conditions conducive to continued economic momentum.

US Recessions, Long Rates & Fed funds

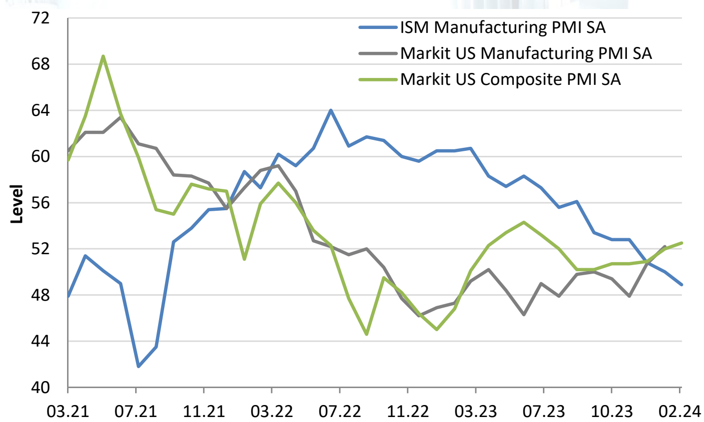


Sources: Bloomberg, BBGI Group SA

Steady improvement in leading indicators

The PMI indices have been rising steadily for several months, and strengthened in March, suggesting positive momentum for the US economy in the months ahead. The Markit US Composite PMI indicator is relatively stable at 52.5, while two distinct trends are materializing in the manufacturing and services PMIs. The PMI for the manufacturing segment improved rather rapidly, rising from 48 in December to 52.5 in March, underlining a clear recovery in the industry. The services PMI, on the other hand, slipped slightly to 51.7, but is still positive for the outlook. Uncertainty diminishes at the start of 2024, with leading indicators clearly dismissing the risk of recession. The consumer confidence index fell slightly in March, partly due to a deterioration in the employment variable. Despite a resilient job market, the future component of the confidence index thus shows slightly more pessimistic signs. Overall, the indicator rules out the risk of recession, but shows less optimism on the employment front, also suggesting slightly more uncertain times ahead for household consumption levels.

PMI-ISM Indicators

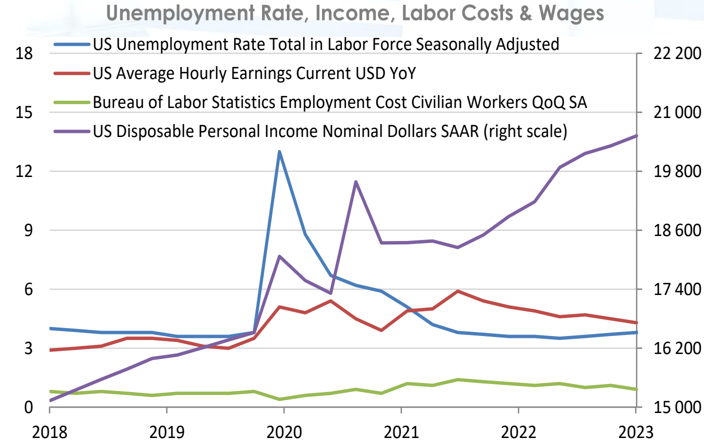


Sources: Bloomberg, BBGI Group SA

Declining tension in the labor market

Unemployment claims still show no clear deterioration in the job market at the start of the year. The fundamental picture remains similar, with claims still close to their 2023 lows, at just 210,000 claims in March 2024. While redundancies are not soaring despite the current slowdown, JOLTS job vacancies continue to decline, stabilizing at around 8.8 million for the past nine months. Employment growth has resumed since October, and now stands at 223,000 jobs in the private sector. Overall, however, continuing claims for unemployment benefit have resumed their upward trend and are now above 1,800,000 claims.

Unemployment Rate, Income, Labor Costs & Wages



Sources: Bloomberg, BBGI Group SA

The easing of tensions in the labor market therefore seems largely linked to the decline in wage growth, which stabilized at +4.3% year-on-year in February. Annual growth in average hourly earnings has also been falling steadily since March 2022 (+6%), to just +1.1% in February.

0.25% cut in key rates in May?

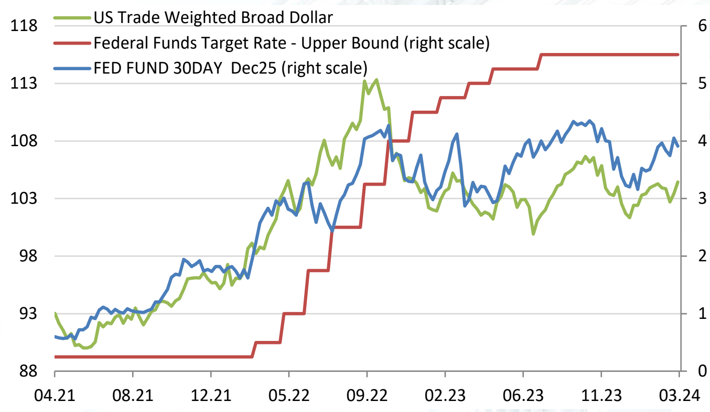
The US central bank can now be satisfied with the positive trend in inflation and the resilience of the economy. Initially, however, it was prepared to accept the negative effects on growth and employment of implementing a restrictive monetary policy to achieve its primary goal of fighting inflation. In the end, it would appear that the potential and accepted risks of recession are now very unlikely to materialize in 2024, given the economic data available to date.

But if the Fed can indeed begin to show some satisfaction at the sight of inflation, which has fallen sharply over the past year, it has yet to determine the timing of its change in monetary policy. At the end of 2023, expectations of a rate cut as early as March clearly seemed to be favoured by the consensus. But economic performance in the US, the resilience of the job market and a slowdown in the downward momentum of inflation at the start of 2024, have called these expectations into question and brought new uncertainty regarding the timing of the Fed's pivot. This was then postponed from March to probably June, while the number of key rate cuts and their amplitudes in 2024 were also revised downwards. However, Chairman Powell seems ready to loosen the reins of his policy if inflation parameters allow and if the job market shows signs of slowing. He will not wait for inflation to fall below his technical target of +2%, and will implement the expected easing. Nevertheless, after eight months of the status quo on rates, the Fed logically decided to leave rates unchanged once again in March, further postponing the end of the current cycle until the next FOMC meetings in May or June, when inflation continues to decline and wage trends finally seem less worrying for future price trends.

At the end of 2023, optimism was undoubtedly at its height when Fed funds rates for June 2024 fell from 5.33% to 4.65%, and expectations of a change in policy were already pointing to a first rate cut in March. In the course of Q1 2024, the aforementioned adjustment pushed them once again to 5.2%, which remains the current level. This now implies a likely 0.25% cut in central bank rates in June. In the longer term, the December Fed funds level (4.64%) suggests a moderate rate cut of less than 100 bps. This expectation is therefore considerably less optimistic than the cut expected at the end of 2023 for December 2024 to 3.8%, which represented a 170 bp decline in Fed rates.

As a result, investor optimism has fallen sharply, and is now close to the median forecast of FOMC members, which stands at 4.625%. The current situation therefore seems to us to reflect reasonable expectations, which are unlikely to be disappointed by the Fed's forthcoming decisions, as it could already cut rates in May.

Fed Funds, Key Rates and USD (Trade-Weighted)

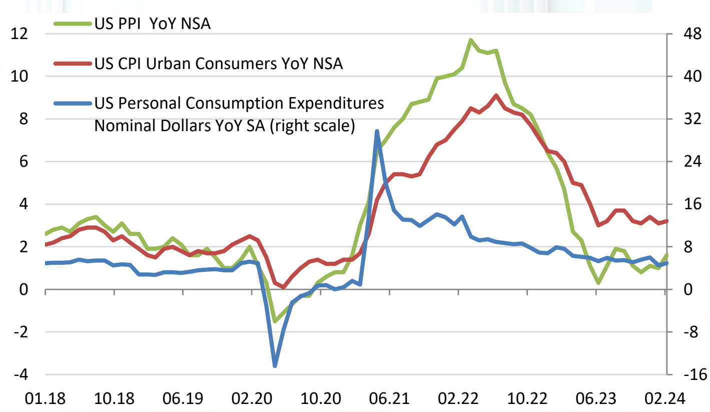


Sources: Bloomberg, BBGI Group SA

Inflation nears Fed target

February's monthly inflation figure of +0.4% proved slightly less encouraging than previous releases, resulting in a slight rise in the CPI index from +3.1% to +3.2% year-on-year. Excluding food and energy, the picture is similar for the month (+0.4%), showing a slide from +3.9% to +3.8% year-on-year. The services component remains resilient (+0.279%) and accounts for the bulk of price growth over the month and year (+3.057%). This loss of price momentum in February does not call into question the overall positive trend. In addition, the Federal Reserve's preferred indicator, the PCE core index, continued to decline in January, falling to +2.8% year-on-year, while the overall PCE index even fell to +2.4%, thus already coming very close to the central bank's +2% target. Import prices also showed a favorable year-on-year trend (-0.8%), while export prices showed a similar trend (+1.8%). Inflation therefore seems to be following the expected trend, which will allow for a forthcoming change in monetary policy, perhaps already at the May 1st meeting of the US central bank.

CPI, PPI & PCE Indexes

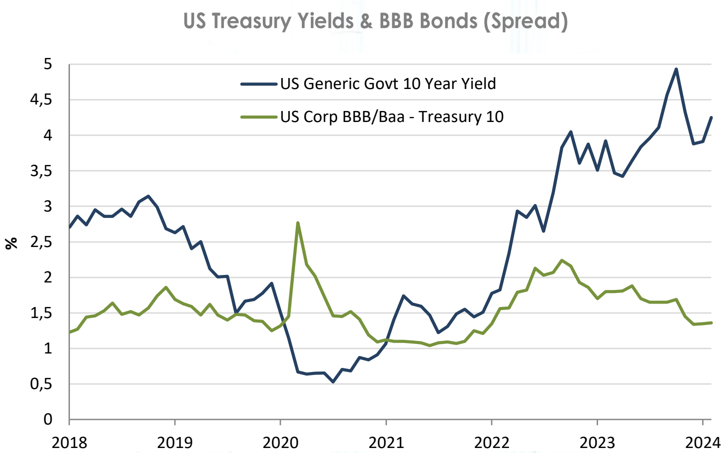


Sources: Bloomberg, BBGI Group SA

Favorable environment for USD bonds

A few months ago, we announced our outlook for inflation and the factors determining interest rates, which were to completely reverse the upward trend that had developed up to October 2023.

In fact, the predicted trend reversal occurred very quickly at various points on the yield curve, particularly on the long end. Ten-year Treasury yields fell rapidly from 5% to 3.8% at the end of the year, in a context that was probably too optimistic for the expected evolution of monetary policy. The readjustment, which took shape in the 1st quarter with yields rebounding to 4.3%, was essentially underpinned by the postponement by a few weeks of the Fed's first rate cut, now expected in June. The loss of momentum in the decline of inflation was logically a determining factor in this rate hike, which we consider temporary. Indeed, having been over-optimistic about the Fed's pivot date, we feel that today's expectations are certainly a little too conventional. As a result, the next quarter should be more positive for bond markets. We are once again anticipating a phase of declining yields, which could push 10-year yields towards the 3.5% level. We therefore expect a new phase of 50 to 70 bps decline in long yields. As a result, new opportunities have arisen in corporate investment-grade bond segments offering both attractive yields and prospects of capital appreciation, as well as in other segments such as high yield.



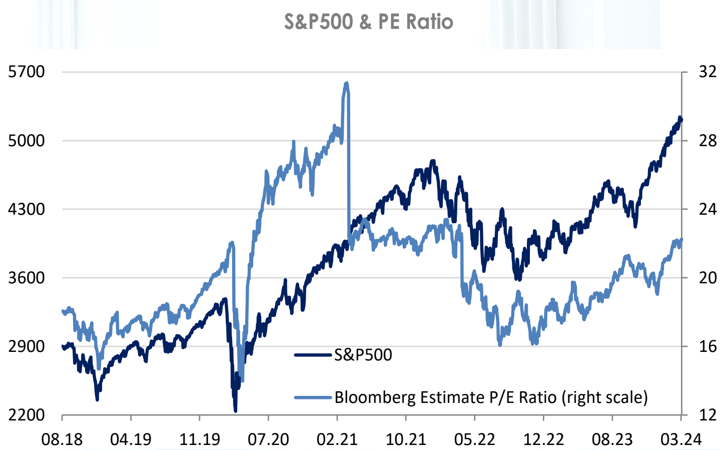
Sources: Bloomberg, BBGI Group SA

The dollar remains a winning currency

The trade-weigthed dollar's correlation with long-term interest rates has remained relatively high over the past six months. The expectation that the U.S. monetary tightening cycle will soon come to an end has obviously not been a positive factor, but the recent rebound in rates has supported its appreciation. The convergence of monetary policy changes in Europe and the USA, together with a simultaneous decline in inflation, will certainly reduce exchange rate volatility in 2024. Yield differentials could remain relatively stable between the main currencies, while inflation differentials are more likely to contract. Against this backdrop, the growth differential could be enough to boost investor interest in investment opportunities and in US assets. This trend will sustain strong demand for dollars. A general appreciation of the dollar seems likely in 2024, particularly against the Swiss franc, which the Swiss National Bank has partly abandoned in its new monetary policy phase.

Beware of generous stock market valuations

Since the peak of long rates at 5%, the S&P500 index has risen by +28%, recording five consecutive monthly increases. Despite volatility in the bond segment and sharp rebounds in interest rates, US equities have performed exceptionally well, without a single sustained period of price consolidation. Our positive expectations for equities have thus been realized, as have those concerning the outlook for growth stocks (+28%), which have effectively outperformed the S&P value index (+22.5%). As a result, US equity valuations for 2024 and 2025 are now at historically high levels, with PEs of 22x and 20x. We believe that the upside potential of US equities remains significant, but the level of valuation still calls for a degree of caution. The concentration of performance on a limited number of stocks (magnificent seven) must give way to a broadening of the indexes' participation in the upside, if the current trend is to continue. We maintain our positive recommendation for US stocks in view of the Fed's forthcoming policy easing.



Sources: Bloomberg, BBGI Group SA

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