WEEKLY ANALYSIS

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FED PIVOT TO TAKE PLACE WELL BEFORE DECEMBER

Loss of economic momentum. ISM leading indicators point downwards. Normalization continues in the labor market. Services inflation finally falls. The Fed is overdue and will have to act. Focus on USD-denominated assets.

Key points

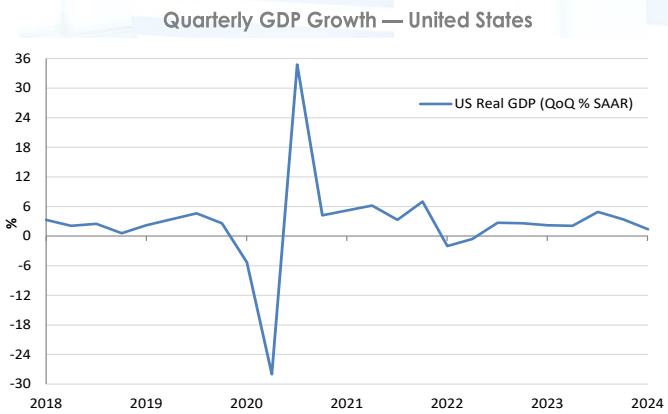
- US economy loses momentum
- Economic slowdown takes shape in Q2
- ISM leading indicators turn downward
- Falling tensions in the job market
- Is the Federal Reserve behind the curve again?
- Inflation nears Fed target
- Favorable environment for USD bonds
- Investors will continue to favor USD assets
- Overall positive environment for equities

US economy loses momentum

GDP The 1st publication at the end of April of economic growth for the 1st quarter of 2024 was a major disappointment, coming in at +1.6%, well below the +2.5% expected by forecasters. Momentum in the final quarter of 2023 was unable to sustain itself, falling sharply from the +3.4% recorded at the time. The end-of-May growth revision even showed a weaker evolution of just +1.3%/year. The exceptionally intense monetary tightening cycle, the general acceleration in interest rate rises and the rise in financing costs for all economic agents, finally seem to have had an impact at the start of the year on the resilience of the US economy. Fixed investment, up +0.9%, made the strongest contribution to growth in the quarter, closely followed by household consumption (+0.98%) and government spending (+0.31%). Net exports pulled GDP down by -0.65%, while inventories fell by -0.42%. Two of the five segments therefore contributed negatively to GDP for the first time since September 2022.

The US economy thus started the year on a less solid note than expected, and in an inflationary environment that was a little more marked than hoped. In a way, however, April crystallized expectations of sustained growth strong enough to prevent inflation from declining, even at the risk of seeing a revival in price rises that would prompt the Federal Reserve to raise its key rates once again. A few weeks later, this scenario seems to have been ruled out by the numerous economic data, which increasingly suggest a slowdown in US growth in Q2. The downward revision of personal spending and retail sales, a labor market that is finally a little weaker, and a less dynamic situation in the real estate segment, all point to the economy operating at a slower pace. The first half of the year will therefore certainly be much weaker than the previous one.

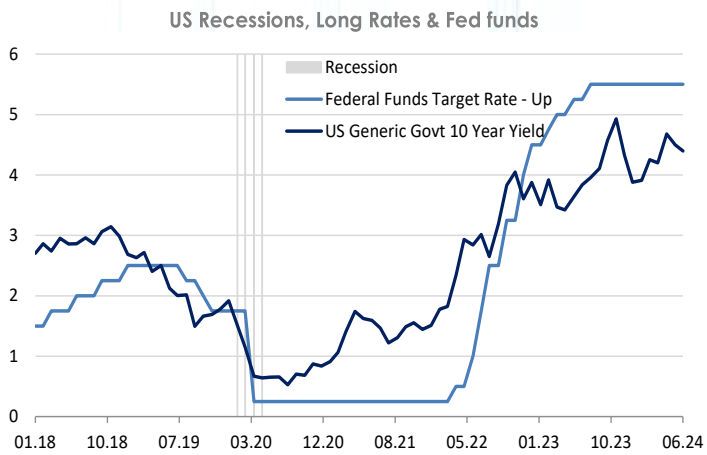
After two years of progressively more restrictive monetary policy, the economy is finally showing signs of weakness. Twelve months of key rates frozen at 5.5%, and a rise in financing costs that has taken mortgage rates to 7% and credit card rates to 24.8%, consumption and investment are finally slowing down. Recurrent jobless registrations reached their highest level since the end of 2021, capital goods orders were down in May, while the trade deficit reached $100 billion.



Sources: Bloomberg, BBGI Group SA

Economic slowdown takes shape in Q2

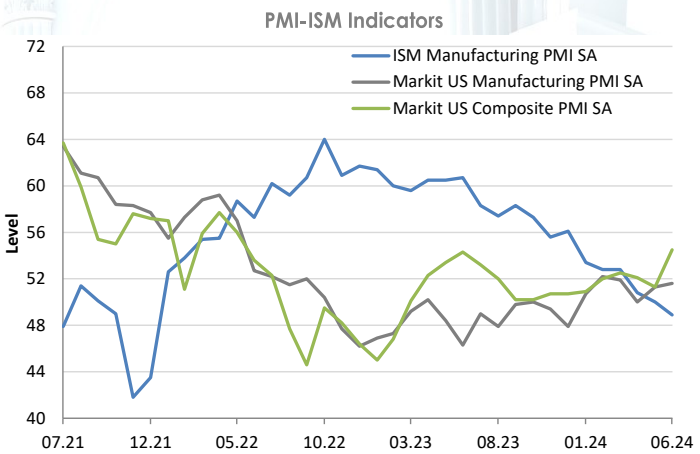
At the start of the year, our central scenario was for a gradual slowdown in the US economy, which is now well underway. While the ECB and SNB have already made their first rate cuts, the consensus forecasters still believe that the US will not make its first rate cut until December. If indeed US monetary policy were to remain restrictive with rates unchanged for another six months, the risk of a sharper and potentially deeper economic slowdown would clearly be higher. After nine months of stabilization at around 1,800,000 continuous jobless claims, the last two months have seen a jump of +3%. Household consumption also reacted logically by halving its monthly growth level between March (+0.6672%) and May (0.248%), despite a +0.5% rise in personal income. As far as consumer confidence is concerned, the continuing high cost of financing in a context of high household indebtedness is certainly weighing on their morale. Since 2022, growth in consumer credit has been on a downward trend, with no sign of a turnaround. After rising by 42 billion in June 2022, the two-year contraction has been extraordinary. Credit growth in April now represents only around 15% of this amount (6.4 billion). 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, until it became unbearable. Credit card balances fell for the first time in three years, reflecting the fact that households are now obliged to control their credit card balances because of high interest rates. In addition, payment defaults have normalized after reaching historically low levels, suggesting a possible return to above-average default ratios. We believe that this phenomenon could last and intensify, at the risk of penalizing household consumption over the coming months.



Sources: Bloomberg, BBGI Group SA

ISM leading indicators turn downward

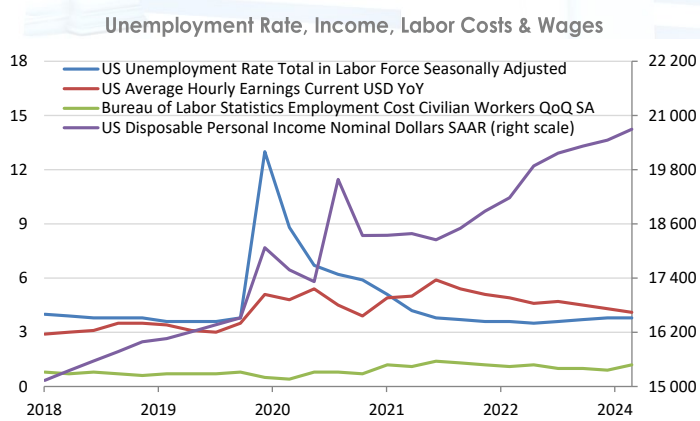
Economic surprises have tended to be negative in recent months, partly due to weakness in the housing market, suggesting that growth expectations may be too optimistic. In terms of ISM indicators, the latest statistics for the services sector turned negative, with the ISM Services index dropping from 53.8 to 48.8. The already negative ISM employment indicator slipped further from 47.1 to 46.1 in June. The decline is fairly widespread across the segments, despite the start of the summer season, clearly suggesting that economic momentum is indeed slowing. The overall index is in contraction, which is a relatively rare occurrence in the history of this indicator. Both current economic activity and the new orders component, down from 54.1 to 47.3 in a single month, are now in contraction for the first time since 2020 and 2022. However, the PMI indices do not yet confirm this potential halt to US growth, and still show a relatively serene picture of upcoming activity. The overall PMI even rose from 54.6 to 54.8, driven by the still high services PMI (55.3), despite a slightly lower manufacturing PMI at 51.6. The consumer confidence index has been falling since February, and slipped again in June from 102 to 100.4, also suggesting an imminent slowdown in pessimistic consumption.



Sources: Bloomberg, BBGI Group SA

Falling tensions in the job market

After several months of lower jobless claims around the 200,000 mark, June once again saw higher claims, closer to 235,000 per week. This trend can also be observed in the job creation statistics (ADP), which have once again taken a downward path over the last four months, gradually slipping from around 200,000 new jobs to just 150,000 in June. Forthcoming Department of Labor releases should also show a decline in non-agricultural hiring from 272,000 in May to around 180,000 in June. Year-on-year redundancy announcements also rose by +19.8% in June, certainly indicating a easing of tensions in the labor market.



Sources: Bloomberg, BBGI Group SA

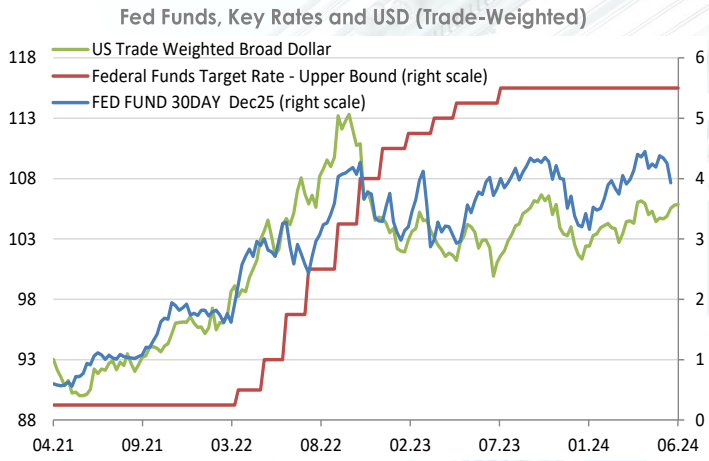
JOLTS job vacancies are well below their recent average, at 8.14 million, still on a downward trend. Wage growth is expected to decline slightly to below +4% in June. Overall, the job market, which has long been a source of concern for the Federal Reserve, should gradually reassure members of the Monetary Policy Committee and support a forthcoming policy pivot.

Is the Federal Reserve behind the curve again?

The US central bank still seems reluctant to adjust its monetary policy, despite the growing flow of statistical data pointing to an economic slowdown. After having feared, probably excessively, that the US economy would not respond to rate hikes and tighter monetary conditions, when employment and inflation statistics stabilized in April, the Fed now seems still trapped by its wait-and-see stance. And yet, having often stressed that its monetary policy would evolve in line with published statistics (data dependant policy), it now seems that it is still positioned on a "neutral" bias, even though signs of a slowdown are materializing ever more clearly. Even though economic data is surprisingly on the downside, and inflation is showing increasing signs of weakening, the Fed does not seem ready to act. According to the forecasts of the members of the Monetary Policy Committee, the implicit target fed funds rate for the end of 2024 is still 5.125% and 4% for the end of 2025. Today's market rate for December 2024 is slightly below 4.96%. It is still 5.24% for September fed funds. Today's effective fed funds rate is 5.33%. Based on the June dot plots, we can therefore assume that Federal Reserve policy-makers are planning just one rate cut between now and the end of the year. This is likely to come late in December.

The Fed is still extremely cautious, and reminds us that it is still too early to say whether recent inflation trends and the slowdown in the economy are sustainable and could justify a cut in key rates.

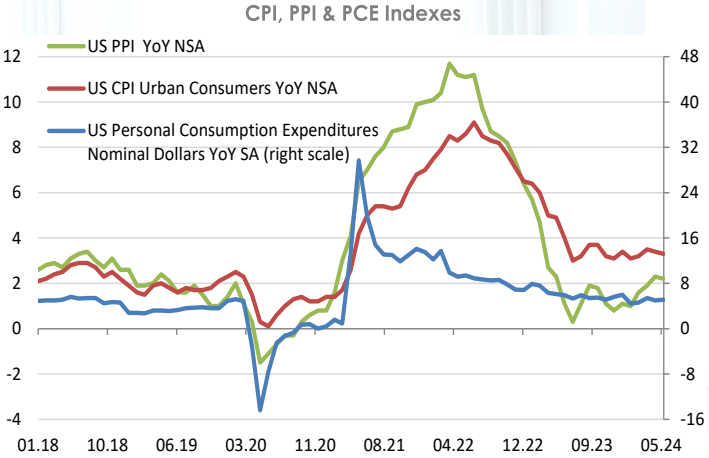
Once again, we feel that, as usual, the US central bank is certainly already behind the curve in terms of the evolution of the US economy. We consider that the current flow of statistics is already sufficient to see the slowdown underway, particularly if we consider that the lagging or sticky elements, which were holding back a further fall in inflation, are now slipping and contributing positively to the fall in inflation measures. The Fed should reassess its positions to adjust policy without waiting for a further deterioration, which could occur if it decides to maintain its wait-and-see stance until December. However, the Fed chairman had stressed that he was ready to loosen the reins of policy if inflationary parameters allowed and if the job market showed signs of slowing. He also mentioned that he would not wait for inflation to fall below his technical target of +2%, and would then implement the expected easing. Today, inflation fell to +2.56% (PCE and core PCE), driven by a drop in the services segment. In our view, the conditions are right for the Fed to implement its long-awaited pivot. We estimate a likely decline in September, without ruling out a positive surprise on July 31, if inflation continues its downward trend in June.



Sources: Bloomberg, BBGI Group SA

Inflation nears Fed target

Monthly inflation for May proved better than expected, rising by just +0.006%. This is now the 3rd consecutive monthly decline in the level of inflation, which is now clearly below the data that had worried the markets in February (+0.4%). The May figure thus sees inflation at its lowest monthly level since May 2020 (-0.1%). Year-on-year CPI thus fell to +3.3%, or +3.4% for the index excluding food and energy. The services component, which was still making a negative contribution to the CPI in January with an increase of +0.4%, has steadily declined over the last four months, contributing just +0.134% in May. In this environment of observable cyclical slowdown, the Federal Reserve's preferred indicator, the PCE core index, continued to decline in May, falling to +2.56% year-on-year, while the overall PCE index also fell to +2.56%, both of which came closer to the central bank's +2% target.



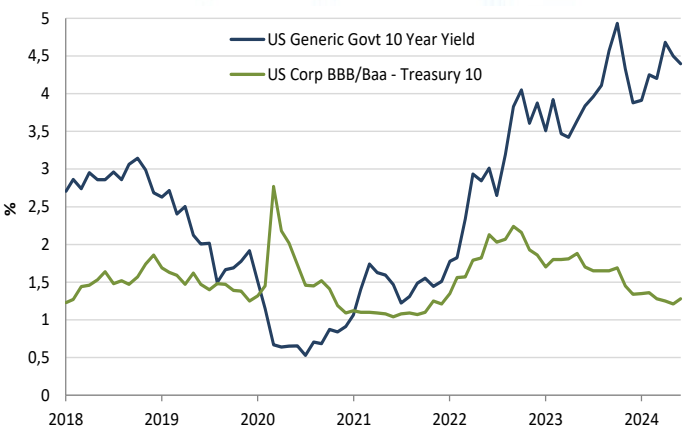
Sources: Bloomberg, BBGI Group SA

Favorable environment for USD bonds

The ongoing economic slowdown in the USA and the positive trend in inflation are now creating the positive conditions for the Federal Reserve to intervene sooner than the consensus would have us believe. In the end, bond markets have only recently begun to take slightly more notice of the growing risks of a downturn in economic activity. At the end of April, general sentiment still favored the prospect of uncontrolled inflation, which could even, if it persisted, provoke a further tightening of

monetary policy. Uncertainty on this front and the Federal Reserve's extremely cautious comments had combined to maintain a climate of uncertainty in the capital markets. From the extreme optimism seen in December, when six rate cuts were expected by 2024, the consensus has now shifted to what we believe is an extremely pessimistic stance. The rebound in ten-year yields from 3.8% at the end of December pushed US Treasury yields to 4.7% in April and 4.61% again at the end of May. It seems that investors remain particularly indecisive despite the stream of negative economic surprises, since at the end of June, ten-year yields were still at 4.4%. The US central bank will have to adjust its stance and, in our view, will not wait until December to lower its key rates for the first time. The summer should bring a little more clarity on the health of the economy and consumers, but also on the likely date of the Fed's next pivot. We believe that, in a weaker economic context and with inflation heading towards +2%, long rates could once again touch the 3.8% threshold, already reached in December. As a result, current interest rate levels present opportunities in both the investment-grade corporate segment and the high-yield sector.

US Treasury Yields & BBB Bonds (Spread)



Sources: Bloomberg, BBGI Group SA

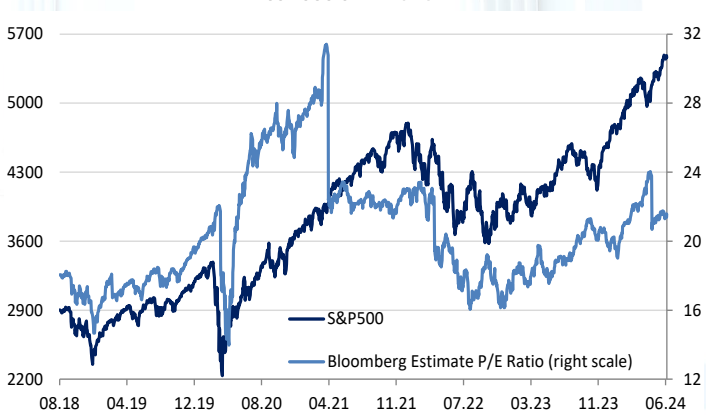
Investors will continue to favor USD assets

The trade-weigthed dollar's correlation with the trend in long rates should be a negative factor for the greenback in the context of the expected economic slowdown and rate cuts. The Fed's next pivot could be seen as an element weakening the dollar, but the rate-cutting cycles initiated by other central banks should in fact have similar effects on the rates of other currencies, with the result that yield differentials will be maintained. The convergence of monetary policy changes in Europe and the USA, and a simultaneous decline in inflation, will therefore probably reduce exchange rate volatility in the 2nd half of the year. Yield differentials are likely to 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 US investment opportunities and assets, but it will certainly be the prospects of capital gains in US bonds and equities that will sustain strong demand for dollars. A general appreciation of the dollar therefore still seems likely, particularly against the Swiss franc, which has been partly released by the Swiss National Bank in its new phase of monetary policy.

Overall positive environment for equities

Since the peak of long rates at 5%, the S&P500 index had risen by +28% before the April correction, and then resumed a positive trajectory, rising by almost +35% by the end of June. Despite volatility in the bond segment and significant rebounds in interest rates, US equities performed exceptionally well, strongly influenced by the seven major Nasdaq stocks. Our positive expectations for equities at the start of the year have thus come true, as have those concerning the superior prospects of growth stocks (+26.7%), which actually outperformed the S&P value index (+5.5%) during the 1st half of the year. 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 is still significant, but valuation levels still call for a degree of caution.

S&P500 & PE Ratio



Sources: Bloomberg, BBGI Group SA

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