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Investment Strategy Q4 2023

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After a two-stage summer on the equity markets and lingering uncertainties on the future shape of monetary policies, wide divergences have emerged from one region to another. What should we keep in mind from the past few months? How should we approach the rest of the year?

Since 30 June, global equity markets have been almost flat in local currencies, but otherwise were driven up by about 2% by the dollar's gains[1]. This occurred in two stages: they rose until early August on company releases and then fell, rather abruptly, on rising interest rates, which triggered an inversion in the yield curve[2]. The real US yield is now hovering around 2%[1]. US statistics have been a positive surprise, whereas in Europe the macroeconomic environment has been marked by stagnation and a recession in Germany. In China, economic figures have brought to light deflation and a significant decline in manufacturer confidence. Markets have also been undermined by higher oil prices. In reaction, investors have fled into money-market investments.

What is behind this divergence in macroeconomic newsflow between the US and Europe? While employment has been resilient, albeit weakening somewhat, on both sides of the Atlantic, the main difference has been in consumer spending. Savings built up during the Covid-19 crisis will soon have been used up completely in the US, whereas in Europe (and in China for that matter), households have opted to hold onto some of those savings, and that, moreover, is keeping the savings rate above its historic average. This divergence is why the growth outlook is so different between the US and Europe, as well as China. Meanwhile, business confidence in manufacturing continued to worsen more in the eurozone than in the US.

Inflation, too, has diverged from one region to another. Core inflation[3] in the US has slowed markedly and, when stripping out its mortgage lending component, has been especially reassuring over the past three months, at about 2%[4]. However, eurozone inflation came in at 5.3% as of the end of August[5], unchanged from one month earlier. Inflation there has been driven higher by wage hikes, which, unlike in the US, have not eased. Meanwhile, the impact of historically hawkish interest-rate hikes has begun to show up, for example on the credit market. Inflation and growth data have therefore created a quandary for central banks in forcing them to stick to hawkish policies, in spite of everything. Yield-curve inversions generally signal an oncoming recession. But this time could be different, as rates had been extremely low just before the tightening cycle began in 2022. Macroeconomic data, which have been rather favourable in the US, are pointing in this direction, whereas a cautious take is more suitable in Europe.

(1) Source: Bloomberg, 31/08/2023.
(2) A graphic depiction of bond yields based on their maturities. In a stable economic environment, with no inflationary pressures or excessive debt, the longer the bonds' maturities, the higher their yields.
(3) Ex food and energy.
(4) Source: U.S. Bureau of Labor Statistics, September 2023.
(5) Source: Eurostat, September 2023.

Things in China are very different from the rest of the world. The authorities have put their foot down in reaction to “excessive liberalism”. This, along with mismanagement of the Covid crisis, has held back the economic recovery, and the first-quarter spurt was short-lived. Business confidence has worsened appreciably and is now approaching contraction levels. Consumer prices have made a foray into negative territory. Excluding energy and food commodities, prices are barely at 1%[(6)]. The real-estate crisis has worsened, with the collapse of major nationwide property developers, and foreign trade continues to shrink. Moreover, as China’s debt is equivalent to almost three years of GDP, monetary authorities have little room to manoeuvre and seem to have opted for a cautious stance, retaining some leeway in case things get even worse. Even so, there are some sources of support that have brightened the outlook for the coming months and the steep recent market correction has led to some especially attractive valuations in the region.

Against this backdrop, we currently see three scenarios for the coming months. The first, the “no landing” scenario, assumes that inflation will not slow down, that wage demands will intensify, and that the central banks’ status quo is only temporary. This would be bad news for both bonds and equities, which would take a hit from higher rates. The second, “hard landing”, scenario assumes that the contraction in manufacturing spills over quickly into services and exacerbates negative growth in construction and fiscal consolidation. This would be bad news for equities, and bond yields would fall. The third scenario, the “perfect landing”, assumes that inflation will be brought under control without derailing economic growth. Receding inflation would restore purchasing power to households and clear the path to a gradual improvement in the global economy in 2024 and to monetary easing. However, the steep inversion of the yield curve would hinder significant returns on the long sections of the curve. Equities would benefit from growth, but margins would be squeezed by the reduced capacity to pass wage hikes on to prices. This would mean little upside in equities.

Clearly, while few market participants adhere to this third scenario, the US market seems to be increasingly pricing it in. Our view is that there is little upside in equities, with the US market risk premium at a 23-year low, justifying exposure below reference levels. This is particularly so, as the bond and money-market asset classes offer medium-term carry opportunities in the case of bonds and solid returns pending other opportunities in the case of the money market.

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(6) Source: National Bureau of Statistics of China, September 2023.

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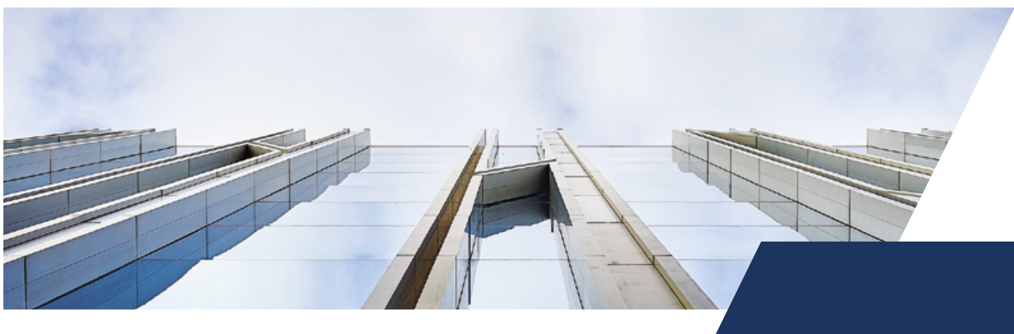

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