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Market Insight

Autumn 2023

Economic context

The soft landing of the U.S. economy has continued and the process of global disinflation is still ongoing (Chart **#1**). Can the conflict between Israel and Hamas derail this scenario? This is unlikely as long as there is no conflagration of the Middle East and extension to Israel's neighboring countries **#2**.

In the United States, manufacturing activity picked up slightly, while services activity remained at a decent level. With a job market still buoyant in September with more than 300k private sector jobs created, soft landing is still relevant. Nevertheless, we believe that growth will slow more sharply by the end of the year in view of the letters of intent to lay off and the coming decline in consumption, which in turn has been accelerated by the rebound in the price of petrol at the pump. History shows that we must be careful with the idea of a soft landing as it is difficult to predict the evolution of the economy. One thing is certain, however, that price growth continues to moderate and inflation to fall, albeit at a slower pace than in the first half of the year **#3**.

In Europe, there were no surprises, with a continued and combined contraction in manufacturing and services. Two countries stand out, however, since German industry continues to slow down and France is falling sharply in services. Thanks to the economic slowdown, inflation is falling rapidly with price decreases recorded during the quarter and everything suggests that disinflation will continue.

In China, visibility remains limited. While the official Purchasing Managers' Index (PMI) are timidly recovering and a slight improvement in industrial production has been recorded **#4**, consumer prices are once again flirting with deflation and the country has recorded the fifth consecutive month of decline in exports. While there is nothing to expect from the real estate sector, the government is considering further announcements to support the economy.

Central Banks

The rise in real rates has been a major concern for investors but also for central banks. The Fed has paused after months of restrictive communication that has had the merit of calming investors' ardour, who were quick to anticipate multiple rate cuts next year. Some central bankers have even been slightly less restrictive in their speeches, advocating more patience. This is not the beginning of the pivot, but it is an encouraging sign in a tense period. We believe that the risk/reward ratio for holding long positions in US rates is favourable again **#5**.

For its part, the ECB has raised rates, probably for the last time, aware that its monetary policy is quite restrictive.

Financial Markets

In the end, the financial markets experienced a "classic" seasonality effect during the month of September **#6** due to the rise in interest rates and its impact on valuations. As we believe the rate correction is nearing its end, equity markets will be able to advance again depending on company fundamentals and earnings. So far, analysts' earnings forecasts have been relatively stable, but the disappointment with LVMH's results illustrates how difficult it is for analysts to make right predictions.

Finally, we should note the rebound initiated at the beginning of October by emerging indices, which could only be extended if the future stimulus measures initiated by China are significant.

Investment Policy

- The potential for a rate hike is now limited and the two pillars of the indexes' rise, lower inflation and a soft landing for growth, are still relevant. As for the situation in the Middle East, it should not lead to a market correction as long as the conflict does not spread to neighbouring countries (Lebanon, Iran).

- Inflation is falling at a slower pace than in H1, which is adding volatility to interest rates. But a soft landing is still good news for EPS.

- Nevertheless, we remain positive on Europe and believe that the valuation of European equities is in line with the current challenges.

- New announcements from the Chinese government to support the economy will arrive in October. They are necessary to prevent the country from entering deflation.

- We favour Asia in the emerging world.

- We are increasing the duration of our portfolios, rates are back to record highs while growth is weakening in Europe and inflation continues to fall.

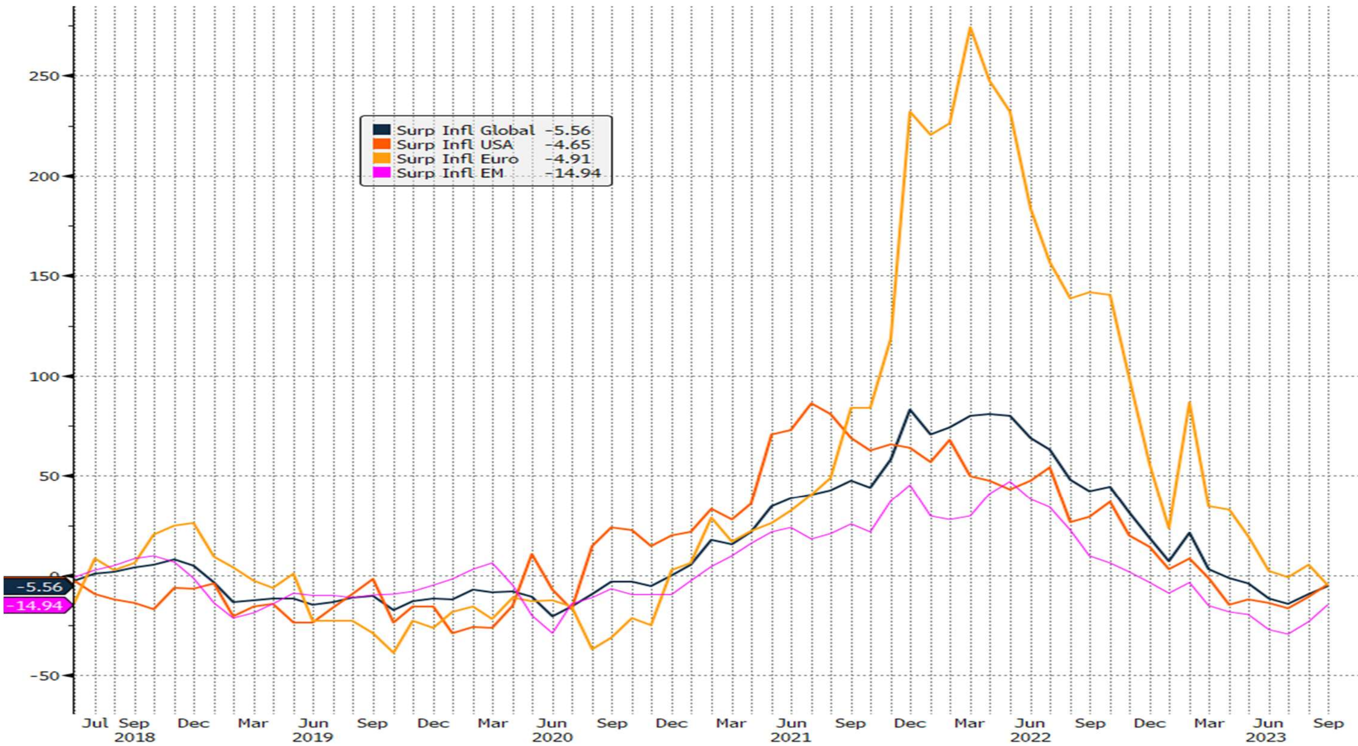
- The countries of the South (Spain, Portugal) retain an insolent economic health, unlike Germany and now France which is beginning to falter.

- After the best performance among the credit sub-segments, we are taking some profits in the HY now that spreads have tightened and refinancings are approaching.

- Emerging market central banks have been highly effective at fighting inflation and are ahead of developed countries. They could cut rates in the coming months and also benefit from a future Fed pivot that would push the dollar lower.

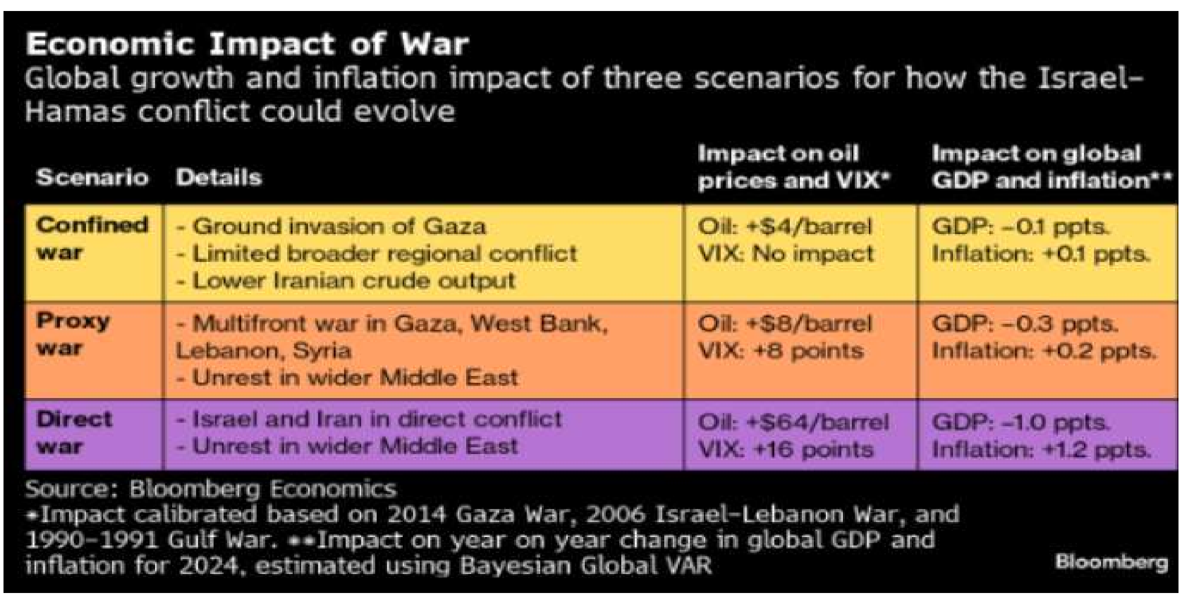
Graphics

#1 No nasty surprises on inflation



Source : Bloomberg

#2 Economic Impact Based on Possible Israeli Conflict Scenarios



Economic Impact of War

Global growth and inflation impact of three scenarios for how the Israel-Hamas conflict could evolve

Scenario	Details	Impact on oil prices and VIX*	Impact on global GDP and inflation**
Confined war	- Ground invasion of Gaza - Limited broader regional conflict - Lower Iranian crude output	Oil: +$4/barrel VIX: No impact	GDP: -0.1 ppts. Inflation: +0.1 ppts.
Proxy war	- Multifront war in Gaza, West Bank, Lebanon, Syria - Unrest in wider Middle East	Oil: +$8/barrel VIX: +8 points	GDP: -0.3 ppts. Inflation: +0.2 ppts.
Direct war	- Israel and Iran in direct conflict - Unrest in wider Middle East	Oil: +$64/barrel VIX: +16 points	GDP: -1.0 ppts. Inflation: +1.2 ppts.

Source: Bloomberg Economics
*Impact calibrated based on 2014 Gaza War, 2006 Israel-Lebanon War, and 1990-1991 Gulf War. **Impact on year on year change in global GDP and inflation for 2024, estimated using Bayesian Global VAR

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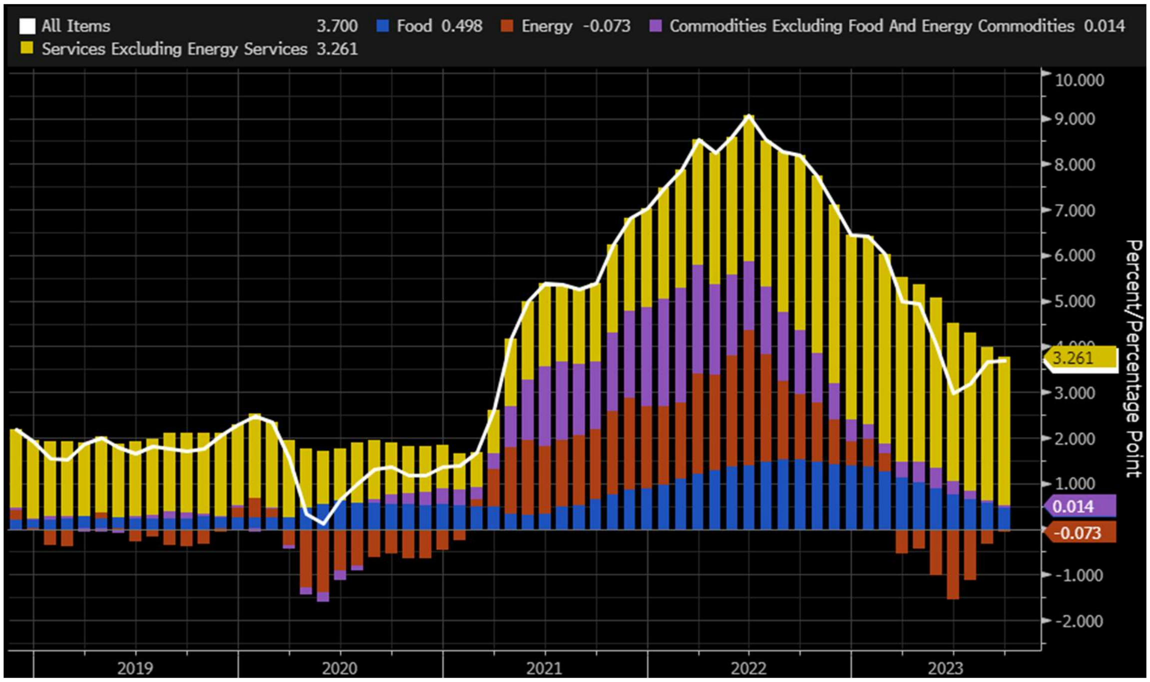
#3 Components of US Inflation (YoY)



Source : Bloomberg

#4 China's Industrial Production

Source : Pictet

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#5 The risk/reward ratio becomes favourable

Estimated 12-month total returns based on different yield movements

	300bp rise	150bp rise	50bp rise	50bp fall	150bp fall	300bp fall
2-year Treasury	2.3	3.7	4.6	5.53	6.5	7.9
5-year Treasury	-5.5	-0.6	2.9	6.45	10.2	16.1
10-year Treasury	-14.9	-5.8	1.0	8.34	16.4	29.8
20-year Treasury	-24.7	-11.6	-1.1	11.37	26.0	53.2
30-year Treasury	-30.4	-15.7	-2.9	13.19	33.5	74.7

Source : Bloomberg

#6 S&P performance in September and Q4 over the last 4 years

Last four Septembers for the S&P:

2020: -3.92%
2021: -4.76%
2022: -9.34%
2023: -5.19% (thru 9/26)

Last three Q4s:

2020: +11.69%
2021: +10.65%
2022: +7.08%
2023: ?

Source : Bloomberg