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Creating Sustainable Value

MONTHLY MARKET REVIEW & OUTLOOK

February 2024

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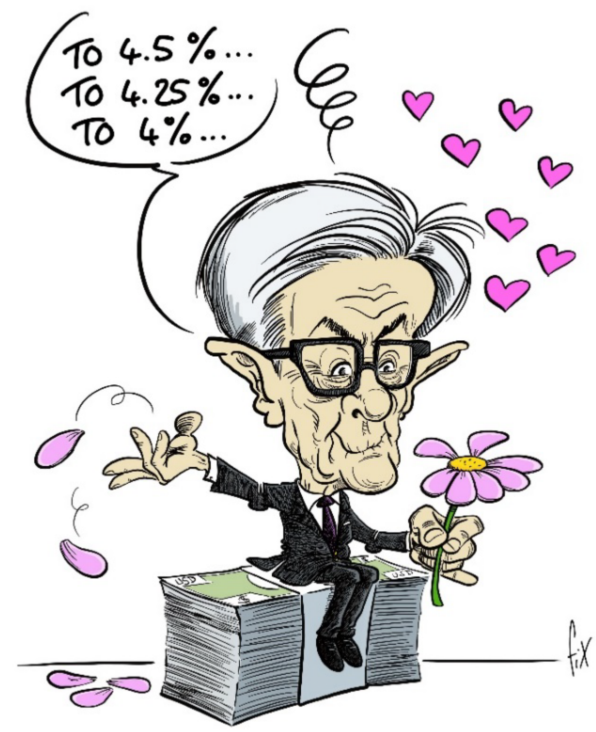
Divergent performance to start the year

In January, the markets welcomed the multiple US macroeconomic data that proved quite significantly above expectations, such as fourth-quarter growth at an annualised rate of 3.3%[1] and survey data including the University of Michigan's Consumer Confidence Index at an almost three-year high. In the euro area, while growth remains low, recession seems to have been technically avoided at the end of 2023, with southern European countries offsetting weakness in Germany. The most recent surveys would suggest a slight recovery in activity during the year ahead.

These pleasant surprises benefit risky assets, as evidenced by a new historic high for the S&P500,[2] which gained 1.7%[1] over the month. As in 2023, the bullish rally remains focused on a handful of stocks, as witness the S&P500 Equal Weight Index having ended January down 0.8%[1]. In Europe, markets continue to rise for the third consecutive month, with a gain of 1.5% for the Stoxx 600.[3]

Full-Year earnings season has started, and technology companies stand out yet again. Media and health are also performing well, at the expense of basic resources and industries that are negatively sensitive to rising rates, such as real estate and utilities. Overall, the spotlight is on growth/quality themes as well as the largest market capitalisations. One point to watch out for again concerns the US regional banking sector. The New York Community Bancorp's January 31 announcement of losses on home loans and an upward revision of provisions raised the spectre of last year's Silicon Valley Bank bankruptcy and Signature and First Republic difficulties.



[1] Source: Bloomberg
[2] The S&P 500 is a stock index based on 500 large companies listed on stock exchanges in the United States. The index is owned and managed by Standard & Poor's, one of the top three financial rating companies. It covers about 80% of the US stock market by its capitalisation.
[3] The STOXX Europe 600 or STOXX 600 is a stock index consisting of 600 of the main European market capitalisations, designed by STOXX

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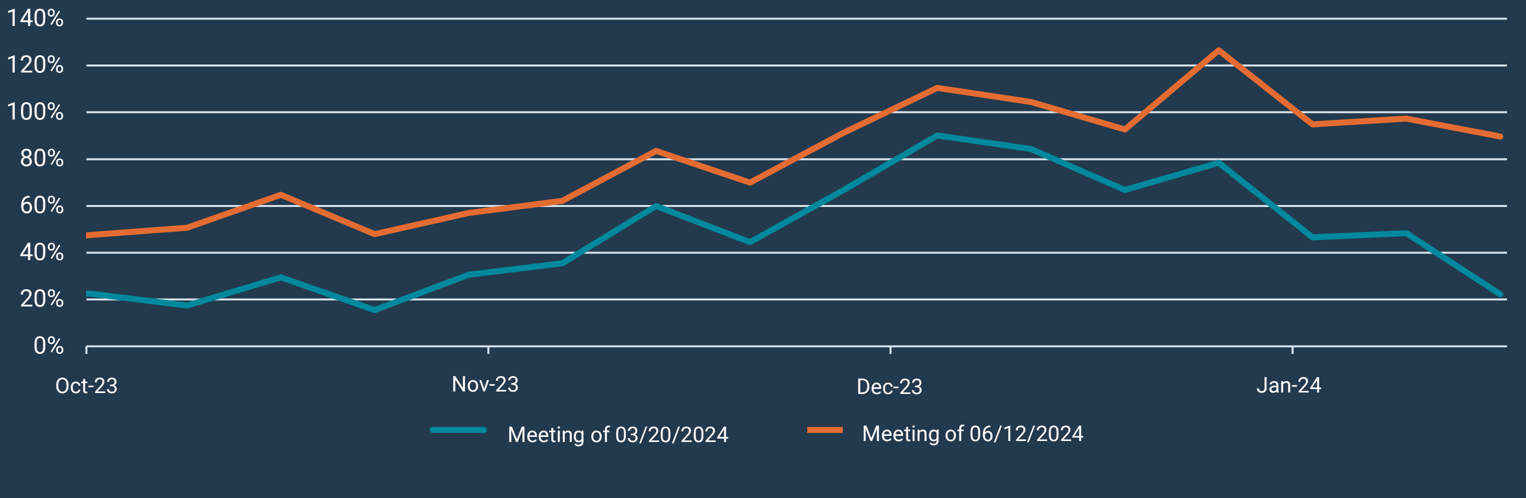
The resilience of the US economy is logically driving up the dollar, which has appreciated by 2%[4] versus a basket of G10 currencies, reversing the trend seen in December.

However, the picture looks different on the bond side. This segment is reacting to the postponement of rate cuts, after chairman Jerome Powell ruled out the scenario of a first action by the Federal Reserve (Fed) [5]as early as March. The lowering of rates is not called into question, but the prospect is simply pushed back on both sides of the Atlantic. Another significant factor at the beginning of the year is rising tensions in the Red Sea, with the Houthis attacking Western ships, reviving concerns over the price of oil, up 6%[4] over the month. In this context, sovereign bonds have lost ground and underperformed slightly. The German 10-year rate, for example, has taken 14 basis points while American 10 years ended up slightly higher (3 basis points). The credit market is doing better, still benefiting from strong demand from investors.

Also, the strong performance of risky assets has not reached the emerging world. China, which faces some economic challenges, has seen its stock market fall to its lowest level in five years, after a loss of 6.3%[4] in January. The MSCI Emerging Markets Index[6] is 4.6%[4] and emerging bonds are 1.2%[4]. This first month of the year therefore appears to be one of strong contrasts, due to the differences in performance between asset classes and between geographical areas.

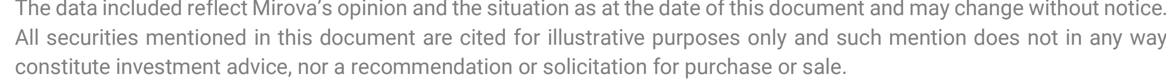
Monthly Chart

Evolution of Expected Probabilities of Fed[5] Rate 25 bp Reduction in March and June 2024



Source : Bloomberg

4 Source: Bloomberg
5 Federal reserve bank
6 The MSCI Emerging Markets is a stock index measuring the performance of stock markets in emerging economy countries, managed by MSCI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Market review & Outlook

Resilience of activity, disinflation and lower key rates will punctuate 2024

Macroeconomic indicators published in January seem to indicate that the macro dynamics of the second half of 2023 continue to hold sway at the beginning of 2024, with resilience visible both via hard data and soft data. Thus, the composite global PMI[7] added a point in January at 51.6[8], driven among other things by the rebound of its manufacturing component, which ultimately leaves it outside the contraction zone. Generally, such a PMI level is in line with annualised global GDP[9] growth of 2.5%[8], which could be revised upwards in the event of a no landing scenario in the United States.

Supporting such an eventuality, the US economy was confirmed in the fourth quarter. Annualised GDP growth was 3.3%[8] over the period, supported by particularly resilient household consumption (up 0.7%[8], in December), as well as good export dynamics. These two growth drivers remain at work. Consumers are benefiting from a still dynamic labour market, and wage increases now exceed inflation as disinflation continues, albeit at a lower rate than last fall. Business profitability remains solid – the first round of results is encouraging on this point. Companies therefore have no reason to lay off workers or reduce their investments.

Moreover, this wage inflation does not in itself constitute an immediate threat to continued disinflation because it is counterbalanced by significant productivity gains, which yield a decrease in unit labour costs, one of the benchmark indicators followed by the Fed. In the euro area, wage inflation is more of a question for monetary authorities, given the lack of productivity gains, but, in our opinion, it should continue to slow in the coming months. Our central assumption remains that underlying inflation should converge to2%[8] mid-year.

Faced with these reassuring factors, central banks will certainly lower their rates during the year, even if this will occur later than initially anticipated by the market. Indeed, the Fed and the European Central Bank (ECB) had to delay, in a relatively coordinated manner, the overly optimistic expectations of investors in terms of a timetable for rate cuts.

Another source of optimism is that the economy should benefit from the support of stimulus plans and expansive industrial strategies in the world's largest economies. The massive U.S. plan covers the next decade, the European Union has deployed only 20 to 30 percent of its Green Deal, and China is expected to support its economy through a major fiscal and monetary stimulus plan. These are reassuring conditions, especially since no major financial imbalance, with the exception China real estate crisis, is at work to make the economy and markets collapse, as was the case in 2000 or 2008.

North America: Americans benefit from a wealth effect

In the United States, growth softened slightly between the third and fourth quarters of 2023, reaching 3.3%[8] in the fourth quarter of 2023.[10] Consumers played a major role in ensuring robustness, which should continue to steer the economy to a soft landing, at worst, this year. Consumers benefit from a wealth effect that will amplify their purchasing power, as well as an increase in real salaries.

The increase in wages, while less than in 2023, remains solid, around 3.5 to 4%,[5] and is combined with a decline in underlying inflation excluding real-estate services (over the last three to six months, at an annualised rate, it

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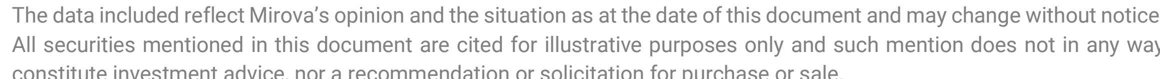
7 The PMI index, for "Purchasing Manager's Index" (Purchasing Manager's Index), is an indicator to know the economic status of a sector.
8 Source: Bloomberg
9 Gross domestic product is the economic indicator that quantifies the total value of annual "wealth production" by economic agents residing within a territory.
10 Source: Bloomberg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is already converging towards 2%[8] in the United States).[5] The resulting increase in purchasing power partly offsets the melting of savings, which Americans, unlike Europeans, did not hesitate to spend in the years following Covid, thereby supporting their national economy. Households do have recourse to consumer credit. They can also rely on their real estate market, which has been growing for 3 years, capitalising the possibility of refinancing their assets based on current prices. This option would become interesting with a loosening of credit conditions (lower mortgage rates) and would result in higher-valued real estate assets for households. Additional assets that also help to amplify the wealth effect are bonds and stocks, the latter flirting with their highest.

Finally, the election period is also an asset for American households. Democrats and Republicans are expected to reach a bipartisan agreement around net tax cuts for fiscal year 2024 – enough to further support demand. Any assumption that the American consumer is set to collapse therefore does not seem likely: consumption should continue to fuel the economy this year.

Understanding the pushback from central banks

At the beginning of the year, the market revision of the timing (postponed until later) and number (fewer) of rate cuts by the Fed and the ECB[11] has had the effect of driving short and long-term rates upwards. The market had indeed wanted, at the end of 2023, to position itself for a rate cut as early as March and central banks dampened this enthusiasm, so as not to lose the beneficial effects of their previous actions.

In our view, this pushback does not call into question the rationale for rate cuts but changes the schedule. We still think they might start at the end of the spring. A consensus is even emerging around a first cut in the US in and in the Eurozone in June, at the ECB meeting, instead of March.

Central banks have also sought to counter any expectations regarding seven cuts in 2024. The push-back movement "wipes out" around two of these cuts. We believe that one of this cut could still potentially be erased, or at least postponed until 2025.

In brief, after the (too?) violent downward movement in rates in the last two months of 2023, we are witnessing a slight retreat by central banks, which are committed to maintaining a sufficiently restrictive monetary framework.

Europe: a later rebound

In Europe, household consumption potential remains intact, thanks to preserved savings. The most positive scenario would involve a resumption of consumer confidence in the wake of lower interest rates. Were this combined with a manufacturing rebound in Germany, concomitant with a recovery in world trade, we would then be entitled to expect a clear recovery in growth.

As it stands, euro area growth stagnated at 0% [12]quarter-on-quarter in Q4 2023, after -0.1%[12] in Q3 2023. Spain once again stood out with growth of 0.6%[12], supported by private and public consumption. In contrast, GDP growth fell by 0.3%[12] in Germany with lower investment, weak global demand for goods and heavy industry suffering from high energy prices. Business and consumer confidence surveys suggest that activity will stabilise in the short term.

In terms of inflation, the headline and underlying component stood at 2.8%[12] and 3.3%[12] year-on-year respectively, with persistent inertia in services (at 4%[12] year-on-year since November), despite a deceleration in goods and food prices and a negative contribution from energy.

In addition to inflation levels, the ECB[11] will also be paying close attention to wage levels in the first quarter, as mentioned by Christine Lagarde.

However, as real wage growth picks up and financial conditions ease, we are anticipating a recovery in investment and activity during the second half of this year.

11 European Central Bank
12 Source : Bloomberg

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China: interventionism as a central policy

In China, the slump triggered by the real-estate crisis is only getting worse, as the court-ordered liquidation of sector giant Evergrande was announced in January. Despite support measures aimed at stimulating bank lending and stock markets, the Chinese authorities have so far failed to reactivate catalysts that could sustainably reverse negative investor sentiment on a long-lasting basis.

However, the macroeconomic context remains relatively stable at the beginning of 2024 following the cyclical trough observed in mid-2023. The intensification of supply-side stimulus has helped stabilise Chinese labour markets, although pockets of structural weakness, such as youth unemployment, persist. Improved labour incomes and lower real rates for households should support private consumption, while industrial production could rebound slightly over time due to improved external demand.

Overall, we believe that Chinese growth could be around 4.5%[12] to 5%[12] this year given the fiscal and monetary support deployed by the authorities but remain pessimistic in the medium/long term about the country's growth potential, given the many structural challenges it faces.

Tensions in the Red Sea: how much to worry?

The geopolitical black spot at the beginning of the year comes from the Red Sea and the tensions generated by the actions of Houthis rebels against Western ships. As demonstrated by the PMI indices published in January, companies anticipate major increases in delivery times, which would disrupt production chains and lead to a supply shock. However, such a shock will not be on the same scale as that experienced during the Covid and should appear in the figures only in 6 to 12 months. At present, trade is backed by increased orders from companies, which want to replenish their inventories in the short term.

The consequences of this conflict could also be felt on the energy front, Qatar has warned that its exports to the European Union, including LNG[13] shipments, would be slowed by the situation. For now, the price of gas is rather down, but an increase is a risk to which the European Union is exposed (please see our Long View hereafter). The United States is more immune, thanks to its local production of shale gas and oil.

13 Liquefied Natural Gaz

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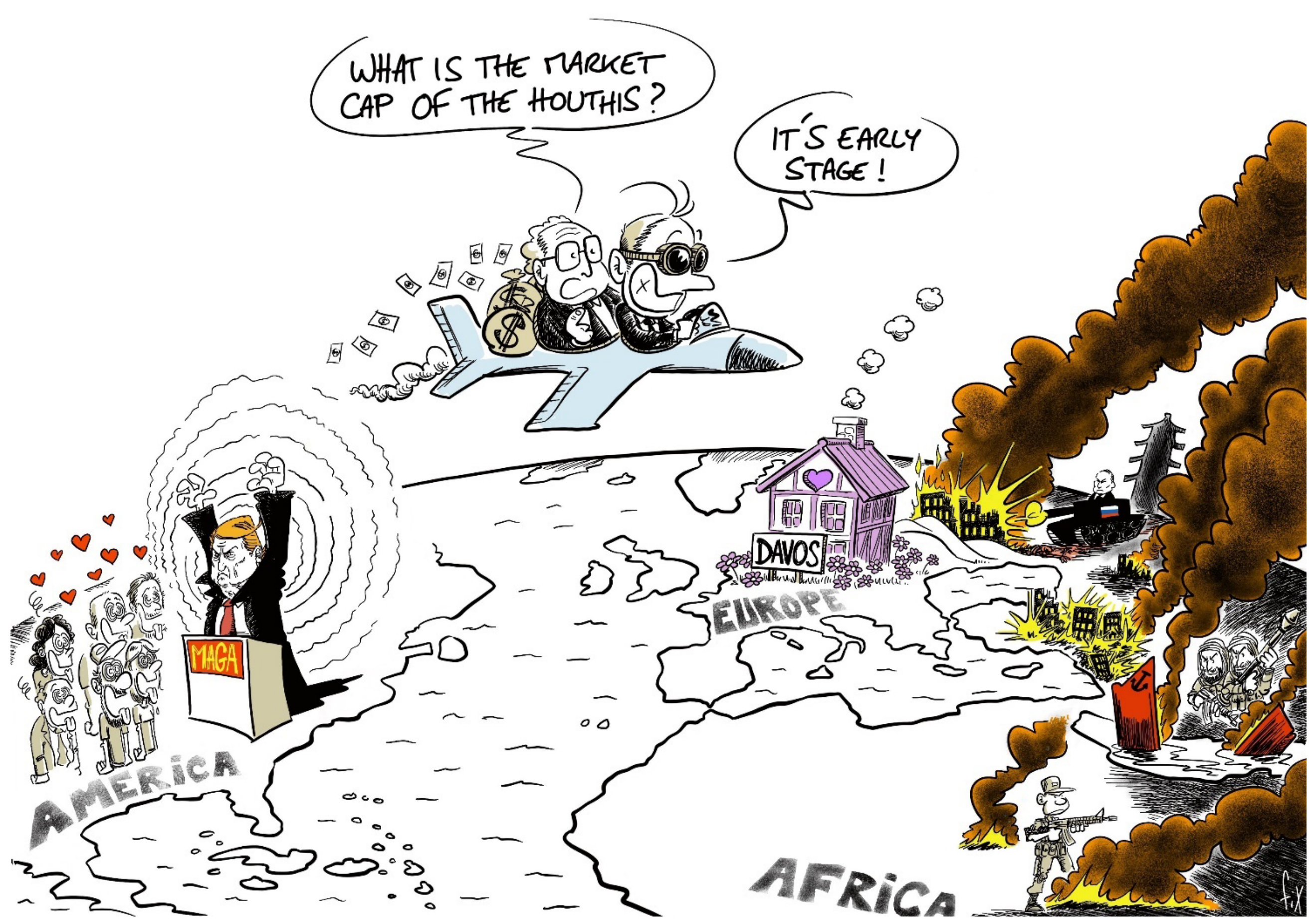

Towards a loosening of credit conditions in the eurozone

With stricter lending standards in 2023, credit has tightened significantly, as shown by surveys for the last quarter of the year. The weakness of credit offers now pleads for a loosening of these conditions, as the construction and real-estate sectors are now significantly affected in France and Germany. Household and business credit applications are also weakening, weighing on confidence.

These factors are putting pressure on the ECB for a rate cut. Encouragingly, such a move could have a faster impact on the real economy in Europe than in the United States. In the European intermediate market, banks are likely to play a more active role in stimulating lending, thereby amplifying the effects of rate cuts.

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The Long View

DOES THE WEST SEE ITS SUPPLY ROUTES THREATENED?

For ten years, the Saudi army, well equipped and supported by forces from a dozen allied countries, has tried to defeat Yemen's Houthis rebels. For ten years, the Houthis have defeated it, thanks to various factors including the topography of Yemen and the culture of its population, rich in a millenary history. These ten years of war, at some points very arduous, seem to us to dispel any hope that bombings by the British and United States armies will lead these same Houthis to renounce their attempts, to hinder the circulation of commercial vessels in the Red Sea, all the more so as they have been successful. They will probably continue this course, and neither Washington nor London seems to be able to change anything in the short term, at least not with the means currently engaged.

These rebels, who still occupy the most populated areas of their country, are pursuing what they see as rational objectives, whatever the credence or lack thereof is given to the justifications they put forward or links to the current situation in the Gaza Strip. One of these objectives seems to be playing out in a very particular context, that of growing tension between the West and what is becoming known as the Global South. The hostile actions of the Houthis only target Western buildings and spare those flying, for instance, the Chinese flag. This is, of course, nothing trivial. Two linked phenomena are thereby brought into relief: inflation, not so much by increasing energy costs as by altering the productive apparatus restricting supply, and the gradual expulsion of European economies from their traditional zones of influence.

Disinflation stopped

Among the factors that contributed to the rise of inflation after the peak of the Covid crisis, there is of course the compression of supply as companies faced difficulties reorganising their production and supply chains. What the Houthis are doing now has similar effects, though to a much lesser degree. While it will not alone suffice to increase the prices of all goods, it will halt the mechanism of disinflation that appeared to be running smoothly for almost a year. Bypassing Africa through Cape of Good Hope is not more expensive than paying to cross the Suez Canal; however, it requires one to two more weeks of transit. At a time of lean management, even if not always applied in Europe, disruptions will not remain painless for long, especially in the automotive industry. Contributing in and of itself perhaps an additional 0.25pp to inflation, this is enough to postpone expectations of interest rate cuts by major central banks, including the European Central Bank.

Deglobalised Europe

At a time when the Chinese naval fleet is strengthening, when the grip of Russian and Chinese interests in Africa is growing and while more or less tacit frictions persist between Saudi Arabia and the United States, Houthis attacks further disrupt the usual circuits of globalisation. However, our readers know that for several years, we have been worried about certain consequences of deglobalisation, or rather, a low-noise exit of Europe from the globalisation network. When Iran acquires nuclear weapons, which we believe should occur by the end of the decade at the latest, it will be able to impose a form of guardianship on the straits of the Arabian Peninsula. The Houthis, who are mostly Shia and enjoy good relations with Tehran, for whom they may incidentally substitute, provide a taste of what the long-term situation might look like. Only the United States has the means to intervene and prevent this outcome, but if it does not, then Europe will have one more thorn in the foot it is trying to stand on in global trade.

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What to conclude for the markets?

At this stage, the consequences remain very manageable, but add a little pressure on the European Central Bank, which we keep repeating that it must ensure that the Euro does not win other world reference currencies to maintain its purchasing power of raw materials. Renewable energy is helping the old continent to become more self-sufficient on this point, but it still takes time for dependence on oil and gas to become less cumbersome.

In the longer term, the situation does not seem tenable: either the United States intervenes to prevent Iran from controlling the straits of the Arabian Peninsula, even indirectly, but it does not necessarily have a direct interest in it, or Europe, ousted from large portions of the "Global South" and largely unarmed, returns to the search for outlets and alternative supplies. Impossible? It has already done so in the past, however, in the fifty years following the fall of what remained of the Eastern Roman Empire. Shortly after the capture of Constantinople, which forbade or complicated the road to Asia for Europeans, the Portuguese, Spanish, Italian, French, British and Dutch explorers launched an assault on the world's oceans in order to open new trade routes to replace those that the Ottomans had closed to them. They found America there... without seeking it.

Summary of Market Views

SUMMARY			
ASSETS CLASS	LONG TERM	CONVICTION	COMMENTS
Equity	○ — ○ — ● (green) =	strong	• Outperformance of stocks in 2024 against a backdrop of disinflation, monetary policy relaxation and macro rebound on a global scale. Positive surprises from the United States • Any substantial correction would be used to strengthen positions
Credit	○ — ○ — ● (green) =	moderate	• Long credit because advantageous carry with spreads remaining attractive. Technical factors still favorable (off-demand imbalance, relatively little refinancing in 2024) • Moderate increase in default rates given macro resilience • Preferred short-term trading range scenario given the strong tightening of spreads in recent months
Duration	○ — ○ — ● (green) =	moderate	• Slight long duration due to the end of the monetary tightening cycle, a continuation of the disinflation movement and a diversification effect vs risky assets now beneficial. Attractive real rate levels in the absence of a growth acceleration scenario in the United States. • Be careful, however, of a potential continuation of the short-term repricing related to the recalibration of the timing and the number of key rate reductions expected in 2024.
Cash	● (red) — ○ — ○ =	moderate	• Attractive short-term risk/return couple but should suffer from a reallocation to risky assets as policy rates drop and our scenario materializes.

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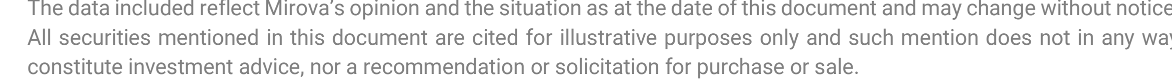
EQUITY

ASSETS CLASS	LONG TERM	CONVICTION	COMMENTS
US	○—○—● (green) =	moderate	• *Successful* soft landing scenario, resilient consumption via wealth effect, continuation of the disinflation movement justifying a relaxation of monetary policy in mid-2024 (June). End of destocking and manufacturing rebound in the second half. • Unfavorable valuation (risk premium, *price earning ratio*, etc.) partially offset by a dynamic of attractive beneficiary revisions relative as evidenced by the last season of results. • Beware of the specific risk associated with the overrepresentation of the “seven magnificent”. Expansion of future sectoral leadership
Euro	○—○—● (green) =	strong	• Macro stagnation followed by a rebound in the second half. Continuation of the disinflation movement justifying a relaxation of monetary policy (June) • Attractive valuation, under-held market, potential recovery of global trade favouring European exports
United Kingdom	○—● (grey)—○ =		• Low growth outlook, high and persistent inflation justifying a very attractive valuation. • Defensive bias (health, sustainable consumption)
Japan	○—○—● (green) =	moderate	• Continuation of ongoing *rerating* related to the private sector liberalization movement (improvement of governance). • Rising wages and inflation expectations should support consumption • Short-term risk remains a potential monetary tightening leading to an appreciation of the Yen
Emerging markets	○—● (grey)—○ =		• BPA growth expected for 2024/2025 is a bit too optimistic while the relative revision dynamics vs. developed countries remain negative. • In positive start of lower key interest rates for some central banks in emerging markets, risk premiums and reasonable valuations. Waiting for a Fed pivot to be more constructive
Growth vs. Value	○—● (grey)—○ =		• End of the rise in real rates and anticipation of monetary stimulus are positive catalysts for the outperformance of growth vs value. Improving the global macroeconomic environment should favour Value segments whose valuation reflects a recession scenario. • Hence the positioning of barbells made up of both high-growth companies (techno, health, etc.) and highly discounted companies (banks, ~~land~~, utilities, etc.). Preference for companies with positive margin and profit revision dynamics
Quality vs. High Volatility	○—● (grey)—○ =		• Recent strong outperformance of the quality style in a context of higher rates and results above expectations. • Overbought style, watch out for potential short-term rotation
Small vs. large capitalisations	○—○—● (green) =	moderate	• Attractive valuation of small capitalizations in relative terms, limiting underperformance potential. • Relative unfavorable season of results since the beginning of the year. • Always positive on this segment in the medium/long term while remaining selective in the short term.
Cyclical vs. Defensive		moderate	• Improvement of the global macroeconomic environment. Discretionary consumption supported by rising real wages • Cyclical vs defensive valuation in line with history

CREDIT

ASSETS CLASS	LONG TERM	CONVICTION	COMMENTS
Investment Grade US	○—● (grey)—○ =		• Preference for EUR IG in terms of valuation. Lower fault rate. • Refinancing needs: 2024 manageable; 2025/2026 more complicated
High Yield US	● (red)—○—○ =	moderate	• Levers in the high historical average while interest expense coverage ratios are falling, due to a decline in revenues and margins. • The *spreads** of BB and B issuers are below their historical average since the 2000s.
Investment Grade Euro	○—○—● (green) =	moderate	• Reasonably priced quality assets that should continue to outperform in today’s environment • Preference for the IG Euro vs US because the relative rating enhancement dynamic is more favorable and the spreads less tight. • Preferred short-term trading range scenario given the strong tightening of spreads in recent months
High Yield Euro	○—○—● (green) =	moderate	• Technical factors are still very favorable (off-demand imbalance, no short-term refinancing problems). Relative valuation HY vs IG more favorable in EUR than in the US. Preference for EUR hybrids

14. “Spread” is the spread or difference between the two prices of an asset in the financial sector. On the one hand we have the value of the purchase and on the other we have the selling price.
15. The Trading Range is a relevant market indicator especially for stochastic indicators.
16. A soft landing, in economics, is a cyclical slowdown in economic growth that avoids recession.
17. Earning per share
18. Federal reserve bank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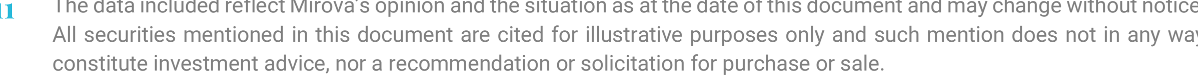
DURATION			
ASSETS CLASS	**LONG TERM**	**CONVICTION**	**COMMENTS**
2 years US	○ ○ ● (=)	moderate	• End of the Fed tightening cycle, attractive real rates in a context of continuing disinflation movement. • 4 expected rate cuts, the first in June. *Aggressive market pricing* on this point, limits the potential in the short term, especially after the positive macro surprises at the beginning of the year
10 years US	○ ● ○ (-1)	moderate	• In positive diversification power and continuation of the disinflation movement. • In negative sales structural pressures (off-demand imbalance, upward revision of potential growth, etc.) • Scenario of bull steepening[19] via drop in short rates as we approach the pivot date. Preferred trading range on the long end
2 years German	○ ○ ● (=)	strong	• End of the ECB[20] tightening cycle: *headline* and underlying *inflation* at an annualised rate over the past few months converges towards the target even if wage inflation remains a short-term brake. • 5 expected rate cuts, the first in June.
10 years German	○ ○ ● (=)	moderate	• Diversification power and continuation of the disinflation movement. • Bull *steepening scenario* resulting from continued normalization of monetary policies coupled with a slight macro rebound in the second half.
Europe peripheral debt	○ ○ ● (=)	moderate	• Lower rates favourable to the sustainability of peripheral debts. • Lower inflation and a status quo on the ECB's balance sheet cut reduce short-term concerns about Italy.
United Kingdom	○ ○ ● (=)	moderate	• Continued disinflation from a higher level than other developed markets; through lower energy prices and progressive labour market normalization. Bank of England break in line with other central banks; attractive carry especially on the long part. • Short-term uncertainties around fiscal stimulus plans, curbs lower rates
Japan	● ○ ○ (=)	moderate	• Increased inflation expectations. Potential increase in policy rates. End of rate curve control? • In the short term, macro dynamics calm the bullish trend.
Emerging markets	○ ● ○ (=)		• Positively, disinflation dynamics and lower key rates in some emerging markets but moderate appreciation potential vs cash USD in the short term. • In local currencies, currency risk related to the change in monetary policy. Limited potential in the short term, more favorable in the long term.

CASH			
ASSETS CLASS	**LONG TERM**	**CONVICTION**	**COMMENTS**
EUR/USD exchange rate	● ○ ○ (-1)		• Macro dynamics and recalibration of timing and number of Fed policy rate cuts favorable to the dollar.

19. Interest rates are falling and the yield curve is steeper.
20. European central bank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