SUNLINE

WEALTH MANAGEMENT

September 2024

The Us Federal Reserve has decided to deliver an Oversized 50 Bps Rate Cut

The markets spent the last several weeks trying to gauge whether the 'bad' economic news was enough to push the US central bank (The Fed) to cut by 50 bps. Chairman Powell called it a 'recalibration' of monetary policy. In fact, economic news has been mixed, along with a slowly deteriorating labor market. This resulted in wild intraday swings in bond yields, expected size of rate cuts and equity sector rotations.

So, the Fed has now joined the other main central banks in pivoting to a new cycle of rate cuts. Despite the outsized rate cut, the market hasn't changed its target for interest rates: that is, 3% for USD rates by June of next year, and 2% for the Euro area, by July of the same year.

Just one month ago such a large rate cut would have been taken as a sign of panic by the Fed. This week it wasn't, maybe because of the presence of a dissenter, for the first time in 19 years, (source UBS), thus the decision to cut was not unanimous among the 12 members of the FOMC.

The accompanying message has been that inflation was largely dealt with. The Fed has called the consumer 'resilient' - with the labor market no longer a primary source of inflation, being less tight than pre-pandemic, and with immigration contributing to both better labor supply, as well as upward pressure on unemployment.

Fed dot plots shifted lower, with median forecasts of a further 50 bps in rate cuts in 2024, and a rate of 3.4% by the end of 2025, thus about 50 bps higher than current implied rates.

It is now clear that the Fed is trying to ensure a soft landing, which means it is not a given anymore, and that it is, in particular, addressing the deteriorating labor market, as part of its dual mandate. We have been saying for a few months that, when looking under the hood, there were increasing signs that not all is well, (for example youth or black female unemployment are all higher than pre-pandemic, surveys about jobs plentiful versus not so plentiful, etc.). Now the Fed and most of the market participants have joined our view. The question is how quickly the labor market is deteriorating.

That is much more difficult to gauge for everybody, including the Fed, due to distortions of the data,(we commented about it in previous editions), and the massive influx of workers, estimated by some investment banks at 2 million, mostly illegal: they would thus show up in some statistics, and not in other ones, (such as those where the employer needs to deliver the social security number: obviously, as an illegal worker you do not have one).

Concerning the 'health' of the consumer, we think it is increasingly bifurcated. While the lower-income consumer is being increasingly constrained and careful about its spending, the crucial, for the economy, middle-income consumer could follow suit: and it is its behavior that we will be closely watching over the next few months to determine the US economic path, and thus Fed's policy direction. Fixed investments are already weak, and lower consumer spending could ultimately trigger a wave of layoffs, which we currently haven't seen outside of the technology space.

Looking at the results (and equity performance) of stores that cater to the different consumer segments, the image is clear: those whose main customers are lower income, such as Dollar Tree and Dollar General have issued both profit and revenue warnings, (stock prices are down respectively 47% and 35% year-to-date), others such as Walmart, whose clients have a higher income, have surpassed expectations, and its stock is up 51% year-to-date.

The perceptions of the labor market, and the consumption behavior of middle-income earners, are crucial to the US economy. Should this category start to have fears about job security, it would ignite a self-feeding mechanism: it would start to adjust its consumption patterns lower, which in turn would trigger a wave of layoffs. Companies, (outside of tech), haven't yet started to reduce their workforce, as they struggled so hard to build it up during the reopening of the economy in 2021 and 2022.

Hence the focus of the Fed on the labor market, and ours on the middle-income consumer.

Other Economies and Central Banks

The Eurozone economy, with the notable exception of Germany, which has essentially been stagnating over the last 12 months, has held up well, notably thanks to an exceptional touristic season, with France receiving a further boost from the Olympic games.

This is unlikely to continue for much longer. Several countries, such as France and Italy, which are both potentially facing Brussels sanctions for excess deficits, have sustained their economies by way of fiscal policies: this is unsustainable over the medium term. The report to the EU commission from Former Italian Prime minister Draghi, asked for a radical change and a move towards more integration in Europe. It also asked, after the success of the post-Covid 800 billion Euro plan, to restart issuing common debt and spend between Euros 750 to 800 billion a year to close the economic 'ditch' with the United States, to ensure EU competitiveness, boost social equity and meet climate targets. Yes, the report is political, however some countries are more competitive than others: Germany clearly must completely rethink its industrial sector.
750 billion is a lot of money, that would be equivalent to 5% of the European GDP, and much more than the Marshall plan after World War II.

Maybe some of it is already being indirectly allocated: the value of infrastructure projects, whether in construction or planned, has already increased from Euros 885 billion to 1.4 trillion in the space of one year.

The European Central Bank (ECB), as expected, has lowered its deposit rate by 25 bps to 3.5%, and, as announced back in March, has lowered its main refinancing operation rate, (the rate at which commercial banks can borrow from the ECB), by 60 bps: this to close the gap to a 'bid-ask' spread of 15 bps with its deposit facility. That should facilitate the flow of credit within Europe, which has been struggling since early 2023: the growth rate of credit in the Eurozone, to households and non-financial corporations, (thus not including banks), has now been close to zero for the past twelve months, a level not seen since late 2015 - early 2016. This is clearly an issue for economic growth, which the ECB hopes to address.

If the economic situation persists, or even worsens, the terminal rate for the ECB at 2% for the middle of next year could be too optimistically high. It could fall towards 1%, in which case it would likely drop below the inflation rate.

Bonds might thus find themselves in the same situation as pre-pandemic: unattractive, when official rates were at zero.

In Switzerland, we think the Swiss National Bank, (SNB), has the scope to drop its policy rate by a further 50 bps, to 0.75%, at the end of the month. The currency is too strong, particularly against the US dollar, and is thus disinflationary: the Swiss government just dropped its inflation target to 1.2% for 2024 and 0.7% for 2025. The Swiss government bond market already reflects this: the entire curve is priced at 0.4%.

The Bank of England stayed put at its recent meeting, leaving rates at 5%. While it mentioned that they would resume rate cutting once evidence emerged that inflationary pressures have subsided. The vote during the BOE decision, which was taken before the one over the pond in the US, shows that recent data, featuring slower-than-expected inflation and the UK's economic recovery fizzling out, has yet to convince officials that the threat from consumer prices has been sufficiently contained. We suspect there is also a political angle to it, in the sense that the BOE wants to see what kind of fiscal decisions the new government will take. The UK government is desperate to find fiscal fixes for many of its dysfunctional services - such as the crisis ridden NHS, (healthcare system) - while potentially raising taxes. The net fiscal balance so far is unknown.

In China, we are starting to lose hope in the prospect of more muscular action from the government and central bank to revive its economy.

China is facing a difficult road to recovery. Support for the housing market has been short lived, even as labor markets deteriorated. Corporate profitability is being affected by worsening consumer confidence.

Financial Markets

Most of the stock market indices recovered, or are above, their levels witnessed before the early August episode, and some of them, such as the S&P 500, are sitting at their all-time highs, led by the usual Magnificent 7. This group, on a market capitalization basis, and amidst high volatility over the last 3 months, is indeed off its all-time high, but it is also up 34% year-to-date: so still very difficult to be underweight those names. The Japanese market, both at the currency and stock market level, continues to be very volatile. Its moves are actually more reminiscent of an emerging market rather than that of a market which represents 6% of the MSCI world.

On the fixed income side, bonds. in yield terms. recently touched new lows for the year, and credit spreads, for both high yield as well as investment grade, are near their lows for the year.

The star performer among the different asset classes, however, is Gold: year-to-date it is up over 25% in dollar terms. It is benefitting from both renewed interest from institutional investors, which restarted to purchase the metal since May-June of this year, having drastically reduced their holding since April 2022, as well as from retail investors. Central banks also continue to accumulate Gold. Notable, is the absence of purchases by China: after drastically increasing its holdings, (and reducing US treasuries), since the start of the war in Ukraine, recent data indicate that the central bank has been absent from the market since April.

Strategy

As communicated in detail, we did invest the proceeds of our reduction in European high yield into the arbitrage between the Turkish Lira and the Euro, locking a 46.5% interest differential over 1 year.
With the US Federal Reserve now joining the other major central banks into a rate reduction cycle, we believe the current environment of moderate expansion should continue to be supportive for a multi-asset portfolio.

Equity

We keep an overweight in Eurozone equities versus the US broader market, while being neutral in the technology sector.

We continue to own, (a now reduced), partial put on US equities.

Fixed income

We continue to favor exposure to credit versus duration. We have exposure to investment grade credit, European high yield, hybrids, financials' subordinated debt, US municipal infrastructure and Asian hard currency debt.

Foreign Exchange

The Japanese YEN exposure is mostly hedged, while we do keep a 5% exposure to the US Dollar

Gold

We continue to keep our allocation to Gold at about 5%: while it doesn't provide any yield, it continues to be a good diversifier in a multi-asset portfolio. This year it is the best relative contributor to the portfolios.

Conclusion

The perspective of lower rates going forward and continuing disinflationary trends are supportive for equity markets, fixed income, and thus a balanced portfolio.

Positioning

Overall Exposure

We are now Neutral Equities, and Neutral Fixed Income, with a Gold position, partially USD and JPY hedged.

Equity: Neutral

We have a very sizeable Overweight to the Eurozone and a very sizeable Underweight in US equities, Slight Underweight US technology, Overweight Nasdaq 100 equal weight, Neutral UK, Neutral Japan, Overweight Asia ex Japan.

Thematic Equities

European Family Holdings, Asian Technology, Health Improving Technologies and Services, European Champions.

Fixed Income: Neutral

Long 1 to 3 years US Treasury Notes. Long 20+ years US Treasuries.

Thematic Fixed Income

Overweight High Yield in EUR and Underweight in USD. Overweight Investment Grade EUR and USD Bonds, Underweight Sovereigns. Long US Municipal Infrastructure Bonds, Long Hybrids, Long Subordinated Financial Credit & Long Asian Bonds in hard currency.

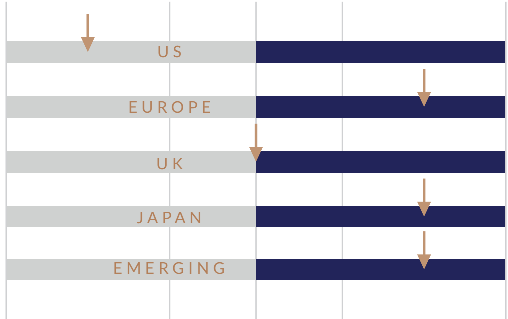
Currencies: Portfolios have a 5 % USD exposure.

Commodities: Overweight

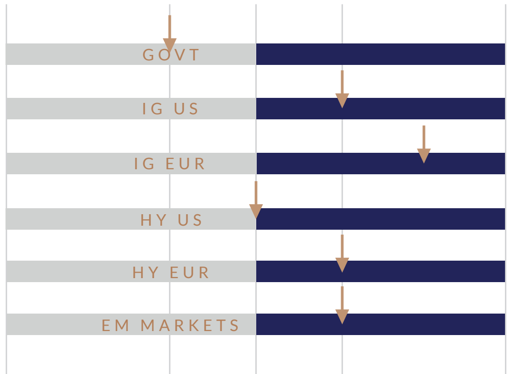
Long Gold.

Conviction thermometer

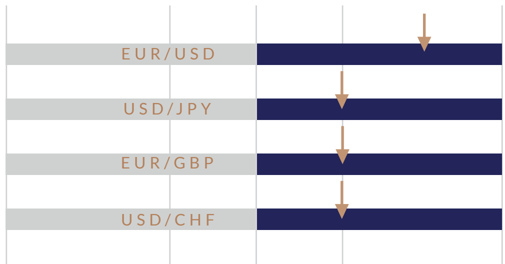
Equities



Bonds



Currencies



Commodities

Negative view Positive view

Market overview as of 30th August 2024

Equities (local ccies)	Level	5D	MTD	YTD	2023
MSCI WORLD	3 661,24	0,35%	2,68%	17,10%	24,44%
US S&P500	5 648,40	0,27%	2,43%	19,52%	26,26%
NASDAQ 100	19 574,64	-0,73%	1,18%	16,96%	55,13%
RUSSELL 2000	2 217,63	-0,01%	-1,50%	10,38%	16,88%
EUROPE EURO STOXX 50	4 957,98	1,00%	1,80%	12,83%	23,21%
GERMANY DAX	18 906,92	1,47%	2,15%	12,87%	20,31%
FRANCE CAC40	7 630,95	0,71%	1,32%	4,02%	20,10%
BELGIUM BEL20	4 184,40	1,74%	1,36%	15,77%	3,51%
SWISS MARKET INDEX	12 436,59	0,72%	0,97%	15,14%	7,06%
UK FTSE100	8 376,63	0,65%	0,83%	11,50%	7,68%
JAPAN TOPIX	2 712,63	1,06%	-2,90%	16,02%	28,28%
MSCI EMERGING	1 099,92	-0,05%	1,64%	9,80%	10,20%
BRAZIL IBOVESPA	136 004	0,29%	6,54%	1,36%	22,28%
CHINA CSI 300	3 321,43	-0,08%	-3,25%	-0,67%	-9,14%
HS TECH	3 560,61	2,64%	1,24%	-4,53%	-8,25%
INDIA SENSEX	82 365,77	1,58%	0,95%	15,28%	20,34%
KOREA KOSPI	2 674,31	-1,01%	-3,46%	1,78%	20,52%
HONG KONG HANG SENG	17 989,07	2,18%	3,89%	9,20%	-10,46%
AUSTRALIA ALL-SHARE	4 576,73	0,49%	0,43%	11,23%	7,70%
SAUDI ARABIA TADAWUL	11679.50	-0,40%	1,21%	4,03%	18,10%

US: Sectors	Level	5D	MTD	YTD	2023
COMMUNICATION SVCS	300,95	-0,69%	1,24%	23,11%	55,80%
CONSUMER DISCRETIONARY	1 500,16	-0,17%	-0,97%	6,37%	42,30%
CONSUMER STAPLES	882,60	0,82%	5,94%	17,68%	0,52%
ENERGY	695,86	1,02%	-1,70%	11,35%	-1,42%
FINANCIALS	759,21	2,96%	4,51%	22,57%	12,10%
HEALTH CARE	1 829,71	1,11%	5,10%	16,31%	2,06%
INDUSTRIALS	1 110,78	1,71%	2,86%	16,26%	18,08%
INFORMATION TECHNOLOGY	4 298,51	-1,47%	1,25%	27,14%	57,84%
MATERIALS	593,39	1,67%	2,39%	11,21%	12,55%
REAL ESTATE	272,90	0,36%	5,79%	10,65%	12,35%
UTILITIES	385,51	1,17%	4,86%	22,55%	-7,08%

EUROPE: Sectors	Level	5D	MTD	YTD	2023
BASIC MATERIALS	2 889,63	1,16%	-0,92%	-0,94%	5,95%
CONSUMER GOODS	4 034,40	2,33%	3,37%	5,84%	-2,46%
CONSUMER SERVICES	1 552,69	0,56%	2,10%	5,11%	21,53%
FINANCIALS	1 043,57	1,47%	1,20%	21,44%	25,42%
HEALTH CARE	4 274,81	2,15%	4,14%	24,19%	8,75%
INDUSTRIALS	4 099,49	1,34%	1,21%	13,31%	27,43%
OIL & GAS	1 518,28	-0,04%	-3,13%	3,29%	9,01%
TECHNOLOGY	1 950,01	0,56%	-1,39%	15,14%	34,72%
TELECOMS	592,71	1,88%	4,48%	17,29%	8,86%
UTILITIES	2 101,84	1,45%	2,35%	7,06%	14,75%

Market overview as of 30th August 2024

Fixed Income	Level	5D	MTD	YTD	2023
Pan-Euro 3-5 yrs IG	209,69	0,00%	0,60%	2,00%	6,68%
Euro Aggregate	240,46	-0,33%	0,44%	1,24%	7,19%
Pan-Euro HY Hedged Eur	441,21	0,34%	1,24%	5,45%	12,32%
Global Inflation hedged EUR	238,71	-0,63%	0,20%	0,38%	2,02%
US Corp High Yield	2 264,90	0,20%	1,63%	6,28%	13,45%
EM USD Aggregate TR	1 260,87	0,03%	2,10%	6,29%	9,09%
EM Aggregate TR Local Ccy	151,16	0,15%	2,75%	3,30%	6,91%
EUR Banks CoCo Tier 1	155,91	0,39%	1,50%	8,43%	5,04%
EU GOVT HEDGED EUR	213,17	-0,45%	0,39%	0,35%	6,31%
Global Aggregate	2 554,99	-0,53%	2,37%	1,86%	5,72%

Commodities	Level	5D	MTD	YTD	2023
GOLD	2 503,39	-0,37%	2,28%	21,35%	13,10%
COPPER	414,50	-1,33%	-0,75%	6,54%	2,10%
OIL WTI	73,55	-1,71%	-5,60%	2,65%	-10,73%
OIL BRENT	78,80	-0,28%	-2,38%	2,28%	-10,32%

Currencies	Rate	5D	MTD	YTD	2023
EURUSD	1,1048	-1,29%	2,05%	0,08%	3,12%
GBPUSD	1,3127	-0,66%	2,11%	3,11%	5,36%
USDJPY	146,1700	1,25%	-2,54%	3,64%	7,57%
USDCHF	0,8496	0,20%	-3,23%	0,97%	-8,99%
AUDUSD	0,6765	-0,44%	3,41%	-0,69%	-0,01%
EURCHF	0,9390	-1,05%	-1,22%	1,09%	-6,13%
USDCNY	7,2980	-0,42%	0,99%	2,79%	2,92%
USDKRW	1 382,10	-1.14%	2,58%	3,86%	1,79%
USDINR	83,8712	-0,03%	0,17%	0,79%	0,57%
USDIDR	15 455,00	-0,23%	-4,95%	0,38%	-1,10%
USDBRL	4,8572	-0.08%	-1,27%	-7,55%	-8,01%
USDTRY	34,0756	0,27%	2,81%	15,40%	57,82%
BITCOIN	59 045,40	-7,29%	-8,54%	40,80%	152,94%

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