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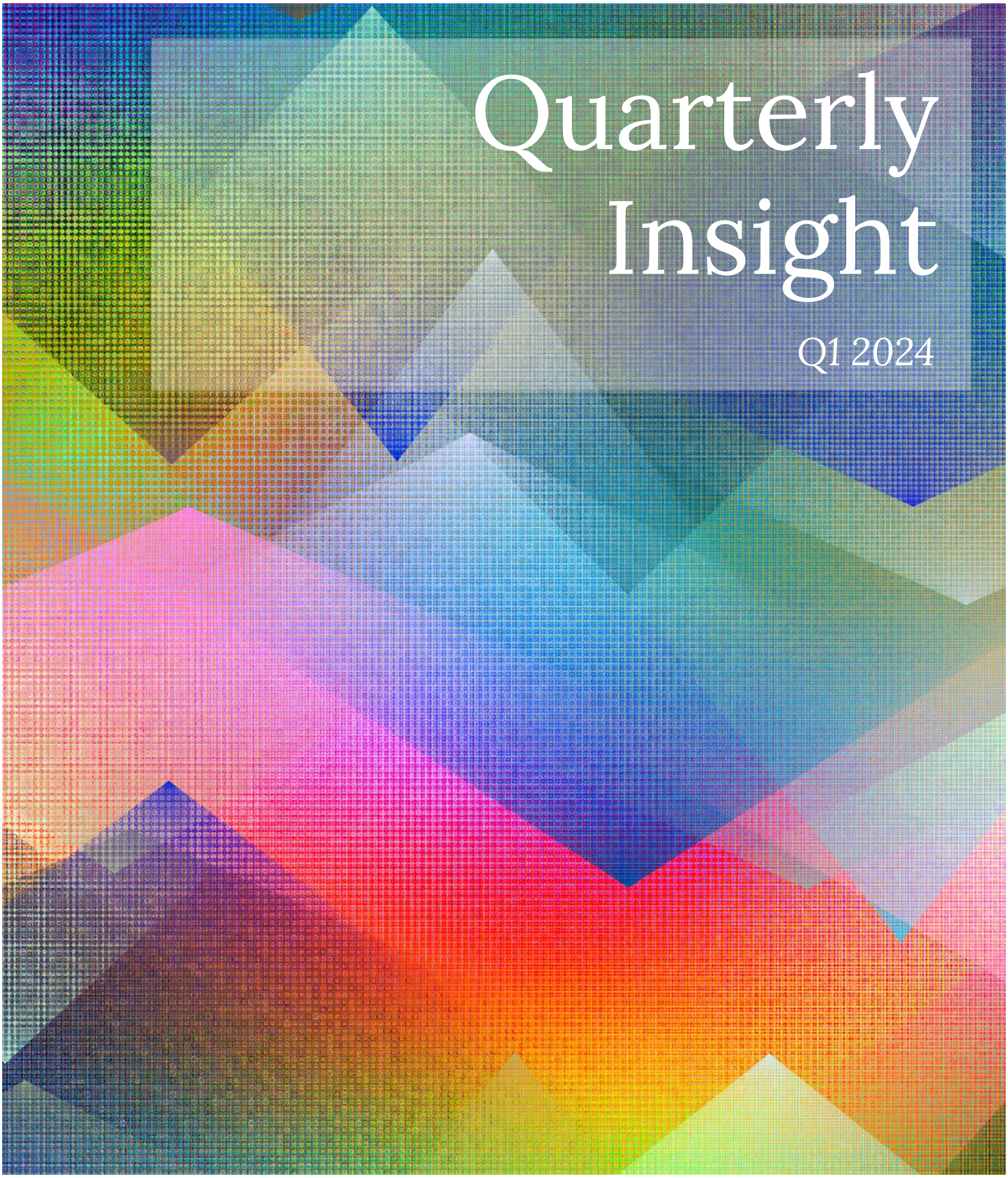
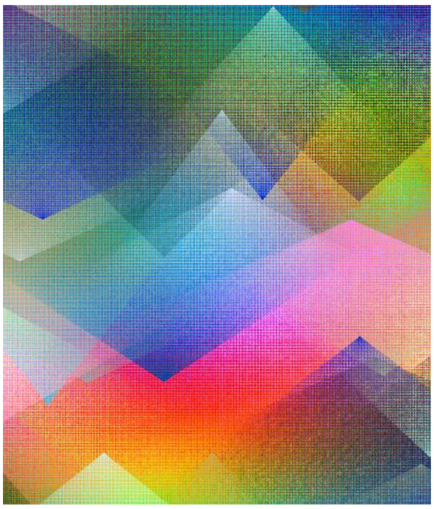


Quarterly Insight

Q1 2024

Creativity within Excellence



Zach Lieberman «Cone overlaps with noise»
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Contents

The Monetary Tide Is Turning

With the rosy expectations for corporate earnings, tight credit spreads, demanding valuation, and a VIX nearing historic lows, we believe that risk assets may not fully capture the challenging macro backdrop.

2023 has been a year full of surprises. Again. The US economy remained more resilient than expected thanks to the unprecedented US fiscal stimulus provided during the pandemic, and global stock markets proved doomsayers wrong. However, this environment was challenging for asset allocators and active investors as equity gains were highly concentrated, and we saw some fast trend reversals in all asset classes throughout the year. What's in store for 2024?

We expect the global economy to continue to lose steam in the first half of the year as the negative consequences of tighter monetary conditions further weigh on economic activity. Still, we expect global growth to remain positive next year, albeit below trend. Depending on the "long and variable lag" of the transmission of higher interest rates to the real economy, some countries, such as the US, might be more resilient than others.

The global disinflation process is well entrenched, and we expect headline and core inflation to continue moderating in 2024 in developed economies, albeit remaining a notch above central banks' targets. Lower inflation and slower growth are incentivizing central banks to pivot into easing mode. The Federal Reserve (Fed) signaled its pivot at the December FOMC meeting, while the European Central Bank (ECB) is likely to follow in its steps. As major central banks start to ease monetary policy, we expect growth to pick up in the second half of the year, providing a strong tailwind for risk assets.

Given the somewhat demanding valuation, the high complacency reflected by a near-historic low VIX, and the rosy earnings' expectations, we think equity markets do not fully price the known risks (recession, rising bankruptcies and credit delinquencies, etc.), as well as the "unknown unknowns" stemming from the normalization of interest rates after an unprecedented era of zero interest rates. The market is expecting double-digit earnings growth in the US and 150 bps of Fed rate cuts starting in March. In addition, credit spreads are historically tight and, in our view do not reflect any deterioration of credit fundamentals. These optimistic expectations stand in contrast with our moderately cautious macro outlook, and we believe that a repricing could take place at some point in H1, weighing on risk assets.

Another risk that we will closely monitor is the artificial intelligence (AI) thematic. While we are very enthusiastic about AI and recognize that it has become a structural force for change, we see the possibility for the narrative to follow a type of sentiment boom-and-bust cycle that has been observed with many new technologies in the past. In our view, some of the forces behind the outperformance of the Magnificent 7 (Apple, Microsoft, Amazon, Nvidia, Alphabet, Meta, Tesla) and their dominance in the S&P500 and Nasdaq100 indices is that they are primary providers and beneficiaries of this AI revolution. For now, we continue to see technology and AI dominating the equity space, at least in the first half of the year. However, the pursuit of the Magnificent 7 leadership is becoming increasingly conditional on earnings' delivery. A disappointment on this front could have deep consequences next year.

Finally, geopolitical tensions have increased over the last two years to levels unseen in decades, a new reality that investors need to factor in. Entering 2024, the Russia–Ukraine and Israel–Hamas conflicts are likely to remain the two geopolitical hotspots. While we deem it too challenging to predict how these conflicts will evolve, we recognize their potential to spill over at least regionally. China is also a source of geopolitical stress, more specifically with regards to its relations with Taiwan and the US.

In the US, the presidential campaign will dominate the political agenda. Mr. Trump, aged 77, could return to the White House despite having been impeached twice and facing scores of charges in multiple criminal cases. He is leading the pack of six Republican candidates so far, while Joe Biden faces little opposition in the Democratic Party. We see the most volatility during the September to November general election period, but expect the election saga to remain front and center throughout the year.

Looking beyond these short-term considerations, we believe that we are entering an era of better prospects for multi-asset portfolios as the medium-term outlook for both bonds and equities has materially improved. Long-term investors have a rare opportunity to reallocate to a traditional balanced portfolio that is poised to deliver attractive risk-adjusted returns going forward.

Global Macro Outlook

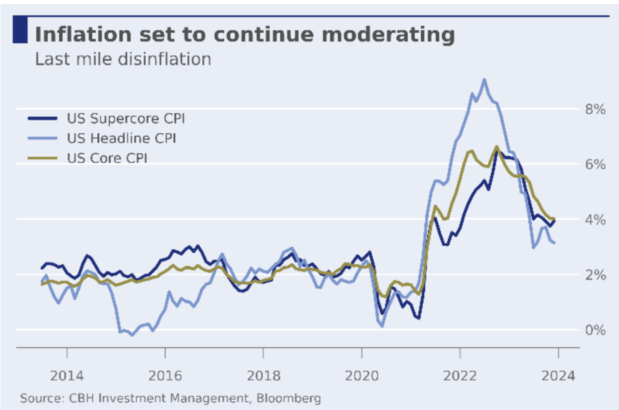
Fed confident it can engineer a soft landing

The transmission lag of tighter financial conditions has been longer in this cycle, in part because corporates and households secured cheap financing during the pandemic zero-rate era. Consequently, most large companies have yet to feel the pinch of higher rates. In addition, two-thirds of homeowners still benefit from a mortgage rate below 4%, as opposed to the prevailing ca. 7% rate for a fixed 30-year mortgage.

The probability of an imminent US recession has receded in our view, and we now err on the side of the soft-landing scenario as we expect inflation to continue cooling down without a significant rise in the unemployment rate. That said, with the drag from the delayed effects of tighter monetary policy set to increase, we expect the US economy to slow down further in the first half of 2024, and to post below-trend growth.

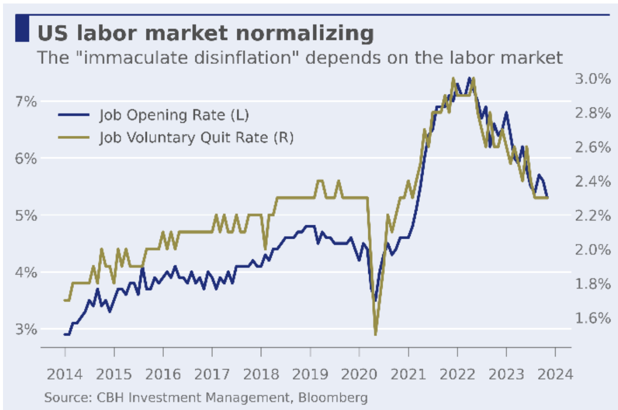
The silver lining is that the Fed has most likely reached peak policy rate and now appears set to start easing monetary policy sometime in the first semester of 2024. As a result, we see the economic momentum starting to recover towards the end of the year. The Fed's baseline scenario is a soft landing, with growth expected to moderate (from 2.6% to 1.4%), PCE inflation to fall further (from 2.8% to 2.4%), and the unemployment rate to rise (from 3.8% to 4.1%).

While the “easy” disinflation stemming from pandemic-related disruptions is behind us (supply chains normalization, year-on-year commodity prices), we expect inflation to continue to normalize globally in 2024. In the US, we see core services inflation gradually declining as nominal wage growth slows down, and we expect shelter inflation to cool down materially, as indicated by leading indicators such as the Zillow rent index. While we expect the US CPI to drop below 3%, we do not see it reaching the Fed's 2% target just yet. We believe the “last mile” of disinflation to the Fed's target will require further softening in the labor market.



In our view, the US consumer is in a much tougher position today than one year ago. The pandemic-era excess savings have largely been spent or will soon be depleted, and the savings rate is at its lowest level since 2008 (excluding 2022). Consumption is increasingly financed by credit card debt, which hit an all-time high of $1.08 trillion at the end of Q3 2023. However, with higher interest rates, credit card debt growth is slowing, indicating that consumers are becoming more reluctant to finance consumption at a 25% rate at a time when the average credit card balances are above $6000, a 10-year high. Case in point, cracks have started to appear for the most cash-constrained consumers as evidenced by the rise in delinquency rates on auto and credit card debt. Moreover, while real wage growth remains positive, we expect nominal wage growth to decline more than inflation in coming quarters, thereby providing less support to households.

As demand for workers weakens, we see tightness in the labor market gradually fading. The job openings rate declined from a peak of 7.4% in March 2022 to 5.3% in October 2023, and the voluntary quit rate has declined from a record high 3.0% per month to 2.3%, in line with the two years before the pandemic. So far, normalization has occurred in a rather benign fashion, with the job openings rate declining without the unemployment rate rising. We believe that the speed and magnitude of the labor market normalization will be a key focus in 2024, and we anticipate the unemployment rate to increase above 4% from the current 3.7% level.



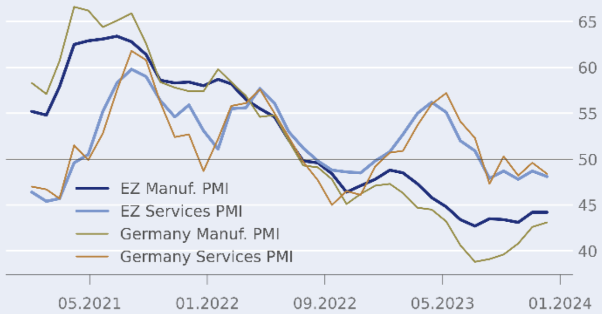
We see risks to this cautiously optimistic view. The labor market could adjust more sharply than expected due to the weeding of unprofitable firms. We could also see renewed stress in the financial system as the consequences of substantially higher interest rates have yet to be fully grasped.

Euro area on the brink of a recession

We continue to see downside risks in the short-term for the Euro area economy as it is in a more troublesome situation than its US counterpart. First, it did not benefit from the same fiscal largesse during the pandemic, and the energy price shock stemming from the Russia–Ukraine conflict took a much larger toll on growth. Second, inflation and growth have slowed sharply since last spring, while the full effects of monetary tightening have yet to be felt. The services sector has held up better thanks to the post-COVID reopening momentum, but this resilience is waning, and we see the slowdown in manufacturing activity spreading out to other parts of the economy.

Eurozone cyclical indicators pointing down

Services are catching up manufacturing on the downside



Source: CBH Investment Management, Bloomberg

EU inflation has peaked and has been falling rapidly in the Euro area from 10.6% in October 2022 to 2.4% in November 2023, mainly due to the energy inflation dropping from 60% inflation in October 2022 to -17% in November 2023. While services inflation remains stickier, it has also started to ease as wage growth normalizes.

As the Eurozone teeters on the brink of recession while inflation falls rapidly, the ECB is under increasing pressure to pivot soon and start cutting rates. Given the less dovish than expected outcome from the December policy meeting, which starkly contrasts with the pivot signaled by the Fed, we now believe the ECB will only cut rates just after the Fed. In our view, the ECB has shifted its focus to wage growth, recognizing that a slowdown is crucial for reducing core inflation.

Still, we expect the picture to improve during the year for the Old Continent. Firstly, declining inflation coupled with still increasing wages indicates that real disposable income is set to improve. Secondly, we expect the negative impact of monetary tightening to gradually decrease as the ECB pivots and starts loosening monetary policy, likely at the end of H1 2024. Interest rate transmission in the Eurozone is swifter than in the US, as 70% of corporate funding is contracted through banks at floating rates, while in the US 80% of corporate funding comes from fixed rate capital market borrowings.

Persistent property market troubles will continue to dampen consumer confidence in China

As Chinese authorities abandoned the zero-COVID policy one year ago, the consensus outlook for China became very upbeat. Unfortunately, these hopes were quickly dashed as the initial economic momentum rapidly stalled in Q2 2023. While Chinese consumers returned to restaurants and cinemas, confidence remained deeply negative, and big-ticket purchases did not return to pre-pandemic levels.

A key driver of this negative sentiment stems from the troubled Chinese real estate market, which has affected property developers and municipal finances, and spilled over to the broader economy. Real estate plays a much larger role in China's GDP compared to developed economies. The sector is vital for the Chinese economy as it represents circa two-thirds of the median Chinese household's assets. Hence, the evolution of house prices has a significant impact on the wealth effect and sentiment of Chinese households.

China consumer confidence in the doldrums

Chinese consumption held back by low confidence

Source: CBH Investment Management, Bloomberg

The real estate market boomed during the first decade of the century as urbanization created a need for new housing units. However, at one point, supply exceeded demand, and the gap was filled by speculators. This prompted authorities to intervene, as Xi Jinping stated, "Housing is for living, not for speculation." The central government cracked down on property developers by limiting leverage and financing. As credit began to dry up, private property developers started to encounter financial difficulties. About half of them have defaulted, with negative consequences on sentiment and consumption that are proving rather sticky.

The market was relying on the Chinese government's support, which started to launch measures in the second half of the year to support growth and increase the demand for housing. However, these policies have so far been targeted and of small scale. While we do expect more credit stimulus, we believe these will remain moderate, as China already has a high debt load to manage. For sure, the contrarian argument is increasingly valid, as a lot of negativity is already reflected in the prices. But for now, we await evidence that the economy has turned a corner.

Asset Class Views

	Less attractive		Neutral		More attractive
Sovereign Bonds					
			USD Long-Term	USD Short & Mid-Term	
			EUR Long-Term	EUR Short & Mid-Term	
Invest. Grade Bonds					
			USD Long-Term	USD Short & Mid-Term	
			EUR Long-Term	EUR Short & Mid-Term	
Other Fixed Income					
		Convertibles	Emerging Debt	Short-Term High Yield	
		Financial Subordinated	High Yield		
Equities					
		Europe	Emerging ex-China	United States	
		China		US Large Cap Growth	
				Global Technology	
Alternatives					
			Gold	Multi Assets	
				HF CTA	
				HF Global Macro	
				HF L/S Equity	
Currencies					
			CHF		
		USD	EUR		

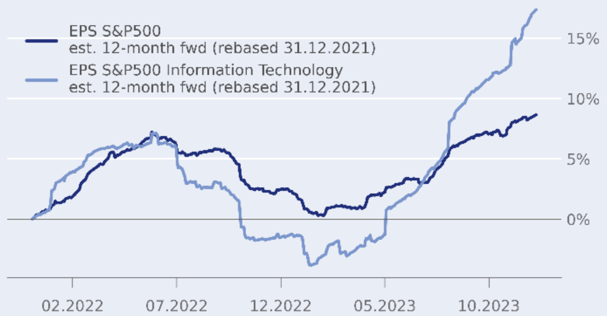
Asset Allocation

Upholding our preference for US equities

The key question for the equity outlook is what is currently priced in the market. As a matter of fact, it appears that analysts (source Factset) are rather optimistic for next year, expecting a 5.5% increase in top-line revenues, with the information technology (9.2%), communication services (7.4%), and consumer discretionary (7.2%) sectors leading the overall progression. Net margins are also expected to expand from 11.7% to 12.3%, again led by the IT sector (26% vs 24.3%). In addition, it is expected that the S&P500 will post double-digit earnings growth of 11.8% in 2024. The technology (17%), communication services (17%), and health care (19%) sectors have the most ambitious EPS growth expectations. In terms of industry, analysts are most optimistic about growth for the semiconductor industry (34%).

Optimistic earnings expectations

Analysts are particularly upbeat for the technology sector



Source: CBH Investment Management, Bloomberg

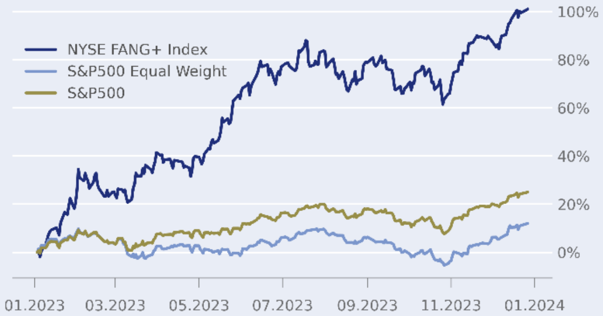
These forecasts stand in stark contrast with our view of a weakening US economy, as slowing growth and consumption should lead to declining top-line revenues. In addition, pricing power is waning for corporate America, and we do not expect further margin expansion in the coming quarters.

On the other hand, we still see strong tailwinds for US equities. First, IT spending related to AI might grow and support this key sector, despite the souring of the economic cycle. Technology being the largest sector, it could support earnings growth at the aggregate S&P500 level. Additionally, the prospect of rate cuts should boost the macro outlook in the second half of the year, with US equities further pricing in better prospects.

There are risks to this scenario, and we expect boots of volatility throughout the year. We believe the market will become increasingly dependent on earnings delivery in the IT sector, and specifically by the Magnificent 7. In addition, we expect that the market will reprice downward some of the ambitious earnings growth expectations during the year. Negative earnings revisions will weight on sentiment.

Stellar performance for mega-cap growth

Outsized contribution of Mag7 in 2023



Source: CBH Investment Management, Bloomberg

Given the balance of forces at play, we expect lackluster but positive earnings growth for developed market equities in 2024. Our stance on equities remains neutral as we enter the new year, with active weights across regions.

Consistent with our positive outlook for the global technology sector, we maintain our preference for the US equity market markedly dominated by growth companies, particularly in the IT sector. While valuation appears to be rich on the surface (12-month forward PE of 19.5x for the S&P500), when adjusting for the market cap effect, it is much less demanding at 16x 12-month forward earnings (S&P500 Equal Weight). Moreover, large cap growth stocks (NYSE Fang+) are merely fairly priced on a forward looking basis with absolute and relative value close to the 5-year median.

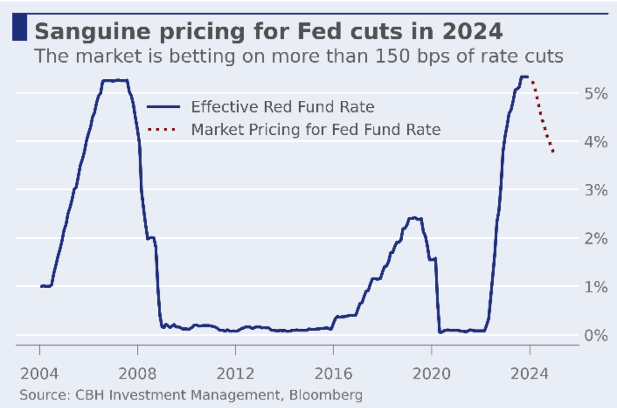
We turned underweight European equities in Q4 2023, despite relative valuation vs the US standing close to the lowest in at least 10 years. In our view, the macro backdrop considerably worsened in 2H 2023. Input costs are still standing above pre-pandemic levels, and we expect higher financing and labor costs. Furthermore, weakening consumer demand and prolonged destocking are likely to weigh on corporate profitability.

We recently cemented our view that Chinese stocks should lag as long as the property sector has not healed, or the authorities step up the scale of their supportive policies. We are neutral Emerging Markets ex-China, as some countries are ahead of the cycle and could benefit from easing monetary conditions earlier and from a softer US dollar. We keep a close eye on Japan as an attractive equity market supported by a macro and micro narratives starting to become convincing. For the time being, we await more visibility about monetary policy and the likely path for the yen.

The opportunity to lengthen duration to be short-lived

At the last FOMC, the Fed made it pretty clear that it is done hiking rates in this cycle at a peak Fed Fund rate of 5.5%. The "dot plot" now suggests that three 25 bps cuts are on the table for 2024. As we anticipate further decline in rents in the upcoming months, inflation is expected to moderate and likely come within touching distance of the Fed's target. We think this is incentivizing the Fed to adopt a more dovish bias. Additionally, with the economy losing steam and the labor market finally cooling, the Fed has even more reason to cut rates soon to keep the economy afloat.

Market expectations for rate cuts, which were already sanguine before the December FOMC, have been reinforced with the view that the Fed will start easing in March. Expectations are for six 25 bps cuts, double what the Fed hinted at. The timeline to the first cut is plausible as the Fed maintained peak rates on average for 8 months since the end of the '80s, which would bring us indeed to March 2024. However, given that inflation will likely not recede as quickly as to fall back to the 2% target before March 2024, we see these expectations as overly optimistic. Hence, while we expect the Fed to cut rates at some point in 2024, the timing is uncertain and will likely remain data-dependent. We thus think the market may be compelled at some point to reprice either the timeline or the magnitude of the forthcoming monetary easing cycle, which will undoubtedly fuel cross-asset volatility.



As for the ECB, while also having strong arguments to pivot, it refrained from doing just that at the last policy meeting of the year. President Lagarde instead reiterated that rates will remain at restrictive levels for "as long as necessary." According to ECB staff projections, headline and core inflation will remain above target until 2025. We view this as a missed opportunity, as the ECB should cut rates even before the Fed to support a derailing economy, and because inflation is falling fast thanks to the contribution of energy prices. The ECB is now likely to wait for the Fed to kick off the easing cycle, but should follow suit immediately after.

Our base case scenario for the longer end of the curve is lower sovereign yields in the US and in Europe, although we think a large portion of the initial downward adjustment in yields has already occurred in Q4 2023 as the market priced in policy easing in the first half of 2024.

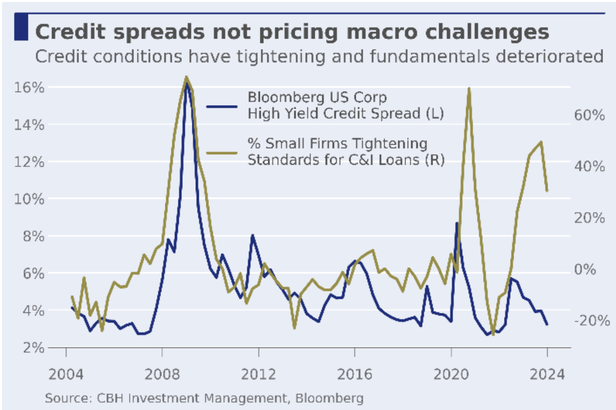
Although macro forces should command lower yields, we do not anticipate a linear downward trajectory. In the US, the exponentially growing US deficit must be financed by an increased supply of US Treasury bonds at a time when there are fewer buyers. This supply and demand imbalance may temporarily push yields higher, and we do not exclude boots of rates volatility. Hence, while we favor lengthening duration, timing will be key.

Credit spreads too tight given macro risks

In many ways, our outlook for credit remains largely unchanged from prior quarters. While the strength of the US economy has helped support credit in 2023, we are now observing signs of deterioration in credit fundamentals. The sharp rise in interest costs and weakening earnings has led to a drop in interest coverage and higher leverage ratios. Tensions are now surfacing in some cyclical areas of the credit market, particularly among issuers with low margins or less pricing power.

Given our prudent macro outlook for the first half of the year, we continue to favor credit quality and particularly medium-term investment grade (IG) corporate bonds. In our view, investors should continue to benefit from an allocation to IG credit as yields stand at attractive levels relative to history and continue to be handsomely rewarded. Additionally, the carry provides a substantial margin of safety against a widening of credit spreads or higher base yields.

Regarding deeper credit, the weakening of the macro backdrop and credit fundamentals is not yet fully priced in credit spreads in our view. It may take a bit longer, but credit spreads will need to widen eventually to reflect the deterioration of fundamentals, as well as the rise in bankruptcies and defaults. High-yield spreads particularly do not appear to discount macro risks, reinforcing our bias toward credit quality.



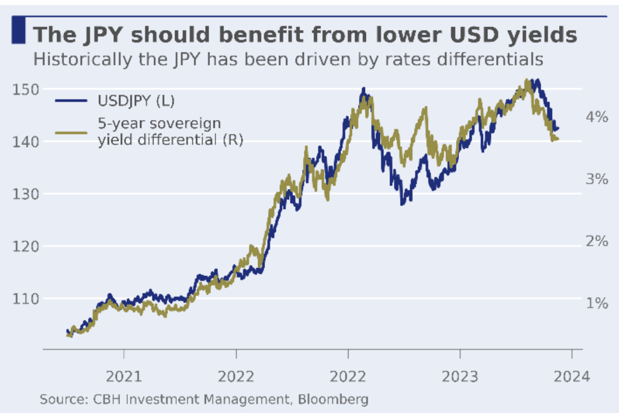
That said, we continue to see an opportunity in short duration credit which is still trading at dislocated prices given the market's uncertainty regarding short-term refinancing needs. The space is an attractive ground for active credit pickers, and the potential return from the pull to par effect remains positive as the average bond trades below par.

Eroding tailwinds for the greenback

We maintain our view that the dollar cycle likely peaked in September 2022, and we expect a marginally weaker dollar in 2024 as several pillars of strength erode. That said, we expect the broad EUR/USD range of 1.05–1.15 to hold in the first half of the year due to offsetting forces. While slower growth and lower yields should be powerful headwinds for the greenback, the weaker state of the Eurozone economy should limit any material appreciation of the euro.

We anticipate lower USD rates as the Fed has signaled its intention to pivot soon. We also believe that the ECB will follow suit shortly thereafter. Hence, we do not expect a marked trend in relative monetary expectations and short-term rate differentials. However, the market is pricing in slightly more cuts for the ECB vs. the Fed, while the ECB's peak rates are 1% lower than the Fed's. We thus believe the market will more aggressively reprice the ECB path, which should cut less than the Fed. This should help the euro in the latter half of the year. In addition, the swifter transmission mechanism to the real economy implies that the EA economy may begin to recover sooner, thereby further supporting the euro.

One attractive opportunity in G10 FX we see for next year is the yen. The timing is highly uncertain, but we expect that the Bank of Japan (BoJ) will end its negative interest rate and yield curve control policies, freeing the upside potential of JPY rates. Yield spreads are already starting to move in favor of JPY strength as expectations for Fed cuts and modest BoJ hikes build up. Additionally, the Japanese yen is currently one of the cheapest G10 currencies when compared to the dollar, which adds to its long-term potential.



Key Convictions

Fed and ECB to cut rates

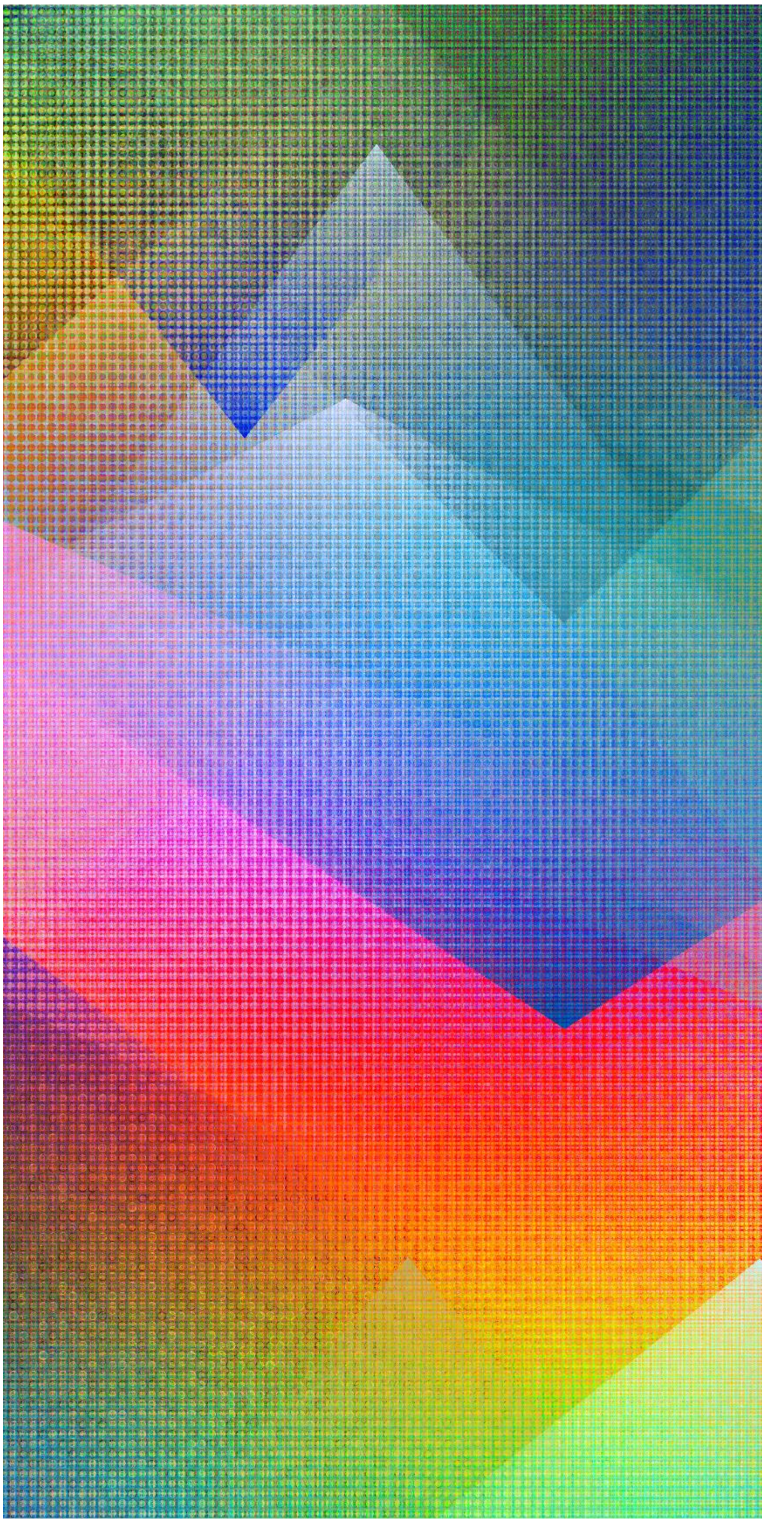
US and EZ inflation to further moderate but remain above target

China growth potential to decrease

Expectations for earnings growth and/or rate cuts to be repriced and generate boots of volatility

Growth and technology stocks to continue leading in H1

Increased noise from geopolitics and politics



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