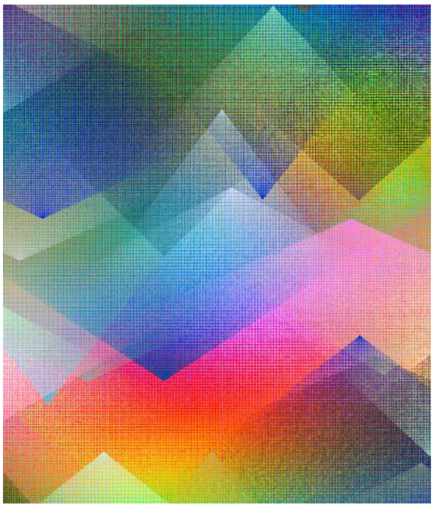
CBH | Investment Management

Quarterly Insight

3Q 2024

V30.09.2023

Creativity within Excellence



Zach Lieberman «Cone overlaps with noise»

Contents

On Track for Rebalancing

As we enter the fifth year after the pandemic shock, the world economy continues to undergo a healthy rebalancing process. We expect the normalization of economic growth, labor markets, and inflation to carry on and provide a benign environment for multi-asset portfolios.

In a Nutshell

While US growth is set to normalize, its resilience bodes well for sustained earnings growth.

The Eurozone economy is showing signs of improvement, but growth is likely to remain muted.

We remain cautious on the outlook for China due to persistent weakness in the property market and subdued levels of consumption.

Monetary policy and macro forces are likely to push government yields lower; hence, the opportunity to lock in carry and duration is likely to fade.

Political uncertainties are expected to weigh on EUR-denominated assets in the short term.

Our stance on credit remains broadly neutral, waiting for moderate spread widening to reallocate some exposure from investment grade to high yield.

For now, we are focusing our risk budget on equities and alternative investments.

The global economic expansion, which began as a rapid recovery from the COVID-19-induced recession, is now entering its fifth year. The pandemic profoundly disrupted the global economy, creating long-lasting imbalances that are still being corrected through a healthy rebalancing process.

After the brief COVID-19 recession in 2020, the US economy rebounded strongly, driven by significant fiscal and monetary stimulus and pent-up consumer demand. Following a 2.2% contraction in 2020, US GDP surged by 5.8% in 2021, the strongest annual growth since 1984. While the economy expanded by 2.5% last year, Bloomberg consensus expects growth to stabilize at 2.3% this year and 1.8% next year, approaching the Federal Reserve's long-term growth rate estimate of 1.8%. This adjustment reflects a healthy process as the residual effects of the pandemic gradually fade, easing inflationary pressures.

Currently, the US economy continues to show robust growth, largely driven by strong consumer spending, bolstered by wage growth and wealth gains. Investment spending has also been unexpectedly strong, despite higher interest rates. This sets a promising stage for sustained moderate growth and inflation, barring major unforeseen shocks. Concerns about a sharp downturn appear overdone, with the weaker first-quarter figures mainly reflecting volatile exports and inventory fluctuations.

US unemployment has been at or below 4% for over two years—the longest such streak since the 1960s—although it has increased slightly from a low of 3.4% in April 2023. The labor market, as measured by job creation (nonfarm payrolls), remains tight by historical standards, but has started to cool. The job openings rate has dropped from its peak of 7.4% in March 2022 to 4.9% in May 2024, and the four-week average of initial jobless claims has risen 17% since last December. The number of people holding multiple jobs is at an all-time high, and job creation is mostly in part-time positions. Additionally, the voluntary quit rate has fallen from a peak of 3% to 2.2%. We see this as a gradual normalization of the labor market imbalance, which surged dramatically during the post-pandemic recovery from 2Q 2020 to 1Q 2022. We do not expect this healthy rebalancing of the labor market to tip the US economy into recession.

In addition to the rebalancing of growth and the labor market, we anticipate inflation to keep normalizing. After peaking at 9.1% in June 2022, US headline CPI dropped rapidly to 3% a year later. This "easy disinflation" was largely due to the normalization of supply chains and commodity prices. However, disinflation has since stalled, with the headline CPI hovering between 3% and 3.7%, likely due to strong economic growth and a still tight labor market. Despite this pause, we expect inflation to gradually decline further. The two main drivers of inflation, rents and wages, are expected to decrease slowly. Rents should continue to adjust with a lag in response to the downturn in the housing market, and wage growth should decelerate as the labor market cools.

We foresee a more balanced distribution of corporate earnings growth across sectors. Recently, much attention has been paid to the significant impact that mega-cap growth companies, particularly the Magnificent 7 (Microsoft, Apple, Nvidia, Amazon, Meta, Alphabet, and Tesla), have had on the performance and earnings growth of equity indices. For example, the positive earnings growth reported for the S&P 500 in 4Q 2023 was solely attributable to these seven companies, while the rest of the market experienced negative earnings growth. However, equity analysts now expect all eleven sectors to show positive earnings growth next year. This healthy normalization should extend the duration of the cyclical bull market.

Global Macro Outlook

US economy continues to show resilience

In this post-Covid era, pinpointing the current state and trajectory of the economic cycle has become increasingly challenging. Although the cycle remains strong on the surface, various forces are pulling in conflicting directions. Some pundits go as far as arguing that the traditional economic cycle no longer exists. In our view, it is more a composite of multiple cycles across manufacturing, services, housing, labor, inflation, investment, and consumption. These cycles have become less synchronized due to the uneven impact of the pandemic on different sectors of the economy.

As we have often noted, the Federal Reserve's sharp monetary tightening has not led to the collapse in economic activity that the market anticipated in early 2023. One reason for this is that corporations and households have taken advantage of the post-Covid zero-rate era to refinance at favorable long-term conditions. As a result, the transmission mechanism of higher rates is much weaker in the current cycle. Nonetheless, higher rates have caused some distress, primarily among over-leveraged corporations, with defaults and bankruptcies rising mostly in the sub-BB high-yield segment. In addition, consumer debt delinquencies have primarily affected the youngest and lowest income individuals.

We continue to adhere to the soft landing scenario as the US economy demonstrates remarkable resilience, particularly in consumption and services. At first glance, disposable income growth has slowed from a peak of 5.3% in June 2023 to 1% by the end of April 2024. With limited disposable income growth, consumers must rely on savings at a time when the savings rate remains historically low at 3.6%. Despite headlines suggesting that pandemic excess savings have likely been exhausted, a closer look reveals that the top quintile of income earners, who account for approximately 40% of consumer spending, still have excess savings. These are the households that frequently spend on services such as restaurants and concerts.

Retail Sales

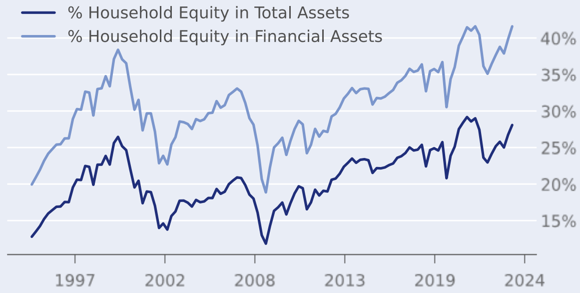
US consumer spending remains robust

Source: CBH Investment Management, Bloomberg

In addition to cash in the bank, we believe the wealth effect, driven by the US equity market reaching all-time highs, is a significant tailwind. Currently, 28% of household wealth is invested in equities, which accounts for a record 42% of household financial assets. House prices have also reached all-time highs, with the homeownership rate at 65.9%, close to the 30-year average. Consequently, while highly leveraged consumers are negatively impacted by higher interest rates, the substantial increase in wealth among middle- and high-income households more than offsets the adverse effects of rising rates. We therefore expect the US consumer to continue to spend at a decent pace, supporting our positive macroeconomic outlook for the coming quarters.

Share of Equities in US Household Assets

Positive wealth effect of equity ownership

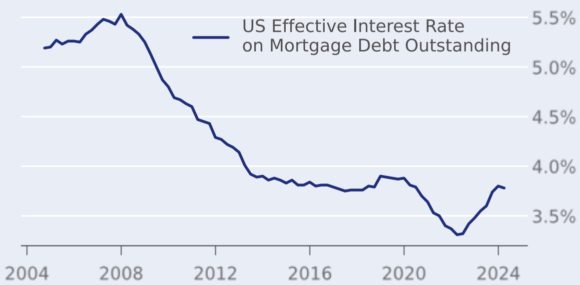


Source: CBH Investment Management, Federal Reserve Bank of St. Louis

Shouldn't a mortgage rate above 7% cripple household finances? Yes, but several factors explain why rising rates have not severely impacted existing homeowners. First, about 40% of households do not have an outstanding mortgage (US Census Bureau). Second, many households refinanced their mortgages during the post-COVID zero-rate era, locking in very favorable long-term conditions. Currently, more than three-quarters of homeowners with a mortgage have a fixed rate below 5%. On aggregate, mortgage debt service as a percentage of disposable income is 4%, well below the 30-year average of 5.3%.

Effective Mortgage Rate

Few homeowners are exposed to current high mortgage rates

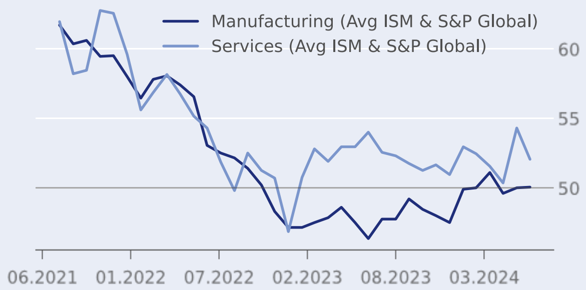


Source: CBH Investment Management, BEA, Bloomberg

The labor market is normalizing, a process that is expected to continue in the coming quarters. The job opening rate is falling, and new jobless claims are gradually rising. Still, we do not foresee a sharp increase in the unemployment rate, as resilient corporate earnings should continue to support the labor market. The state of manufacturing activity is mixed, with the ISM and the S&P Global surveys sending conflicting signals. An average of both series suggests that manufacturing has been recovering modestly since summer 2023, but not convincingly. The ISM Manufacturing ratio of new orders to inventory indicates that the economy is restocking rather than increasing production, a concerning cyclical indicator. Conversely, services remain robust. With services accounting for more than three-quarters of GDP, this supports our view of a resilient US economy in the face of higher capital costs.

US Manufacturing and Services Surveys

Services resilient, manufacturing gradually recovering

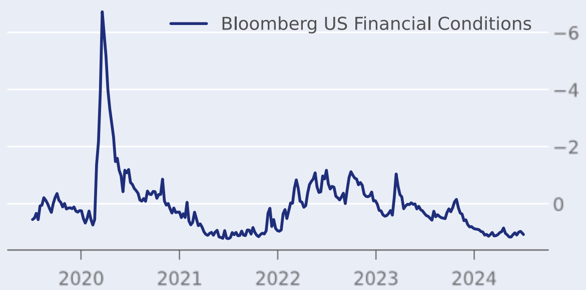


Source: CBH Investment Management, Bloomberg

After four strong months, inflationary pressures eased somewhat in May, with the headline CPI standing at 3.3%. Core services accounted for 58% of this figure, with shelter the main driver at 35%. In our view, the inflation outlook hinges on wages and rents. As the labor market normalizes, the balance of power becomes less favorable to employees. This loss of bargaining power means that wage growth will continue to decelerate below 4% in nominal terms. Shelter inflation stands at 5.4% after peaking at 8.2% in March 2023, and remains the largest contributor to core inflation. The depressed housing market should continue to push rents lower with a lag of around 1.5 years, as suggested by leading indicators. Hence, given our outlook for waning inflationary pressures in wages and rents, we continue to expect the disinflationary process to persist. However, with core services inflation remaining above 5% (5.3% at the last print), we believe that inflation will remain above the 2% target for this year and next.

US Financial Conditions

Easing financial conditions offset the pain of higher interest rates



Source: CBH Investment Management, Bloomberg

At the December 2023 FOMC meeting, the Fed signaled that it was done hiking rates and that a pivot was likely. This prompted financial markets to aggressively price in upcoming rate cuts, driving equities up and interest rates down. In addition, credit conditions have eased substantially since 4Q 2023, with the share of banks tightening lending standards, dropping from a cyclical high of 50% at the end of September 2023 to 15.6% currently. This substantial easing in financial conditions has mitigated the muted impact of higher interest rates, helping to keep the economy afloat. As the Fed further removed the tail risk of a rate hike at the June FOMC, we anticipate that financial conditions will remain supportive of risky assets in the second half of the year.

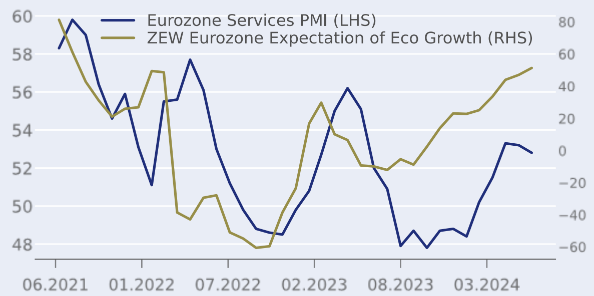
A slow and muted recovery process in Eurozone

After five quarters of stagnant growth and a slight contraction in 4Q 2023, Eurozone GDP finally rose by 0.3% in 1Q 2024. This recovery was primarily driven by a sustained improvement in the terms of trade, owing to declining energy prices. Consequently, inflation decreased significantly, with the headline CPI falling from a peak of 10.6% in 4Q 2022 to 2.6% by May 2024. The well-advanced disinflation process prompted the ECB to begin its rate-cutting cycle in June, which is expected to stimulate investment and construction.

The resilience of the European labor market, with unemployment rates at or near historical lows in most countries, also remains mildly supportive, bolstering business and consumer confidence. This is evidenced by the strong Services PMI and ZEW Expectations figures. Moreover, while wage growth has likely peaked, it will decelerate only very gradually. With inflation falling more swiftly, households are regaining the purchasing power they lost during the energy crisis. However, not all the clouds have cleared. Manufacturing remains a weak spot, with activity stabilizing but the recovery process proving uneven. The Manufacturing PMI fell to 45.6 in May from 47.3 in April, reflecting the sector's ongoing struggles. Moreover, the recovery in the manufacturing sector is uneven across member states, highlighting the economic heterogeneity within the Eurozone.

Eurozone Business Confidence

Services leading the recovery in Eurozone



Source: CBH Investment Management, Bloomberg

While we expect disinflation to continue in the Eurozone, the rebound in headline and core inflation in May underscores that the path to the 2% inflation target is likely to be long and non-linear. While most of the inflationary pressures stemming from commodity prices and supply chain disruptions have abated, second-round effects on wages are now driving inflation. Given the rigidity of the European labor market, wage adjustments will be slow.

Overall, domestic demand is expected to strengthen, initially through consumer spending in the second half of

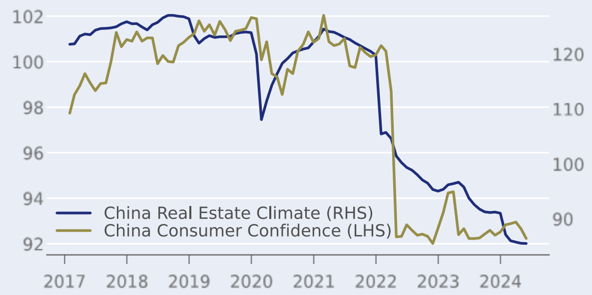
2024, followed by increased investment in 2025. This trajectory will facilitate a return to potential GDP growth. This moderate optimism is reflected in consensus growth expectations, which have risen from 0.5% to 0.7% year-to-date. Nevertheless, substantial risks remain. Geopolitical conflicts in the Middle East and Ukraine pose significant threats to this moderately positive outlook. Other risks include monetary policy divergence with the Fed, heightened political uncertainty in France, and deteriorating economic relations with China.

Chinese economy remains unbalanced

The Chinese economy continues to navigate a complex landscape with many challenges. Yet, in 1Q 2024, GDP growth reached 5.3% year-on-year, exceeding expectations. One of the key drivers of growth is robust industrial production, supported by government policies that prioritize high-end manufacturing, green technologies, and national security. However, this growth is structurally unbalanced as consumption remains subdued due to high youth unemployment (15.3%), stagnant incomes in major cities and the negative wealth effect from declining house prices. These factors continue to dampen consumer and business confidence, weighing on spending and investment.

Chinese Confidence

Depressed sentiment among consumer a drag on China growth



Source: CBH Investment Management, Bloomberg

The property sector remains a serious concern, with continued instability and key housing market indicators that have yet to bottom out. With property accounting for the largest share of the average Chinese household's wealth, it is difficult to see how confidence can be restored without a turnaround in the housing sector. To support the economy, the government tends to prioritize fiscal stimulus over monetary easing, with investment in infrastructure and technology continuing to drive growth. In addition, local government debt levels continue to escalate, posing systemic risks to financial stability. Geopolitical tensions, particularly with the United States and Taiwan, also threaten export-oriented industries. Achieving a balanced economy is key for China. This warrants further reforms to boost household income, encourage consumer spending, and address overcapacity in certain industrial sectors.

Asset Class Views

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

Asset Allocation

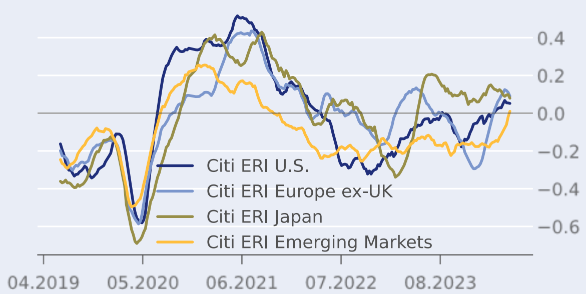
Equities benefit from macro and micro tailwinds

In the first half of the year, the US equity market posted a strong performance in the face of a sharp repricing of the Fed's cuts from seven to less than two. This strength was primarily driven by the composition of the US equity indices, which are heavily weighted towards mega-cap growth and technology companies. The Magnificent 7 have contributed 60% of the year-to-date gains in the S&P 500, benefiting from improving earnings forecasts fueled by the potential of AI. The latest earnings reports confirm our view that the AI investment cycle is in full swing and still in its early stages. We are witnessing significant investment in AI infrastructure, as data centers require considerable upgrades to accommodate AI workloads. The primary beneficiaries so far have been semiconductor companies, which are experiencing high demand for cutting-edge chips, high-bandwidth memory, and networking equipment. Consequently, we maintain our favorable outlook on Cloud Computing and Artificial Intelligence themes.

Our positive view on equities is also driven by supportive macro and micro tailwinds. While US economic growth is set to normalize, it remains remarkably resilient with robust consumer spending and a strong labor market. Inflation is expected to gradually decline, although the "last mile" may be protracted. Factor in the fact that President Biden is leveraging every available tool to support growth ahead of the November presidential election, and the macro backdrop remains supportive of corporate America's ability to grow earnings in the second half of the year.

Regional Earnings Momentum

Positive earnings revision except for Japan



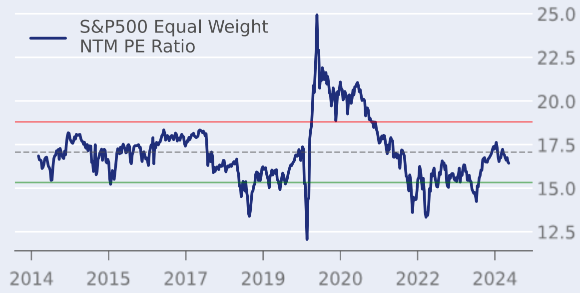
Source: CBH Investment Management, Bloomberg

This is also the aggregated opinion of stock analysts, who expect US earnings to grow by 11.3% in 2024 and 14.4% in 2025 (S&P 500, FactSet data). Technology, of course, stands out, with expected growth of 18.8% in 2024 and 19.5% in 2025. Another key support for the longevity of the cyclical bull market is that, in addition to growth in AI-related sectors, we see earnings growth expanding in many other sectors. Nine of the eleven sectors are forecasted to grow earnings in 2024, and by 2025, all eleven sectors are expected to expand EPS. This is a paradigm shift from the recent past, when earnings growth was concentrated in mega-cap growth stocks. With earnings driving prices, we should also see the US market progress less on the back of a concentrated group of behemoth companies.

After a 26% total return in 2023 and 15% year-to-date, do US and global equities still have some upside left? One long-term way to look at this is through the prism of valuation. At 21x forward earnings, the S&P 500 can be considered expensive as it is more than one standard deviation above its 10-year average. This elevated valuation largely stems from the technology sector, the largest in the index, which has an NTM PE of 30x. Outside of the technology bubble of the early 2000s, the valuation gap between tech and the market has not been this wide. Looking at a better proxy for the "market", the S&P 500 *Equal Weight*, which corrects for the distortion of market capitalization, the valuation picture is very different with an NTM PE of 16x, slightly below the 10-year average. Hence, outside of technology and mega-cap growth stocks, we do not see valuations as demanding.

US Equities Valuation

Adjusted for mega-cap firms, valuation remains fair



Source: CBH Investment Management, Bloomberg

Nevertheless, many risks remain. Our primary concern is the lofty expectations associated with artificial intelligence, as much of the positive news and anticipated future earnings growth seems already reflected in current valuations. Our caution also centers on the cognitive path of this enthusiasm. This is well described by Gartner's Hype Cycle, which shows how a new technology often triggers an initial wave of hope that leads to inflated expectations, which are then deflated before regaining traction in a more reasonable way. We fear that we are currently climbing the slope that leads to the peak of inflated expectations. While we share the widespread optimism about the tremendous potential for productivity gains and new business opportunities from generative AI, we believe it will take time for these productivity improvements to permeate the broader economy.

Entering the third quarter, we maintain our overweight in equities, as the outlook remains bright on the back of supportive macro and micro forces. We are overweight US equities, with a tilt on growth stocks, while we are moderately underweight Europe and Emerging Markets equities. Europe remains attractive from a valuation perspective, but we believe the region suffers from underexposure to technology and growth companies. In addition, the recent political turmoil in France has brought back a political risk premium into European assets, creating a short-term drag. We remain cautious on emerging markets, particularly China, despite some positive macro developments that have prompted a market rebound. We hold our overweight in tactical equities, as we see fertile ground for active stock picking with high dispersion.

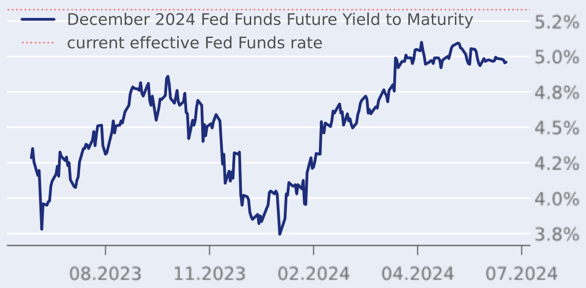
Fed in no rush to cut

In the first half of the year, fixed income markets were dominated by the repricing of Fed rate cuts and the resurgence of the “higher for longer” narrative driven by a less dovish policy outlook. As the US 10-year yield rose from 3.9% to 4.4%, duration negatively impacted bonds. Conversely, shorter-duration and riskier bonds have outperformed year-to-date as credit spreads have tightened.

While we continue to believe that the cyclical peak in US yields is behind us, we have long been skeptical of the market’s sanguine pricing of Fed cuts and have only gradually added duration. The timing of the first rate cut remains uncertain and data-dependent, as Chair Powell has frequently reiterated, and our base case is for a first cut in September. However, given the difficult path of “last mile” disinflation and the resilience of the US economy, the alternative scenario of no cuts this year has become more likely.

Over the medium term, economic forces and looser monetary policy should push Treasury yields lower. Nonetheless, the path to lower yields is likely to be non-linear, as heavy Treasury supply at a time of fewer buyers could create momentary upswings. From a technical analysis perspective, the series of lower highs in the US 10-year yield suggests that the prevailing trend is now downward. Therefore, we reiterate that duration has its place in a multi-asset portfolio. We believe that any upward yield movements close to 4.5% on the US 10-year Treasury provide an attractive entry point to add duration and lock in carry.

Fed Pricing
Since April, market pricing for Fed cuts has been stable



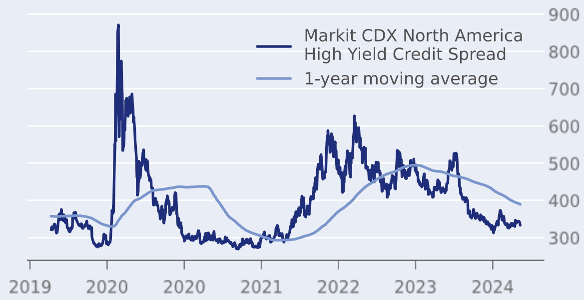
Source: CBH Investment Management, Bloomberg

Credit remains (too) expensive

In 2Q 2024, credit spreads for both investment grade (IG) and high yield (HY) bonds remained broadly stable in the US and Europe. Quarterly performance was positive on the back of attractive carry, with high yield indices posting a year-to-date total return of over 2.5% on both sides of the Atlantic. In contrast, investment grade performance hovered around zero. Despite the most aggressive monetary tightening in 50 years, the delayed impact of higher financing costs has been relatively contained within the sub-BB ratings, supporting credit indices.

Credit fundamentals remain healthy and demand for credit is strong as investors continue to pile in to lock in attractive carry levels. Supply is also strong, with many companies taking advantage of low spread levels. Valuations remain rich, however, as credit spreads continue to trade tight, well below the 10-year average and close to historical lows. Overall, credit spreads have tightened to levels seen when the Fed began hiking rates in 2022. In this context, we maintain our preference for IG credit over HY and emerging debt, as high quality corporate bonds appear more resilient to cyclical headwinds.

High Yield Credit Spreads
US High Yield remains expensive



Source: CBH Investment Management, Bloomberg

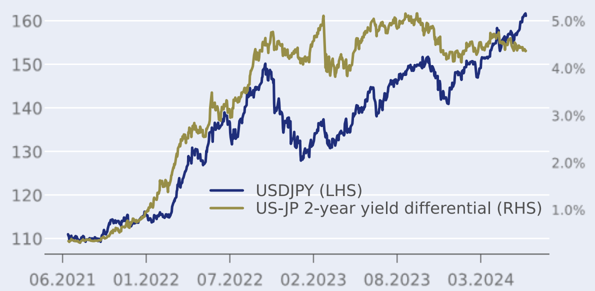
Politics to weigh on the Euro again

Overall, higher interest rates, delayed Fed cuts, and a stronger US economy continue to argue in favor of the USD in the short-term. The main driver of G10 FX remains relative monetary policy expectations, as evidenced by the high correlation between the Dollar Index and the pricing of the 1-year forward Fed Fund rate. Since April, the outlook for the Fed has been fairly stable, with expectations for a little less than two cuts this year. For the ECB, the market was anticipating two cuts by the beginning of June, with the first already delivered on June 6th. Moreover, the European legislative elections and the subsequent turmoil in French politics have reintroduced a political premium into EUR crosses. Typically, political stress in Europe causes the EUR to fall more against the CHF than the USD, and this has been confirmed once again. We believe that the tug-of-war between French politics and the Fed vs. ECB outlook will largely drive EURUSD in the third quarter, with the pair likely to trade in the 1.05 to 1.09 range. We expect the 1.05 floor to hold, barring further political stress in the Eurozone. Longer term, we anticipate the dollar to gradually weaken as US growth normalizes and the Fed joins the rate cut party.

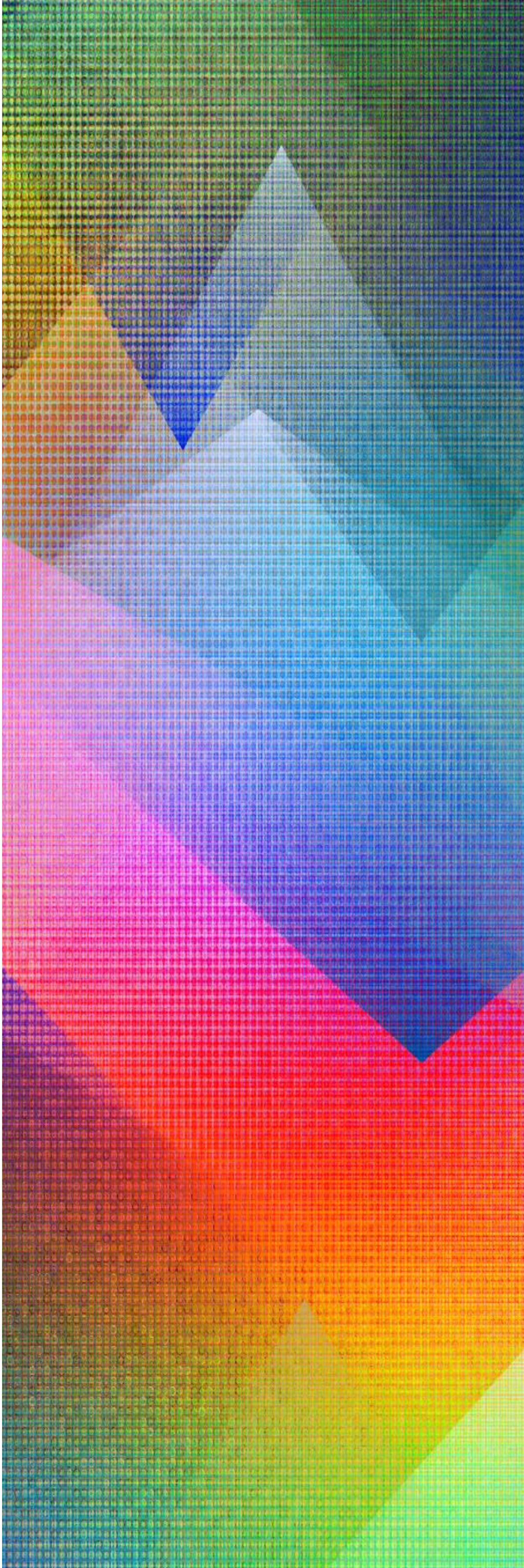
Aside from the resurgence of political risk in Europe, the most important recent development in G10 FX has been the further weakening of the JPY, which has fallen past 160 USDJPY to its lowest level in 38 years. In recent years, USDJPY has been mostly driven by interest rate differentials, but it has recently depreciated despite stable yield differentials. So, what is behind the yen's recent weakness just after the Bank of Japan's (BoJ) pivot marked the end of decades of ultra-loose monetary policy? While many potential explanations have emerged, none seems entirely convincing. We see two major medium-term headwinds for the yen that could be part of the equation. First, the long-awaited BoJ pivot has so far been very timid and the path of policy normalization remains slow. While the abandonment of yield curve control is a significant shift, the BoJ disappointed hawkish market expectations by offering no guidance on a July hike and postponing the decision on slowing JGB purchases until the July policy meeting. Second, global risk appetite remains elevated, a favorable environment for carry trade strategies. On a one-year basis, the yen has weakened by 10-11% against the highest yielding G10 currencies USD, GBP, NZD and AUD. Thus, the widespread use of the yen to fund carry trades may be another element behind the JPY's persistent weakness. On balance, we see the marginal rise in JGB yields and the potential for a BoJ FX intervention being more than offset by the positive outlook for risk assets and stable US yields until the Fed finally starts cutting rates.

USDJPY vs Yield Differential

JPY weakness has recently overshot interest rate differentials



Source: CBH Investment Management, Bloomberg



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