STRATEGY FOCUS

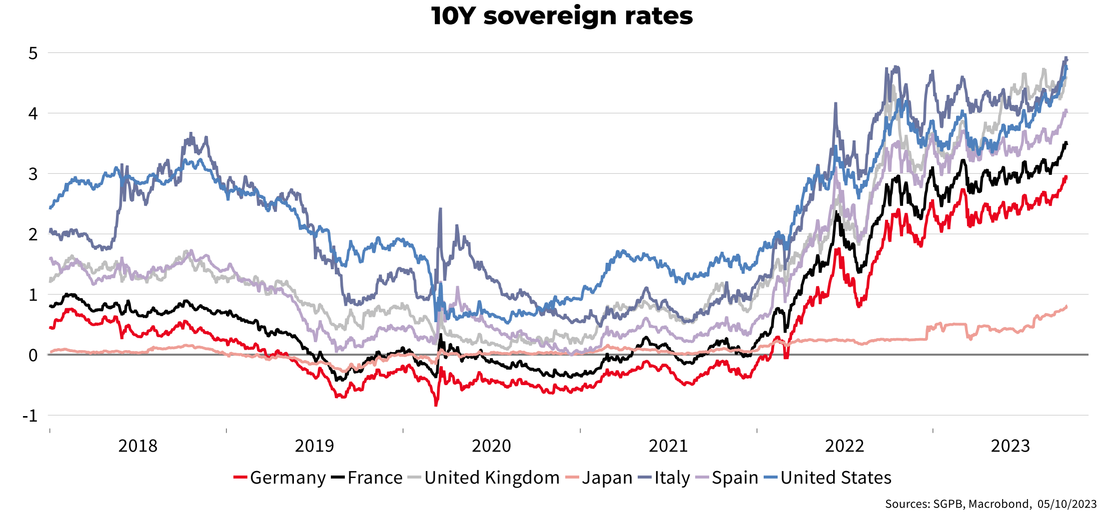
Renewed bond market tensions

Bond yields have increased again since the beginning of September with most topping their 2008 Great Financial Crisis peaks. The reasons for this increase are fourfold: (i) the United States economy continues to power along with surprising strength, (ii) the rise in oil prices has raised fears of a fresh bout of inflation, (iii) central banks continue to strike a hawkish tone, and (iv) budget discussions are reviving fears for the sustainability of public debt in several countries.

10-year sovereign yields have risen to near 4.8% in the United States, 3% in Germany and 3.5% in France. The rise has been less marked in the UK where already high yields remain close to 4.6%. Pressure has been particularly fierce on Italian bonds, now trading at a near 200 bp spread to the German bund.

We stand by our central scenario of resilient but weaker economy. Companies and households still have the cash to mitigate, at least in part, the latest tightening of monetary and financial conditions. Meanwhile, persistently strong labour markets and an easing of inflation will help sustain household purchasing power. **But we see some risk of a tighter fiscal stance, particularly in the euro zone, which could weigh on economic growth. Moreover, the surge in bond yields also raises the risk of financial instability, as seen in the United Kingdom a year ago or with US regional banks in March.**

We remain confident in our strategic balance between equities and fixed income. The latest bond market tensions have been accompanied by a fall in equity markets and a depreciation of the euro against the dollar. As it stands, we stick to our highly diversified positioning in order to be protected against these turbulences. That said, we remain highly vigilant, and ready to react to any changes in the situation.



FEARS FOR YIELDS ON SEVERAL FRONTS

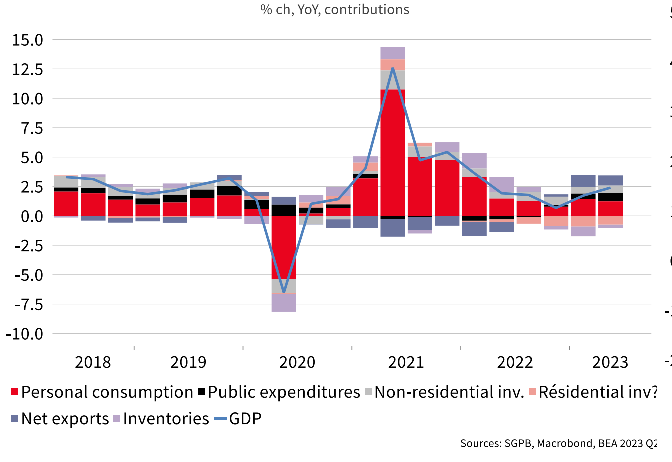
The United States economy has proved stronger than markets expected. At the start of the year, the consensus expected a sharp slowdown in US growth due to monetary tightening, a view reinforced by the regional banking crisis. However, the US economy has proved mightily resilient, growing at an annualised average of 2% in H1 2023 and set to speed up in Q3. The consensus has now upgraded its forecasts for full-year US growth in 2023 from 0.8% at the start of the year to 2%. As such, the jump in bond yields reflects in first instance the fact that markets now see less chance of the US going into recession.

Higher oil prices raise fears of renewed inflationary pressure. Oil prices fell steadily through H1 2023, allowing headline inflation to ease across the developed world. However, energy prices have recently spiked again, with the price of barrel of oil up 20% on the quarter, after OPEC+ countries said they were extending their production curbs. This spike has revived fears of inflation.

Central banks still sounding hawkish. The world's main central banks all announced pauses in their rate cycle in September except for the ECB, which unexpectedly put through another quarter-point hike. However, the tone of their comments has remained markedly hawkish. Banks have been keen to signal their willingness to keep rates high for an extended period and to continue reducing their balance sheets. This hard line reflects fears that the easing of inflation seen in the last quarter may not perdure, given the labour market tightness and risks of energy inflation. In the first half of the year, bond markets tended to shrug off this tone, but the persistently strong US economy and further hawkish messaging from central banks have forced them to rethink, pushing up yields. This is most evident in the return into positive territory of the US 10-year bonds term premium and in markets no longer expecting rate cuts in the next few quarters.

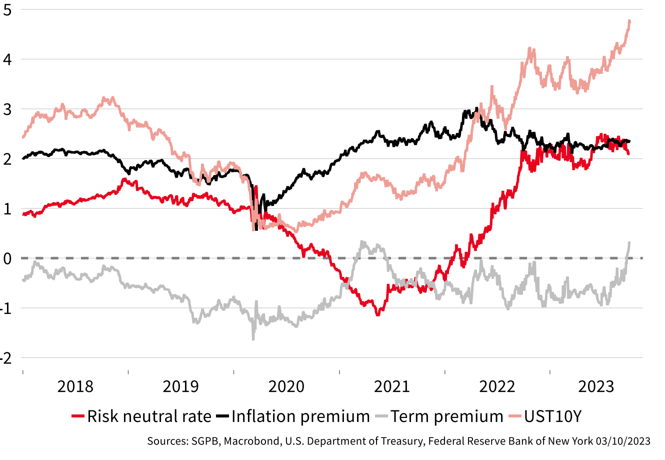
A more challenging backdrop for public finances. The final factor driving the jump in bond yields is the deterioration in public finances. The US federal deficit has expanded to 8% of GDP (Q2 2023) amid strong growth with the Treasury scheduled to place USD 1 trillion during Q3 2023. Moreover, political governance in the United States continues to worsen, reducing the likelihood of a clear-cut fiscal adjustment. In Europe, the fiscal outlook remains challenging for both France and Italy.

United States: Real GDP growth



Sources: SGPB, Macrobond, BEA 2023 Q2

United States: 10Y Treasury rate decomposition

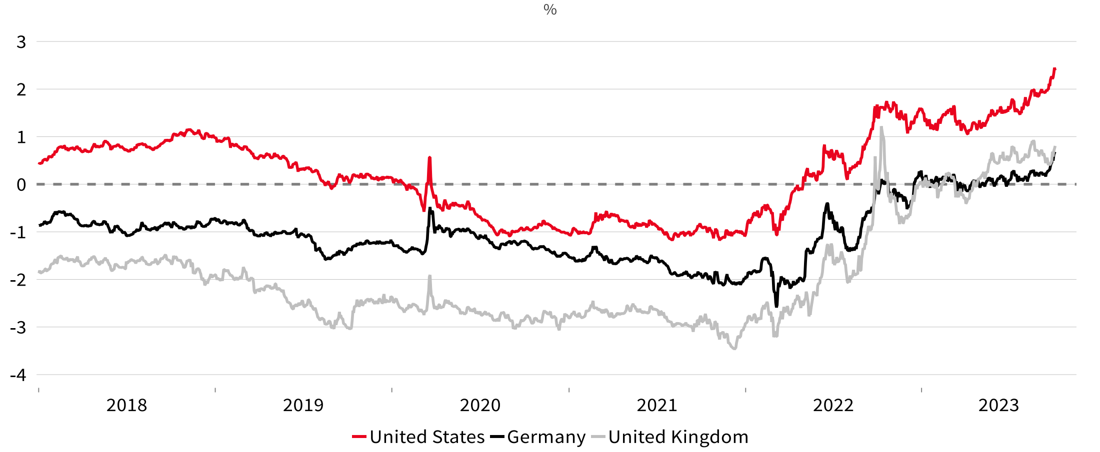


Sources: SGPB, Macrobond, U.S. Department of Treasury, Federal Reserve Bank of New York 03/10/2023

WE MAINTAIN OUR CENTRAL SCENARIO OF RESILIENT BUT WEAKER ECONOMY

Renewed tightening in monetary conditions. Central banks have been tightening monetary conditions for many quarters now and the main result has been a rise in real interest rates. We believe central banks have reached their interest rate peak and are likely to keep them at this level over the coming quarters. The latest increase in bond yields should therefore lead to a further tightening of credit conditions, making it harder and costlier for households and firms to borrow.

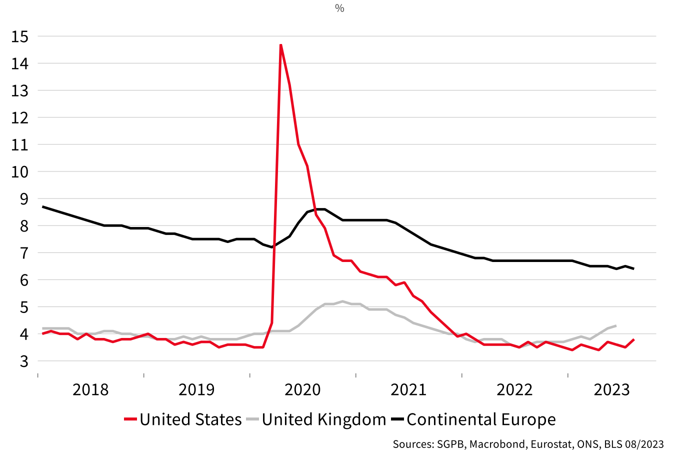
Real interest rates (10Y sovereign yield-10Y inflation breakeven



Sources: SGPB, Macrobond, Macrobond, U.S. Department of Treasury 04/10/2023

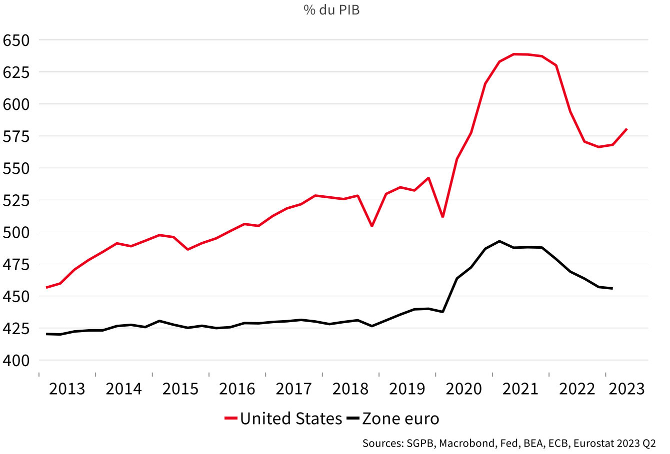
Mitigating factors are still at work, particularly in the United States. Economies have so far held up well against the monetary tightening, particularly the US economy which continues to surprise positively. Companies and households can still count on their healthy balance sheet to mitigate the clampdown on credit. For one thing, thanks to a large proportion of their debt at fixed rate or at medium- and long-term maturity, higher interest rates has only partly fed through to households and corporate. For another, in the United States and - to a lesser extent - in the euro zone households still have more net wealth (assets minus liabilities) than before Covid. Meanwhile, robust labour markets and the ongoing easing of inflation continue to boost purchasing power. Having said that, we are likely to see clearer signs of a slowdown in coming months, due not only to monetary tightening but also to fiscal adjustment measures that may be stepped up before too long.

Unemployment rate



Sources: SGPB, Macrobond, Eurostat, ONS, BLS 08/2023

Households net worth



Sources: SGPB, Macrobond, Fed, BEA, ECB, Eurostat 2023 Q2

RISKS OF A TIGHTER FISCAL STANCE, NOTABLY IN THE EURO ZONE

Public finances back in the spotlight. The latest narrowly averted “shutdown” of the US government and the announcement of the 2024 draft budgetary plans for France and Italy have put public finances back in the spotlight. This, just as the cost of public sector debt is being driven up by higher debt ratios and higher rates.

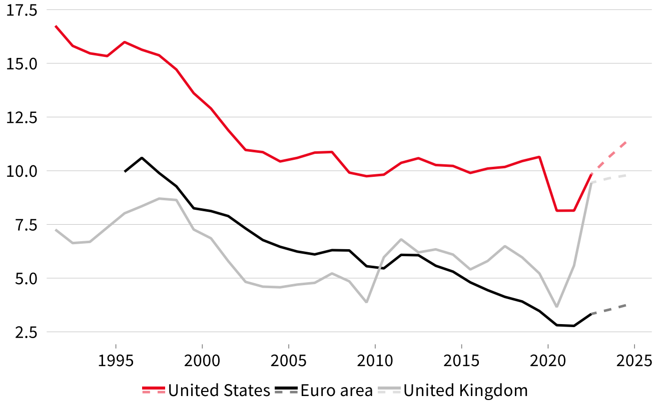
No short-term funding issue in the United States, the euro zone as a whole or the United Kingdom. The major economies have increased the maturity of their debt over the past ten to fifteen years to around 7 years in the US or the main euro area countries and 14 years in the UK. This should help smooth the impact of higher interest rates. Moreover, nominal GDP growth (real growth plus inflation) continue at a fairly robust pace – albeit less so than in 2021-23. This means the big developed economies can count on a positive “snowball effect”: all else being equal when nominal GDP grows faster than debt service costs it results in falling debt/GDP ratios – unless public deficits (excluding interest payments) are too large.

But countries with larger public debt are more vulnerable. Several euro zone countries – e.g. France, Italy, Spain and Belgium - are getting closer to the point where their public sector debt could start to snowball negatively (i.e. lock into a self-reinforcing uptrend) unless offset by significant budget surpluses (ex interest). Note that these countries are currently making efforts to rein in their budgets after several years of exceptional spending on Covid and the energy crisis. But the process is proving very gradual. The recent rise in bond yields could crank up the pressure further, potentially forcing them to take more drastic fiscal adjustment measures.

Long-term fiscal adjustments and/or reforms are essential. The ageing population means that public sector spending on healthcare and pensions will be driven inexorably upward in coming years. This comes on top of the costs of fighting climate change. As a result, the issue of debt sustainability is here to stay. Governments will have to push through economic reforms to boost growth, structurally improve public sector efficiency and either rein in discretionary spending or raise taxes.

Public debt service

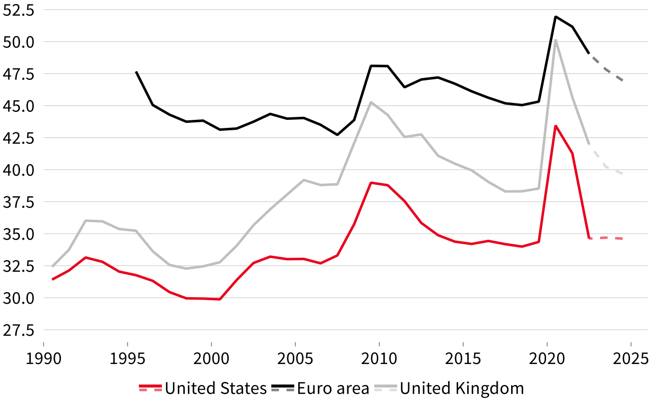
As % of public expenditures, European Commission forecast



Sources: SGPB, Macrobond, DG ECFIN 2024

Primary public expenditures

% of GDP, European Commission forecast



Sources: SGPB, Macrobond, DG ECFIN 2024

WE ARE STANDING BY OUR STRATEGY IN TURBULENT MARKETS

A less favourable momentum in equity markets. When crude oil prices first took off in early September, equity markets - except energy sectors - fell sharply. This slide was then exacerbated by the accelerating rise in yields. European equity markets are now below their 200-day moving averages and US markets are close to it, a level that is traditionally a harbinger of persistent weakness.

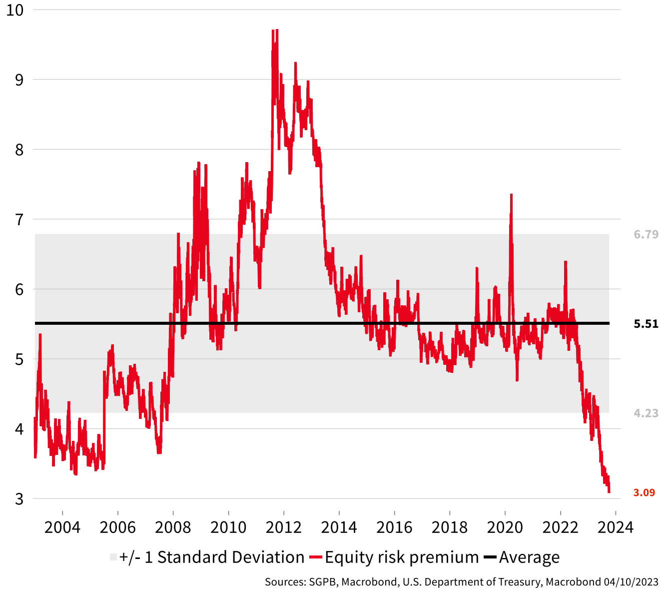
But market valuations are broadly unchanged. In both absolute terms (price/earnings) and relative to the 10-year bond yield (risk premium), US equity markets were already expensive before the latest market turmoil, though not unprecedentedly so. European markets looked more attractive on a P/E basis but were also trading on historically high equity risk premiums. However, the recent drop in equity and debt markets has not been large enough to radically affect these valuations nor their relative attractiveness.

Broad-based decline in equities. Since mid-September, the downward trend has spread to all sectors, though structurally high leverage sectors (e.g. utilities) or sensitive to consumption have been hit the hardest.

We are therefore standing by our balanced positioning in equity and fixed income, still preferring the US markets. Our diversified stance should continue to provide some protection if the current turbulence persists, while also catching any potential rebound in equity markets. We still prefer the United States markets which stand to gain from the better economic outlook.

MSCI USA: Equity risk premium

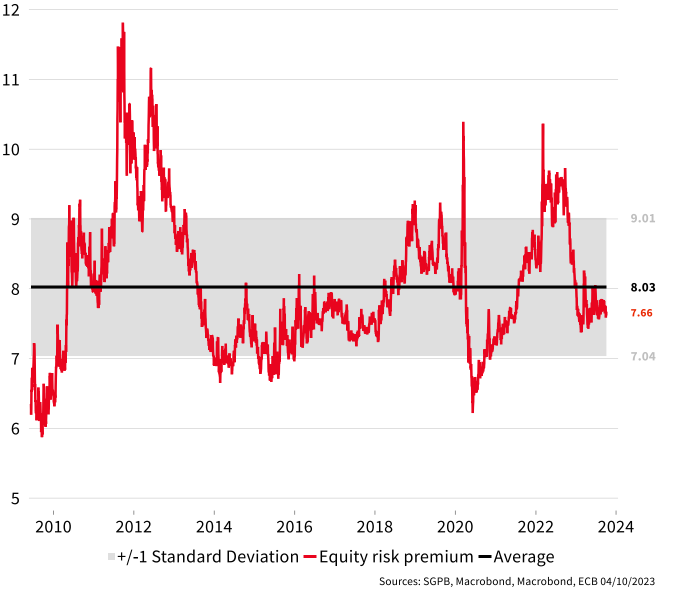
Equity earnings yields adjusted for UST10Y real rate



Sources: SGPB, Macrobond, U.S. Department of Treasury, Macrobond 04/10/2023

MSCI Europe: Equity risk premium

Earnings yields adjusted for Bund10Y real rate



Sources: SGPB, Macrobond, Macrobond, ECB 04/10/2023

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