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Market views and strategy

Ostrum ASSET MANAGEMENT

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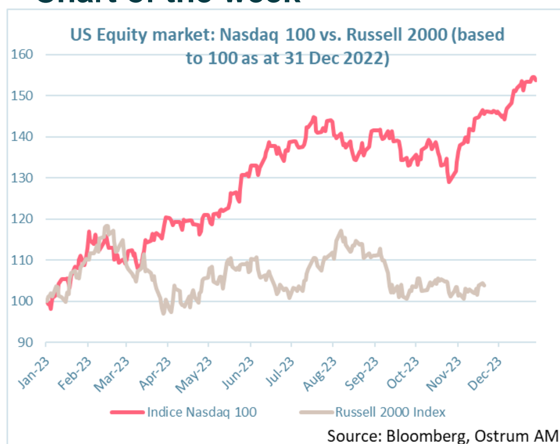
Topic of the week: Outlook 2024: in Fed we trust!

- **Growth remains uneven with solid activity in the US, whilst the euro area tries to escape stagnation and China faces structural headwinds;**
- **Market equilibrium is highly dependent on a series of Fed rate cuts expected in 2024;**
- **The risk of bubble induced by a dovish Fed appears significant. Markets are priced for flawless disinflation. Credit offers the best trade-off between yield and volatility;**
- **Bonds are priced for a full-fledged easing that seems inconsistent with quantitative tightening. Given high government borrowing needs, a resurgence of tensions in the repo market would put an end to QT.**

Market review: The hangover

- **Job growth still healthy in the US;**
- **Inflation rose to 2.9% in the euro area;**
- **Yields bounce as equities fall;**
- **Very strong activity across primary bond markets.**

Chart of the week



Source: Bloomberg, Ostrum AM

The stock market year ended with a bang in the United States with a final bull run fueled by the expectation of multiple Fed rate cuts in 2024.

The favorable investment theme underpinning growth stocks, which are highly sensitive to long rates, and the rapid development of AI resulted in a very strong outperformance of the Nasdaq compared to the small stocks represented in the graph opposite by the Russell 2000 index. The Nasdaq outperformance is close to 45%.

However, US small caps have seen renewed interest with a 14% price rebound in December which accounts for most of their annual performance in 2023. 2024 will perhaps be the year of rebalancing portfolios towards small caps. values neglected for too long by investors.

Figure of the week

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Source : Bloomberg

The 2023 price performance in percentage of the equal-dollar weighted FANG index of US-listed powerhouse technology stocks (such as Meta, Tesla, Netflix, Nvidia, Microsoft...).

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● Topic of the week

Outlook 2024: in Fed we trust!

The year-end everything rally can only be sustained if the Fed rolls back monetary tightening as expected by market participants and the US economy avoids a recession. In turn, untimely easing (or the expectations thereof) runs the risk of bubble forming in US equities. Europe is stagnating with the ECB unwilling to ease pre-emptively. Government bond markets will have to deal with increased net issuance in the context of quantitative tightening. Whether QT can stick is an open question at this juncture. The sweet spot may be in credit, as spreads remain less volatile than rates.

A three-speed world

US: the no-landing risk

Early on in 2023, a consensus among economists and market participants was that a recession was likely to occur in the US. Instead, the US economy proved extremely resilient hitting almost 5% annualized growth in the third quarter thanks to fiscal stimulus and strong immigration flows. The unemployment rate remains below 4% at the end of the year, even as job openings, a measure of labor demand, started to decline. Solid wage gains, disinflation and balance-sheet strength ensured that domestic demand remained robust. Investment spending is still fostered by public subsidies to key sectors of the economy (clean-energy, semiconductors). In our scenario, though a soft patch is likely in the first half, US growth should remain average 2% in 2024. If anything, the considerable easing in financing conditions makes it more likely that the US will fare well in 2024. Fiscal policy will nevertheless be less stimulative as Congress cannot agree on a budget bill. The current battle in Washington could result in a partial government shutdown as early as January 14th. Furthermore, 2024 is an election year in the US. Immigration, though a great support to the economy at present, will be a cornerstone issue for the Republican camp in the upcoming presidential campaign. The support to Ukraine's war effort could also be in jeopardy if Donald Trump returns to power next November. Anti-immigration policies, the threat of protectionism and renewed trade wars could all revive inflationary tensions. In sum, politics will have considerable bearing on the economic outcome.

Euro area: emerging from stagnation

In the euro area, the economy appears stuck in a protracted stagnation. Fiscal policy has provided little support whilst a series of rate increases weighed on credit growth. Low productivity gains combined with solid wage growth amid low unemployment could be the recipe for stagflation. Growth should nevertheless improve as households tap excess savings as inflation settles around 2.5%. The European budget rules have been reinstated in a form that does not force immediate fiscal tightening. The gradual approach should help cement a return to potential output in the second half of 2024.

China: facing structural challenges

China is facing growth challenges. The real estate sector is being dealt with by a series of half measures that fall short of the holistic approach needed to tackle excessive debt load. This goes well beyond the housing sector and should encompass the debt of local governments (LGFV). The collapse in foreign direct investment, a by-product of US trade sanctions and Chinese government policies, represents another structural brake to growth, which may soon dip to the 4% area. In 2024, the focus of government economic policy will revert to industrial production and advanced technology as opposed to private consumption last year. The shift to a demand-led economy has fallen short of expectations. Success in semiconductor production has recently made headlines to the surp-rise of Western powers, but it won't be enough to spur a growth revival.

The monetary policy puzzle

Cuts expected everywhere…

Disinflation has thoroughly reshaped financial markets in the last quarter of 2023. The downside surprises on inflation in the US and Europe have sparked a widespread everything rally from bonds to credit and high yield and even cryptocurrencies. The everything rally has one common denominator, namely the Fed's pivot around the November FOMC meeting. Central bank policies are thus once again the "only game in

town". The guessing game has been intense in the last few weeks of 2023. Short-term interest rate (STIR) markets indeed price in considerable monetary easing by Central banks next year and it is fair to say that few investors are willing to take the other side of the trade at this juncture. Many commentators and central bankers are puzzled by the multiple cuts priced in interest rate futures. The pushback from policymakers against early rate cuts has barely had any impact. However, at current pricing levels, STIR contracts look extremely vulnerable to another bout of inflation or a growth surprise, or a delay in the timing of the first reduction in interest rates.

Disinflation has come a long way but the bulk of the downside surprises in the recent CPI releases in the US has come from energy and imported goods from China. Domestic imbalances in the labor market and housing still pose upside risks to inflation. In the euro area, productivity is stagnant and real wages are picking up. Unit labor costs up 5% from a year ago are out of line with a 2% inflation target.

… and inconsistencies in the conduct of monetary policy

The policy rate path penciled in for 2024 is inconsistent with the continuation of quantitative tightening (QT). Jerome Powell insisted on many occasions that balance-sheet policies can be separated from interest-rate policy. This is pure fiction. So far, QT has mostly affected the reverse-repo balances, not bank reserves. If Treasury bill rates slip below the rate offered by the Fed's RRP facility (5.30% now), bank balances will shrink and repo rates risk repeating the September 2019 spike… which forced the Fed to launch a 'temporary and technical' quantitative easing fix (which really means hundreds of billions in T-bill purchases). The repo rate is the essential piece of plumbing of the US financial markets. Net borrowing from the US government is likely to hover about $2.5 trillion next year. The repo market cannot be disrupted. Nor can the basis trades that link the futures market to the cash bond market. The Fed is walking a fine line. Furthermore, the post-GFC ample reserve system requires to put a floor on the total amount of bank reserves. It is unclear where that minimum level stands but the Fed is unlikely to allow reserves to drop below $2.5 trillion from over $3.5 trillion at present.

The same is true of the multi-faceted ECB monetary policy. The balance sheet of the Frankfurt monetary authority will continue to shrink via multiple channels: TLTRO repayments, APP maturities and, from July 2024, PEPP maturities to the tune of €7.5 billion per month. In 2024, the ECB total assets should fall by about €900 billion. Quantitative tightening will remain intense in 2024 and seems at odds with the 160 bp worth of monetary easing priced in by markets.

Market thoughts: in Fed we trust!

Equities: Market rebalancing and the pitfalls of untimely easing

Rate cut expectations have spurred the rally in World equities. Growth stocks have done well mirroring the duration trade in bonds but there are signs of a turnaround to the benefit of unloved market groups. In the leading US market, the Magnificent 7 rally, powered by the AI investment theme, draws comparisons to the 1999 Tech bubble. The small-cap Russell 2000 index has staged a late rally after 10 months of trading sideways. The bounce in small-cap performance hints at a market turnaround. An equal-weighted equity portfolio should therefore outperform in the coming quarters. In Asia, the stark underperformance of Chinese stocks stands out with double-digit negative returns. Pessimism is so widespread (and for good reasons) that Chinese stocks could be the contrarian trade of the year.

In Europe, corporate margins have been more resilient to wage pressures than anticipated and there is always scope for higher valuations from 13x earnings. The story about Europe markets is the lack of powerful investment case, able to revive flows.

In a worst-case scenario, asset prices out of line with fundamentals would correct. Many investors would be hurt by a downturn in US equity markets. This is not to say that AI does not bring about higher productivity gains, but trees just don't grow to the sky. A crash in AI stocks, from sky-high valuations enabled by the Fed pivot, could tip the economy in a 2001-style recession. Equity losses would then lead to a broad-based credit crunch, corporate restructuring and job losses. This is the hidden danger of the untimely easing of financial conditions as rate cut expectations build.

Bonds: Fully-priced and no margin for error

US Treasury yields have fallen precipitously as the higher-for-longer market narrative gave way to that Fed pivot. In 2023, 10-Yr note yields shot up to 5% before plummeting to 3.90% in the last two months of the year completing a round-trip from the 2022 close (3.87%). Built-in rate cut forecasts have dwarfed the impact of bond refinancing and a deteriorating US credit. The US Treasury may issue around $ 2.5 trillion in net terms in 2024 while trying to lengthen the duration of the debt portfolio. The DV01 to be sold to the market (the $-duration risk) is unheard-of. That makes continuation of the quantitative tightening policy all the more questionable. Meanwhile, market pricing can stick, barring a recession scenario that would steepen the yield curve swiftly. A pickup in inflation also entails a risk to the unprepared bond market. Breakeven inflation rates are near 2% one year out and beyond, pricing no risk of upside surprises on inflation in the medium term. For this reason, TIPS offer a cheap hedge against a bounce in food prices (mind the El Niño factor in the first half of 2024), energy prices (in case of additional curbs to OPEC output) or even housing costs. The fate of the US bond market is tied to a familiar Fed put.

In the euro area, the reinstalment of fiscal rules resulted in a compromise. Italy and France will not have to curb spending in the near term even as public debt and annual deficits are out of line with the levels held to be sustainable in the long run. Without such a compromise, the campaign in the run up to the European elections in the Spring could have been acrimonious. The delayed start of PEPP wind-down represents additional support for government bond markets. As concerns Italy, the risk of a downgrade to high yield has diminished greatly after Moody's raised its outlook to stable. Spreads have nevertheless fallen to low levels despite large net issuance looming over the coming months. Net issuance taking the ECB's QT into account could fetch €700 billion in 2024. Some sovereign bonds (France's OAT) will face increased competition from EU bonds amid tighter swap spreads.

Credit: valuable carry

The hierarchy of volatilities across assets appears lopsided. Risk-free government bonds have been the most volatile, with equity risk keeping low at 13% and credit volatility near the long end of its range. Whether low volatility is likely to persist depends on the economic outlook. A recession would certainly send spreads wider, but the liquidity cushion of corporate borrowers and manageable maturities this year should keep spreads stable. In speculative-grade space, sub-4% default rates will continue to underpin European high yield although single-B bonds may look overpriced.

Conclusion

The market equilibrium at the end of 2023 is the opposite of the market conditions that prevailed before the Fed pivot in early November. Low yields, inverted curves, high equity prices and tight spreads all point to a goldilocks scenario. The house of cards could collapse if inflation accelerates again or growth surprises either way.

Axel Botte

Market review

The hangover

The difficult start of the year partly erases the excesses of the last two months. The rate scenario adjusts to solid employment in the United States and the rebound in European inflation.

The new year brings its share of surprises. The Magnificent Seven, which had led the American stock market to new heights, are suffering from profit-taking like small stocks whose end-of-year rebound already seems to be running out of steam. Excessive optimism about the prospects for monetary easing is now facing a mechanical rebound in inflation in the euro area and the solid employment data in the United States. Sovereign spreads are resisting the first syndications and difficult long-term bond auctions in France and Spain. Credit spreads or swap spreads remain stable despite the avalanche of new issuance observed since the start of the year, particularly in the banking sector. European banks, however, are benefiting from the rebound in bond yields, outperforming in the context of a falling equity market since the 2023 close. As is often the case, the dollar acts as a barometer of risk aversion, showing a rebound of more than 1% year-to-date. The Japanese yen, on the other hand, is falling as a sign of capitulation in the face of a BoJ that still appears undecided on the timetable for exiting negative rates. In Asia, Xi Jinping evokes quality growth which may put an end to the previous growth model fueled by the accumulation of debt. This comment by the Chinese President weighs on the Hong Kong stock market.

The FOMC minutes unsurprisingly confirmed the accommodative bias relayed on December 13 by Jerome Powell. The inevitable slowdown after the strong acceleration in the 3rd quarter (annualized growth at +4.9%) should reduce growth to around the potential of close to 2%. Monthly job creations remain within a range of 150 to 200k, which should result in a gradual increase in the unemployment rate. The lower quits rate also points to a gradual slowdown in wages. Earnings growth should slow towards 3.5% around mid-year compared to 5.2% at present which should go hand-in-hand with further deceleration in consumer prices. A majority of Fed members now believe that inflation risks are balanced. In the euro area, the rise in inflation turns out to be a little less strong than expected. The harmonized price index stood at 2.9% in December, and 3.4% excluding volatile elements. Over the coming months, the reweighting of the consumer price index, the total or partial withdrawal of government measures capping energy costs and the volatility of oil and food prices will create uncertainty surrounding the convergence of prices to the target of 2%. However, growth remains mediocre according to surveys, even though slow growth does not lead to job losses or even a slowdown in wages. In China, Xi Jinping's speech emphasizing the “quality of growth” emphasizes the need to move away from a growth model driven by real estate and debt. Prioritizing high-tech industry and clean-energy risks worsening unemployment in the short term.

The Treasuries market seems to erase some of the excesses of the end of last year. The first cut in Fed funds rates expected in March is now less likely thanks to solid employment figures. Sentiment has also rebalanced among the most active participants and option positioning on the downside are accumulating. At the end of the week, the American 10-year returned to around 4% in a movement of repentance. In the Eurozone, inflation at 3.7% in Germany will give weight to Joachim Nagel or Isabel Schnabel to oppose attempts at relief. The Bund yield rises towards the level of 2.20%. This upward adjustment tightens swap spreads below 50 bps and has almost no impact on sovereign spreads. The 10-year OAT nevertheless traded at 54 bps against the Bund after the first mediocre auctions on the longest maturities. Profit taking is observed on Greek debt. Slovenia (€1.5 billion for 10 years at MS +58 bp) then Portugal (€4 billion for 10 years at MS +40 bp) carried out the first sovereign syndications of the year to which many issuers were added agencies and supranationals.

Credit faces numerous financial bond sales totaling more than €20 billion in the first three days of 2024. The spreads deviate by around 10 bp, almost returning to 100 bp mark in asset swap spread terms. Hedging flows through CDS indices are notable. The decompression of high yield against IG seems to be returning. American high yield corrects its excesses (+48 bp) in the wake of equities. At the same time, the Nasdaq lost 4%. In Europe, financials welcome the rebound in rates but the indices are weakening.

Axel Botte

Main market indicators

G4 Government Bonds	08-Jan-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.59%	+19	-10	+19
EUR Bunds 10y	2.19%	+17	-8	+17
EUR Bunds 2s10s	-40.4bp	-2	+2	-2
USD Treasuries 2y	4.39%	+14	-33	+14
USD Treasuries 10y	4.05%	+17	-17	+17
USD Treasuries 2s10s	-33.6bp	+4	+16	+4
GBP Gilt 10y	3.83%	+29	-21	+29
JPY JGB 10y	0.61%	0	-17	-5
€ Sovereign Spreads (10y)	08-Jan-24	1wk (bp)	1m (bp)	2024 (bp)
France	54bp	+1	+1	+1
Italy	170bp	+2	+2	+2
Spain	100bp	+3	+3	+3
Inflation Break-evens (10y)	08-Jan-24	1wk (bp)	1m (bp)	2024 (bp)
EUR 10y Inflation Swap	2.18%	+5	-1	+5
USD 10y Inflation Swap	2.45%	+4	-1	+4
GBP 10y Inflation Swap	3.58%	+5	-10	+5
EUR Credit Indices	08-Jan-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Corporate Credit OAS	145bp	+7	+0	+7
EUR Agencies OAS	70bp	+0	-3	+0
EUR Securitized - Covered OAS	77bp	-1	-3	-1
EUR Pan-European High Yield OAS	409bp	+10	-33	+10
EUR/USD CDS Indices 5y	08-Jan-24	1wk (bp)	1m (bp)	2024 (bp)
iTraxx IG	64bp	+6	-3	+6
iTraxx Crossover	341bp	+28	-27	+28
CDX IG	60bp	+3	-2	+3
CDX High Yield	373bp	+16	-32	+17
Emerging Markets	08-Jan-24	1wk (bp)	1m (bp)	2024 (bp)
JPM EMBI Global Div. Spread	403bp	+19	-2	+19
Currencies	08-Jan-24	1wk (%)	1m (%)	2024 (%)
EUR/USD	$1.095	-0.852	1.691	-0.9
GBP/USD	$1.271	-0.173	1.275	-0.2
USD/JPY	JPY 145	-2.415	0.291	-2.4
Commodity Futures	08-Jan-24	-1wk ($)	-1m ($)	2024 (%)
Crude Brent	$76.4	-$0.6	$0.4	-0.8
Gold	$2 021.9	-$41.1	$17.3	-2.0
Equity Market Indices	08-Jan-24	-1wk (%)	-1m (%)	2024 (%)
S&P 500	4 697	-1.80	2.02	-1.5
EuroStoxx 50	4 467	-1.21	-1.24	-1.2
CAC 40	7 423	-1.59	-1.38	-1.6
Nikkei 225	33 377	0.21	3.31	-0.3
Shanghai Composite	2 888	-2.94	-2.76	-2.9
VIX - Implied Volatility Index	13.82	11.00	11.90	11.0

Source: Bloomberg, Ostrum AM

Additional notes

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