INDOSUEZ WEALTH MANAGEMENT

CIO PERSPECTIVES

Alexandre Drabowicz – Chief Investment Officer

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No time to land

The US economy continues to surprise on the upside, buoyed by a strong consumer. This dynamic leads us to be more confident about US growth in 2024, which we have revised upwards from 1.4% to 2.3% year-on-year (YoY). This robust growth should be accompanied by continued disinflation, enabling the Federal Reserve (Fed) to begin adjusting the restrictive nature of its monetary policy during Q2 2024. This optimistic scenario does, however, highlight the risks of a possible reacceleration in the US economy and inflation. Against this backdrop, we remain positive on US equities, but cautious on the long end of the yield curve.

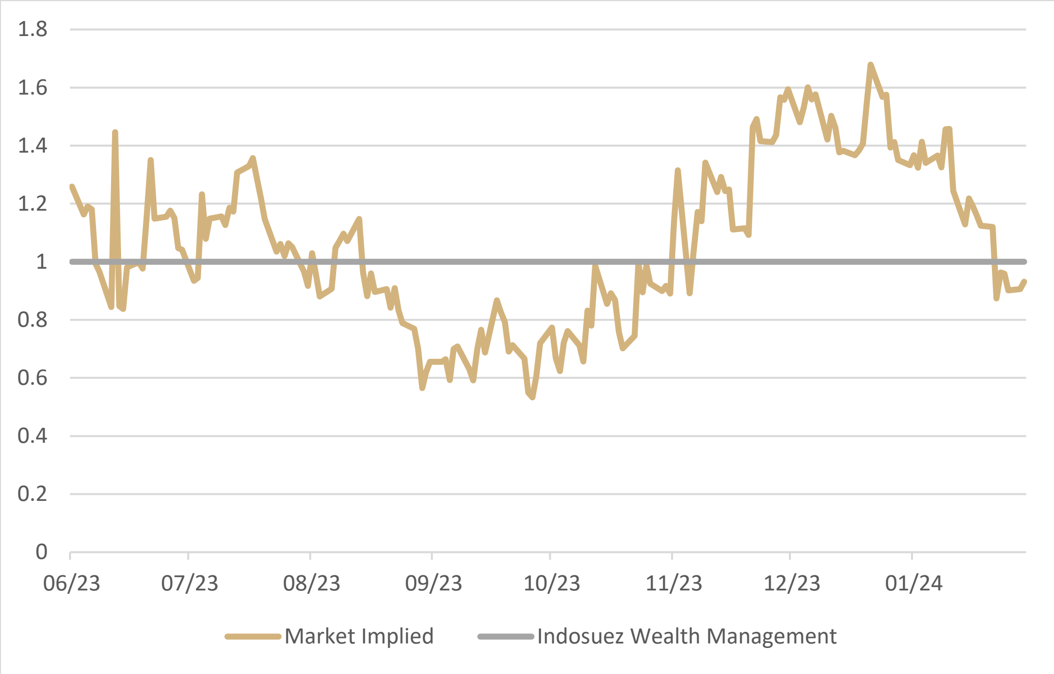
More optimism for US growth

The US economy ended the year with a bang; surpassing all expectations with a GDP growth of almost 4% (annualised) in the second half of 2023. At the same time, this resilience has not prevented disinflation from continuing, with the Core PCE hovering at 1.9% over 6 months on an annualised basis in December 2023. Behind this resilience lies a consumer dynamic that continues to surprise, having accelerated by 3% (annualised) in the second half of the year. And with good reason: since 2019, American consumers have benefited from a significant improvement in their purchasing power and net worth, driven by significant wealth effects on the financial and property markets. At the same time, the labour market remains extremely robust and financial conditions are at their most permissive since mid-2022. For several months, we have been anticipating a soft landing without recession for the US economy in 2024, and recent growth *momentum*, particularly in consumer spending, has led us to take an even more positive view of the outlook for the US economy. As a result, we have revised our growth forecast to an annual average of 2.3% for 2024, above the 1.4% we were previously expecting. This solid forecast also reflects a significant carry over for 2024: zero growth in US GDP over the next four quarters would still see annual average growth standing at 1.3% in 2024. Against this backdrop, we remain confident in the US economy's ability to continue the *momentum* seen in 2023, combining resilient growth with continued disinflation, which we see remaining above the Fed's target at an annual average of 2.6% in 2024 and 2.4% in 2025 for headline inflation. This disinflation should be accompanied by the Fed cutting rates from Q2 2024 onwards, so as not to increase the restrictive nature of its monetary policy due to real rates (inflation-adjusted) that would mechanically become higher, justifying a scenario of 100 basis points (bps) of rate cuts in 2024.

The return of "Good news is good news”

In our February edition of the [Monthly House View] (An (almost) perfect scenario?), we mentioned our concerns about financial markets pricing a perfect scenario combining resilient growth, smooth disinflation and aggressive rate cuts by the Fed from March 2024, with the market anticipating cuts of almost 170 bps in 2024. January's inflation and employment data, which all came in well above expectations (CPI, PPI, Non-Farm Payrolls, ISM Services Prices Paid), albeit partly due to seasonal effects, served as a reminder that the final step towards the 2% target could prove to be the most complicated. As a result, the markets have pushed back their expectations of the first rate cut to June 2024, and are now expecting only 90 bps of rate cuts in 2024, in line with our scenario (Chart 1).

Chart 1: Markets are now expecting only 90 bps of rate cuts by the Fed in 2024, in line with our expectations, bps

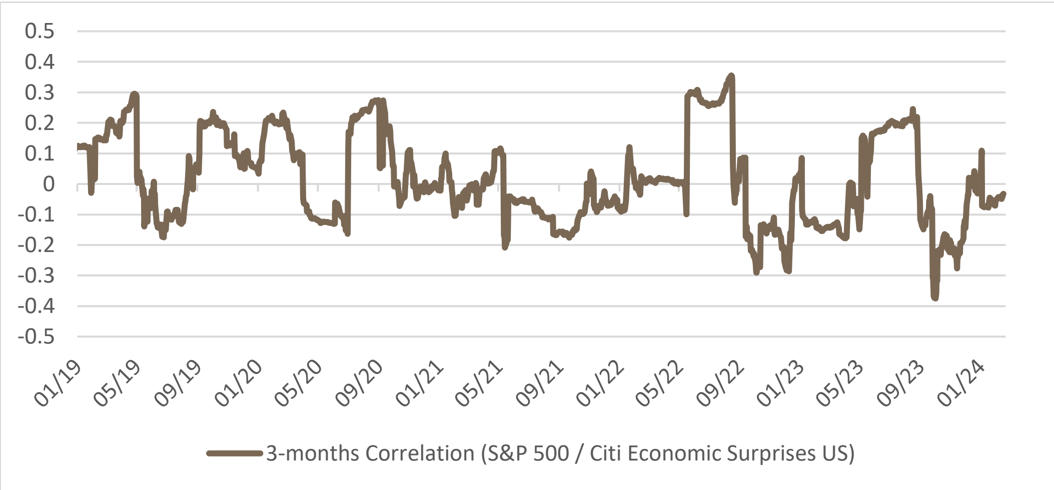


Source: Bloomberg, Indosuez Wealth Management.

However, while expectations of disinflation and aggressive rate cuts had driven the end-of-year rally in US equities, the repricing of these expectations seen since the beginning of the year has not had the opposite effect: the S&P 500 continues to break all-time highs, supported by positive macroeconomic data, Artificial Intelligence (AI) and the good earnings season. The US equity market continues to defy gravity, while sentiment and positioning indicators appear historically stretched overall, even if this pro-risk investor sentiment is not entirely widespread, as evidenced by the still substantial flows into safe-haven assets such as bonds and money market instruments.

This divergence between equities and bonds performances also demonstrates that equity markets, buoyed by the disinflation seen in 2023 and the Fed's pivot last December, are now more comfortable with the outlook for inflation (historically, the correlation between equities and bonds tends to be negative when inflation is below 3%) and have shifted their focus from inflation to growth. A "Good news is good news" regime, where good macroeconomic news is seen primarily in terms of positive growth, rather than as a possible driver of inflationary risk implying a more restrictive Fed (Chart 2).

Chart 2: Correlation between the S&P 500 and US economic surprise indices



Source: Bloomberg, Indosuez Wealth Management.

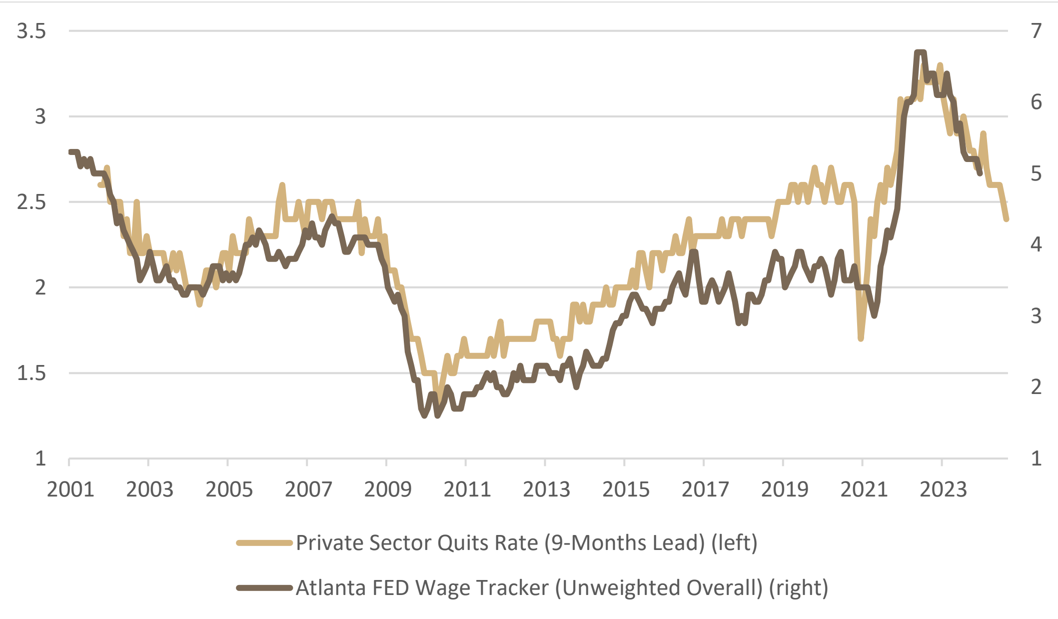
Although the risk of re-acceleration looms

We believe that disinflation should continue, reaching levels of between 2% and 3%, figures that are more comfortable for the markets and justify almost 100 bps of rate cuts by the Fed in Q2 2024. This illustrates a positive scenario for a normalisation of the traditionally negative correlation between equities and bonds. However, given the context which combines robust US growth, sticky services inflation, which still stood at 5.4% YoY in January 2024, and a labour market that remains historically tight, one of the major risks for our scenario and for the markets lies in a re-acceleration of the US economy and inflation in particular. For the time being, this risk seems to be somewhat underestimated, with many economists leaning towards optimism about US growth and removing recession from their central scenario altogether. In this respect, the upward surprises on job creation, inflation and wages in January 2024 point to the risk of more rigid inflation, which could distress markets and lead to a return of a "Good news is bad news" regime: a scenario hostile to the traditional 60/40 portfolio (60% equities and 40% bonds).

We're staying the course on disinflation

However, we continue to believe that US inflation should continue to decelerate in 2024, particularly in the services sector, which is still supported by a housing component (accounting for 1/3 of the CPI) that should sustain part of the disinflation as it tends to lag US rental prices by almost a year; the latter have fallen sharply since peaking in 2022. The other key point in services inflation is the *momentum* of wages, which are still growing by almost 5% (YoY, Atlanta FED Wage Tracker), a level that remains well above the 3.5% considered by Jerome Powell as an equilibrium level for keeping US inflation within the 2% target. Over and above the seasonal effects that supported the January job creation index, we expect the deceleration in the labour market seen over the past few months to continue. This rebalancing is reflected in the downward trend in the US quits rate, a symbol of the decline in employees' bargaining power since 2022 (Chart 3). This should help to ease the pressure on wages, which also remain a function of actual and expected inflation, which have decelerated sharply in recent quarters.

Chart 3: The fall in the US quits rate signals a continuation of the wage deceleration, %

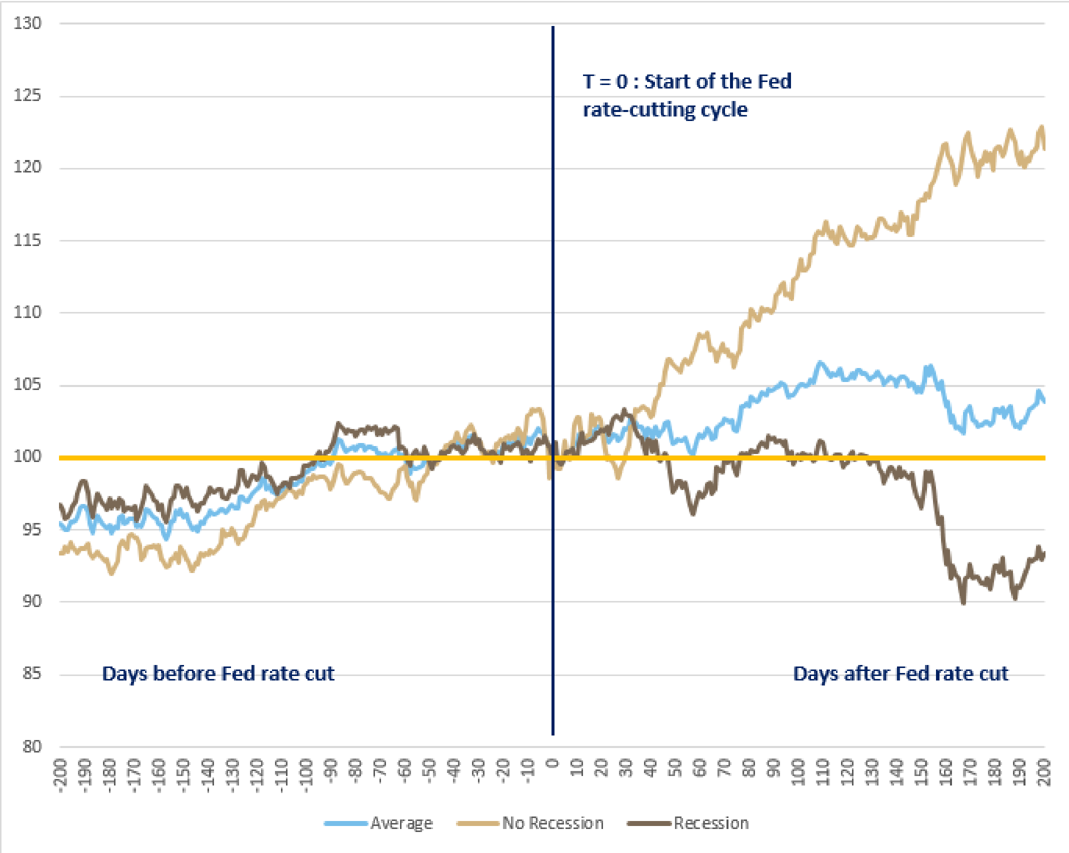


Source: Reuters, Indosuez Wealth Management.

Implications

Given our scenario of robust US growth, continued disinflation in a higher inflation regime (Global Outlook 2024: Searching for a new inflation regime) and the start of the Fed's rate-cutting cycle in Q2 2024, we remain strategically positive on US equities (Chart 4), which are also the most likely to benefit from the spread of AI. However, technical indicators and investor sentiment suggest that we should hold off on increasing our exposure at this stage. Regarding bonds, although we remain more comfortable with market expectations of rate cuts, which have come into line with our scenario in recent weeks, we remain cautious on the long end of the US yield curve. This view is linked to the fiscal deficit and a possible rebuilding of the term premium and because volatility on this segment remains historically high. Finally, we remain tactically positive on the dollar, which should continue to benefit from the outperformance of the US economy and remains an attractive asset to hold to protect against the risk of inflation accelerating further. In the longer term, however, we expect the dollar to lose ground, particularly as the Fed begins its rate-cutting cycle, which should bolster pro-risk sentiment and thus support the more cyclical currencies.

Chart 4: The S&P 500 tends to perform better when the Fed cuts rates in the absence of a recession (T = 0: Start of the Fed rate-cutting cycle, 1980-2019)



Source: Reuters, Indosuez Wealth Management.

Alexandre DRABOWICZ
Chief Investment Officer

Lucas MERIC
Investment Strategist

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