2pm PERSONALIZED PORTFOLIO MANAGEMENT

Quarterly market review

OCTOBER 2023

Editorial

A highly volatile end of summer

The month of July was rather peaceful on the markets, with the American stock market up more than 4% against a backdrop of publicized good results from American companies. But nervousness returned to stocks at the beginning of August in a context of a marked rise in long-term rates on both sides of the Atlantic. The yield on the 10-year US Treasury Bond has indeed risen from the level of 3.95% at the end of July to 4.80% at the time of writing. In Europe, the yield on the 10-year Bund remained stable in August but shifted significantly upwards in September, going from 2.46 to almost 3% a few days ago. From then on, the declines on the equity markets were substantial: More than 6% decline on the American and European stock markets over August-September and a decline of almost 10% on the emerging stock markets, although a little further ahead of the rate cycle with several central banks having already started to decrease their key rates.

So what happened to cause nervousness to come back to the fore while the American economy is showing great resilience?

A first part of the answer lies at the level of central banks. Operators are increasingly wondering whether now is the time for central bankers to take a break from this process of monetary tightening that began in March 2022 and which will have been the fastest and most aggressive since the 1980s. The solution is to be found between two sources of concern: Inflation and growth.

In the United States, the American Federal Reserve can only welcome the drop in inflation which went from a peak of 9.1% YoY in June 2022 to 3.7% last month. However, the Fed cannot yet throw in the towel, believing that there is still a way to go for the decline in core inflation and still noting strong resilience in wages. This is clearly due to a still robust labor market, linked to a more solid overall economy than expected, due to the stability of household spending. Stability itself supported by two factors: savings accumulated during the pandemic (but be careful, the savings rate has declined significantly since 2020) and a still solid labor market. This explains the tone of Jerome Powell's last speech two weeks ago. Operators were certainly expecting a message of firmness from the Fed president, despite the status quo on key rates in the 5.25%-5.50% range. But they did not imagine that the central bank would show such determination, with a new increase of a quarter of a point clearly envisaged before the end of the year and half as many rate cuts in 2024: 50 points basis in total while in June, an easing of 100 bp was expected for next year. For the moment and contrary to what we observe in Europe, concerns about American growth are still relatively moderate, the financial situation, both for businesses and households is at this stage still rather healthy (even if some households more exposed than others to variable rates suffer, particularly via credit cards) and in such a context, it cannot be ruled out that many more months will pass before the first reduction in key rates occurs . Hence the recent adjustment of the bond market to this new situation, with this increase in long-term rates which will have had a significant impact on the most expensive stock market values in terms of Price Earning Ratio.

In Europe, the ECB seems even more concerned than the Fed about price dynamics. Inflation figures are in fact falling towards the 2% objective at a slower pace than that observed in the United States, probably due to the consequences of the conflict in Ukraine and the delay with which Christine Lagarde began her cycle of increases in relationship to the Federal Reserve. This is why the ECB once again raised its deposit rate to 4% at the meeting on September 23, despite signs that monetary tightening is starting to significantly affect financial conditions. Monetary policy error ? This is the point that we try to explore in more depth in our Special Topic on page 4. Because there is an additional difficulty to overcome for the European Central Bank: the Euro Zone economy is already in the process of showing signs of slowdown, or even recession, as in Germany, which is suffering from the current weakness in exports to China. The countries of southern Europe, with a greater weight of the economy dedicated to services, show a lesser deterioration, but nonetheless, 2023 growth is expected to be weak. The European Commission has just reduced its forecasts by 0.3 points, now forecasting 0.8% GDP growth for this year (and 1.3% for 2024). The ECB is therefore not in an easy position. Rate increases are already having an impact on credit and economic activity, but for the moment, in its opinion, have an insufficient effect on core inflation. Operators have therefore had to integrate this new situation in recent weeks, now anticipating, like the United States, that rate cuts in Europe are unlikely in the very short term.

Especially since a second factor of concern has gripped the market in recent weeks, with the sharp rise in oil prices. Saudi Arabia will in fact continue to reduce its oil production by one million barrels per day for three additional months, from October to December 2023, maintaining its strategy aimed at supporting crude prices. The same goes for Russia with a reduction in exports of 300,000 barrels per day. And this in a context where demand remains strong. It was enough for barrel prices to quickly adjust upwards. The barrel of Brent thus rose from $82 on August 24 to $97 at the end of September, after a spring of 2023, when crude prices remained in a very moderate price corridor, between $70 and $80. Hence, the recent rise in the energy component in overall inflation index. And nervousness in Europe, a structurally importing area. According to the ECB, a $10 increase in crude oil prices leads to a 0.2% drop in real GDP in the Euro Zone in the medium term.

	Q3 2023	YTD 2023	Close 30/09/23
DOW JONES	-2.62%	1.09%	33 507.50
S&P 500	-3.65%	11.68%	4 288.05
FTSE 100	1.02%	2.10%	7 608.08
EUROST.50	-5.10%	10.04%	4 174.66
CAC 40	-3.58%	10.22%	7 135.06
FTSE MIB	0.04%	19.13%	28 243.26
MSCI EM	-3.71%	-0.38%	952.78
CRUDE OIL	28.52%	13.12%	90.79
GOLD	-3.68%	1.35%	1 848.63
EUR/USD			1.0573
EUR/CHF			0.9676
EUR/GBP			0.8666
EURIBOR 1M			3.847%

Add to this, the persistent concerns surrounding the Chinese economy. China, over the first 8 months of the year, did not really play a driving or even moderating role in the global economy (see our Wide Angle on page 2). Thus, despite the first rate cuts observed in certain emerging countries, the MSCI Emerging Markets index posted a very disappointing -0.38% over the first 9 months of the year, far behind the Eurostoxx50 (+10.04 %) and the S&P500 (+11.68%).

Finally, the global geopolitical context remains in general, if not tense, at least very uncertain.

The conflict in Ukraine risks getting bogged down with the onset of winter and the persistence of this conflict on our doorstep is clearly not a good thing, neither for risk appetite, nor for the potential negative consequences in terms of energy or food deliveries. Getting bogged down is all the more likely as American domestic policy considerations have an undeniable impact on the rest of the operations. An emergency funding measure for the administration, for only forty-five days, was adopted in the House of Representatives, then in the Senate, last Saturday at the end of the day, a few hours before the end of the shutdown. At the dawn of the last day before the dreaded deadline and after having exhausted all other options, Kevin McCarthy, the Republican Speaker of the

House of Representatives, accepted what his radical base had refused: a compromise, allowing the Republican and Democrat votes to be joined. In mid-afternoon, by 335 votes to 91, thus bringing together a large bipartisan majority, the House adopted and transmitted to the Senate a text ensuring the financing of the federal state for forty-five more days. Additional funds, $16 billion, were allocated to respond to natural disasters. On the other hand, and this is an important lesson for Kyiv and European capitals, pressure from the Republican base led to the pure and simple abandonment of any new aid package for Ukraine. Donald Trump is very high in the polls despite his legal difficulties and there is no doubt that the coming months will be at loggerheads, both between Democrats and Republicans, as well as within the Republican Party itself, as evidenced by the unprecedented eviction of the speaker of the House a few days ago. In the rest of the world, the possibility of China sooner or later wanting to take control of Taiwan remains a Damocles sword for the markets because such an event would have very damaging consequences for the global economy. As for Africa, recent events in Niger and Gabon cast doubt on the stability of this continent, which is nevertheless so promising in many aspects. Eight coups d'état in Africa in recent years and a growing influence of Russia and China on this continent to the detriment of France; a major fact which is not without consequences for Europe, including from a migration point of view.

We have moved in 30 years from a relatively understandable bipolar world to a much more uncertain multipolar world, in which the financial markets are in the process of integrating.

However, these markets are full of opportunities after this normalization observed this year in interest rates and last year's crash in stocks. Investors and especially their most conservative fringe can once again benefit from bond allocation as a credible investment alternative. Rates, both short and long, are not far from their high point in our view and this validates the thesis of increased exposure to the bond asset class. We continue to strengthen mature bond funds, with a slight preference today for predominantly investment grade funds compared to 100% high yield funds. These funds currently have an average return of around 5%. Today, the highest quality papers once again offer more than decent returns and there is no need to degrade too much in terms of quality to obtain good performance in the bond sector. On the long part of the curve, a good protection against the risk of recession is to gradually build up an allocation to long-term government borrowing. It can be the 10-year Bund, which currently yields around 2.9%, or the 10-year US Treasury Bond which offers a yield of 4.75%.

In the short term, equity markets may remain a little nervous and sensitive to sometimes confusing messages from central bankers. That being said, valuations have relaxed considerably and as long as there are not too many bad surprises in terms of earnings per share or cash flow (as with Alstom which lost 38% on the October 5 session following the announcement of a sharp reduction in its free cash flow), the world stock markets should sooner or later start to rise again. The signal will certainly come from the turning point of falling long-term rates. Is it before the end of the year? Or for Q1 2024? Still a little early to say, but it will be advisable to be opportunistic and selective, with a quality bias which should undoubtedly prove useful in the coming months. In any case, and this is rather good news for our portfolios, the expected aggregate return of a diversified bond + stock portfolio, with a 60% bond, 40% stock profile has never been as attractive as today compared to the last 15 years. The bond engine will once again play its role as a contributor to performance for our portfolios. As for stocks, let's not forget that bull markets are almost always born during recessions. Or to quote the famous phrase of Sir John Templeton: *Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria*.

Christophe Carrafang

The Big Picture

What is happening to the Chinese economy?

Unlike 2008 when China restarted its economy through fiscal stimulus, today the Chinese government is hesitant about what to do. The country is more in debt than in the past and the scars of the bursting of the real estate bubble two years ago are still present. While investors expected faster economic improvement following the end of the Zero Covid policy, China is experiencing a sluggish recovery. This is focused on a growth objective of just over 5% for 2023; far from what China has accustomed us to in the past. Since the second quarter of 2023, China has suffered a deflationary shock due to simultaneous slowdowns in the two main drivers of the economy: real estate and exports.

Real estate sales in China have been declining since April: in a context of economic uncertainty, households are delaying their property purchases. This weakening weighs more on the most indebted promoters. The good performance of the Chinese economy is linked to the rebound in the real estate sector: it cannot recover until the real estate market has improved. Today, the outlook depends almost entirely on politics. For several months, politicians have strengthened support for the market: by lowering mortgage rates, by relaxing restrictions on home purchases in small towns, but for the moment, this remains without effect. The Politburo meeting at the end of July appeared to open the door to stronger measures, such as a major national recovery program. A few months later, this type of announcement has not taken place.

One of the main explanations is that decision-makers want to reduce the dependence of the Chinese economy on real estate: this explains their reluctance to pursue a major revival of the real estate market. Officials hope that a shift to new growth engines will put the economy on a stable trajectory after the housing boom ends.

The meeting at the end of July, despite everything, resulted in a set of measures to stimulate the financial and also real estate markets. Compared to what has been done in the past, these measures appear quite aggressive, suggesting that officials are concerned about weak financial markets. So far, the market reaction has been lukewarm, with investors awaiting more clarity from the government.

However, recent economic figures show that China's growth dynamic stabilized and even improved in August after the sharp deterioration in the second quarter: which gives us hope that the worst is behind us. The two most important figures to remember are: the stabilization of the real estate sector – sales volume has improved and exports appear to have reached their lowest level compared to previous months.

We do not believe we are at the dawn of a financial crisis, driven by the real estate sector. China's small banks may be numerous, but the financial sector is dominated by around 20 large state-owned banks, which are solidly capitalized and conservatively regulated.

(continued on page 4)

Macro-economy

Inflation: The decline continues.

- Euro Zone: Inflation fell to +4.3% in September, with the core index also falling to +4.5%.
- In the USA the price index rose from +3.2% to +3.7% due to energy prices. The core index continues to decline at +4.3%.
- In the United Kingdom the price index is also falling but remains at still high absolute levels; +6.7%.
- Producer price indices are falling sharply almost everywhere, a consequence of the manufacturing recession (see below). This is nevertheless good news for company margins.

Job market: Still going well.

- Despite activity which is also slowing in services (see below), the unemployment rate in the Euro Zone remains very stable; at the lowest since the beginning of the indicator calculation in 1998, at 6.4%.
- In the United States, the unemployment rate increased slightly from 3.4% to 3.8%, but job creation remains solid.

Manufacturing activity: Stabilization of activity.

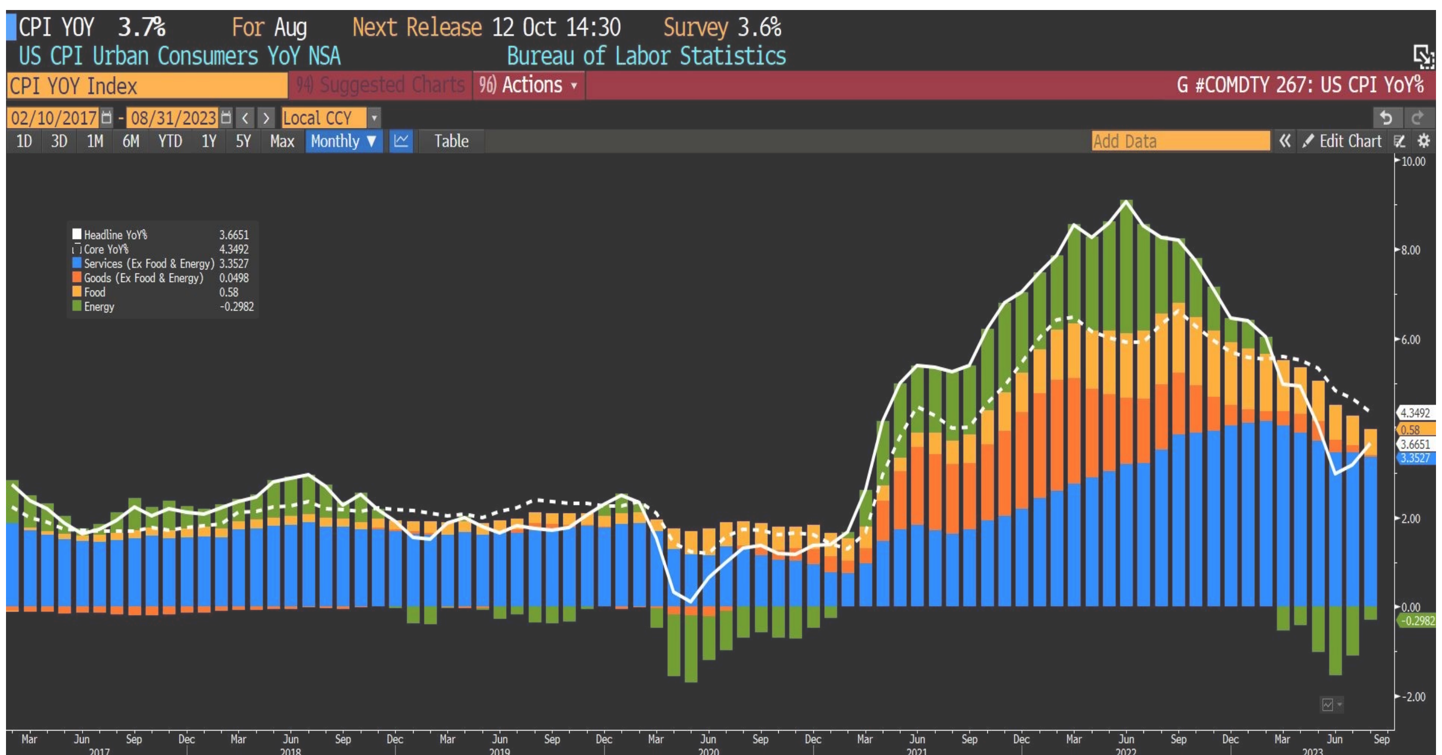
- The overall indicator stabilizes around 49, still in the recession zone.
- Europe remains lagging behind with indicators between 42 and 43 for several months.
- Chinese activity has started a slight rebound since August: from 49.2 to 50.6.
- The rise in interest rates weighs on investment desires.
- The end of stock clearances did not restart activity, but stabilized it.

Services activity: The slowdown is confirmed.

- The overall indicator has weakened for 3 months from 54 in June to 50.8 at the end of September; rate increases are now also weighing on services activity.
- In the United States, stability is around 54.
- In the Euro Zone the indicator drops below 50 to 48.7.
- Activity in China is disappointing and indicators, both private and government, are declining while remaining in a growth zone (51.7 and 50.2).

Damien Liegeois

US CPI YoY (*) since 2017



(*) This index represents changes in the prices of all goods and services purchased by American urban households.

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Special Topic

ECB: A new monetary policy error?

In mid-September, the European Central Bank surprised the markets with the 10th rate increase since July 2022. In just over a year, the key rate went from zero, where it had been since 2016, to 4.5%; an increase of unprecedented speed.

If the previous increases were all more or less expected, the last one surprised in more ways than one.

First of all, since the end of 2022 we have clearly been in a disinflationary environment. There is no longer any pressure on producer prices. The inflation rate fell from 10.6% to 5.2%, and the core index began its decline in March 2023; it is now at +5.3%. It is this core inflation, that is to say without the cyclical elements of energy and food prices, which bothers Ms. Lagarde. However, it is a lagging indicator which will adjust over time once the rate increases have been digested, and which will not fail to fall with the decline in activity, as shown by the American core indicator.

Subsequent economic growth logically shows signs of weakness; manufacturing activity is in recession and the services sector has been declining for 5 months; it is now in a contraction zone. Rate increases are already clearly weighing on economic players. Thus, growth in the Euro Zone went from +1.1% in the first quarter to +0.5% in the second, and probably even less for the second part of the year.

And if we add another recessive element, namely the recent increase in the price of oil, this latest increase clearly seems too much. Furthermore, this could also, in the long term, make the euro more expensive against the dollar, which will not help European exporters either.

Unfortunately, the ECB is accustomed to this, and since its creation, we can already remember two overreactions that were quickly corrected. In July 2008, while the subprime crisis was brewing and growth was turning around, after a long pause, the ECB, going against the tide, increased its rate from 4 to 4.25%, before rushing to lower it a few weeks later.

Same thing in 2011; it increased its rate in the midst of the Euro Zone crisis from +1 to +1.5%, before once again lowering it in the fall.

Through its mandate, the responsibility of the ECB has always been price stability and the Euro, even if it meant sacrificing growth. As economic activity is not the priority, the focus remains on the level of inflation. But if this is still the case, it could resemble a new overreaction, which some politicians in Euro Zone countries are beginning to denounce.

Damien Liegeois

(Continued from page 2) ***It is also interesting to consider the performance of bank stocks as a leading indicator of an economy's financial difficulties. When bank stocks hit lows, it is generally a signal that investors should head for the exit: this was the case in 2007-2008 in the United States, bank stocks fell by -60% between February 2007 and July 2008; the same pattern in Europe, between January 2010 and August 2011, with a decline of -45%. Today, if we take the performance of Chinese bank stocks over the last five years, compared to their American and European counterparts, they seem to be weathering the storm.***

We can also note the return of Chinese tourists to Macau – at the same level as 2018; car sales remain very high; China's online sales to consumers continue to progress well (Alibaba had its strongest first quarter in history). These indications clearly show that Chinese consumption is holding up well. The Chinese consumer continues to consume, even if not with the same enthusiasm as in pre-Covid years.

The mood is generally positive in the consumer services segments (tourism, accommodation, cosmetics) which benefit from the post-Covid effect and the savings accumulated during these long months of confinement.

The decision of households to return with vigor to the financial markets will mean that the restart has begun. For now, they are still cautious. But the potential is there. Households have purchased significantly less real estate over the past two years. In addition, during the country's lockdown, they consumed less. They therefore have a larger available savings reserve.

In the portfolios, we have maintained our exposure to Chinese markets despite their negative performances experienced for almost two years. We have noted a stabilization for several months; valuations have returned to historically low levels and we believe that the Chinese government is pragmatic and will take the necessary measures to get things moving again.

Damien Beasse

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